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Pushback on §2704 proposed Regs.

In August the IRS proposed sweeping new Regulations under IRC §2704 on intrafamily transfers. Certain restrictions and lapsing rights would be ignored for transfer tax purposes in certain circumstances. The Treasury claimed to be closing a loophole. The effect would seem to be ending discounts for transfers of minority interests and for illiquidity in a family setting.

The negative response to the proposal has been swift and substantial. On September 29, 41 Republican Senators sent a letter to Treasury Secretary Jacob Lew asking that the proposal be withdrawn, and that future regulatory projects in this area be more narrowly targeted on perceived abuses. Three bills have been introduced to nullify the proposed Regs., S. 3436, H.R. 6100 and H.R. 6042. A hearing on the Regs. will be held on December 1.

An attorney-adviser with the Treasury Office of Tax Legislative Counsel, Catherine Hughes, argued that the proposal has been widely misunderstood. Speaking at the ABA's Tax Section meeting in Boston, Hughes claimed that minority discounts would still be available. The problem is that the IRS believes that certain state law changes and cases that the IRS has lost in the courts have effectively gutted §§2701 and 2704. The proposed Regs. are intended to "reinvigorate the intent of the statute as written," she said.

—2016-36 IRB 329; 81 F.R. 51413-51425

COMMENT: To say that the Regs. have been widely misunderstood may be an understatement. Most professionals and lay observers have interpreted the proposal as sounding a death knell for family limited partnerships as estate planning vehicles. For example, see Mitchell Gans and Jonathan Blattmachr in Steve Leimberg's Estate Planning Email Newsletter—Archive Message #2441. Leimberg has long been known as a nonpartisan forum for estate planning information, but issued a call to action to stop the proposal in Archive Message #2455. On the other hand, Leimberg later published an analysis by estate planner Ron Aucutt [Archive Message #2456]. Aucutt buttressed the point of view expressed by Hughes, that the proposal was being read too broadly. He felt that with appropriate changes when the Regs. are finalized, they could be properly targeted to abusive situations.

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Unnecessary QTIPs

In 2001 the IRS provided a procedure for ignoring a QTIP election if the election were not needed to reduce estate taxes to zero [Rev. Proc. 2001-38]. If the assets were held in a trust that would otherwise bypass the surviving spouse's estate, declaring the election null and void would, in turn, cause the assets to be excluded from the survivor's estate.

The landscape changed with the advent of the Deceased Spouse's Unused Exemption Amount (DSUEA). Now, in appropriate circumstances, a QTIP election that is not needed to reduce estate taxes to zero may instead be made because it increases the DSUEA. Accordingly, the situations in which a QTIP election will be ignored have changed. The estate of the first spouse to die must have been zero, with or without the QTIP election, and no portability election made for that spouse's estate. If the portability election were made, it will be assumed that the QTIP election was not an error.

—Rev. Proc. 2016-49; 2016-42 I.R.B. 1

The hunt for estate tax payments

The estate plan of noted author Tom Clancy had three equal trusts, one for the children of his first marriage, a marital trust for his surviving second wife, and a family trust for the second wife and the daughter they had together. The trusts were funded from the residuary estate, and Clancy's will called for death taxes to be paid from the residue. The personal representative of the estate (who also had drafted the will) proposed to pay half of the federal estate taxes due on the $83 million estate from the trust for the adult children, the other half from the family trust. The taxes came to roughly $15 million.

Mrs. Clancy objected. Before his death, Clancy had executed a codicil to his will, to make it clear that he intended both the family trust and the marital trust to qualify for the marital deduction. Assets that don't share in the creation of the estate tax burden should not be tapped to pay those estate taxes. To the extent that the widow's share is used to pay the tax, the marital deduction must be reduced, which means still more tax, and a further reduction in deduction, and yet more taxes, in an extended circular computation. If Mrs. Clancy's share is free from the tax burden, the actual estate tax due drops by nearly a third, to roughly $11 million.

That's what the probate court decided, and in a 4-3 decision the Maryland Court of Appeals affirmed in August. A savings clause in the codicil "explicitly directs that the personal representative not act to adversely impact the benefit of the marital deduction of the marital trust and the family trust."

—Michelle Bandy et al. v. Alexandra Clancy, case number 93, in the Court of Appeals in Maryland

COMMENT: The result is decidedly unequal for the five children. The child from the second marriage will get roughly one-third of the estate, undiminished by taxes. The share for the other four will be reduced roughly 40% for taxes, and then split four ways among them. Whether Mr. Clancy expected an outcome for his estate plan as convoluted as the books that he wrote remains an open question.

A new worry for executors

Defendant was the executor of the estate of C. C. Wang, a noted art collector and the father of fashion designer Vera Wang. Plaintiff alleges that the defendant engaged in a scheme to deprive the plaintiff of her inheritance. Elements of the scheme included a demand that plaintiff turn over assets in exchange for artwork of hers that he had misappropriated, and the auctioning off of two unlawfully acquired paintings. Plaintiff brought civil suit in federal district court, alleging violation of the Racketeer Influenced and Corrupt Organizations Act (RICO). In the event of success, plaintiff will receive triple damages.

Question 1: Can the federal court even entertain this suit, or is it covered by the "probate exception," which limits the federal courts' jurisdiction when the action requires probate or annulment of a will or administration of a decedent's estate. The District Court held that although this case involved probate-related claims, they are of the sort that may be pursued in the federal courts after the U. S. Supreme Court's decision in *Marshall v. Marshall* [547 U.S. 293 (2006)]. Second Circuit Court of Appeals affirms on this point.

Question 2: Has the plaintiff adequately pleaded the elements of a RICO claim. The District Court said no, but the appellate court reverses. "To adequately plead a pattern of racketeering activity, a 'plaintiff must plead at least two predicate acts, and must show that the predicate acts are related.' GICC Capital Corp. v. Tech. Fin. Grp. Inc., 67 F.3d 463 (CA-2, 1995)." Factors include the length of time over which the acts occurred, the number and variety of acts, the number of victims, the number of participants, and the presence of separate schemes. Here, the pleadings were sufficient for the appellate court to order the RICO suit to go forward.

—King v. Wang, CA-2, August 26, 2016

More Madoff madness

James Heller's $26 million estate included a 99% interest in an LLC whose sole asset was a $16.5 million Madoff Securities account. Heller's daughter and son each owned a 0.5% interest in the LLC. Heller died on January 31, 2008. To pay taxes and administrative expenses, his executors withdrew $11.5 million from the Madoff account. The son and daughter received $115,000, and the remaining $11.385 million covered the estate's immediate liquidity needs. The withdrawals began on March 4, 2008, and were completed by November 28, 2008.

Just in the nick of time (perhaps). On December 11, 2008, Bernard Madoff was arrested for his multi-billion dollar pyramid scheme, to which he eventually pled guilty. The remaining $5 million in Heller's Madoff account immediately went to zero. On its estate tax return, filed on April 1, 2009, the estate showed the full nominal value of the Madoff account at the time of Heller's death, and claimed a $5.1 million theft loss deduction for the loss in the account's value during the period of administration.

The IRS did not dispute the fact of the loss, or that it was due to fraud. Rather, it argued that the loss belonged to the LLC, not to the estate.

The Tax Court disagrees, in a case of first impression. IRC §2054 "allows for a broader nexus (i.e., between the theft and the incurred loss) than does the respondent's narrow interpretation." The loss suffered by the estate relates directly to the LLC, which became worthless because of the fraud. What's more, allowing the theft loss under IRC §2054 is consistent with the overall statutory scheme of the estate tax.

Summary judgment for the estate was ordered.

—Estate of James Heller v. Comm'r, 147 T.C. No. 11

COMMENT: The story may not be over for this estate. The Madoff Securities trustee filed a claim against the estate to recover amounts withdrawn from the account before the Ponzi scheme became public knowledge. On May 31, 2011, the estate filed a protective refund claim to cover the possibility that it will lose that lawsuit.

Flexible response

Great-grandmother established an irrevocable trust before September 25, 1985. The date signifies that the trust is protected from the generation-skipping transfer tax (GSTT) by the so-called "grandfather rules" for pre-existing trusts. The trust continues for the lives of Great-grandmother's children, grandchildren, and great-grandchildren. The great-grandchildren acquire a demand right when they reach age 25, and they receive the balance of their share of the trust when they reach age 35.

As it happens, one great-grandchild was born with cognitive deficits and other disabilities. That beneficiary does not have the capacity to exercise the demand right, and her parents have been appointed her permanent conservators.

The trustees have petitioned the local court to change the terms of the trust, to hold the disabled beneficiary's interest in trust for life, rather than forcing a distribution at age 35. The trustees may distribute income or principal to the beneficiary in their sole discretion. It was represented that Great-grandmother never considered the possibility that a descendant might be disabled, and that this change will further the essential purpose of the trust. The court ordered the modification, contingent upon a favorable ruling from the IRS.

The Service has no problem with the change. The modification will not cause the interest to pass to a lower generation beneficiary. At the disabled beneficiary's death, the entire remaining interest will be included in her taxable estate.

—Private Letter Ruling 201633022

Striking a blow for investment freedom

When James Martin had his will drafted in 1962, he had strong opinions about investments. He created a trust with a remainder interest for Rockefeller University for the purpose of combatting arteriosclerosis. The remainder, which was to be held in a perpetual trust, was delivered in 2007 and was then worth nearly $13 million.

The will restricts the University from selling securities in 17 enumerated industrial corporations. What's more, the University is barred from investing in "mortgages, corporate bonds, preferred stock, or government bonds while the value of the United States dollar remains unindexed to the price of gold, or to the purchase of securities in companies engaged in steel, copper, and railroad equipment production, and management of investment trusts and securities under any circumstances."

To date, the University has abided by the investment restrictions, even though six of the 17 named corporations no longer exist as independent entities. One of the companies that had to be retained was Eastman Kodak, and the shares in the University's hands have fallen in value by 50%. The performance of the Martin portfolio has fallen far short of that achieved by the University's endowment overall.

Accordingly, the University asked to be relieved from the investment restrictions. The New York Attorney General agreed, and the estate did not object. Citing the emergence of modern portfolio theory, the court granted the wish.

—In the matter of Rockefeller University,
Supreme Court of the State of New York,
Index Number 153142/2016