The New World of Estate Planning After the 2012 Tax Act 15 (Abbreviated Outline) An Estate Planner's Perspective on Recent Tax Developments: The Year in Review

John B. O'Grady

Howard M. Zaritsky

Repository Citation
https://scholarship.law.wm.edu/tax/704

Copyright c 2014 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax
WILLIAM & MARY TAX CONFERENCE

November 7, 2014

THE NEW WORLD OF ESTATE PLANNING
AFTER THE 2012 TAX ACT

Featuring:

John B. O'Grady, Esq.
McGuireWoods LLP
One James Center
901 East Cary Street
Richmond, Virginia 23219-4030
Telephone: (804) 775-1023
Telecopier: (804) 698-2132
E-mail: jogrady@mcguirewoods.com
AN ESTATE PLANNER’S PERSPECTIVE
ON RECENT TAX DEVELOPMENTS --
THE YEAR IN REVIEW

by

Howard M. Zaritsky, J.D., LL.M. (Tax)
Consulting Counsel

www.howardzaritsky.com
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>II. ESTATE TAXES</td>
<td>1</td>
</tr>
<tr>
<td>A. Code § 2010</td>
<td>1</td>
</tr>
<tr>
<td>1. IRS Permits Late Estate Tax Returns to Elect Portability for Estates of Decedents Dying Before 2014</td>
<td>1</td>
</tr>
<tr>
<td>2. Basic Exclusion Amount Adjusted for Inflation</td>
<td>3</td>
</tr>
<tr>
<td>3. Extensions Granted to Make Portability Election</td>
<td>3</td>
</tr>
<tr>
<td>B. Code §§ 2031, 2032, 2032A and 7520</td>
<td>4</td>
</tr>
<tr>
<td>1. No Discounts Allowed for Marital Trust Assets When Trust Distributions Had been Frozen by Trustee or For Suits Against the Decedent’s Estate and the Marital Trusts</td>
<td>4</td>
</tr>
<tr>
<td>2. Holding Company Valued Under Net Asset Value Method, Rather than Capitalized Income; Limited Discount for Built-In Capital Gain Allowed</td>
<td>6</td>
</tr>
<tr>
<td>3. Tax Court Values LLC Interest as Membership Interest, Rather than Assignee Interest, and Excludes Taxpayer's Appraisal For Not Complying With Expert Witness Rules</td>
<td>7</td>
</tr>
<tr>
<td>4. Tax Court Rejects Estate's Valuation of Controlling Interest in LLC Holding Liquid Assets</td>
<td>8</td>
</tr>
<tr>
<td>5. Special Use Farm Value Interest Rates Set for 2012 and 2013</td>
<td>9</td>
</tr>
<tr>
<td>6. Section 2032A Limitation Adjusted for Inflation</td>
<td>9</td>
</tr>
<tr>
<td>C. Code § 2036-2038</td>
<td>10</td>
</tr>
<tr>
<td>Assets Transferred to GRAT and QPRT Included in Deceased Grantor’s Gross Estate Under Section 2036(a)</td>
<td>10</td>
</tr>
<tr>
<td>D. Code §§ 2056, 2044, 2519, 2523, 2207A</td>
<td>11</td>
</tr>
<tr>
<td>1. Defense of Marriage Act (DOMA) Unconstitutionally Denies Estate Tax Marital Deduction to Otherwise Legally Married Same-Sex Couple</td>
<td>11</td>
</tr>
<tr>
<td>2. Failure to Divide Marital from Nonmarital Trust Results in Substantial Distributions Being Deemed Made From Nonmarital Trust and Increases Surviving Spouse’s Gross Estate</td>
<td>15</td>
</tr>
<tr>
<td>3. Sale of Assets Distributed from QTIP for Deferred Private Annuity Results in Taxation Under Section 2519</td>
<td>16</td>
</tr>
<tr>
<td>4. IRS Applies a Law-of-the-Ceremony Rule to Same-Sex Marriages</td>
<td>18</td>
</tr>
<tr>
<td>TABLE OF CONTENTS</td>
<td>Page</td>
</tr>
<tr>
<td>---------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>(continued)</td>
<td></td>
</tr>
<tr>
<td>5. Marital Deduction Not Allowed for</td>
<td>22</td>
</tr>
<tr>
<td>Portion of Elective Share That</td>
<td></td>
</tr>
<tr>
<td>Cannot Actually Be Transferred to</td>
<td></td>
</tr>
<tr>
<td>Surviving Spouse</td>
<td></td>
</tr>
<tr>
<td>6. Transfers Under premarital</td>
<td>23</td>
</tr>
<tr>
<td>Agreement Qualify for Marital</td>
<td></td>
</tr>
<tr>
<td>Deduction</td>
<td></td>
</tr>
<tr>
<td>7. The “Huh?” Award for 2013: IRS</td>
<td>25</td>
</tr>
<tr>
<td>Agrees to Ignore QTIP Election Made</td>
<td></td>
</tr>
<tr>
<td>on Credit Shelter Trust That Could</td>
<td></td>
</tr>
<tr>
<td>Not Be a QTIP Anyway</td>
<td></td>
</tr>
<tr>
<td>III. GIFT TAXES</td>
<td>26</td>
</tr>
<tr>
<td>A. Code § 2503</td>
<td>26</td>
</tr>
<tr>
<td>Annual Exclusion Adjusted for Inflation</td>
<td>26</td>
</tr>
<tr>
<td>B. Code § 2512</td>
<td>26</td>
</tr>
<tr>
<td>1. Tax Court Denies Summary Judgment</td>
<td>26</td>
</tr>
<tr>
<td>to IRS on Net, Net Gift</td>
<td></td>
</tr>
<tr>
<td>2. Self-Cancelling Installment Note</td>
<td>28</td>
</tr>
<tr>
<td>Not Valued Under Section 7520;</td>
<td></td>
</tr>
<tr>
<td>Premium Based on Seller’s Actual</td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td></td>
</tr>
<tr>
<td>C. Code § 2518</td>
<td>31</td>
</tr>
<tr>
<td>Disclaimer of Pre-1977 Interests</td>
<td>31</td>
</tr>
<tr>
<td>is Timely if Made Within a Reasonable</td>
<td></td>
</tr>
<tr>
<td>Time After First Learning of</td>
<td></td>
</tr>
<tr>
<td>the Existence of the Interest</td>
<td></td>
</tr>
<tr>
<td>D. Gift Tax Procedures</td>
<td>31</td>
</tr>
<tr>
<td>Assets of Irrevocable Trust May Be</td>
<td>31</td>
</tr>
<tr>
<td>Foreclosed Upon to Satisfy Grantor’s</td>
<td></td>
</tr>
<tr>
<td>Gift and Income Tax Deficiency, Because of Purchase-Money Resulting Trust</td>
<td></td>
</tr>
</tbody>
</table>
I. INTRODUCTION

This outline was prepared by Howard M. Zaritsky. Howard carefully compiled insightful cases and comments, and I am greatly indebted to him for allowing me to use his outline.

The past twelve months have witnessed substantial changes in the estate, gift and generation-skipping transfer (GST) taxes and in the income tax laws relating to estate planning.

This outline summarizes the legislation, regulations, revenue rulings and procedures, regular decisions of the Tax Court, the Claims Court and the courts of appeals, as well as selected district court and Tax Court memorandum decisions, private rulings, notices, announcements and other Service and Treasury documents from the past year. This outline includes those developments reported publicly from April 1, 2013 through April 28, 2014.

Each category is divided by Internal Revenue Code section, except that special consolidated discussions examine the various developments relating to the taxation of family partnerships and LLCs and charitable remainder trusts.

II. ESTATE TAXES

A. Code § 2010. Unified Credit; Portability


Section 2010(c)(5)(A) specifically provides that a portability election is effective only if made on a Form 706 that is filed within the time prescribed by law (including extensions) for filing such return. Temp. Regs. § 20.2010-2T(a)(1) states that an estate that elects portability will be considered to be required to file a return under Section 6018(a), even if the gross estate is below the filing threshold ($5.340 million in 2014). Accordingly, the due date of an estate tax return required to elect portability is nine months after the decedent’s date of death, or the last day of the period covered by an extension (if an extension of time for filing has been obtained). Regs. § 301.9100-3 allows the IRS to grant discretionary extensions of the time in which to make elections whose due dates are pre-

1 Private letter rulings (PLRs) and technical advice memoranda (TAMs) are not legal precedents. Code § 6110(k)(3). They may, however, show how the Service might address a similar case, and they have been cited and discussed by several courts. See, e.g., Wolpaw v. Comm'r, 747 F.3d 787 (6th Cir. 1995), rev'd T.C. Memo. 1993-322 (taxpayers can rely on 20-year old PLR, absent definitive regulations); Estate of Blackford v. Comm'r, 77 T.C. 1246 (1982) (noting that the Service litigation position was contrary to a prior PLR); Xerox Corp. v. U.S., 656 F.2d 659 (Cl. Cl. 1981) (stating that PLRs are useful in ascertaining the scope of the doctrine adopted by the Service and demonstrating its continued and consistent application by the Service); Fanning v. U.S., 568 F.Supp. 823 (E.D. Wash. 1983) (noting that a distinction between the facts of the instant case and those of prior cases had been cited in a TAM, and that TAMs are often relied upon by the courts).

All references to “Code” are to the Internal Revenue Code of 1986, as amended to date, unless otherwise specifically indicated. References to “Regs” are to the regulations of the Treasury Department, unless otherwise specifically indicated.
scribed by regulation or other administrative guidance, rather than by the Code. The due date for electing portability for those estates required to file an estate tax return under Section 6018(a) is prescribed by statute, but the due date for electing portability for those estates not otherwise required to file an estate tax return is provided by regulation. Temp. Treas. Reg. § 20.2010-2T(a). Therefore, the executor of an estate that is under the filing threshold should be able to seek a discretionary extension of the time for making the portability election under Regs. § 301.9100-3. This discretionary relief will be granted if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. Normally, relief under Regs. § 301.9100-3 requires that the taxpayer file a request for a private letter ruling, and pay a substantial filing fee. Rev. Proc. 2014-18, however, provides a simpler alternate procedure for obtaining a discretionary extension of the time for filing an estate tax return to elect portability, if the estate was not otherwise required to file an estate tax return. Rev. Proc. 2014-18 applies if: (a) The taxpayer is the executor of the estate of a decedent who died after December 31, 2010 and before January 1, 2014, leaving a surviving spouse; (b) The surviving spouse was a citizen or resident of the United States on the date of death; (c) The taxpayer is not required to file an estate tax return under Section 6018(a) (as determined based on the value of the gross estate and adjusted taxable gifts, without regard to portability; (d) The taxpayer did not file a timely estate tax return to elect portability; (e) The taxpayer files a complete and properly-prepared federal estate tax return on or before December 31, 2014 (An estate tax return is considered complete and properly prepared if it is prepared in accordance with Temp. Regs. § 20.2010-2T(a)(7)); and (f) The taxpayer states at the top of the return that it is “FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A).” A taxpayer who meets these requirements will be deemed to meet the requirements for relief under Regs. § 301.9100-3 and will be allowed an extension of the time for electing portability. For purposes of electing portability, the taxpayer’s estate tax return will be considered to have been timely filed in accordance with the regulations. The taxpayer will receive an estate tax closing letter acknowledging receipt of the taxpayer’s Form 706. A taxpayer who does not meet all of these requirements can still seek a discretionary extension of the time within which to elect portability, by filing a private ruling request under Regs. § 301.9100-3. See Rev. Proc. 2014-1, 2014-1 I.R.B. 1 (or its successors). This would apply to estates of decedents who died after December 31, 2013. A taxpayer who actually filed a timely estate tax return does not usually need to take advantage of Rev. Proc. 2014-18, because the mere filing of the return is deemed to be an election of portability. Temp. Treas. Regs. § 20.2010-2T(a)(3)(i)). A timely return can avoid the election of portability only by making an affirmative statement that portability is not desired. Id. Relief under Rev. Proc. 2014-18 is “null and
void” if it is ultimately determined that the taxpayer was required to file an estate tax return under Section 6018(a), based on the value of the gross estate and taking into account any taxable gifts. The surviving spouse (or his or her executor) must file a claim for a credit or refund of an overpayment of tax by reason of a portability election made on a late return pursuant to Rev. Proc. 2014-8, before the regular limitations period of two-years after the payment of the tax or three-years after the filing of the return. Rev. Proc. 2014-18 is effective January 27, 2014. Until January 1, 2015, no private rulings under Regs. § 301.9100-3 will be issued for an extension of the time to elect portability with respect to an estate that qualifies under Rev. Proc. 2014-18. An executor who has a private letter ruling request pending on January 27, 2014 and who would otherwise qualify under this revenue procedure may rely on the procedure, withdraw the letter ruling request and receive a refund of its user fee. Such ruling requests will be processed, however, unless the executor withdraws the request before March 10, 2014, or the earlier date on which the letter ruling is actually issued.


The IRS annual inflation adjustments for tax year 2014 include an increase of the basic exclusion amount to $5.34 million, from $5.25 million in 2013.

3. Extensions Granted to Make Portability Election. PLR 201414001 (April 4, 2014); 201410013 (March 7, 2014); 201406004 (Feb. 7, 2014); 201407002 (Feb. 14, 2014)

The IRS granted an estate a discretionary extension to make a portability election under Section 2010(c)(5)(A) to an estate that failed to file an estate tax return and that was below the filing threshold. In each case, the decedent’s executor did not file a Form 706 to make the portability election before the required deadline. The estate discovered its failure to elect portability after the due date for making the election. The personal representative represented that the value of the decedent’s gross estate was less than the basic exclusion amount in the year of death and that during his lifetime, the decedent made no taxable gifts.

The IRS granted an extension of time pursuant to Regs. § 301.9100-3 to elect portability of the decedent's DSUE amount pursuant to Section 2010(c)(5)(A). The IRS noted that Temp. Regs. § 20.2010-2T(a)(1) provides that an estate that elects portability will be considered, for purposes of estate tax purposes to be required to file a return under Section 6018(a), so that the due date of the return required to elect portability is 9 months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). Regs. § 301.9100-1(c) provides that the IRS may grant a rea-
sonable extension of time to make a regulatory election, if the taxpayer provides evidence to establish to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, and the professional failed to make, or advise the taxpayer to make, the election. Regs. § 301.9100-3(b)(1)(v). Temp. Regs. § 20.2010-2T(a) specify that the portability election must be made on a timely-filed Form 706, and for estates not required to file an estate tax return under Section 6018, the portability election is a regulatory election. Therefore, the IRS granted an extension of time of 120 days from the date of this letter in which to elect portability under Section 2010(c)(5).


B. Code §§ 2031, 2032, 2032A and 7520. Valuation

1. No Discounts Allowed for Marital Trust Assets When Trust Distributions Had been Frozen by Trustee or For Suits Against the Decedent’s Estate and the Marital Trusts. Estate of Foster v. Comm=r, __ Fed.Appx. __, 2014 WL 1229928 (9th Cir. March 26, 2014), aff’g T.C. Memo. 2011-95

The estate of the decedent, Ellen D. Foster, was involved in complex litigation stemming from the collapse of F&G, a successful mail-order horticulture business founded by her husband, Thomas S. Foster, that had relied heavily on a sweepstakes program as part of its direct mail advertising. In 1995, Thomas sold most of his shares to the company=s ESOP, which bought them with a $70 million loan from F&G, which had, in turn, borrowed the money from four institutional lenders. Thomas, who then died in 1996, leaving his estate to three marital trusts for the decedent’s lifetime benefit. Ellen could withdraw all of the principal of one trust (Marital Trust # 3) at any time. Northern Trust Company and Ellen were the co-trustees of the marital trusts and together could invade principal for Ellen’s benefit. In 1998, F&G began experiencing financial trouble, its earnings declined, and it fell into violation of the financial covenants of the ESOP loans. The ESOP lenders (including Northern Trust) asked F&G to restructure the ESOP loans, which had been unsecured, to give the lenders a security interest in F&G’s assets. Ellen withdrew $12 million from Marital Trust # 3, and then lent $6.8 million to F&G. The ESOP beneficiaries sued U.S. Trust and Thomas (and Ellen, as executrix of Thomas’s estate), for breach of fiduciary duty. Northern Trust unilaterally froze Ellen’s right to withdraw the principal of Marital Trust # 3. In 2003,
the court granted summary judgment to Ellen, because her Thomas’s estate had been closed and no judgment could be enforced against her in her fiduciary capacity. The court left open the possibility that the plaintiffs could proceed against Ellen as a co-trustee of the marital trusts, if they could establish that Thomas had committed a breach of fiduciary duty. The court later held for the defendants, finding no such breach. The ESOP plaintiffs appealed to the Court of Appeals for the Seventh Circuit, which ultimately affirmed. Ellen died while the appeal was pending. Her co-executors and the co-trustees of the marital trusts entered into a settlement agreement whereby the ESOP plaintiffs released their claims against the estate. The decedent’s estate also sued both Northern Trust and an attorney for breach of fiduciary duty, conflicts of interest, and malpractice, with respect to the prior transactions. The estate informed the IRS that the value of these claims were additional assets of the estate. The suit against the attorney was later settled for $850,000 and the suit against Northern Trust was settled for $17 million. The estate valued the marital trust’s with a 29 percent discount for the risks of litigation respecting the suits against the decedent and the trusts. The estate valued the lawsuit at $33,000. The IRS assessed a deficiency based on the inclusion in the gross estate of the value of the claims against the former attorney and Northern Trust, and denial of the deduction for the value of the claims against the decedent.

The Tax Court (Judge Cohen), held that in valuing the marital trusts for estate tax purposes, the trust assets were not subject to discount for hazards of litigation, nor were they subject to discounts for lack of marketability and control as result of a freeze imposed by co-trustee on withdrawal of trust assets. The court noted that the litigation could not have affected a buyer’s rights in the marital trust assets, because the district court had already ruled in favor of the decedent before her death. The estate could, therefore, have transferred the marital trust assets to a buyer free of the claim, because the ESOP beneficiaries had not filed a stay of judgment pending appeal. The court also valued the claim by the decedent’s estate against the former attorney and Northern Trust at $930,000, rejecting both the IRS’s claimed $5.1 million valuation and the estate’s claimed $33,000 valuation. The court held that the estate could deduct its actual litigation expenses under Section 2053.

The Ninth Circuit (Judges Callahan, Smith and Hellerstein) affirmed *per curiam*, in an unpublished opinion, holding that the Tax Court had not erred in refusing to apply discounts for hazards of litigation, lack of control, or lack of marketability, noting that the plaintiffs in the lawsuit did not seek to recover specific, unique assets from the defendants, and the lawsuit did not cloud the title of the trust assets. A hypothetical buyer of the trust assets would not, the court noted, become a defendant in the lawsuit, so there was no basis for a hazards of litigation discount. Citing *Shackleford v. United States*, 262 F.3d 1028, 1031 (9th Cir. 2001). Similarly, the court sustained the Tax Court’s refusal to apply discounts for
lack of control and lack of marketability, because while there the freeze on
distributions from the trust was not being strictly enforced. Finally, the
court agreed that the Tax Court had properly rejected the estate's argument
that the estimated date-of-death value of the ESOP beneficiaries' lawsuit
was deductible as a claim against the estate, noting that the lawsuit was
disputed on the date of death, and that post-death events may be consid­

2. **Holding Company Valued Under Net Asset Value Method, Rather
   than Capitalized Income; Limited Discount for Built-In Capital Gain
   11, 2014)

At the time of her death, Helen P. Richmond owned a 23.44-percent inter­
est in Pearson Holding Company (PHC), a 76-year-old family-owned in­
vestment holding C corporation, the assets of which on the date of death
were over $52 million of publicly traded securities. The company paid
dividends annually to its shareholders. Were the underlying securities
sold on the date of death, the company would recognize a $18 million cap­
ital gains tax. The turn-over of the company's holdings was quite slow,
averaging only 1.4 percent per year. The decedent's estate had its ac­
countants value the stock, and the accountants applied the capitalized div­
idend approach to produce a $3.1 million value for the decedent’s interest.
The accountant was not a certified valuation expert and provided the estate
with an unsigned draft report documenting his conclusions. Although the
estate never received a signed final report, it, nevertheless, used the re­
port’s value conclusion for its estate tax filing. On examination, the IRS
valued the company under the net asset valuation approach, which valued
the decedent’s interest at $9.2 million. The IRS also declined to allow a
discount for the built-in capital gains tax. The IRS assessed a $2.9 million
deficiency and a 40-percent gross valuation misstatement penalty.

The Tax Court (Judge Gustafson) held that the value of the de­
cedent’s stock was $6.5 million, and sustained the imposition of an accura­
cy-related penalty. At trial, the estate's expert (a different expert from the
one on whose work the estate tax return had been based) applied the capi­
talized dividend approach and valued the decedent’s interest at just over
$5 million, and then applied a net asset valuation as corroboration. The
IRS's expert applied a net asset value approach, producing a $7.3 million
value for the decedent's interest, after a 6-percent discount for lack of con­
trol, a 15-percent built-in gain tax liability discount, and a 21-percent dis­
count for lack of marketability. The court rejected the capitalization-of­
dividends method, because it relies entirely on estimates of future earn­
ings, whereas the net asset valuation method relies on "concrete and reli­
able" actual market prices publicly traded securities constituting the com­
pany’s portfolio. Furthermore, the capitalization-of-dividends approach
assumes that a potential investor will look only at the potential dividend
stream, but any reasonable investor would recognize that the company's assets are completely marketable and liquid, and that they are worth $52 million. With respect to the built-in gain discount, the court refused to use a dollar-for-dollar discount "in a case like the present one," presumably because the assets were entirely publicly-traded securities and the company sold them only sparingly. The court rejected both the estate's and the IRS's methods of calculating the discount, holding that the better approach was to assume a 20- to 30-year holding period, based on the average turnover of the securities, and adjusting the discount for the time over which the assets would be sold. The court found the IRS $7.8 million discount closer to the mark. The court then allowed a 7.75-percent discount for lack of control and a 32.1-percent discount for lack of marketability, essentially averaging the discounts from various studies cited by the IRS and the estate. The court also sustained the accuracy related penalty under Section 6662, finding the estate failed to demonstrate good faith or reasonable cause, because it used an unsigned draft report prepared by its accountant as the basis for its valuation, and because the accountant was not a certified appraiser.

Note. The court is correct that holding companies are traditionally valued by the net asset valuation method, and that this seems especially reasonable when the underlying assets are readily marketable. On the built-in gain discount, however, the court's approach differs from that adopted in Estate of Dunn v. Comm'r, TC Memo. 2000-12, rev'd and remanded, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke v. Comm'r, TC Memo. 2005-131, rev'd and remanded, 507 F.3d 1317 (11th Cir. 2007), reh'g en banc denied, 277 Fed. Appx. 977 (Table) (11th Cir. 2008), cert. denied, 555 U.S. 826 (2008); and Estate of Jameson v. Comm'r, TC Memo. 1999-43.


Diane Tanenblatt's estate included the assets owned by her revocable trust, including a 16.667-percent interest in an LLC that held as its principal asset a 10-story commercial building in New York City. The estate obtained professional appraisals of the underlying real estate and the LLC interests. The property appraisal valued the real estate at $20.6 million, and the LLC appraisal valued the 16.667-percent interest with a 20-percent discount for lack of control and a 35-percent discount for lack of marketability, resulting in a net value of $1.79 million for the estate's LLC interest. The IRS accepted the value of the underlying property, but reduced the discounts to 10 percent for lack of control and 20 percent for lack of marketability, resulting in a value of $2.48 million for the LLC interest. The estate then retained another appraiser to revalue the LLC interest, and she reduced its value to $1.04 million. The estate referred to the
second appraisal in and attached a copy of the second appraisal to its Tax Court petition. At trial, the estate could not obtain the testimony of the second appraiser, but it argued that attaching the appraisal to its petition constituted a stipulation by the IRS to it as evidence.

The Tax Court (Judge Halperrn) refused to admit the second appraisal into evidence, because the estate did not submit and serve a copy of the appraisal report, as required by Rule 143(g), Tax Court Rules of Practice and Procedure, and the court's standing pretrial order. The court stated that the estate’s counsel told the court that the estate was embroiled in a fee dispute with the appraiser, and could not get the appraiser to testify. The court stated that the appraisal could not be admitted unless the appraiser testified and was subject to cross-examination and that Tax Court Rule 91 does not require that the IRS stipulate to an appraisal merely because it was attached to the petition. The court held that the rules on stipulations do not overrule the rules on expert testimony, and that the court always has the final authority to decide what is acceptable expert testimony. The court then accepted the opinion of the IRS’s expert regarding the value of the underlying property, and allowed discounts of 10 percent for lack of control and 26 percent for lack of marketability, resulting in a $2.3 million valuation for the estate's LLC interest. The court also held that the estate’s interest was a membership interest, rather than an assignee’s interest, despite the fact that the LLC operating agreement stated that a non-family member transferee could not become a member without the unanimous approval of all of the members, and despite the fact that the decedent had transferred her membership interest to her revocable trust. The court noted that Section 2038 includes the assets of the revocable trust in the decedent’s gross estate as if she had owned them herself.


The decedent, John F. Koons, III, created Central Investments Corp., which established and ran a soft drinks vending machine business. He made a large series of gifts of stock of Central to various family members, including his four children, his many grandchildren, and his three ex-wives. Less than three months before his death, the decedent sold the operations to Pepsi for $400 million, to settle a dispute with the soft-drink company. Central Investments then created Central Investments, LLC ("the LLC"), to hold and invest the sales proceeds. The shareholders of Central Investments entered into a Stock Purchase Agreement that: (a) required the company to distribute the LLC membership interests to the shareholders; (b) required the redemption of the interests of several of the donees after the decedent’s death; (c) limited discretionary distributions to 30 percent of “the excess of ‘distributable cash;’” (d) permitted removal of the 30-percent limitation by a majority vote; and (e) required a 75-percent vote for any member to transfer his or her interests to a non-family mem-
The redemptions left the decedent’s estate with a 70.42-percent voting interest in the LLC, which then held approximately $351 million of assets, of which $322 million was in cash, and had a net asset value, after liabilities, of approximately $318 million. The estate valued its interests in the LLC with a 31.7-percent discount (a 26.6-percent discount for lack of marketability, a four-percent discount for post-sale contingent liabilities, and a three-percent discount for the 75-percent vote required to transfer interests outside of the family).

The Tax Court (Judge Morrison) held for the IRS, finding that the appropriate discount was 7.5 percent, rather than 31.7 percent, and that the loan interest was not deductible. The court strongly favored and adopted the views of the IRS’s expert, Prof. Mukesh Bajaj, ignored the 30-percent discretionary distribution limitation, because a simple majority vote could remove it. He also noted that the LLC’s underlying assets were overwhelmingly liquid, so a 70.42-percent owner could distribute most of these assets without liquidating the entity. These facts made the typical restricted stock transaction studies inapplicable, the IRS expert contended, leaving an appropriate discount of 7.5 percent. The court noted that the estate’s expert failed to consider that the discretionary distribution limitations could be overcome with a simple majority vote allowing the 70.42-percent owner to distribute much of the underlying liquid assets. The court stated that the IRS's expert's views were based on “experience and common sense,” and that he arrived at the more accurate valuation, in part because (a) the estate’s expert used a regression equation derived from an evaluation of 88 businesses engaged in mainly active businesses as opposed to holding cash assets; (b) the estate’s expert explained only one-third of the variation in the discounts in the ownership interests in the 88 companies; (c) the estate’s calculation involved ownership of minority interests; and (d) the estate’s expert overestimated the relationship between block size and the valuation discount.


The interest rates by farm credit system territories to be used in computing the special use value of farm real property for which an election is made under Section 2032A are listed for estates of decedents dying in 2013.


An estate can reduce the estate tax value of qualifying real property used in a farm or business and valued under Section 2032A, by up to $1,090,000 for estates of decedents dying in 2014.
C. Code § 2036-2038. Retained Life Estate or Power to Alter Beneficial Enjoyment


Helen A. Trombetta created a 15-year GRAT and a 15-year QPRT. The GRAT was required to pay Helen $75,000 a year, increased by four percent per annum, for 15 years, and then distribute the remainder to Helen's children or grandchildren. The trustees could also distribute any excess income above the annuity obligation to Helen. During the term of the trust, the payments were most often in amounts other than the required annuity, either larger or smaller. In 2005, Helen concluded that her health was failing and so she unilaterally reduced the trust terms to 156 months. Helen's QPRT also was to continue originally for 180 months, and at this time Helen amended the QPRT to require that the trust create a "charitable remainder unitary trust." The trustee of the QPRT did, after Helen's death, create a charitable remainder unitrust with a five-year term and a 19.9105-percent unitrust amount.

The Tax Court (Judge Cohen) held that the assets of the two trusts were includible in Helen's gross estate under Section 2036(a) and 2035, because of her interests in the trusts. The court held that the transfer to the GRAT was not a bona fide sale for adequate and full consideration, because the consideration was not equal to the value of the transferred assets (as proven by the gift tax return) and because the transfers were not a bona fide sale. The transfers were not bona fide sales because the trust was prepared without any meaningful negotiation or bargaining; Helen dictated the form and operation of the trust and exercised control over the trust's activities. Also, there was no legitimate and significant nontax reasons for the transfer. The court also held that Helen impliedly retained the right to possession or enjoyment of the entire GRAT trust fund, noting that she made all decisions with respect to the trust assets and the co-trustees generally did whatever she directed them to do. Furthermore, Helen had sole signatory authority with respect to the disposition of the properties, and she had 50 percent of the voting power regarding distributions of additional income to herself. The court also held that Helen's relinquishment of part of her annuity interest within three years of her death caused the property to be includible in her gross estate also under Section 2035. The court rejected the contention that only the rental value of the residence held by the QPRT was includible in Helen's gross estate. The court noted that Section 2036(a) includes the value of the entire underlying asset if the transferor retains for life (or a term that does not end before death) a right to the personal use of that asset. Estate of Disbrow v. Comm'r, T.C. Memo. 2006-34. Helen had the right to live in and actually did live in the property held by the QPRT, and it is includible in her gross estate.

Note. The court also held that the estate was entitled to deduct its obligation under a mortgage on the property held by the GRAT, because it established that the decedent was personally liable on that debt. The court denied the deduction for the remainder interest in the charitable remainder trust created from the
QPRT, because the trustees had no authority to create that trust under the terms of the trust instrument.

D. Code §§ 2056, 2044, 2519, 2523, 2207A. Marital Deduction


Edie met and established a committed relationship with Thea in 1963, and they lived together until Thea's death in 2009. The couple registered as domestic partners in New York City, when that became available in 1993. They married in Canada in 2007, and New York law recognized the validity of that marriage. Thea's executor (Edie) filed an estate tax return claiming the estate tax marital deduction, but the Service denied the deduction, based on DOMA. Edie paid the tax and sued for a refund and a declaration that section 3 of DOMA violates the Equal Protection Clause of the Fifth Amendment. Attorney General Eric Holder announced that the Department of Justice would no longer defend DOMA's constitutionality, because he and the President believed that a heightened standard of scrutiny applied to classifications based on sexual orientation, and that Section 3 of DOMA failed under this standard. Given the Attorney General's decision not to enforce DOMA, the Bipartisan Legal Advisory Group of the U.S. House of Representatives ("BLAG") was allowed to intervene in the suit and to defend the constitutionality of the statute.

The U.S. District Court for the Southern District of New York (Judge Jones) granted summary judgment in favor of Windsor, and found that the application of DOMA to deny the estate tax marital deduction was unconstitutional. The Second Circuit (Chief Judge Jacobs) affirmed, with 1 judge dissenting in part and concurring in part. The U.S. Supreme Court granted certiorari.

A divided U.S. Supreme Court affirmed and struck down section 3 of DOMA, but without addressing the appropriate standard of equal protection review. Justice Kennedy wrote the majority opinion, in which Justices Ginsburg, Breyer, Sotomayor, and Kagan joined. Chief Justice Roberts filed a dissent; Justice Scalia filed a dissent in which Justice Thomas joined and in which Chief Justice Roberts joined in part; and Justice Alito wrote a dissent in which Justice Thomas joined in part. The Court first held that it had jurisdiction to consider the case, despite the refusal of the U.S. Attorney General to defend DOMA. Article 3, Section 2 of the U.S. Constitution provides that the Supreme Court cannot issue advisory opinions – it may only hear a case or controversy. The Court explained that there was clearly a case or controversy in the U.S. District Court, because a taxpayer was challenging the collection of a specific tax assessment as being unconstitutional. Despite the decision of the Attorney General not
to defend DOMA’s definition of marriage, the United States retained a sufficient stake in the outcome to support Constitutional jurisdiction on appeal. The government had not yet returned to the plaintiff the estate tax she had paid, and that refund was “a real and immediate economic injury” to the government, whether or not the government decided to defend DOMA. Quoting Hein v. Freedom From Religion Foundation, Inc., 551 U.S. 587 (2007). The Court acknowledged that, even when there is a constitutional case or controversy, “prudent concerns” conditions judicial review on a finding of “concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult constitutional questions.” These concerns, however, can be outweighed by such countervailing considerations as the extent to which adversarial presentation of the issues is ensured by the participation of amici curiae prepared to defend with vigor the legislative act’s constitutionality. In this context, BLAG’s defense of DOMA’s definition of marriage satisfied the prudential concerns that otherwise might make the Court reluctant to hear an appeal from a decision with which the principal parties agree. Thus, the Court held that it could properly decide the case.

The Court then held that DOMA unconstitutionally deprived persons of equal liberty in violation of the Fifth Amendment. The opinion of the majority appears to rely both on the requirement of Federalism—that certain actions and subjects are the domain of the states, rather than the federal government—and equal protection. The Court noted that the states, not the federal government, have historically and traditionally defined and regulated marriage, and that state responsibilities for defining and regulating marriage date to the beginning of the country: for “when the Constitution was adopted the common understanding was that the domestic relations of husband and wife and parent and child were matters reserved to the States.” Quoting Ohio ex rel. Popovici v. Agler, 280 U.S. 379, 383–384 (1930). The Court stressed the special nature of the marital relation, stating:

The States’ interest in defining and regulating the marital relation, subject to constitutional guarantees, stems from the understanding that marriage is more than a routine classification for purposes of certain statutory benefits. Private, consensual sexual intimacy between two adult persons of the same sex may not be punished by the State, and it can form “but one element in a personal bond that is more enduring.” Lawrence v. Texas, 539 U.S. 558, 567, 123 S.Ct. 2472, 156 L.Ed.2d 508 (2003). By its recognition of the validity of same-sex marriages performed in other jurisdictions and then by authorizing same-sex unions and same-sex marriages, New York sought to give further protection and dignity to that bond. For same-sex couples who wished to be married, the State acted to give their lawful conduct a
lawful status. This status is a far-reaching legal acknowledgment of the intimate relationship between two people, a relationship deemed by the State worthy of dignity in the community equal with all other marriages. It reflects both the community's considered perspective on the historical roots of the institution of marriage and its evolving understanding of the meaning of equality. 133 S.Ct. 2675, at 2692.

DOMA, the Court stated, rejects the decisions of some states to give a particular class of couples the right to marry. The resulting injury and indignity is a deprivation of an essential part of the liberty protected by the Fifth Amendment. The Court stated:

DOMA seeks to injure the very class New York seeks to protect. By doing so it violates basic due process and equal protection principles applicable to the Federal Government. See U.S. Const., Amdt. 5; Bolling v. Sharpe, 347 U.S. 497 (1954). The Constitution's guarantee of equality "must at the very least mean that a bare congressional desire to harm a politically unpopular group cannot" justify disparate treatment of that group. Department of Agriculture v. Moreno, 413 U.S. 528, 534-535 (1973). In determining whether a law is motivated by an improper animus or purpose, "[d]iscriminations of an unusual character" especially require careful consideration. Supra, at 19 (quoting Romer, supra, at 633). DOMA cannot survive under these principles. 133 S.Ct. 2675, at 2693.

The Court held that DOMA's principal effect was to identify and make unequal a subset of state-sanctioned marriages, and to deprive some couples married under the laws of their state, but not others, of both rights and responsibilities. This would create two contradictory marriage regimes within the same state and force same-sex couples to live as married for the purpose of state law, but unmarried for the purpose of federal law. This, the court stated, would reduce the stability and predictability of basic personal relations the state deemed it appropriate to protect. The Court, appearing to blend the requirements of equal protection and Federalism, then concluded that:

The class to which DOMA directs its restrictions and restraints are those persons who are joined in same-sex marriages made lawful by the State. DOMA singles out a class of persons deemed by a State entitled to recognition and protection to enhance their own liberty. It imposes a disability on the class by refusing to acknowledge a status
the State finds to be dignified and proper. DOMA instructs all federal officials, and indeed all persons with whom same-sex couples interact, including their own children, that their marriage is less worthy than the marriages of others. The federal statute is invalid, for no legitimate purpose overcomes the purpose and effect to disparage and to injure those whom the State, by its marriage laws, sought to protect in personhood and dignity. By seeking to displace this protection and treating those persons as living in marriages less respected than others, the federal statute is in violation of the Fifth Amendment. This opinion and its holding are confined to those lawful marriages. 133 S.Ct. 2675, at 2695.

There were three separate dissenting opinions. Chief Justice Roberts argued that the Court lacked jurisdiction to review the decisions of the Second Circuit, because there was no case or controversy. On the merits, the Chief Justice stated that he believed that Congress acted constitutionally in passing DOMA, because of the national interests in uniformity and stability in the application of federal laws. He distinguished the issue of same-sex marriage from other subjects on which state marriage laws may differ, finding the gender of the parties to be too fundamental to permit state-by-state variations. Justice Scalia’s long dissent contended that the majority had overreached and attempted to replace the proper decision of the Congress with its own. Justice Scalia argued that the agreement between the plaintiff and the government on the proper interpretation of DOMA eliminated any case or controversy and deprived the Court of jurisdiction to hear the appeal. He also stated that there were several good reasons for DOMA’s definition of marriage, including the avoidance of difficult choice-of-law issues that are likely to arise in the absence of a uniform federal definition. Justice Alito dissented, stating that the United States lacked standing to appeal from the holding of the District Court and the Second Circuit, because it sought to sustain those holdings, rather than to change them. He argued that BLAG was the proper appellant in this case. Justice Alito also contended that the Fifth Amendment cannot defeat DOMA under the notion of substantive due process, because that rule protects only “fundamental rights and liberties which are, objectively, ‘deeply rooted in this Nation’s history and tradition.’” He denied that the right to same-sex marriage can fall within that category at this time.

Note. Windsor means that same-sex married couples residing in a state that recognizes such marriages as valid will clearly be treated as married for both state and federal purposes. Recognition of their marriage for state law purposes will afford the surviving spouse such benefits as elective share or augmented estate rights in the first spouse’s estate, status as an heir at law in the estate of an intestate decedent, whatever priority may exist for surviving spouses in the selection of an administrator of a dece-
dent's estate, and whatever marital deduction or favorable rate may be allowed surviving spouses under applicable state estate or inheritance tax laws. Such surviving spouses will now also qualify for the federal estate and gift tax marital deductions and portability of a deceased spouse's unused basic exclusion amount.


Elwood and Grace Olsen created reciprocal revocable trusts as part of their estate plan. Elwood was named trustee of both trusts. Grace died first, and her instruments required that her assets be divided into a nonmarital trust and two marital trusts. Elwood, however, failed to divide the trust. The terms of the nonmarital trust provided for distributions of income and principal to the couple's children and grandchildren, and distributions to charitable organizations. Principal and income of the nonmarital trust could be used for the Elwood, if the marital trust principal had been exhausted. After Grace's death, Elwood donated from Grace's trust a total of $1.08 million to Morningside College, where he and Grace had gone to school and where he had been employed. Elwood also withdrew $393,978 from Grace's trust and deposited it into one of his own accounts.

In examining Elwood's estate, the IRS contended that all of these transfers should be charged against the nonmarital trust, and that the remaining assets should all be deemed part of the marital trust and includible in Elwood's gross estate under Section 2044.

The Tax Court (Judge Chiechi) held that $607,928 (the value that was to have been transferred to the marital trusts, less the withdrawals that Elwood deposited into his own account) must be included in Elwood's gross estate as assets of the marital trusts. The court noted that the marital trusts did not permit distributions to charity, so that it must conclude that the was made from the nonmarital trust, which allowed such distributions. The estate argued that the withdrawals should be treated as having come from the marital trusts because the instrument expressed the grantor's intent to minimize estate taxes for the benefit of the remainder beneficiaries. Had the withdrawals come from the marital trusts, they would have been effectively eliminated by the surviving spouse's death, reducing total estate taxes. The court, however, found equally persuasive the couple's long history of philanthropy and the express authority in the nonmarital trust to make charitable distributions.

**Note.** It is unusual for a nonmarital trust to authorize charitable distributions, because they would constitute deductible distributions made from a nontaxable fund. It would be much better tax planning for the marital trust to authorize and then make distributions of principal to the surviving spouse, and then for the surviving spouse make the charitable gifts personally. This produces additional charitable income tax deductions for
the surviving spouse, and takes full advantage of the gift tax charitable de-
duction, too:

3. Sale of Assets Distributed from QTIP for Deferred Private Annuity
Results in Taxation Under Section 2519. *Estate of Kite v. Comm’r*, T.C.
No. 6772-08, 2013 TNT 208-18 (Unpub’d Op., Oct. 25, 2013)

Virginia Kite (the decedent) was the current income beneficiary of numer­
ous trusts, including two QTIPs, a general power of appointment marital
trust, and a revocable trust. QTIP-1 had been created by the decedent for
the lifetime benefit of her husband, James, who died a week later, creating
a QTIP trust for the decedent. QTIP-2 was a reverse QTIP trust created at
James’ death. The power of appointment marital trust was created at
James’ death. In 1996, the trusts created a limited partnership, a majority
of the shares of the corporate general partner (Easterly) of which were
owned by Virginia, through her revocable trust, and the balance by her
children, directly and through various trusts. In 1998, the limited part­
nership was moved to Texas and became the Baldwin Limited Partnership.
In May 1998, Virginia, through her trusts, sold her remaining interest in
the partnership to her children, either individually or to their trusts, for
$12.5 million in of secured, fully recourse promissory notes (the Baldwin
notes). On December 31, 2000, Virginia’s trusts contributed the Baldwin
notes and Easterly contributed 1 percent of its value to form Kite Family
Investment Co. (KIC), a Texas general partnership. In 2001 the QTIP
trusts and the marital deduction trust were liquidated, and the trusts’ as­
sets, which consisted entirely of family partnership interests, were trans­
ferred to Virginia’s revocable trust. The family partnership interests held
by the revocable trust were then transferred to the decedent’s children in
exchange for 10-year deferred private annuity agreements.

The Tax Court (Judge Paris) held that, under the step-transaction
doctrine, Virginia was deemed to have made a taxable disposition of the
qualifying income interest. Therefore, the sale was taxable as a gift of the
remainder interest in the property sold for a private annuity. The court
recognized that the proportionate share of the annuity value that was
traceable to the QTIP trusts was not readily apparent, and it asked the par­
ties to calculate the amount of the gift. The parties submitted their pro­
posed valuations, and not surprisingly, they disagreed rather strongly on
the amount of the deemed taxable gift. The Tax Court, in an unpublished
opinion, sustained the IRS calculation of the amount of the taxable gift.
The court noted that Section 2519(a) states that any disposition of all or
part of a qualifying income interest for life is treated as a transfer of all in­
terests in the property other than the qualifying income interest, and the
regulations add that the spouse is treated as making a gift of the remain­
der interest under Section 2519 and of the income interest under Section 2511.
Regs. § 25.2519-1(a). The amount of the remainder interest gift is “the fair
market value of the entire property subject to the qualifying income inter­
est, determined on the date of the disposition * * *, less the value of the
qualifying income interest in the property on the date of the disposition."
The parties agreed that the fair market value of the QTIP trust assets was $2,665,106 and on the disposition date the value of the annuity traceable to remainder interest in the QTIP trusts was $1,484,011. The taxpayer, however, argued that no gift tax was due, because the court had held that the annuity transaction was a bona fide sale for adequate and full consideration. Therefore, the taxpayer argued, Mrs. Kite had transferred an income interest worth $1,181,095 for an annuity worth $1,181,095, and she had transferred a remainder interest worth $1,484,011 for an annuity worth $1,484,011. The court explained, however, that this is not how Section 2519 operates. The court agreed with the IRS that the Kite annuity transaction was an intermediary step between terminating the QTIP trusts and selling the QTIP trust assets to the Kite children, in an attempt to circumvent the QTIP regime and avoid any deemed transfer under Section 2519. A deemed transfer of a remainder interest under section 2519 cannot be reduced merely because consideration is received for the transfer of the income interest. The donee spouse cannot receive consideration in exchange for a remainder interest that the donee could not actually transfer. The court also stated that this result was supported by the intent of the marital deduction and the QTIP regime, that property passes untaxed from a predeceasing spouse to a surviving spouse but is then included in the estate of the surviving spouse. Estate of Letts v. Comm’r, 109 T.C. 290, 295 (1997), aff’d without pub’d op., 212 F.3d 600 (11th Cir. 2000). The QTIP provisions allow QTIP to pass to a surviving spouse tax free at the first spouse’s death, but they require that the QTIP be subject to transfer taxes at the earlier of (1) the date on which the surviving spouse disposes (by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the surviving spouse’s death. See H.R. Rept. No. 97-201, 97th Cong., 2d Sess. at 161 (1981)

Note. The application of Section 2519 should not be that much of a concern to practitioners. First, the previously-QTIP assets were sold for a deferred annuity, with no payments to be made for the first 10 years. There was, therefore, no income interest after the sale.

Second, Virginia removed the corporate trustee and put her children in as trustees of the QTIP; it was unclear whether the children even had authority under the instrument to terminate the QTIP trust and distribute all of its assets to the decedent, as they did.

Third, the step-transaction argument was pretty easy to sustain, because the children terminated the QTIP and distributed its assets to Virginia on the same day that they were substituted as trustees. The next day, the family consolidated assets of several partnerships in one extant family partnership. The day after that, Virginia sold her partnership interests for the deferred private annuity.

Fourth, the court approved the fact that the QTIP created a family partnership and converted its assets to partnership interests. The court
stated that this was just a change in the form of the investments, and did not impair Virginia’s qualifying income interests for life.

So, what does this tell us. Probably just that if, in a clearly integrated transaction, you withdraw principal from a QTIP and transfer the underlying assets without retaining an income interest, you risk taxation under Section 2519. I am not sure how much of a surprise that ought to be.

See also discussion of gift tax consequences of the private annuity sales under Section 2511.


The IRS responded to the Supreme Court’s opinion in Windsor, ruling that same-sex couples who are legally married in states or foreign countries that recognize the validity of their marriages will be treated as married for all federal tax purposes, even if they live in a state or other jurisdiction that does not recognize same-sex marriages. The IRS noted that it had long interpreted such as “husband,” “wife,” “spouse,” and “married” for income tax purposes in this manner. In Rev. Rul. 58-66, 1958-1 C.B. 60, the IRS had stated that individuals who entered into a common-law marriage in a state that recognizes common-law marriages should be recognized as married for federal income tax purposes, regardless of the law of the jurisdiction in which the individuals are currently domiciled. The IRS explained that:

The Service has applied this rule with respect to common-law marriages for over 50 years, despite the refusal of some states to give full faith and credit to common-law marriages established in other states. Although states have different rules of marriage recognition, uniform nationwide rules are essential for efficient and fair tax administration. A rule under which a couple's marital status could change simply by moving from one state to another state would be prohibitively difficult and costly for the Service to administer, and for many taxpayers to apply.

This ruling is relatively old, but it has been cited by the IRS as recently as this year. See, e.g., PLRs 201310047 (“In the administration of federal income tax laws, the marital status of individuals is determined under state law pursuant to Rev. Rul. 58-66”), 200524006, 200524007, 200339001, 9850011.

The IRS explained further that, after Windsor, gender-neutral terms in the Code that refer to marital status, such as "spouse" and "marriage," must include both individuals married to a person of the same sex if the couple is lawfully married under state law, and such a marriage between individuals of the same sex. The IRS explained that this reading was the
most natural, that is was consistent with *Windsor*, which involved a Code reference to "spouse," that "a narrower interpretation would not further the purposes of efficient tax administration," and that this interpretation "avoids the serious constitutional questions that an alternate reading would create, and is permitted by the text and purposes of the Code." The IRS stated that *Windsor* recognized that it had an effect beyond the estate tax marital deduction, noting that the Court had stated that:

> [t]he particular case at hand concerns the estate tax, but DOMA is more than simply a determination of what should or should not be allowed as an estate tax refund. Among the over 1,000 statutes and numerous Federal regulations that DOMA controls are laws pertaining to... taxes.

*Windsor*, 133 S.Ct. 2675, at 2694 (S.Ct., 2013). The IRS also stated that an interpretation of the gender-specific terms in the Code to exclude same-sex spouses should be avoided because it would raise "serious constitutional questions under the Fifth Amendment analysis in *Windsor* "by creating two contradictory marriage regimes within the same State, DOMA forces same-sex couples to live as married for the purpose of state law but unmarried for the purpose of Federal law, thus diminishing the stability and predictability of basic personal relations the State has found it proper to acknowledge and protect." *Windsor*, 133 S.Ct. 2675, at 2694 (S.Ct., 2013). The IRS also stated that the Code permits a gender-neutral construction of the gender-specific terms, noting that, among other things Section 7701(p), by its cross-reference to the Dictionary Act, provides that "words importing the masculine gender include the feminine as well," and that the 1871 legislative history of this statute explained that it was designed to avoid having to "specify males and females by using a great deal of unnecessary language when one word would express the whole." 1 U.S.C. § 1; Cong. Globe, 41st Cong., 3d Sess. 777 (1871) (statement of Sen. Trumbull, sponsor of Dictionary Act). One court has, the IRS noted, read this as requiring construction of the phrase "husband and wife" to include same-sex married couples. See *Pedersen v. Office of Personnel Mgmt.*, 881 F. Supp. 2d 294, 306-07 (D. Conn. 2012). The IRS also explained that a "gender-neutral reading of the Code fosters fairness by ensuring that the Service treats same-sex couples in the same manner as similarly situated opposite-sex couples" and also "fosters administrative efficiency because the Service does not collect or maintain information on the gender of taxpayers and would have great difficulty administering a scheme that differentiated between same-sex and opposite-sex married couples."

The IRS stated that, therefore, the terms "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if they were lawfully married in a state whose laws authorize the marriage of two individuals of the same sex, and the term "marriage" includes
such marriages of individuals of the same sex. Individuals of the same sex will be considered to be lawfully married for federal tax purposes as long as they were married in a state whose laws authorize the marriage of two individuals of the same sex, even if they are domiciled in a state that does not recognize the validity of same-sex marriages. The IRS explained that "our increasingly mobile society" makes it important to have a rule that can be applied with certainty, and that a state-of-domicile rule "would present serious administrative concerns" and would raise challenges for employers who operate in multiple states or who have employees or former employees residing in different states.

A rule of recognition based on the state of a taxpayer's current domicile would also raise significant challenges for employers that operate in more than one state, or that have employees (or former employees) who live in more than one state, or move between states with different marriage recognition rules. Substantial financial and administrative burdens would be placed on those employers, as well as the administrators of employee benefit plans.

The IRS added, however, that for Federal tax purposes, the term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law. The use in federal tax law of such terms as "spouse," "husband and wife," "husband," and "wife" will not include individuals who have entered into such a formal relationship, whether the individuals have entered into such relationships are of the opposite sex or the same sex.

The IRS stated that this ruling will be applied prospectively as of September 16, 2013. For tax year 2013 and going forward, taxpayers generally must file returns reflecting marital status as determined under Rev. Rul. 2013-17. Therefore, married same-sex couples would file income tax returns either as married filing separately or jointly filing status, and they would be able to file gift tax returns gift-splitting and claiming the gift tax marital deduction. For tax year 2012 and all prior years, same-sex spouses who file an original tax return on or after September 16, 2013 also must generally file using a married filing separately or jointly filing status. Same-sex spouses who filed their 2012 income or gift tax returns before September 16, 2013, may, if they wish, amend their returns to file reflecting their marital status as determined under Rev. Rul. 2013-17. For tax years 2011 and earlier, same-sex spouses who filed their tax returns on time may, but are not required to, amend their federal tax returns to file reflecting marital status determined under Rev. Rul. 2013-17, if the statute of limitations for amending the return has not expired.

Note. Same-sex married couples will now be treated as married for federal income, gift, estate, and GST tax purposes. Same-sex spouses will now be afforded such advantages as gift splitting, the federal estate and gift tax marital deductions, the ability to make a reverse QTIP election for GST tax purposes, the ability to treat a spouse who is significantly young-
er than the transferor as being assigned to the same generation for GST tax purposes, and the ability of the surviving spouse to obtain portability of a deceased spouse's unused basic exclusion amount. Same-sex spouses will also, however, lose the ability to file two independent income tax returns, and will have to file federal income tax returns either as married filing jointly or married filing separately.

Rev. Rul. 2013-17 may also affect the state tax treatment of some same-sex couples. *Windsor* did not require that states recognize the validity of same-sex marriages, and many states, such as Virginia and Ohio, have statutes and Constitutional provisions that expressly reject the validity of same-sex marriages. Some of these states also require that the same filing status be used for federal and state income tax returns. See, however, Va. Code § 58.1-341 (requiring a husband and wife who file a joint federal return to file a joint Virginia return, and requiring a husband and wife who file separate federal returns to file separate Virginia returns). It is unclear how a state department of taxation will resolve the conflict between such anti-same-sex marriage provisions and state laws that require taxpayers to use the same filing status for federal and state tax returns. In states in which the state constitution prohibits recognition of same-sex marriages, it seems likely that the statutes requiring conformity in filing status would be subordinated to the state constitutional provisions. In states in which both issues are addressed only statutorily, the results are uncertain and unpredictable.

There is also a question about the constitutional considerations where a same-sex couple who is married in state A that permits such marriages then becomes domiciled in state B, that does not recognize such sex marriages. Article IV, section 1 of the U.S. Constitution states, in part, that “Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State.” A marriage entered into in one state would fall under the “public Acts” provision of the full faith and credit clause. Generally, the courts have held that full faith and credit afforded public acts differs from that afforded judgments. Public acts of one state may be disregarded by a forum state if they violate a strong public policy of the forum state. See *Baker by Thomas v. General Motors Corp.*, 522 U.S. 222 (1998); *Galliard v. Field*, 381 F.2d 25 (10th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968); *Roy v. Star Chopper Co.*, Inc., 442 F.Supp. 1010 (D.R.I. 1977), *aff’d*, 584 F.2d 1124 (1st Cir., 1978), *cert. denied* 440 U.S. 916 (1979). Generally, the Full Faith and Credit clause does not appear to require one state to give effect to same-sex marriages performed in another state. A forum state may choose to do so, but it is not required to do so, particularly if doing so would violate a strong public policy of the forum state.

It is interesting that *Windsor* struck down only section 3 of DOMA. Section 2 of DOMA, which was not discussed by the Court, provides that:
No State, territory, or possession of the United States, or Indian tribe, shall be required to give effect to any public act, record, or judicial proceeding of any other State, territory, possession, or tribe respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, territory, possession, or tribe, or a right or claim arising from such relationship. 28 U.S.C. § 1738C.

This statement appears to be authorized by the second sentence of Article IV, section 1 of the U.S. Constitution, which states “And the Congress may by general Laws prescribe the Manner in which such Acts, Records, and Proceedings shall be proved, and the Effect thereof.” It is unclear whether Section 2 of DOMA adds anything of significance. Each state already appears to have the authority under the Full Faith and Credit Clause to ignore public acts of another state, if they violate a strong public policy of the forum state. Furthermore, Section 2 of DOMA does not require that states refuse to recognize same-sex marriages obtained in another state—it merely authorizes them to do so. Thus, the retention of Section 2 of DOMA appears to have little consequence.

In Tax Bull. 13-13 (Nov. 8, 2013), the Va. Dept. of Tax’n stated that, because same-sex married couples are not married under Virginia law, and despite Rev. Rul. 2013-17, must file as unmarried persons for Virginia income tax purposes, even if they file as married persons for federal purposes. They must create a pro forma federal income tax return using either single or head-of-household status, as the case may be, in order to determine their Virginia taxable income. See also similar declaration from the Utah Tax Commission (Oct. 15, 2013), http://incometax.utah.gov/filing/filing-status, which also noted that the taxpayers should not file the “as-if” federal return either with the federal government or the Utah Tax Commission, but rather keep it as part of their tax records, in case of an audit.

5. Marital Deduction Not Allowed for Portion of Elective Share That Cannot Actually Be Transferred to Surviving Spouse. C.C.M. 201416007 (April 18, 2014)

D, a U.S. person, made a gift to an irrevocable trust in Country A for the benefit of D and D’s adult child, Child. The trust is not subject to the jurisdiction of the U.S. courts. D died, survived by Spouse, who asserted her right under applicable state law to an elective share of D’s estate. Under state law, Spouse was entitled to a fractional share of D’s augmented estate, which included the gifts made to the trust for D and Child. The augmented estate would be satisfied first by D’s probate assets and the assets of D’s revocable trust, and if that is inadequate, with the gifts made by D that are includible in the augmented estate. The probate and revocable trust assets were insufficient, and Spouse became entitled to part of the
gift made by D to the trust. D’s executors deducted the elective share as marital deduction property on D’s estate tax return.

The IRS Chief Counsel stated that, to the extent that the elective share was satisfied with property given to a trust for D and Child, it could not qualify for the estate tax marital deduction, because it did not pass from D to Spouse. The IRS noted that, under the law of Country A, state laws governing spousal inheritance have no effect on the continuation of the trust and the courts of Country A will not recognize the rights of Spouse against the assets of the trust. State law determines the property rights passing to Spouse in the property, though federal estate tax law determines the taxation of those property rights. Comm'r v. Bosch, 387 U.S. 456 (1967); Heim v. Comm'r, 914 F.2d 1322 (9th Cir. 1990). In this case, the pecuniary amount of the elective share passing to Spouse was determined under state law by taking into account the value of the trust assets, but those assets are not actually available to satisfy that elective share, because they are held subject to the laws of Country A and those laws will not permit distribution of the trust assets to Spouse. Normally, an elective share is treated as passing from the decedent to the surviving spouse for marital deduction purposes. See Code § 2056(c)(3) and Reg. § 20.2056(c)-1(a)(3). Any property interest transferred during life is considered as having passed to the person to whom the decedent transferred the interest, however. Reg. § 20.2056(c)-1(a)(5). Property that passes from a decedent in trust is considered to have passed from the decedent to the surviving spouse only to the extent of the surviving spouse’s beneficial interest in the trust. Citing Estate of Turner v. Comm’r, 138 T.C. 306 (2012) (“[a] property interest is considered as passing to the surviving spouse only if it passes to the spouse as beneficial owner” (emphasis added)). In the facts in this ruling, because Spouse received none of the beneficial ownership of the trust assets, they are not deemed to have passed to Spouse for purposes of the marital deduction, and they are not deductible.

Note. Practitioners are sometimes asked how to avoid the rights of a surviving spouse under an augmented estate statute modeled after the Uniform Probate Code. This has always been a difficult issue to resolve, but this memorandum suggests that creating a foreign situs asset protection trust to hold a substantial portion of a client’s assets may succeed in frustrating the elective share rights of a surviving spouse. It is a pretty dramatic step to take, but at least the practitioner now has one suggestion that he or she can make.

6. Transfers Under premarital Agreement Qualify for Marital Deduction. PLR 20140011 (March 7, 2014)

Taxpayer and Spouse executed premarital agreement under which each waived their respective right of election to take against the other’s will. The agreement provides that upon Taxpayer’s death, if Spouse survives him and if they are then married and living together, Spouse will receive an outright payment of $w, free and net of any and all estate, transfer and
income taxes, or, if Taxpayer and Spouse were married and living together for at least 10 years when he dies, Spouse will receive a QTIP marital trust with at least x percent of Taxpayer's taxable estate, before deducting amounts due for Federal estate tax purposes under the premarital agreement. Taxpayer established a revocable trust to carry out the provisions of the premarital agreement, providing that if Spouse makes a timely election to waive elective share, the trustee will allocate and make distributions to Spouse as provided in the premarital agreement. The trust provides that the trustee can satisfy the payments under the premarital agreement with preferred non-voting units of LLC. Taxpayer, as trustee of the revocable trust, holds voting and non-voting common units of LLC and all of the preferred units.

The IRS stated that Spouse's right to elect under the premarital agreement and the revocable trust is not a "contingency" that would disqualify the transfers for the estate tax marital deduction, under Section 2056(b)(1). The revocable trust property actually distributed outright to Spouse and to marital trust will be property "passing from the decedent to his surviving spouse" for marital deduction purposes. The IRS discussed several precedents. In Rev. Rul. 54-446, 1954-2 C.B. 303, a couple signed a premarital agreement under which each spouse renounced rights in the other's estate. The husband died, and his will left the wife more than was required by the premarital agreement, and specified that the dispositions were in lieu of any rights she might have under the premarital agreement. The IRS ruled that the amount left to the wife under the will "passed from the decedent to his surviving spouse" and qualified for the estate tax marital deduction. In Rev. Rul. 68-271, 1968-1 C.B. 409, a wife renounced her marital rights by signing a premarital agreement, in return for a promise of a stated sum from husband's estate, if she survived him. The husband died and his will made no provision for the wife. The wife put in a claim against the husband's estate and the estate paid the required sum to the wife. The ruling stated that the interest passing to the wife pursuant to the premarital agreement "passed from the decedent to his surviving spouse" and qualified for the estate tax marital deduction. In Estate of Tompkins v. Comm'r, 68 T.C. 912 (1977), acq., 1982-1 C.B. 1, a decedent gave his widow a life estate in trust, and by codicil provided that she could elect to take an outright cash bequest in lieu of the life estate. To elect the cash bequest, the widow had to file an election with the executor within 60 days after his qualification. The widow elected the cash bequest and the court held that the procedural requirement did not prevent the disposition from qualifying for the estate tax marital deduction, and that the cash bequest was a nonterminable interest. In Rev. Rul. 82-184, 1982-2 C.B. 215, the IRS considered a situation similar to that in Tompkins and reached the same conclusion. In the ruling, the IRS stated that the 180-day requirement for Spouse to claim the interests promised by the premarital agreement did not interfere with the estate tax marital deduction, and that the QTIP interest would be deductible. The IRS also noted that the terms of
the QTIP trust directed the trustee to distribute all net income at least quarter-annually, and that the fact the bequest was satisfied by LLC preferred units did not prevent allowance of the marital deduction. The IRS noted that the sale of LLC preferred units was not unreasonably restricted by the LLC agreement, which allowed a member to transfer units to (a) another member, (b) a qualified institutional transferee, (c) the husband, his children, and/or any affiliate, without obtaining the prior written consent of a majority in interest of the members.

7. The “Huh?” Award for 2013: IRS Agrees to Ignore QTIP Election Made on Credit Shelter Trust That Could Not Be a QTIP Anyway. PLR 201338003 (Sept. 20, 2013)

Decedent’s will left all of his tangible property outright to Spouse and left the residue of his estate to his revocable trust. The revocable trust provided for division of the fund into Trust 1 (a marital trust) and Trust 2 (a credit shelter nonmarital trust). The amount to fund Trust 2 is that amount that will pass free of federal and state death taxes. The trustee of Trust 2 has discretion to pay so much of the net income and principal as is necessary for the health, education, support and maintenance of Spouse and Decedent’s children. Undistributed income will be accumulated and added to principal. Upon Spouse’s death, Trust 2 will continue for the benefit of Son, until Son reaches age 35, when the trust corpus will be distributed to Son. Spouse, the executrix of Decedent’s estate, allocated all of the assets of Trust to Trust 2 and did not establish Trust 1. Spouse filed a timely estate tax return and listed Trust 2 under QTIP property. With the assistance of new counsel, Spouse discovered that the QTIP election for Trust 2 was not necessary to reduce Decedent’s estate tax liability to zero.

The IRS stated that it would ignore the QTIP election made with respect to Trust 2. The IRS cited Rev. Proc. 2001-38, 2001-1 C.B. 1335, in which the Service stated that it would treat a QTIP election as null and void for purposes of Sections 2044(a), 2056(b)(7), 2519(a), and 2652, where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. The IRS stated that it would ignore the QTIP election in this case because it was not required to reduce the decedent’s estate tax to zero, and that Spouse would not be deemed to be the transferor of Trust 2 for GST tax purposes, absent a “reverse QTIP” election under Section 2652(a)(3). Furthermore, the property held in Trust 2 will not be includible in Spouse’s gross estate under Section 2044, and Spouse will not be treated as making a gift under Section 2519 if Spouse disposes of the income interest with respect to the property.

Note. It is hard to fathom why the IRS gave this ruling, because Trust 2 fails to meet any of the requirements of a valid QTIP. It does not require that all income be paid currently to Spouse, and it permits distributions to persons other than Spouse during Spouse’s lifetime. The IRS
should simply have ruled that there was no valid QTIP election as to Trust 2 in the first place.

III. GIFT TAXES

A. Code § 2503. Gift Tax Annual Exclusion


The gift tax annual exclusion rises to $14,000 for transfers made in 2014. The annual exclusion for gifts to a non-U.S. citizen spouse is raised to $145,000 for gifts made in 2014.

B. Code § 2512. Valuation of Gifts

1. Tax Court Denies Summary Judgment to IRS on Net, Net Gift. Steinberg v. Comm' r, 141 T.C. ___ (No. 8) (Sept. 30, 2013)

When she was 89, Jean Steinberg entered into a binding agreement with her four daughters under which Jean would make gifts of cash and securities to her daughters in exchange for the daughters' agreement to assume and pay any federal gift tax liability connected with the gifts, including any federal or state estate tax liability imposed under Section 2035(b) if Jean died within three years of the gifts. (Section 2035(b) includes in a decedent's gross estate the gift taxes paid on any gift made by the decedent within three years of death.) The net gift agreement was the result of several months of negotiation between Jean and her daughters, and they each were represented by separate counsel. An independent professional appraiser calculated the aggregate fair market value of the net gift, taking into account the agreement to pay the gift and potential estate taxes. The appraiser valued the net gift by reducing the fair market value of the cash and securities by both (1) the gift tax paid by the donees, and (2) the actuarial value of the donees' assumption of potential Section 2035(b) estate tax. The appraiser determined the actuarial value of the donees' assumption of the potential Section 2035(b) estate tax by calculating Jean's annual mortality rate for the three years after the gift (the probability that she would die within one, two, or three years of the gift), among other things. The appraiser stated that the value of the net gift was $71.6 million, reflecting, among other things, a $5.8 million value for the assumed Section 2035(b) estate tax liability. Jean filed a timely gift tax return and paid $32 million of gift tax.

The IRS issued a notice of deficiency, increasing the value of the net gift to $75.6 million and the amount of the tax to $33.8 million, because it disallowed the valuation adjustment for the assumption of the Section 2035(b) estate tax liability. The IRS conceded that Jean had accurately stated the value of the cash and securities given, that the net gift agree-
ment was legally enforceable, and that Jean had properly reduced the amount of the gift by the gift taxes that the donees assumed. The IRS moved for summary judgment in Tax Court, however, arguing that the assumption of potential Section 2035(b) estate tax liability could never constitute consideration in money or money's worth under Section 2512(b), and thus could not reduce the amount of Jean's taxable gift. The IRS relied largely on the Tax Court's earlier decision in McCord v. Comm'r, 120 T.C. 358 (2003), rev'd and rem'd sub nom. Succession of McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006).

The Tax Court (Judge Kerrigan for the majority), rejected the summary judgment and stated that, while this case was not appealable to the Fifth Circuit and it was by Succession of McCord, the Fifth Circuit's reasoning was persuasive and the Tax Court would no longer follow its own 2003 opinion in McCord. The majority, adopting the Fifth Circuit's reasoning, stated that the value of the assumption of the estate tax liability was not "too speculative," and that a willing buyer and a willing seller would, in appropriate circumstances, take into account the assumption of potential estate tax liability in arriving at a sale price. See Regs. § 25.2512-1 (the value of a gift is the price at which the transferred property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts). The court stated that, whether Jean would survive three years after making the gift was a simple contingency based on the possibility of survivorship. The court rejected the IRS's assessment that the assumption of potential estate tax liability failed under the estate depletion theory. To qualify as consideration in money or money's worth, the consideration received must be reducible to value in money or money's worth; consideration consisting of something unquantifiable, such as love and affection or the promise of marriage, is wholly disregarded. Regs. § 25.2512-8. Under the estate depletion theory, a donor receives consideration in money or money's worth only to the extent that the donor's estate has been replenished. The IRS argued that the donees' assumption of potential Section 2035(b) estate tax liability would not benefit the estate, but the court stated that it could provide a tangible benefit to the donor's estate. The majority stated that the Tax Court's earlier distinction between a benefit to the donor's estate and a benefit to the donor was incorrect, and that for purposes of the estate depletion theory, the donor and the donor's estate were "inextricably bound" and the donees' assumption of potential estate tax liability could provide a tangible benefit to the donor's estate. Judges Colvin, Foley, Vasquez, Wherry, Holmes, Paris, and Buch joined in the majority opinion.

Judges Gale, Goeke, Kroupa, Gustafson, Morrison and Lauber concurred in the result only. Judge Lauber wrote a concurring opinion, agreeing with the court's conclusion that the IRS's motion should be denied, but disagreed that it was appropriate for the court to overrule
McCord at this stage of the litigation. Judge Lauber stated that a "foreseeable valuation issue . . . may result from the strategy in this case at the time of a donor's death." The valuation of the obligation would, he contended, require consideration of the facts and circumstances of each case, including: (1) whether Jean's daughters, at the time of the gifts, were beneficiaries under her will; (2) whether Jean's daughters, if not then beneficiaries under her will, should be regarded as such because they were the natural objects of her affection and bounty; (3) whether Jean, a New York resident when she made the gifts, should be deemed a New York domiciliary for purposes of applying the New York apportionment statute; (4) whether the net gift agreement provides an effective enforcement mechanism that does not exist under applicable New York law; (5) whether the bulk of Jean's assets will be subject to probate or will pass by trust or other nonprobate mechanism, which might affect ease of enforcement; and (6) whether any incremental enforcement benefit is substantial enough to constitute "consideration" under Section 2512(b). Judges Gale, Goeke, Kroupa, Gustafson, and Morrison agreed with this opinion.

Judge Goeke added that it was not logical to presume that the value of an obligation to pay potential Section 2035(b) liability is the same when the obligation is made as at the time of the donee's death. Judge Goeke stated that the effect of the donor's estate tax apportionment clause would be relevant to determining the value of the donees' obligation.

Judge Halpem wrote a dissenting opinion, stating that he would grant the IRS's motion because allowing a reduction of an otherwise taxable transfer by an actuarial estimate of the value of the estate tax that might result because of the application of Section 2035(b) was inconsistent with the purpose of Section 2035(b).

Note. The Steinberg litigation will continue, but this opinion is a very hopeful sign that net gifts will be more useful where the donees enter into a binding agreement to be responsible for both the gift tax and any estate tax attributable to inclusion of the gift tax in the donor's gross estate under Section 2035(b). Such an additional assumption may, as demonstrated in this decision, meaningfully reduce the value of the transfer for gift tax purposes, even if the donor ultimately survives for more than three years.

2. Self-Cancelling Installment Note Not Valued Under Section 7520; Premium Based on Seller's Actual Health. CCA 201330033 (July 26, 2013)

D established several separate grantor for the benefit of his family members. D funded the trusts with common voting and preferred non-voting stock of Y corporation. Thereafter, D sold Y corporation stock to the trusts in exchange for interest-bearing self-canceling installment notes. The notes required that the trust make only annual interest payments during the term of the note and further required that the principal be paid on the final date of the term. The appraised value of the stock
that D transferred to the trusts was $x, and the total face value of the self-cancelling notes was almost double the value of the stock sold, reflecting the premium for self-cancellation. The premium was calculated using the actuarial tables under Section 7520. In some notes, the principal was increased to reflect the SCIN premium, and in other notes, the interest rate was increased. D died less than six months after the transfer, and therefore, received neither the interest payments nor the principal due on the notes.

The Chief Counsel advised that: (1) if the fair market value of the notes is less than the fair market value of the property transferred to the grantor trusts, the difference in value is a deemed gift; (2) the notes should be valued based on a method that takes into account the willing-buyer willing-seller standard and should also account for D’s medical history on the date of the gift; and (3) there is no estate tax consequence associated with the cancellation of the notes with the self-cancelling feature upon D’s death. The IRS explained that, where property is exchanged for promissory notes, there is no gift if the value of the property transferred is substantially equal to the value of the notes. The face value and length of payments of the notes must be reasonable in light of the circumstances. To determine whether there is a gift, the IRS determines the value of the transferred stock and the value of the notes, taking into consideration the self-cancelling feature. If the fair market value of the notes is less than the fair market value of the property transferred to the grantor trusts, the difference in value is deemed a gift. The IRS discussed Estate of Costanza v. Comm’r, 320 F. 3d 595 (6th Cir. 2003), rev’g T.C. Memo 2001-128, in the Sixth Circuit stated that, “a SCIN signed by family members is presumed to be a gift and not a bona fide transaction.” Id. at 597. The court stated that the presumption may be rebutted by showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness, and on the facts before it, the presumption had been rebutted. The taxpayer rebutted the presumption in Estate of Costanza, but in this case, the Chief Counsel noted, the decedent did not need the stream of cash and used the SCIN arrangement as “a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock.” The Chief Counsel also concluded that it was not clear that there was a reasonable expectation that the debt would be repaid. The principal amount on the notes exceeded the value of the assets sold to the trust, though the IRS did recognize that the trusts had some assets from the initial gifts, and thus the estate could argue that the notes were bona fide and that the trusts had sufficient assets to repay the loans.

The Chief Counsel also determined that D could not value the SCIN premium based strictly on the Section 7520 tables. The Chief Counsel stated that the Section 7520 tables should not apply to value SCIN notes, because Section 7520 applies only to value “an annuity, any interest for life or term of years, or any remainder.” The Chief Counsel
Counsel stated that the notes must be valued "based on a method that takes into account the willing-buyer willing-seller standard" and that "the decedent’s life expectancy, taking into consideration decedent’s medical history on the date of the gift, should be taken into account." Citing GCM 39503 (May 7, 1986). The IRS explained that, because of D’s health, it was unlikely that the full amount of the note would ever be paid. Thus, the note was worth significantly less than its stated amount, and the difference between the note’s fair market value and its stated amount constitutes a taxable gift.

Note. The IRS was correct that there is a taxable gift if the value of the promissory notes is less than the value of the transferred assets, and that the SCIN should be effective to remove the underlying assets from the seller’s gross estate. It was incorrect, however, when it contended that the lack of an independent nontax purpose for the transaction means that the SCIN should be disregarded, or that the Section 7520 tables are inapplicable to determine the SCIN premium.

With respect to the application of Section 7520, the IRS relies solely on GCM 39503, in which the IRS stated that:

The value of the installment obligation and the property sold must be substantially equal. However, unlike the private annuity, there is no requirement that the actuarial tables are to be used in determining the gift taxation of installment sale. Thus, the taxpayer’s particular health status may be considered, and there is more room to establish that the terms of the sale are reasonable.

GCM 35903, however, predates Section 7520, which states that actuarial tables must be used to value an “annuity, any interest for life or a term of years, or any remainder or reversionary interest.” Int. Rev. Code § 7520(a). Section 7520 states that it must be used to value “an interest for life or a term of years,” which precisely describes the payments under a SCIN. Furthermore, the IRS publication “Actuarial Values, Alpha Volume,” which implements the IRS actuarial tables under Section 7520, includes an example that uses the tables to determine “the present worth of a temporary annuity of $1.00 per annum payable annually for 10 years or until the prior death of a person aged 65. . . .” This, too, appears to describe precisely the calculation of the premium for a SCIN. Thus, Section 7520 appears to apply to the valuation of a SCIN premium. It may also be noteworthy that in Dallas v. Comm’r, T.C. Memo. 2006-212 the IRS appears to have determined the value of a SCIN using the actuarial tables under Section 7520.

Practitioners should generally use the actuarial tables under Section 7520 to calculate the premium on a SCIN, but they should also be aware of the possibility that the IRS may challenge this calculation to the
extent that the seller's actual life expectancy is significantly different from his or her actuarial life expectancy.

C. Code § 2518. Disclaimers

Disclaimer of Pre-1977 Interests is Timely if Made Within a Reasonable Time After First Learning of the Existence of the Interest. PLR 201334001 (Aug. 23, 2013)

Grantor created four Trusts several years before his death before January 1, 1977. The trusts were to provide for the lawful lineal descendants of Daughter, per stirpes. Daughter's son, Grandson, is the current beneficiary of the four trusts. Upon Grandson's death, Grandson's son (Taxpayer) will be entitled to income distributions from Taxpayer's per stirpes share of Trusts. The income distributions will continue until the earlier of Taxpayer's death or the perpetuities date. Upon termination of each of the Trusts, any remaining trust property will be distributed to Taxpayer and his brother, per stirpes. Taxpayer, who is over 18 years of age, represents that he learned of the transfers creating his interests in Trusts only on Date 2 and that, until then, he did not even know that he had any interest in Trusts. Taxpayer proposed to disclaim his interests in Trusts on or before Date 3, which is not more than nine months after Date 2. The disclaimers would be valid under applicable state law.

The IRS stated that the disclaimers would be timely, even though made far after the date set by Section 2518 for a qualified disclaimer. Section 2518 requires that a disclaimer of a transfer made after December 31, 1976, must be made within nine months of the date on which the transfer occurs, but disclaimers of transfers made before January 1, 1977 need only be made within a reasonable time following the date the disclaimant first learns of the interest. See Jewett v. Comm'r, 455 U.S. 305 (1982). The IRS concluded that nine months was a reasonable time after Taxpayer learned of the existence of the transfers, and that the disclaimer would be respected for estate and gift tax purposes.

D. Gift Tax Procedures


In 1993, Douglas Brown created the Brown Family Trust, an irrevocable trust for himself, his wife, and their four children. Douglas's brother-in-law, Robert Tingey, was named trustee. Douglas and his wife, Barbara, negotiated to buy a ski cabin. The seller conveyed undivided half interests in the cabin to two trusts that he created (the Jensen Trusts), and each of those trusts then conveyed its interest to Tingey, for the Family Trust. Douglas paid an earnest-money deposit, and then gave a cashier's check for the $72,000 down payment, and executed a $200,000 promissory note in favor of the Jensen Trusts. Douglas was the sole ob-
ligor on the note, he executed a trust deed to the cabin as security, and he gave the Jensen Trusts as additional security a security interest in a snow-plowing machine and a share of stock representing the water rights to the cabin. The lots were not marketable without the water rights. Douglas and Barbara began used the cabin without the trustee’s permission, performed maintenance work, and paid the utility bills and premiums on an insurance policy for the cabin issued in Douglas’ name. Douglas later leased the cabin to a friend and instructed him to pay rent directly to the Jensen Trusts to be applied against the payments due on the note. The note payments were also satisfied from direct payments by Douglas and other sources closely connected with Douglas.

Douglas was found to owe the IRS over $2 million in unpaid gift and income taxes, and the IRS attempted to foreclose on the ski cabin.

The U.S. District Court for Utah (Judge Jenkins) permitted the IRS to foreclose on federal tax liens on the ski cabin, despite the fact that it was titled in the name of the Family Trust and the taxes were owed by Douglas and his wife. The court held that Douglas and Barbara were the beneficial owners of the cabin, because Douglas had a purchase-money resulting trust arising from his having bought the cabin and then conveyed it to the trust.

The U.S. Court of Appeals for the Tenth Circuit (Judge Hartz) affirmed, by a two-to-one vote. The court noted that when Douglas created the Family Trust, his finances were already in a precarious state. Douglas owed almost $350,000 in income taxes for 1993 and filed no return. The next year he was sued by investors and the year after he was indicted for financial transgressions, but the claims and charges concerned misconduct beginning in late 1990. Douglas retained significant control over the Family Trust’s affairs: Tingey consulted with Douglas and relied on Douglas’s knowledge of the investment industry in making decisions regarding trust assets, Douglas often presented Tingey with investment opportunities for the trust, and the trust was intimately intertwined with Douglas’s business affairs. Tingey argued that (1) that the government waived the right to assert that Douglas and Barbara held the beneficial interest in the cabin, and (2) no purchase money resulting trust was created under state law. The court rejected both arguments. The court held that there was no waiver, despite the stipulated order in Douglas’s criminal securities-fraud case, that required that the proceeds of certain stock held by the Family Trust be forfeited to the United States as restitution, and that lifted any further restraint on remaining trust property. Even if the government was fully aware of the Family Trust’s claims to the cabin, its agreement to the stipulated order did not waive its rights to pursue a tax claim, because the order said nothing about tax liability or who had beneficial interests in the cabin. The court also held that there was a valid purchase money resulting trust under state law, noting that a purchase money resulting trust usually arises where a transfer of properties is made to one person and the purchase price is paid by another. Zion’s First Nat’l Bank v. Fennmore (In re Estate of Hock), 655 P.2d 1111 at 1115 (Utah 1982) (quoting Restatement (Second) of Trusts § 440 (1959)); accord Restatement (Third) of Trusts § 9(1) (2003). There is an exception where the transfer of property is made to donor’s close family, as happened here, unless the one paying the purchase price intends that the transferee should have no bene-
ficial interest in the property. In this case, the court stated that the record showed that Douglas, with the trustee’s acquiescence, ignored the formalities of the trust in managing the property, making note payments out of personal funds that were not routed through the trust, taking care of maintenance, paying insurance premiums (on a policy that was in Douglas’s name), and renting out the cabin without the trustee’s knowledge. Douglas had as much control of the property as he would have had if it had been in his own name, and he kept the title to the water rights in his name, making the trust’s asset unmarketable. Douglas knew when he created the trust that he was accruing significant tax and civil liabilities, and he created the trust for asset protection purposes. An intent to shield assets from creditors can support the imposition of a purchase money resulting trust.

Chief Judge Briscoe dissented, finding that the government had not met its burden to produce “clear and convincing” evidence that Douglas intended to retain a beneficial interest in the cabin. The Chief Judge stated that he would reverse and remand for further proceedings to determine if the IRS can enforce a lien under its alternate theory of fraudulent transfer, which the district court did not address. The Chief Judge argued that the purchase money resulting trust is not an equitable remedy designed to benefit creditors, but rather a remedy designed to give effect to the purchaser’s intent, and that the fact that Douglas made payments on the note cannot serve as evidence to rebut the presumption that Barbara and the couple’s children held the beneficial interest. Rather, he contended, the trustee’s co-signing the note supports the view that the Family Trust was the true beneficial owner, and that the parties anticipated that the trust would make future payments. An intent to protect assets from creditors is a factor in determining whether we should impose a purchase money revocable trust, the Chief Judge agreed, but it is not the only factor. “[A] purchaser could quite plausibly want to protect his assets and gift the property to his relatives.” 2013 WL 2321656 at *12.

The Chief Judge stated that the evidence supporting a conclusion that Douglas intended to retain a beneficial interest is ambiguous as to intent. There was no evidence that the beneficiaries were unaware of their interest in the cabin, or that Douglas used it for his own purposes to the exclusion of the beneficiaries. Furthermore, the trustee had long considered the cabin a trust asset, and Barbara and the children used the cabin for their own enjoyment. Also, none of the parties with knowledge of this transaction has made an assertion explicitly contradicting the presumption that Douglas intended the cabin as a gift for his wife and the children.