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SUMMARY OF RECENT ESTATE TAX AND WEALTH TRANSFER CASES

You will find the summary of some of the recent, key estate tax and wealth transfer cases below a useful guide to planning for sophisticated clients and working with their professional advisors.

ESTATE TAX

EGTRRA: Contained the infamous "sunset" provision and eventual repeal (and reprise) of estate tax.

RESULT: Efforts to accelerate the repeal of estate tax or make the scheduled one year (2010) repeal permanent are continuously being attempted in Congress. But as of today, under current law, the federal estate tax will not be repealed until 2010 and then the repeal itself will "sunset" in 2011 and the pre-EGTRRA estate tax law will be reinstated. It's both silly and scary!

PLANNING TIPS: Don't panic. Don't celebrate. Certainly, it will not be prudent to plan for no federal estate tax. There's many a slip twixt spoon and lip. There are many years between now and the time repeal would become effective. And there is many a Congress with many a deficit problem and/or political ax to grind between now and the scheduled 2010 repeal.

Beware of apathy, inertia, and under-liquidity! The estate tax has been repealed and come back Òmany times before – and the "modified" carryover basis regime that would accompany repeal is likely to be far worse – and will affect far more people – than the estate tax ever would have been. And don't forget, the need for liquidity and estate planning both extend far beyond the federal estate tax.

VALUATION

DEPUTY: Deputy Estate v. Commissioner, T.C. Memo 2003-176 (June 13, 2003).

RESULT: The Tax Court considered the components of discounts for lack of control and lack of marketability in a matrix offered by the estate appraiser.

PLANNING TIPS: The court liked the six part "matrix approach" and the idea that the matrix covered company-specific information with respect to: (1) financial information availability and reliability, (2) investment size, (3) company outlook, management and growth potential, (4) ability to control, (5) restrictions on transferability and anticipated holding period, and (6) dividend payout history and outlook. A theme of this case, echoed in other valuation cases below, is the importance of using a professional, full-time independent, qualified appraiser who not only knows his/her business but also documents -- in the appraisal report – that he/she really understands the business being valued.

McCORD: McCord v. Commissioner, 120 T.C. No. 13 (May 14, 2003); Hamm v. Commissioner, T.C. Memo 1961-347, aff'd, 325 F.2d 934 (8th Cir. 1963); Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944).

RESULT: The taxpayers argued that, by a formula clause, any value in excess of a specified amount going to their children would go to charity and therefore qualify for a gift tax charitable deduction. But the Court refused to allow taxpayers to use that formula clause to cap their potential gift tax liability,

PLANNING TIPS: Do not count on a defined value or a formula clause to minimize transfer taxes. Don't count on giving a charity a miniscule charitable interest in a family limited partnership or LLC to save the day. If a donor wants to claim that a charity is a partner or assignee in an FLP or member of an LLC in order to enhance a valuation discount argument, that charity should be given a real and meaningful interest.

STRANGI: Strangi v. Commissioner T.C. Memo 2003-145 (May 20, 2003); see also Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242.

RESULT: The existence of Mr. Strangi's FLP was ignored by the IRS and courts for estate tax purposes. That resulted in the taxation of the underlying assets with no valuation discounts. – Strangi's retention of control, albeit indirect, caused estate tax inclusion. The partnership agreement gave the managing partner, his son-in-law and the holder of his power of attorney, “sole discretion” over distributing income in excess of business needs. This led to the finding of an “implied understanding” among the family that Strangi would continue in control of the assets he placed into the FLP and, coupled with numerous other facts, triggered the loss of his estate's case.

PLANNING TIPS: One or more parties other than the decedent should contribute substantial assets to a family partnership. Don't just call it a duck. It should walk the walk and talk the talk. Corporate and partnership formalities must be observed. Sufficient liquid (not just “liquefiable”) assets outside the partnership should be retained to provide realistically for anticipated living expenses. Clients should not transfer a home (or any other “personal assets,” e.g., investment portfolio or business interest) to the partnership or an LLC. If partnership assets are needed for personal use (such as a home), insist on arms' length negotiation and that the rental or lease payment between the partnership (or LLC) and the client be fair and actually made – now – and not accrued! Be sure distributions from the entity are based on business rather than personal reasons, and are made proportionate to ownership interests rather than on the basis of the client's personal needs or whims. Don't directly or indirectly retain sole discretion over cash distributions.

HARPER: Morton B. Harper, T.C. Memo 2002-121, (May 15, 2002); Christine M. Hackl v. Commissioner, 118 T.C. No. 14 (March 27, 2002); Church v. United States, 2000-1 USTC 60,369 (W.D. Tex. 2000), aff'd. without published opinion, 268 F.3d 1063 (5th Cir. 2001).

RESULT: In Harper, the Tax Court held that the assets of a family partnership were included in the decedent's estate under Code Section 2036(a). The commingling of the decedent's assets with partnership assets, as well as the pattern of partnership distributions to the decedent whenever he needed or wanted money, allowed the court to conclude that there was an implied agreement that the decedent would retain the possession or enjoyment of the assets within the meaning of Code Section 2036.

PLANNING TIPS: Existing Partnerships: Pay closer attention to the observance of partnership formalities. New Partnerships: Observe partnership formalities. Don't treat partnership assets as if they were personal assets. When possible, younger generation partners should make significant contributions of capital or services, to support the position that there is a genuine pooling of interests and a business purpose.

LEICHTER: Estate of Leichter v. Commissioner, T.C. Memo 2003-66; Hall v. Commissioner, 92 T.C. 312.

RESULT: The Tax Court determined the value of a 100% interest in an S corporation.

PLANNING TIPS: An appraiser valuing stock or other business interest must do due diligence and exercise care. The client and other professionals must give the appraiser significant factual information about the business. The appraiser must really understand the nature of the business and how it works, and incorporate his/her knowledge of the specific business in the appraisal report. The appraiser must be sure key dates and other facts are accurate. Counsel and professional advisors should check and must demand thoroughness and probity.

POLACK: Polack v. Commissioner, T.C. Memo 2002-145.

RESULT: The Tax Court held in favor of IRS in its valuation for gift tax purposes of the non-voting stock of a closely held corporation. The taxpayer's appraiser never interviewed anyone other than the client in doing his appraisal.

PLANNING TIPS: An appraiser must go above and beyond blind reliance upon client representations, especially on critical issues, for the basic information upon which to base a transfer tax valuation report. An appraiser must find and interview personnel who are knowledgeable in the necessary information about the company. A client must be willing to provide the appraiser with access to both company information and personnel. A "company tree" diagram or an organizational chart is a helpful – make that essential - tool in this regard.

DAILEY: Estate of Dailey, TC Memo 2002-301 (instant Sec. 7430 matter); TC Memo 2001-263 (substantive matter); Secs. 7517 and 7430; Tax Court Rule 143.

RESULT: The Service litigated both the valuation of the FLP interest and the existence of the FLP. The Tax Court awarded reimbursement of legal expenses to the estate based on the extent to which the litigation was on the issue of ignoring the existence of family limited partnership. The IRS has now conceded there was no reasonable basis for disregarding the partnership entity and to that extant, the estate was entitled to reimbursement. The court made it clear that to the extent the litigation costs dealt with valuation issues, there was no right of reimbursement, since there, the government used a qualified expert.

PLANNING TIPS: When creating an FLP, be sure to check that relevant state laws are met. Typically, FLP status requires a degree of activity rather than mere holding or joint ownership or pooling of investment assets; that is, there must be an "enterprise" or investment or business activity for profit purposes.

SCHOTT: Schott v. Commissioner, No. 02-70007 (9th Cir. Feb. 18, 2003), rev. and rem. T.C. Memo 2001-110; Walton, 115 T.C. at 603-04; Cook v. Commissioner, 269 F.3d 854, 858 (7th Cir. 2001); Treas. Reg. § 25.2702-2(a)(5) ; Sections 25.2702-3(b) and (d). See also R. Coplan, "Seventh Circuit Affirms GRAT Contingent Spousal Annuity Not Qualified Interest", The Tax Advisor, January, 2002.

RESULT: The 9th Circuit has reversed the Tax Court and held that a two-life annuity in a grantor retained annuity trust (GRAT) can be valued under Code Section 2702.

PLANNING TIPS: This decision implies that the Regulations specifically permit the use of the two-life GRAT. However, it emphasizes that a GRAT should not include conditions such as marital status as a requirement of the survivor obtaining the annuity. Not everyone agrees that the Schott decision is correct. If you are not in 9th Circuit, go slow. It's not safe to reduce value of the gift on creation of a GRAT to take into consideration the revocable spousal interest.

KERR: Kerr v. Commissioner, (Fifth Cir., 2002) affirming 113 TC # 30; IRC. § 2704(b)(2)(A), (2)(B), & (3)(B); Treas. Reg. § 25.2704-2(b).

RESULT: In yet another Fifth Circuit opinion, the court upheld the Tax Court. At issue was the valuation of gifts of limited partnerships interests to grantor retained annuity trusts (GRATs). The appellate court agreed with the government and Tax Court in holding that transfers to a GRAT were gifts of limited partnership interests, not assignee interests. This higher level ownership interest reduced the size of the valuation discounts. Discounts for lack of control and marketability could be applied, however, because Code Section 2704(b) didn't apply, and restrictions on liquidation of the partnerships could be considered for valuation purposes. Restrictions on liquidation contained in the partnership agreement did not constitute "applicable restrictions" within the meaning of Code Section 2704(b).

PLANNING TIPS: Most states have amended their partnership and LLC laws to expressly provide for restrictions similar to those in the Kerr case. This makes it easier to obtain a valuation discount. Consider making a charity a legitimate, meaningful and bona fide partner/member as another tool to document the valuation depression affect of partnership restrictions (with a legitimate third party owner such as a charity, it's more likely certain restrictions in a partnership's operating agreement will be enforced) and thereby enhance the size of the gift or estate tax valuation discount.

DUNN: Estate of Dunn v. Comm., 2002 TNT 151-6 (5th Cir. August 1, 2002), rev'g, T.C. Memo 2000-12.

RESULT: The 5th Circuit held that the built-in gains tax liability of a corporation's assets must be considered as a dollar-for-dollar reduction when calculating its asset-based value. Also, if an asset-based valuation approach is used, it must be assumed the corporate assets will be sold, and a capital gains tax paid.

PLANNING TIPS: The built-in tax liability of a corporation provides a readily ascertainable dollar for dollar reduction in value for gift, estate, and GST tax purposes.

GRANT: Estate of Constance R. Grant v. Commissioner; No. 00-4066 (June 21, 2002); IRC Sec. 2053; Estate of Constance R. Grant v. Commissioner, T.C. Memo. 1999-396; Reg. Sec. 20.2053 3(a); Estate of Millikin v. Comm'r, 125 F.3d 339, 344 (6th Cir. 1997); Estate of Love v. Comm'r, 923 F.2d 335, 337-38 (4th Cir. 1991).

RESULT: The Second Circuit of Appeals held an estate must base deductible executor's fees on the size of the probate estate rather than the (often much larger) combined size of the "expanded estate" (probate plus revocable trust). The court also held that to be deductible, the executor's fees must meet both federal and state requirements. This is a case of first impression and it may somewhat diminish the tax utility of a revocable living trust.

PLANNING TIPS: Meticulous records should be kept by counsel and an estate's representative showing the "time spent" and the breakdown of expenses according to probate and non-probate assets.

MARITAL DEDUCTION

DAVIS: Estate of Ralph H. Davis, et al. v. Commissioner; T.C. Memo. 2003-55; No. 210-02, February 28, 2003; IRC Secs. 2001 , 2051 , 2056 (b)(5) and (7) ; Reg. Sec. 20.2056(b)-5(a)(1); Estate of Armstrong v. Commissioner, 119 T.C. 220 (2002); Estate of Clack v. Commissioner, 106 T.C. 131, 137 (1996); Estate of Doherty v. Commissioner, 95 T.C. 446 (1990), rev'd. on other grounds 982 F.2d 450 (10th Cir. 1992).

RESULTS: Because of limitations on the right of the surviving spouse to trust income, and limitations on her power to consume or appoint principal, the trust did not qualify for the federal estate marital deduction. The court concluded that the surviving spouse's power to invade trust principal was not exercisable in all events, and, accordingly, not a qualifying power of appointment.

PLANNING TIPS: Even if you are not an attorney, you may be called upon to review a marital deduction document. Use the Davis decision to review and create quality-control checklist of "marital deduction" requirements. Be sure, if the client's intent is to obtain a marital deduction, that there is an "intent and savings clause" to help assure such a deduction.

DOMICLE ISSUES

JACK: Estate of Robert A. Jack, et al. v. United States; No. 01-410T (November 27, 2002); IRC Secs. 2001, 2031, 2101, and 2106; Anwo v. INS, 607 F.2d at 437,438 (D.C. Cir. 1979); United States-Canada Free Trade Agreement, Pub. L. No. 100-449, 102 Stat. 1851 (1988); Carlson v. Reed, 249 F.3d 876 (9th Cir. 2001).

RESULT: The Federal Court of Claims granted the IRS' motion for a partial summary judgment to determine whether Dr. Jack, a Canadian citizen employed in the United States on the date of his death, admitted to the United States under non-immigrant, temporary professional classifications, was legally capable of forming an intent to be domiciled in the United States for federal estate tax purposes. His original visa allowed for the temporary entry of certain types of Canadian professionals under the United States-Canada Free Trade Agreement of 1988. [NOTE: This "TC" status no longer exists and has been replaced by "TN Temporary Professional" status.]

The estate had argued that the intent to establish domicile by the holder of a TN Temporary Professional visa would be in direct violation of the terms of the visa and therefore such an intent would be an impossibility. And without domicile in the U.S. only the property owned by an alien at death and actually located in the U.S. is subject to federal estate tax. But the IRS claimed that the holder of a TN Temporary Professional visa is legally capable of forming the intent to be domiciled in the United States for federal estate tax purposes. And that was sufficient to cause estate tax inclusion of assets Dr. Jack owned in Canada.

PLANNING TIPS: Ascertain and/or confirm with EVERY client and his/her spouse their citizenship – and domicile intentions. Become conscious of the traps - and planning opportunities - for those who are not U.S. citizens or residents. Domicile is determined under state law and is usually based on the jurisdiction with which an individual has the most significant contacts.

Officials will examine many factors to determine a person's intent. Among them are size, nature, and location of residences (including those of family members), days spent here in U.S. , voting registration, place of business, filing of income tax returns, automobile registration, driver's license, social security information, credit cards, passport, bank and brokerage accounts, registration of personal property such as boats, and planes, club and religious memberships, and (given less credibility because they are self-serving but still factors that are examined), declarations of domicile and recitations in wills or deeds of trust.

GIFT TAX ISSUES

COSTANZA: Estate of Duilio Costanza, et al. v. Commissioner; 2003 FED App. 0055P (6th Cir.); No. 01-2207 ; February 19, 2003; Estate of Duilio Costanza v. Commissioner, T.C. Memo. 2001-128; Estate of Moss v. Comm'r, 74 T.C. 1239, 1247 (1981) (upholding the validity of a SCIN).

RESULTS: The Sixth Circuit held that a sale of SCINs (self-canceling installment notes) was a bona fide sale of property rather than an intra-family gift. It remanded the case back to the Tax Court to ascertain if any portion of the SCIN was a " bargain sale" and, therefore, partially a taxable gift.

PLANNING TIPS: When dealing with private annuities, installment sales, and self-canceling installment notes, it is extremely important that the terms and conditions of the agreement are adhered to and followed by both the buyer and the seller. Payments should be made in the amounts and at the times promised. If they are not, the seller should demand compliance. Professional advisors must create quality control and mechanical follow-through checklists and create and use an "action matrix" – making sure the parties dot their i's and cross their t's.

ARMSTRONG: Estate of Frank Armstrong Jr., et al. v. Commissioner; 119 T.C. No. 13; No. 1118-98 (Oct. 29, 2002); Estate of Frank Armstrong v. United States, No. 0-1305, 2002 WL 53914 (4th Cir. 2002); United States v. Frank Armstrong, Jr. Trust, 86 AFTR. 2d 2000-6674 (W.D. Va. 2000).

RESULTS: Armstrong held that Code Section 2035(c) requires the inclusion of federal gift tax on all transfers made by the decedent within three years of death, regardless of who pays the tax. (In this case, the recipients of gifts he made were required to and did pay gift tax). Yet the gift tax they paid was brought back into his estate for computational purposes. The Tax Court at least inferred that the federal estate tax does not require a "transfer" of property to impose the estate tax.

PLANNING TIPS: Carefully consider the implications of a provision requiring donees to pay tax on a gift. In spite of the hysteria over gifts within three years of death, a study of the actuarial tables (NumberCruncher will quickly compute the probabilities: 610-924-0515) show that, at almost any age, the chances of death within three years of a transfer are very small and a late-in-life transfer may well be worth the risk – particularly where otherwise includable life insurance is involved.

WELLS FARGO: Wells Fargo Bank New Mexico, et al. v. United States; No. 01-2212 (11 Feb 2003), Estate of Sanford v. Commissioner, 308 U.S. 39 (1939); Estate of Davenport v. Commissioner, 184 F.3d 1176 (10th Cir. 1999). Commissioner v. Wemyss, 324 U.S. 303, 306 (1945). Tres. Reg. § 25.2511-2(b).

RESULT: The taxpayer in the Wells Fargo case made a gift to a spouse but due to a technicality, marital deduction tests were failed and the gift was therefore entirely taxable. The taxpayer tried to avoid the consequences of the disallowance of the marital deduction by asserting that her intention was to obtain a marital deduction and failing that, she meant to make no gift. Arguing that no gift was effectively made under state law, her logic was that therefore, no gift tax can be assessed. Neither the IRS nor the court agreed. By creating an irrevocable life interest on behalf of her spouse, the donor/grantor completely parted with dominion over the transferred funds. Under federal law, that action - relinquishment of dominion and control of the asset/property - made the event taxable.

The Tenth Circuit Court of Appeals reversed the US District Court (which had held the event giving impetus to the tax was an incomplete transfer under New Mexico law; thus, no gift took place, and the Estate owed no federal gift tax) and held that the imposition of the gift tax is dependent on federal tax statutes, and not state law.

PLANNING TIPS: The case would never have occurred had a single box on a single form been checked. Details, details, details. All professionals should establish a quality control checklist for all elections and other time sensitive actions. Consider an "Action Matrix" approach.

HACKL: Christine M. Hackl, et vir v. Commissioner; 118 T.C. No. 14, aff'd, Nos. 02-3093 and 02-3094 (7th Cir. July 11, 2003); Estate of Cristofani v. Comm'r, 97 T.C. 74 (1991); Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968); Kieckhefer v. Comm'r, 189 F.2d 118 (7th Cir. 1951); Gilmore v. Comm'r, 213 F.2d 520, 522 (6th Cir. 1954); Md. Natl. Bank v. United States, 609 F.2d 1078, 1080-1081 (4th Cir. 1979).

RESULT: The Seventh Circuit affirmed the Tax Court's conclusion that the Hackls' outright gifts of interests in an Indiana LLC failed to qualify for the federal gift tax annual exclusion. The result was a federal gift tax deficiency of over $600,000.

PLANNING TIPS: Contrary to many planner's expectations, two courts have now held that a mere outright gift of a FLP or LLC interest will not automatically obtain an annual exclusion. Don't expect an annual exclusion if donees don't have the ability to freely sell or give away the LLC units or to compel distributions from the entity. Clients who want an annual exclusion (and not all do) must either avoid or eliminate restrictions in an FLP or LLC operating agreement that make it impossible for the donee children and/or grandchildren to obtain any immediate economic benefit. So donees must be able to (1) unilaterally cash in their interest, or (2) sell their units without approval, or (3) force a dissolution of the entity. Planners should consider (1) a 60-day window for free transferability, or (2) give the donees a temporary "put" under which the buyback price is the fair market value of the units. The FLP could borrow money to carry out the buyback, or distribute assets in kind.

QPRTS

IRS SAMPLE QPRT FORM: Revenue Procedure 2003-42.

RESULT: In Revenue Procedure 2003-42, published in the Internal Revenue Bulletin 2003-23 dated June 9, 2003, the Internal Revenue Service issued an annotated sample declaration of trust and alternative provisions designed to meet the requirements of Code Section 2702(a)(3)(A) and Reg. Sec. 25.2702-5(c).

PLANNING: Planners should use the new IRS form – but only as a starting point for customized QPRTs. It's best to customize rather than use the IRS form (as is), since there are invariably key provisions that are appropriate or necessary to a client's particular situation that the IRS form does not contain.

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