Proskauer

Wealth Management Update

November 2017

November Interest Rates for GRATs, Sales to Defective Grantor Trusts, Intra-Family Loans and Split Interest Charitable Trusts

The November § 7520 rate for use with estate planning techniques such as CRTs, CLTs, QPRTs and GRATs is 2.4%, up from 2.2% in October. The November applicable federal rate (AFR) for use with a sale to a defective grantor trust, self-canceling installment note (SCIN) or intra-family loan with a note having a duration of 3-9 years (the mid-term rate, compounded semiannually) is 1.99%, up from 1.84% in October.

Despite the recent uptick, the still relatively low § 7520 rate and AFRs continue to present potentially rewarding opportunities to fund GRATs in November with depressed assets that are expected to perform better in the coming years.

The AFRs (based on semiannual compounding) used in connection with intra-family loans are 1.38% for loans with a term of 3 years or less, 1.99% for loans with a term between 3 and 9 years, and 2.58% for loans with a term of longer than 9 years.

Thus, for example, if a 9-year loan is made to a child, and the child can invest the funds and obtain a return in excess of 1.99%, the child will be able to keep any returns over 1.99%. These same rates are used in connection with sales to defective grantor trusts.

IRS May Audit Estate of First Spouse to Die if Survivor's Estate Tax Return Reflects Portability Election *Estate of Sower v. Commissioner*, 149 T.C. No. 11 (September 2017)

Frank Sower died in 2012. His estate filed an estate tax return, in which a deceased spousal unused exclusion (DSUE) was reported, and portability of that DSUE was elected. The IRS accepted the return as filed, and provided Frank's estate with an estate tax closing letter. Frank's wife, Minnie, died in 2013. Her estate claimed the unused DSUE reported by Frank's estate in filing and paying her estate tax. Minnie's estate was audited, and as part of the process, Frank's estate was examined, due to the fact that Minnie's return reflected portability of the DSUE. In examining Frank's estate, it was determined that Frank's unused DSUE was lower than expected, and that as a result, Minnie's estate had an estate tax deficiency. Minnie's estate challenged this finding on the basis that the IRS should not have been allowed to examine Frank's estate.

Code Section 2010(c)(5)(b), enacted in 2010, gives the IRS the power to examine a predeceased spouse's return and adjust the DSUE without regard to the statute of limitations in Code Section 6501. An exception to this power exists however, in cases where the first spouse's estate is audited.

Minnie's estate argued that the IRS was estopped from examining Frank's estate, because the estate had already been examined, and the estate tax return accepted and approved, as evidenced by the estate tax closing letter received in connection with Frank's estate tax return.

The Tax Court however rejected the argument that an estate tax closing letter is a closing agreement between the IRS and the estate concluding any examination. In doing so, it stated that the issuance of a generic estate tax closing letter does not estop the IRS from examining the return of the predeceased spouse. What's more, estate tax closing letters, including the one issued to Frank's estate, included language advising that the estate could be reopened for examination for any valid reason.

The court similarly rejected the argument posed by Minnie's estate that an examination of Frank's estate constituted a "second examination" by the IRS, as Frank's estate was not audited. The opinion expresses that absent an actual audit of Frank's estate, there was no "first examination" until the one initiated in light of Minnie's estate claiming Frank's estate's unused DSUE.

The Court further held that Minnie's estate only had standing to argue the validity of examinations of Minnie's estate, not Frank's estate.

In this case, both spouses died after the enactment of Code Section 2010(c)(5)(b) in 2010. However, it is worthwhile to note that the Tax Court's opinion in this case makes mention that only the survivor need to have died after the enactment of Code Section 2010(c)(5)(b) to enable the IRS to examine the estate of the first spouse to die.

Finally, the Court held that the period of limitations on assessment of tax for the estate of the predeceased spouse is not implicated if there was no determination of estate tax deficiency for the estate of the predeceased spouse.

IRS Tax Liens Trump Reasonable Administration Expenses of Estates *In re: Estate of Simmons*, 120 AFTR 2d 2017-5368 (July 2017)

Frederick Alan Simmons died on June 5, 2014. His surviving spouse and personal representative, Raelinn M. Spiekhout, opened a probate estate in their home state of Indiana. Upon the opening of the estate, several claims were filed against the estate for a total of $1,812,622, one of which was a $591,406 claim by the IRS for unpaid federal income taxes and trust fund recovery penalties. The personal representative did not serve notice on the U.S. in accordance with 28 USC 2410(b) so as to trigger a 30 day period allowing removal to federal court. The main asset of the estate was a piece of real property. The surviving personal representative sought and was granted permission from the court, and successfully sold the property for $275,000, receiving a net payout of $245,766 after payments of commissions and other fees. The probate court would eventually issue an order closing the estate as insolvent, and directing distribution of estate assets, which were essentially the proceeds from the sale of the property. This distribution listed the federal tax lien as seventh in priority among creditors of the estate.

Shortly thereafter, the U.S. removed the state court action to district court, challenging the probate court's decision with regard to the priority of the federal tax lien against the estate. The personal representative then filed a motion for a hearing to determine claim priorities. The court, relying on the Federal Tax Lien Act (Code Sections 6321-6323) held the federal government had priority over all claims, including any claims for fees or reimbursement of costs by the personal representative. The personal representative challenged this holding noting that (1) the judge improperly relied on the Federal Tax Lien Act, and not the Federal Priority Statute, in determining priority of claims, and (2) without her efforts, the property would not be sold, and the estate would be completely insolvent. The personal representative did not argue that the federal government took priority over other claims (instead of being seventh in line as the probate court determined) but rather took the position that she was entitled to compensation for her expenses before making payment to other creditors.

On appeal, the court acknowledged that generally, the Federal Priority Statute is appropriate for determining priority of claims against an estate, and that further, generally, ordinary expenses of administration of an estate, like the ones incurred by the personal representative, would be paid, regardless of what other claims existed. However, the court cited, and based its ruling upon *U.S. v. Romani* (S. Ct. 1998), which held that the Federal Tax Lien Act, and not the Federal Priority Statute applies when determining order of payments of claims when dealing with insolvent estates of delinquent taxpayers. Thus, in light of the estate being insolvent, the Federal Tax Lien trumped all claims, including those in connection with the expenses incurred in the administration of the estate.

The court further held that the personal representative's efforts and costs are irrelevant where the federal government takes priority as determined by the Federal Tax Lien Act.

Estate Tax Deduction Unavailable for Unpaid Gift Tax on Net Gift *Estate of Sommers v. Commissioner,* 149 T.C. No. 8 (August 2017)

Sheldon Sommers made gifts to his nieces, Wendy, Julie and Mary Lee, within approximately one year of his death. These gifts were contingent upon an agreement that each niece would pay the gift tax associated with her gift. Sheldon's surviving spouse / executor, Bernice Sommers, filed motions of summary judgment seeking determinations that (1) the gift tax owed on death for these gifts was deductible, (2) that the estate was entitled to a marital deduction equal to Sheldon's non-probate estate, given that under New Jersey state law, such was exempt from debts and expenses of the estate (including the aforementioned payments of gift tax) and (3) that any federal estate tax due must be apportioned among the nieces, as recipients of these gifts, so as to not reduce the estate's marital deduction. The Tax Court held against Bernice on all three counts.

The court found that as the nieces' payment of the decedent's gift tax liability would have given rise to a claim for reimbursement from the nieces under the agreements governing the gifts, the gift tax owed on those gifts at death was found to not be deductible.

The court further determined that as the actual marital deduction turns on the question of the extent to which assets otherwise exempt from claims against the estate are used to pay estate debts and expenses, the motion regarding the effect of debts and claims on the marital deduction was also without merit, and thus was similarly denied.

Finally, because New Jersey state law does not allow apportionment of estate tax liability among any other individuals, the court also denied the surviving spouse's motion to apportion estate tax liability among nieces.

Conveyance of Home from Taxpayer to Parents Determined to be Part Sale and Part Gift *Fiscalini v. Commissioner,* T.C. Memo 2017-163 (August 2017)

In 1993, Robert Fiscalini, along with his parents, purchased a home for $274,312. Mr. Fiscalini contributed $234,312 of this amount, and his parents paid $40,000 in cash. Ten years later, Mr. and Mrs. Fiscalini transferred their interest in the home to their son, Robert, gratuitously, and without consideration. Over the next four years, Robert Fiscalini made several improvements to the home, using resources from his construction business, and also refinanced the house several times. In 2007, the mortgage owed was up to $664,048, and the Robert had fallen behind on his mortgage payments. In an effort to avoid foreclosure, he sold the house back to his parents. The closing statement showed that the total consideration was $975,000, which consisted of his parents paying off the mortgage balance on one hand, and Robert making a gift of his equity interest in the property, valued at $295,655, to his parents.

Robert did not file or pay taxes on the sale of the home on his 2007 return, because he did not have the funds to do so. He finally did so however, in 2013. Upon receipt of this very late filing and payment, in addition to levying failure to file and failure to pay penalties, the IRS sought determinations on the amount realized by the sale, and Robert's basis, arguing that Robert had underreported his amount recognized by $335,655, which included the $295,655 listed on the closing statement as the portion of this house gifted to his parents, and the $40,000 value of the portion of the house previously gifted to him by his parents. A further underreporting was alleged in connection with the additions to his basis in the property resulting from his reported improvements.

The Tax Court agreed with Robert's argument that the $40,000 value of the parents' gift to him of their interest in the house should be included in his basis, thus elevating such basis to the initial total purchase price of $274,312. The court, however, declined to accept the inclusion of his improvement costs in the house, as he was unable to present any sort of evidence of cost or payment, beyond anecdotal evidence. This is likely due to the fact that the he used resources from his own construction business to make the improvements, and seemingly did not keep track of his expenses.

The Tax Court did however also agree with Mr. Fiscalini regarding his amount realized. While the IRS argued that the amount realized was the full $975,000 shown in the closing statements, the Tax Court ruled that the transaction was actually part gift and part sale, and thus, Mr. Fiscalini's amount realized was limited to the portion actually sold, and not gifted, to his parents.

Determination that Inappropriate Method Was Used in Valuing Hunting Trophies Donated to Charity Results in Significant Reduction of Charitable Deduction *Gardner v. Commissioner*, T.C. Memo 2017-165 (August 2017)

This case begins "To paraphrase Ernest Hemingway, there is no hunting like the hunting for tax deductions." Paul Gardner, an avid big game hunter, decided in 2006 to downsize his substantial collection of hunting trophies by donating many of his less desirable specimens to the Dallas Ecological Foundation. This donation consisted of mounted animal heads, skulls, antlers, skins and hides, etc. Relying on an appraisal, he claimed a charitable deduction of $1,425,900, which he was able to carry forward into 2007 and 2008. The IRS selected his 2006, 2007 and 2008 returns for examination, and determined that the value of the specimens were at most $163,045. The IRS accordingly determined a total deficiency of $411,875.

The appraiser and the IRS had such disparate valuations because the appraiser used a replacement cost valuation method, while the IRS used a comparable sales valuation method. The question of which valuation method was appropriate to use would turn on the quality and rarity of the specimens. If the specimens were indeed rare and/or high quality, the appraiser's replacement cost system would be appropriate, whereas if the specimen were found to be ordinary, for lack of a better word, the comparable sales model would be appropriate.

The IRS referred to record books maintained by certain hunting organizations, which provide guidelines as to the quality of a hunting trophy based on scoring systems, including the animal's size or other features, as well as any other unusual provenance. These record books only list animals whose features or provenance would score exceptional ratings. Mr. Gardner donated 177 specimens in all, none of which were found to be "record book" quality. The Tax Court notes that of his entire collection, only three trophies were record book quality, and none of those were donated.

The Appraiser, however, still used the replacement cost method, taking the position that the costs reflected in his report were Mr. Gardner's likely costs of travelling to find, killing, transporting back to the U.S., and mounting or otherwise preparing a specimen. For instance, one Central Asian sheep's skin was valued at $75,600.

It turns out that after accepting the donation, the Dallas Ecological Foundation put all of the items into storage, and eventually dispersed them all, selling or donating the same. As such, no experts were able to testify at trial as to the quality of the specimens.

After the IRS conducted its own valuation using comparable sale valuation, it determined that Mr. Gardner's tax liability would not increase for 2006, as it would be covered by the deduction they calculated, but would increase significantly for each of 2007 and 2008.

The Tax Court agreed with the IRS, finding, absent physical evidence of the specimens actually donated, that given the presumed quality/rarity of the specimens, that Mr. Gardner was only entitled to use the comparable sales valuation method.

Withdrawal of Proposed § 2704 Regulations

As a result of Executive Order 13789 which set its sights on regulations, the Treasury Department has announced the withdrawal of the proposed § 2704 Regulations, which were designed to curtail valuation discounts on interests in family-controlled entities, due to the owners' limitations over control/alienability of these interests.

Announcement of 2018 Unified Estate and Gift Tax Exclusion Amount, Generation-Skipping Transfer Tax Exemption and Gift Tax Exclusion

The 2018 Exception and Exclusion amounts are expected to be officially announced by the IRS shortly.

The unified estate and gift tax exclusion amount, as well as the GST tax exemption are both expected to be $5,600,000, up from $5,490,000.
The gift tax annual exclusion amount is expected to be $15,000, up from $14,000.

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