Current Issues in Estate and Gift Tax Audits and Litigation

National Association of Estate Planners & Councils

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Anticipate the Dispute

- **Prepare for the audit at the planning stage**
- **Common IRS challenges**
  - Valuation
  - Formula transfers
  - Installment sales to intentionally defective grantor trusts
  - Split-dollar life insurance
  - GRATs
  - S corporation valuation
  - Section 2036
  - Penalties
  - Ahmanson Foundation/Warne

Prepare for Audit

- **Anticipate your potential audience at the planning stage**
- **IRS issues broad requests**
  - "All documents relating to the creation of the entity from any attorney, accountant or firm involved in recommending the creation of the entity."
- **Understand and preserve all privileges**
  - Attorney-client privilege
  - Work product immunity
  - Tax practitioner's privilege
- **Your files could be subpoenaed — including emails**
- **You might have to testify about reasons for creating entity**
- **Help your client — best evidence of non-tax reasons comes from contemporaneous correspondence (*see Stone*, *Schutt*)**
- **Okay to discuss tax attributes, but talk about non-tax attributes and reasons too (*see Stone*, *Schutt*, *Mirowski*)**

Relevant Valuation Decisions

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
Strangi I (2000)	securities	Tax	31%
Knight (2000)	securities/real estate	Tax	15%
Jones (2001)	real estate	Tax	8%; 44%
Dailey (2001)	securities	Tax	40%
Adams (2001)	securities/real estate/minerals	Fed. Dist.	54%
Church (2002)	securities/real estate	Fed. Dist.	63%
McCord (2003)	securities/real estate	Tax	32%
Lappo (2003)	securities/real estate	Tax	35.4%
Peracchio (2003)	securities	Tax	29.5%
Deputy (2003)	boat company	Tax	30%
Green (2003)	bank stock	Tax	46%
Thompson (2004)	publishing company	Tax	40.5%
Kelley (2005)	cash	Tax	32%
Temple (2006)	marketable securities	Fed. Dist.	21.25%
Temple (2006)	ranch	Fed. Dist.	38%
Temple (2006)	winery	Fed. Dist.	60%
Astleford (2008)	real estate	Tax	30% (GP); 36% (LP)
Holman (2008)	Dell stock	Tax	22.5%
Keller (2009)	securities	Fed. Dist.	47.5%
Murphy (2009)	securities/real estate	Fed. Dist.	41%
Gallagher (2011)	publishing company	Tax	47%
Koons (2013)	cash	Tax	7.5%
Richmond (2014)	marketable securities	Tax	46.5% (37% LOC/LOM & 15% BIG)
Giustina (2016)	timber company	Tax	25% LOM
Streightoff (2018)	marketable securities	Tax	18% LOM
Grieve (2020)	marketable securities	Tax	35% (98.8% non-vot. LLC int.)
Nelson (2020)	equipment co.	Tax	40.5% (stock); 31.6% (LP)

Formula Transfers

- **Potential Benefit — Allows transferor to define the dollar value of hard-to-value assets passing to taxable transferees**
- **Types of formula clauses:**
  - Defined value clause based on values "as finally determined for estate/gift tax purposes" (*Christiansen*, *Petter*, *Wandry*)
  - Defined value clause (*McCord*, *Hendrix*)
  - Price adjustment clauses (*King*)
  - Reversion clauses don't work (*Procter)*

Formula Language – It Matters!

- ***Wandry*** – "I hereby transfer to _____ that number of shares of the Company with a fair market value as finally determined for federal gift tax purposes equal to $ [specific dollar amount]."

- ***Petter*** – "I hereby transfer 100 shares of the Company to [taxable transferee] and [charity/QTIP/GRAT] to be allocated between the transferees as follows: (1) that number of shares with a fair market value as finally determined for federal gift tax purposes equal to $ [specific dollar amount] to [taxable transferee]; and (2) the remainder of the shares to [charity/QTIP/GRAT].

- ***King*** – "I hereby sell 100 shares of the Company in exchange for a promissory note with a principal amount of $_[X]_ (which the parties believe to be equal to the fair market value of the shares). The term of the promissory note shall be [add note terms/interest]. If the fair market value of the shares as finally determined for federal gift tax purposes is greater or less than $[X], the principal amount of the note shall be adjusted to the finally determined value effective as of the date of the transfer. The parties intend for the sale to be at fair market value and that no gift result from the sale."

Nelson v. Commissioner, T.C. Memo. 2020-81 (June 10, 2020)

- Formula clause and valuation
- Memorandum of gift stated:

  [Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

- Memorandum of sale stated:

  [Mrs. Nelson] desires to sell and assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment * * *.

- No definition of FMV or requirement to reallocate value

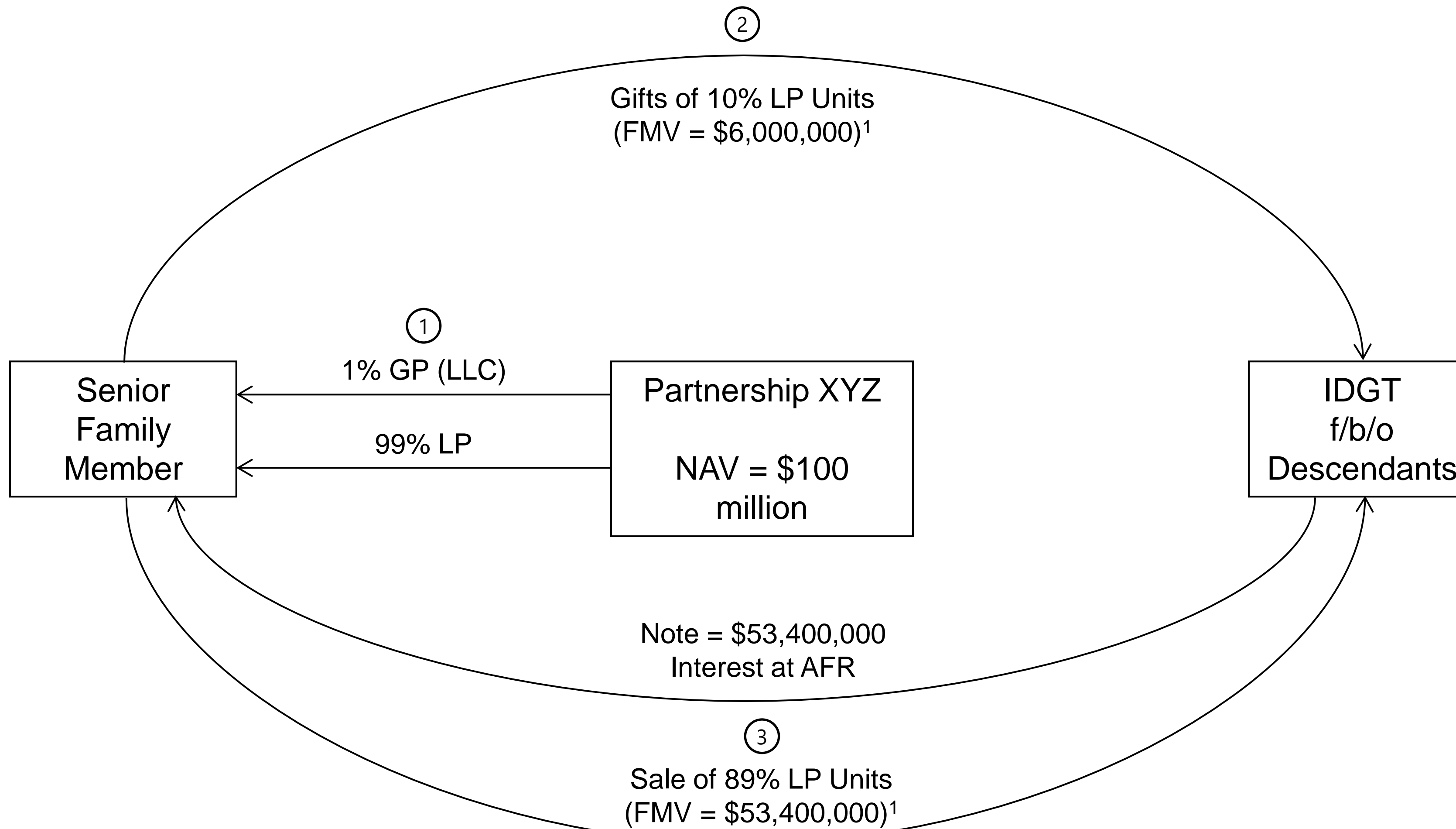
Nelson v. Commissioner

- Gift tax return reported the gift as "having a fair market value of $2,096,000 as determined by an independent appraisal to be a 6.1466275% limited partner interest" in the company
- Did not report sale on a gift tax return
- Taxpayer's position -- transferred LP interests with value of $2,096,000 and $20,000,000, based on values as finally determined (*Wandry/Petter*)
- IRS's position -- transferred 6.14% and 58.65% LP interests
- Tax Court -- "the clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes" (citing *Christiansen* and *Petter*)
  - "[U]nlike the clause in *Succession of McCord*, 'fair market value' here already is expressly qualified....
  - Petitioners ask us, in effect, to ignore 'qualified appraiser within [a fixed period]' and replace it with 'for federal gift and estate tax purposes.'
  - While they may have intended this, they did not write this.
  - They are bound by what they wrote at the time.... [W]e conclude that Mrs. Nelson transferred 6.14% and 58.35% of limited partner interests...."

Potential Donees of the "Excess Amount" Under *Petter* Style Formula Clause

1) **Public Charity/Donor Advised Fund**
    - Independent fiduciary obligation
    - Subject to private inurement and excess benefit rules
    - *McCord*, *Hendrix*, *Petter*
2) **Private Foundation**
    - Self-dealing, excess business holdings and other rules make it difficult
3) **Lifetime QTIP**
4) **GRAT**
5) **None? — *Wandry***
6) **Consideration Adjustment? — *King***

Installment Sales to IDGTs



[1] Assume LOC/LOM discount = 40%. FMV per 1% = $600,000

Potential Benefits
1. Freeze transfer tax value at FMV of LP units
2. No capital gains tax on sale to IDGT
3. Grantor pays income tax on IDGT income

Installment Sales – Issues

1) **Gift Tax Issues**
    - FMV of interest sold
        - Step transaction/*Pierre* issue
    - FMV of consideration received
        - Valuation of note – Is § 7872 a safe harbor (or just an interest rate safe harbor)?
2) **Estate Tax Issues**
    - 2036/2038 with respect to interest sold
        - *Pierre* issue/adequate and full consideration?
        - Payment of note
    - *Woelbing/Beyer* cases

Split-Dollar Life Insurance – *Morrissette v Commissioner*, T.C. Memo 2021-60

- In 2006, the decedent set in motion a plan to pass family stock in a closely-held moving company to her sons.
  - The decedent made her sons trustees of her revocable trust.
  - She created three dynasty trusts – one for each of her sons. The shareholder agreements provided that the trusts would purchase the stock held by each of the brothers when one of them died. To fund the buyouts, each trust would secure a life insurance policy on the lives of the two other brothers. The decedent arranged to pay all the projected premiums for the policies in lump sums sufficient to maintain them for her son's life expectancies (14 to 18 years).
- The trusts entered into split-dollar agreements under which the revocable trust would be reimbursed for the greater of $30 million of premiums it advanced or the cash surrender value of the policy at the earlier of (i) the termination of the agreement, if the trusts agreed; or (ii) the insureds' death.
- Sons had a difficult time getting along and parents wanted them to continue the business with equal ownership.
- Decedent owned split-dollar rights a death in 2009; estate tax return valued at $7.5 million.
- IRS asserted §§ 2036, 2038, and 2703.

Split-Dollar Life Insurance – *Morrissette v. Commissioner*

- **2036(a)(2)/2038(a)(1) holding:**
  - Clara had a legitimate and significant nontax purpose for entering into the split-dollar agreements. The arrangement sought to ensure management succession in the Morrissette family business, which has long been held to constitute a legitimate and significant nontax purpose.
  - Neither the policies' cash surrender values nor the premiums paid were included in the gross estate under §§ 2036 or 2038.

- **2703 holding regarding split-dollar rights:**
  - The provisions of the agreements that prevented the decedent from immediately withdrawing her split dollar investment were not disregarded under § 2703 when valuing the decedent's rights under the agreements. The split-dollar agreements had business purpose, were not a way to transfer property for less than full and adequate consideration, and were comparable to agreements entered into in arm's-length transactions in light of the brothers' acrimonious relationships and disputes regarding the company. *Compare* to *Cahill*.

Split-Dollar Life Insurance – *Morrissette v. Commissioner*

- **Valuation holding:**
  - Primary issues affecting value were (1) the data to be used to derive the present value discount rate, and (2) the assumptions regarding early termination.
    - Court rejected life-settlement yields in favor of the debt yields of insurance companies to determined present value discount rate.
    - Court adopted termination assumption 4.5 years from the valuation date rather than life expectancy of insured because the family and advisors has discussed cancelling certain policies, advisor insisted the policies not be cancelled until three years after estate tax limitations period expired, and brothers had complete control over the arrangement.
- **Penalty holding:**
  - Reasonable cause defense of § 6664(c)(1) did not apply.
    - Legal advice defense waived by asserting the attorney client privilege.
    - Reliance on the appraisal filed with the estate tax return not reasonable because (1) the $7.5 million appraised value was not reasonable given that the brothers had paid $30 million for the split-dollar rights, (2) the insurance agent and the estate planning attorney marketed the arrangement as an estate tax savings strategy whose benefits would be obtained through "undervaluation" of the split-dollar rights at a substantial discount, and (3) the attorney (i) recommended the appraiser and (ii) asked the appraiser to make changes to the report that reduced the values.

Split-Dollar Life Insurance – *Levine v Comm'r*, 158 T.C. No. 2 (February 28, 2022)

- In 2008,
  - The decedent created a life insurance trust (signed by her three attorneys-in-fact) and South Dakota Trust Company as the independent/directed trustee. The beneficiaries were the decedent's children and grandchildren. The trust's "investment committee" consisted of a family business advisor who also served as one of her attorneys-in-fact.
  - The insurance trust purchased life insurance on the decedent's daughter and husband. To pay the $6.5 million premiums, the insurance trust borrowed most of the funds through a split-dollar arrangement.
  - Under the split-dollar agreements:
    - The decedent's revocable trust loaned the funds to pay the premiums.
    - The insurance trust assigned the policies to the revocable trust as collateral for the split-dollar loans.
    - The revocable trust would be repaid greater of (i) $6.5 million of premiums paid, and (ii) either (a) the current cash-surrender value of the policies upon the death of the last surviving insured, or (ii) the cash-surrender values of the policies on termination, if before the death of both insureds.
  - Key Fact -- ***Only*** the insurance trust (through the "investment committee") could terminate the life insurance.
- Decedent owned a split-dollar receivable at her death in 2009; estate tax return value of $2 million.
- IRS asserted §§ 2036 and 2038 (to include the cash surrender value) and § 2703 (with respect to the value of the split-dollar receivable).

Split-Dollar Life Insurance – *Levine v. Commissioner*

- **2036(a)(2)/2038(a)(1) holding:**
  - The decedent did not have a right, alone or in conjunction with any other person, to terminate the policies or receive the cash surrender value of the polices because only the irrevocable trust had that right.
  - The insurance trust was irrevocable; the decedent had no right to change, modify, amend or revoke it.
  - Neither the policies' cash-surrender values nor the premiums paid were included in the gross estate under § § 2036 or 2038.

- **2703 holding regarding split dollar receivable:**
  - The IRS argued that the split-dollar agreements constituted a restriction on the decedent's right to obtain the $6.5 million of cash advanced to the insurance trust under the split-dollar agreements.
  - The court opined that § 2703 only applies to property interests held by the decedent at the time of death, which was a split-dollar receivable.
  - Since there were no restrictions on the split-dollar receivable, § 2703 did not apply.

GRATS

- **Terms Comply with § 2702 Regs?**
- **GRAT operated in accordance with terms?**
    1) Substantiation of annuity payments
    2) *Atkinson* analysis – CCA 202152018
- **Valuation**
    1) Initial transfer of assets (*see Grieve v. Comm'r*, T.C. Memo 2020-28)
    2) Exercise of power of substitution
    3) Use of hard to value asset to pay annuity
    4) Consider *Wandry* or *King* provisions for 2 & 3

Tax Affecting S Corporation Cash Flows

- Should S Corporation cash flows be reduced by corporate level taxes in a discounted cash flow ("DCF") analysis?
- Numerous cases say no, unless taxpayer can demonstrate the fact that shareholder level taxes affect the value of the shares. *See, e.g., Gross v. Comm'r*
- S Corporation Job Aid for IRS Valuation Analysts says "absent a compelling showing that unrelated parties dealing at arms-length would reduce the projected cash flows by a hypothetical entity level tax, no entity level tax should be applied in determining the cash flows of an electing S Corporation"
- If tax affecting cash flows of an S Corp, appraisal needs to address the reasons for adjusting for taxes and any benefit/detriment to S Corp status
- Research demonstrates that shareholder level taxes affect the value of the shares. *See,* N. Fannon and K. Sellers, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle*
- Tax affecting allowed in *Estate of Jones v. Comm'r* and *Kress v. United States*
- Tax affecting not allowed in *Estate of Jackson v. Comm'r* because the Estate's experts (1) did not persuade the court that a taxpaying entity would be the likely hypothetical buyer of the assets at issue, (2) did not consider the tax detriments and benefits of pass-through status, and (3) the Estate's expert disagreed on the appropriate tax rate.

Section 2036 - Most Litigated Issue

- **Section 2036 provides that:**

  General Rule —The value of the gross estate shall include the value of all property to the extent of any interest therein of which *the decedent has at any time made a transfer* (except in case of *a bona fide sale for an adequate and full consideration* in money or money's worth), by trust or otherwise, *under which he has retained* . . .

  (1) *the possession or enjoyment of, or the right to the income from, the property*, or

  (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom

- **Ramifications — If IRS successful, all assets of entity might be brought back into estate**
  - Even if interests in partnership transferred during life (*Harper*, *Korby*)
  - Marital or charitable deduction may not be applicable (*Turner*)
  - Double counting potential (*Powell*)

Bona Fide Sale for Adequate and Full Consideration Exception

- **Two part test:**

  (1) Adequate and Full Consideration — Interests proportionate and value of contributed property credited to capital accounts

  (2) Bona fide Sale — "Significant and legitimate non-tax reason" for creating the entity

  Case-by-case analysis:

  - Centralized asset management (*Stone*, *Kimbell*, *Mirowski*, *Black*)
  - Involving next generation in management (*Stone*, *Mirowski*, *Murphy*)
  - Protect from creditors/failed marriage (*Kimbell*, *Black*, *Murphy*, *Shurtz*)
  - Preservation of investment philosophy (*Schutt*, *Murphy*, *Miller*)
  - Avoiding fractionalization of assets (*Church*, *Kimbell*, *Murphy*)
  - Avoiding imprudent expenditures by future generations (*Murphy*, *Black*)

2036(a)(2) - Retained Right to Designate Persons Who Will Possess or Enjoy Assets Contributed or Income From Assets

- ***Strangi, Turner, Cohen***
- **Investment powers not subject to § 2036(a)(2) (*Byrum v. U.S.*)**
- **Distribution powers?**
  - *Cohen/Byrum* — "If the agreement may be said to give the trustees unlimited discretion . . . , so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would constitute a 'right' under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such 'rights' exists."
- **Should senior family member be general partner?**
  - How about co-general partner?

2036(a)(2) - *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017)

- **2036(a)(2) holding:**
  - Section 2036(a)(2) applied because (1) the decedent, in conjunction with the other partners, could dissolve the partnership, and (2) the decedent, through her son as the GP and as her agent, could control the timing and amount of distributions
- **Potential Ways to Avoid Powell § 2036(a)(2) holding :**
  - Satisfy bona fide sale test
  - Create two classes of interests
    - One with vote on dissolution/amendment
    - One without vote on dissolution/amendment
  - Senior family member disposes of all interests in entity more than three years before death (does bona fide sale for full consideration of interest avoid 3-year rule [§ 2035(d)]?)
  - Terminate entity more than three years before death (potential income tax issues)

Substantial Estate or Gift Tax Valuation Understatement Penalties (§ 6662 (g) & (h))

- Substantial valuation understatement -- value of item reported is 65% or less than finally determined value (20% penalty)
- Gross valuation understatement -- value of item reported is 40% or less than finally determined value (40% penalty)
- Reasonable cause exception in § 6664(c) requires taxpayer to act in "good faith" and "with reasonable cause" in reporting the value
  - Reasonable reliance on professional advice qualifies. Treas. Reg. § 1.6664
  - Relying on appraisal may or may not be "reasonable." *Compare Estate of Richmond v. Comm'r*, T.C. Memo 2014-26 (February 11, 2014) and *Litman et. al. v. United States*, 326 F.3d 1268 (Fed. Ct. 2008)
  - *Morrissette v. Comm'r*, T.C. Memo 2021-60, is instructive
    - Legal advice defense waived by asserting attorney client privilege
    - Reliance on appraisal not reasonable because (1) $7.5 million appraised value not reasonable given $30 million paid for split dollar rights, (2) professionals marketed benefits to be obtained by “undervaluation” of rights at substantial discount, and (3) attorney asked for changes to report that reduced value

Ahmanson Foundation/Warne - Avoiding the charitable/marital gross estate mismatch

- *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981)
  - Decedent owned (through a revocable trust) a corporation that had 100 shares. Only one of those shares was a voting share; the remaining 99 shares were nonvoting. The decedent bequeathed the one voting share to his son and the 99 nonvoting shares to a charitable foundation.
  - Gross estate value based on value of all 100 shares of the corporation.
  - Charitable deduction based on value of the non-voting shares received by the charity, which included discounts for lack of control and lack of marketability -- "when valuing charitable contributions, we do not value what an estate contributed; we value what the charitable organizations received."
- *Estate of Warne v. Commissioner*, T.C. Memo 2021-19 (Feb. 18, 2021)
  - 100% of Royal Gardens, LLC included in decedent's gross estate.
  - 75% passed to family foundation; 25% passed to a church.
  - Relying on *Ahmanson Foundation*, court held that "the estate may deduct only the 25% and 75% interests received by the respective charities."