Estate Planning Update

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Estate and Gift Tax Legislation

1. Senators still seeking compromise, but no longer on front burner

2. Still tension among:

- Lincoln-Kyl Provision — $5 million exemption, 35% rate, phase-in? [$253 + $60 billion cost]
- House version (2009 system) [$253 billion cost]
- Something with higher taxes than 2009 system (Example, S. 3533: $3.5 million exemption, rates up to 65%, valuation discount restrictions)

3. Timing

4. Retroactivity — higher likelihood of election between estate tax and carryover basis as we get later in the year

Estate and Gift Tax Legislation

5. GRATs — 10-year minimum term (In at least 6 different bills; Senate not likely to include in anything other than estate and gift tax legislation)

- H.R. 4849, "Small Business and Infrastructure Jobs Tax Act of 2010," passed House 3/24/2010;
- H.R. 5297, "Small Business Jobs Relief Act of 2010," passed House 6/15/2010 (but not included in the Senate counterpart to this House bill);
- H.R. 4899, "Supplemental Appropriations Act of 2010," passed House 7/1/2010;
- S.B. 3533, "Responsible Estate Tax Act of 2010," introduced in Senate 6/24/2010;
- S.B. 3548, "Extend COBRA Premium Assistance Program Act of 2010," introduced in Senate 6/29/2010; and
- H.R. 5764, "Responsible Estate Tax Act," (very similar to S.B. 3533) introduced in House 7/15/2010.

Estate and Gift Tax Legislation

6. GST proposal to limit exempt status to two generations

a. Letters from Professors Alexander, Langbein, and Waggoner and attorney Raymond H. Young to Treasury Department urging Congress, *in current estate and gift tax legislation discussions*, to impose two-generation limit on exempt trusts

b. GST "loophole" has arisen because states have changed laws to have very long perpetuities periods. GST tax laws assumed state laws would present outer limit on exemption. This has created a lure for states to adopt long perpetuities periods.

c. American Law Institute in May 2010 proposed two-generation limit on perpetuities (i.e., trust must terminate at death of youngest beneficiary who is no more than two generations younger than settlor)

d. Staff of Joint Committee on Taxation several years ago proposed that taxpayers could not allocate GST exemption to "perpetual dynasty trusts" (i.e., trusts with a beneficiary more than two generations below settlor)

e. Possible approaches: Invalidation approach (Staff of Joint Committee on Taxation approach) or Expiration approach

§ 2036; Gift of Fractional Interest to Co-Occupant

***Estate of Margot Stewart v. Commissioner*, 106 AFTR 2d 2010-XXXX (2d Cir. August 9, 2010), vacating and remanding, T.C. Memo. 2006-225 (2006)**

Facts

1. Decedent and son co-owned East Hampton rental property and Manhattan property (two residential floors where decedent and son lived and three rental floors)
2. Either decedent or son would receive rents from East Hampton property and evenly split income every several months
3. October 1999, decedent met with planner about giving part of Manhattan property to son. Planner's notes: decedent said "to give son one-half of building and rent."
4. January 2000, decedent diagnosed with pancreatic cancer
5. May 2000, decedent deeded 49% of Manhattan property to son (not recorded until after her death)

§ 2036; Gift of Fractional Interest to Co-Occupant

Facts (cont'd)

6. May-November 2000, decedent and son continued to live on two bottom floors; three top floors rented and decedent received all income and paid 92% of expenses
7. November 27, 2000, decedent died
8. Executor filed gift tax return reporting gift and filed estate tax return with undivided interest discount; Parties stipulated to 42.5% undivided interest discount
9. IRS in audit applied §2036; All Manhattan property in estate so no undivided interest discount
10. Tax Court: Agreed that §2036 applied; All in estate; No undivided interest discount

§ 2036; Gift of Fractional Interest to Co-Occupant

Holding of Second Circuit

1. Split decision (3-judge panel); vacate and remand to Tax Court
   a. No clear error in Tax Court determination that there was an implied agreement of retained enjoyment, but "it was clearly erroneous for the Tax Court to find that the terms of the agreement were such that Decedent would enjoy the substantial economic benefit of 100% of Brandon's 49% interest in the Manhattan property."
   b. Gave guidance to Tax Court regarding how to determine what part of the transferred 49% is included under § 2036. As to the residential portion (the bottom two floors), the son received all of the economic benefit of his 49% by his co-occupancy.

§ 2036; Gift of Fractional Interest to Co-Occupant

Analysis of Court

1. Section 2036(a):

   "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 …under which he has retained for his life…

   1) the possession or enjoyment of, or the right to the income from, the property…"

2. Regulations:
   "If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence." Treas. Reg. §20.2036-1(c)(1)(i).

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3. Implied Agreement for Residential Property:
   a. Two factors are particularly significant in determining whether there is an implied agreement for retained possession or enjoyment of residential property: (1) continued exclusive possession by the donor; and (2) withholding of possession from the donee
   b. If both factors are present, the taxpayer has lost every case (citing *Estate of Maxwell*; *Estate of Reichardt*; *Estate of Kerdolff*; *Estate of Linderme*; and *Estate of Rapelje* (donor's occupancy is "almost exclusive").)
   c. If neither factor applies (i.e., if there is joint occupancy by the donor and the transferee) the taxpayer has won every case "despite the great burden faced by the taxpayer in all these cases" (citing *Union Planters Nat'l Bank v. U.S.*; *Estate of Binkley v. U.S.*; *Diehl v. U.S.*; *Stephenson v. U.S.*; *Estate of Roemer*; *Estate of Gutchess*; *Estate of Weir*; and *Estate of Burr*).
   d. Most of these cases were interspousal transfers, but *Diehl* and *Estate of Roemer* involved other family members. *Estate of Roemer* explicitly rejected a "spouses only" reading of these cases.

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3. Implied Agreement for Residential Property (cont'd)
   e. Key Issues Regarding Co-Occupancy of Residential Property:

      Co-occupancy with a related transferee will not necessarily, by that fact alone, mean there is no implied agreement of retained enjoyment. However, if the IRS **"points to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning [residential property] cannot stand."**

      Conclusion as to residential portion of the Manhattan property: **"Decedent's residential use of part of the Manhattan property does not indicate an implied agreement that she would to any extent retain the substantial economic benefits of the residential portion of Brandon's 49% interest."**

§ 2036; Gift of Fractional Interest to Co-Occupant

4. Implied Agreement for Commercial Portion:
   a. Taxpayer: Even though decedent received all the income and paid most expenses prior to her death, decedent and son intended to split the income and expenses (including income from East Hampton property, and son had received all of income from that property during the same period)
   b. Tax Court did not find son's testimony credible, partly because accountant did not know of an "agreement to reconcile all income and expenses"
   c. The Tax Court did not mention the testimony of the estate planning specialist, who initially discussed the gift of a portion of the Manhattan property to the son, indicating that decedent wanted to give the son "one-half of building and rent."
   d. Finding of implied agreement as to commercial portion of property is upheld but is subject to apportionment

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5. Apportioning How Much of the Transferred Interest Has Retained Enjoyment:
   a. Revenue Ruling 79-109: Portion includable under § 2036 "is that portion of the transferred property that would be necessary to yield the retained income."
   b. Bifurcate the residential and commercial portions
   c. For residential portion, no retained enjoyment
   d. Apportion based on net income — (for the residential portion, Brandon should be treated as having imputed income — "the fair market rental value one would have paid to be Decedent's housemate from May 9, 2000 to November 27, 2000")
   e. Determine whether son's receiving all income from other property is among the "facts and circumstances surrounding the transfer" that should be considered. (The IRS argued that the decedent's relationship to other property could not be considered at all.)

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6. Dissent:
   a. Decedent's relationship to the property changed "in not one significant respect" after the transfer.
   b. Majority opinion misread cases and mere co-occupancy should not be treated as "highly probative" of the absence of an implied agreement, observing that the majority opinion in effect shifts to the IRS the burden of proving the existence of an implied agreement, and that the majority's reasoning "makes it near impossible for the Commissioner to meet his new burden."
   c. The opinion "opens a new loophole that will vitiate to a considerable degree" § 2036 and invites "easy dodges by future tax avoiders."

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Planning Opportunity

1. Major Taxpayer Victory — The effect of the case is to allow an undivided interest discount (stipulated at 42.5%) because not all of the interests in the property are included in decedent's estate
2. Transfer of fractional interests to donees results in discount for transferred interests (for gift tax purposes) AND what is retained (for estate tax purposes) as long as the transferred interests are not brought back under § 2036
3. Follow formalities; avoid sloppiness in recognizing co-owners (i.e., record deeds, split income and expenses proportionately)
4. Use formal co-ownership agreement, detailing rights and responsibilities of co-tenants and describing procedures for splitting income and expenses

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Planning Opportunity (cont'd)

5. *Stewart and Wineman* (T.C. Memo. 2000-193) both suggest that retaining proportionate use consistent with any retained ownership should not trigger § 2036.
6. As mentioned in *Wineman*, the key is whether surviving co-tenants can convince the judge that there was no understanding that the decedent would have full use of the transferred interest.
7. If client transfers entire residence, pay fair rental value for any continued use of property (*Estate of Barlow*, 55 T.C. 666 (1971); QPRT Letter Rulings). But no guarantees; paying full fair rental value and respecting tenant-landlord status are critical. *Estate of Maxwell*, 3 F.3d 591 (2d Cir. 1993); *Disbrow*, T.C. Memo. 2006-34.

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

Estate of Jensen v. Commissioner, T.C. Memo. 2010-182 (August 10, 2010)

Facts

1. Decedent had a revocable trust that owned 82% of a C corporation
2. If corporate assets had been sold at death, the corporate level capital gains tax would have been about $1.1 million. However, on the date of death a sale or liquidation of the corporation was not imminent or planned.
3. IRS allowed $250,042 built-in gains tax discount on audit. (Parties agreed on a 5% lack of marketability discount. Only unresolved issue for court was amount of built-in gains tax discount.)

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

Holding

The built-in gains tax discount is determined (by Judge Vasquez) based on a present value analysis, taking into consideration anticipated future appreciation in the corporate assets. However, the manner in which the court applied its present value analysis (using the same assumed growth rate and "discount-to-present value" rate) resulted in the same discount as a "dollar-for-dollar" discount.

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

Taxpayer and IRS Positions

1. Taxpayer's Expert: Apply dollar-for-dollar discount (based on the full amount of built-in gains tax at the date of death) because "[t]he adjusted book value method is based on the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation in the assets."

   On appeal, the taxpayer calculated the dollar-for-dollar discount at $1,133,285 (state and federal tax).

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

Taxpayer and IRS Positions (cont'd)

2. IRS Expert: Using a novel approach, the IRS expert examined the amount by which built-in gains tax exposure to each of six closed-end funds depressed their values in relation to their net asset values. The expert found no direct correlation between higher exposure to built-in gains tax to the discounts for net asset value for those funds. The built-in gains tax exposure did not exceed 41.5% of the net asset value for any of the six funds. Therefore, the expert concluded that no built-in gains tax discount should be allowed to the extent that the built-in gains tax did not exceed 41.5% of the net asset value.

   The expert "opined that full consideration (i.e., a dollar-for-dollar discount) should be given" for the built-in gains tax that exceeded 41.5% of the net asset value.

   To support its conclusion of allowing a discount of about 50% of the built-in gains tax, the expert opined that there are methods to avoid paying the built-in gains tax, such as by engaging in a § 1031 like kind exchange or converting to an S corporation (while acknowledging that there are limits and restrictions on those methods).

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

Court's Analysis

1. Dollar for Dollar Discount. This case is appealable to the Second Circuit. *Estate of Eisenberg* was a Second Circuit case (one of the first to allow a built-in gains tax discount) that did not address whether the discount should be dollar-for-dollar. The Fifth (*Estate of Dunn*) and Eleventh (*Estate of Jelke*) Circuits subsequently allowed dollar-for-dollar discounts (the primary argument being administrative convenience, because of the inherent uncertainty about using any other amount). The court refused to speculate on how the Second Circuit would rule, and did not accept the taxpayer's approach of simply using a dollar-for-dollar discount.
2. Court Rejects IRS Expert's Approach
   a. Closed-end funds analysis rejected. (Funds reviewed were not comparable; Discounts for closed-end funds are attributable to various factors in addition to built-in gains tax)
   b. There is no "viable method" for a hypothetical buyer to avoid the built-in gains tax.

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

3. Present Value Approach
   a. Steps: Estimate future appreciation in property; calculate sales price at end of anticipated holding period; calculate corporate capital gains tax; discount future tax to present value
   b. The court estimated a holding period of 17 years (the "average useful or depreciable life" based on the depreciation figures used in the taxpayer's real estate report).
   c. Court considered two scenarios: Growth rate and discount rate of 5% (rate of appreciation assumed in the taxpayer's separate real estate appraisal) and using a growth and discount rate of 7.5% (based on pre-tax return of income data in the taxpayer's expert's report). Court did not discuss why the discount rate should be the same as the assumed growth rate.
   d. Using same rate as growth rate and discount rate results in dollar-for-dollar discount.

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

4. Considering Future Appreciation in Present Value Analysis
   a. Cases Rejecting: *Estate of Bailey* (T.C. Memo. 2002-152); *Estate of Jelke* (T.C. Memo. 2005-131), rev'd on other grounds, 507 F.3d 1317 (adopting dollar-for-dollar approach).
   b. Cases Where IRS Experts Supported: IRS experts considered future appreciation in *Estate of Borgatello* (T.C. Memo. 2000-264) and *Estate of Bailey* (T.C. Memo. 2002-152).

Built-In Gains Tax Discount, Considering Post-Transfer Anticipated Future Appreciation

4. Considering Future Appreciation in Present Value Analysis (cont'd)

   c. Supporting — *Estate of Litchfield* (T.C. Memo. 2009-21, Judge Swift). Court referred to the corporate level tax on future appreciation as the "tax-inefficient entity drag."

      Rationale:
      "On the facts presented to us, we believe that, as of the valuation date, a hypothetical buyer of LRC and LSC stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in a built-in capital gains discount that would be negotiated between the hypothetical buyer and seller."

   d. Appropriate Rate: The assumed holding period, assumed growth rate, and "discount-to-present value" factor obviously greatly impact the calculation of the built-in gains tax discount. Courts should focus on specific discussion by experts of the reasons supporting the specific values for these factors used in their analyses.

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