Estate Planning Update

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Estate and Gift Tax Legislation

GRAT — 10-year minimum term

- H.R. 5486 (replacing H.R. 4849, earlier Jobs Bill passed by the House on 3-24-2010) "Small Business Jobs Tax Relief Act of 2010" passed House on 6-15-2010 by vote of 247-170
- H.R. 5486 will likely be merged with H.R. 5297, "Small Business Lending Fund Act of 2010"
- Includes identical GRAT proposal as in H.R. 4849
  - 10-year minimum term
  - No frontloading
  - Remainder value greater than zero
  - Effective date: GRATs executed after date of enactment
- GRAT proposal is primary revenue offset ($5.3 billion over 10 years; interestingly, H.R. 4849 estimate was $4.45 billion)
- Strong Senate preference to keep GRAT proposal as an offset to estate and gift tax legislation, but no objection to the proposal has emerged

Estate and Gift Tax Legislation

Senate Finance Committee staffer insights

- Cost projections (10 years):
  - 2009 system — $253 billion
  - 2009 system indexed — $270 billion
  - $5.0 million exemption/35% rate — Additional $60 billion
- Find offsets for relief beyond 2009 system (That means 60 votes are required in Senate because the Senate Pay-Go approach only has an exception for extending the 2009 system, indexed in the second year, for two years)
- GRAT 10-year term: No resistance, but save for estate tax legislation offset
- Section 2704: Strong adverse resistance
- Awareness: Aware of planning complexities, but political hang-up

Estate and Gift Tax Legislation

Senate negotiations

- In April-May, there were significant negotiations among Senators Baucus, Grassley, Kyl, and Lincoln (all on the Senate Finance Committee) regarding estate and gift tax legislation
- Senators Kyl and Lincoln pushing for $5 million exemption (indexed if possible), 35% rate
- Struggle to find revenue offsets for the $60 billion cost over extending the 2009 system
- One possible offset considered: "Prepayment trust;" Eliminating state death tax deduction probably included
- May 18: Announcement that there is no agreement
- Senate Finance Committee reluctant to approve proposal that could not garner 60 votes
- Some predict that 80% of Senate Democrats would oppose a $5 million/35% plan
- Even if Senate agrees, House leaders (including Speaker Pelosi and Ways and Means Chairman Levin) state they will not agree to a $5 million exemption or 35% rate

Estate and Gift Tax Legislation

General issues

- Only 40 days left in Session
- Retroactivity? (Some propose election to be subject to estate tax or carryover basis)
- No indication of anything to break the 60-vote logjam in the Senate
- Other reform measures: Portability, Unification of gift exemption
- Significant possibility of no action in 2010

Estate and Gift Tax Legislation

If no action in 2010, carryover basis applies on 1-1-11

- $1.3 million and $3.0 million basis adjustments to fair market value
- Carryover basis applies to decedent's one-half of community property (§1022(d)(1)(C) — "for purposes of this section," even though the heading to §1022(d) suggests that the special rule applies only for purposes of the $1.3 and $3.0 million basis adjustments)
- §6018 Report
  - No form yet
  - When: Due date of final income tax return (Oct. 15 if extended)
  - Who: Estates with $1.3 million of non-cash assets
  - What: Recipient names, Description and FMV, Basis, Holding period, Whether gain on sale is ordinary income, Basis adjustment allocations

Holman v. Commissioner, 105 AFTR 2d ¶ 2010-1802 (8th Cir. April 7, 2010) *aff'g* 130 T.C. 170 (2008)

Facts

- Form FLP with Dell stock
- Eight days later, gave LP interests

Indirect gift; step transaction issue not appealed

- Tax Court: Step transaction doctrine applicable in concept, but does not apply on these facts; "real economic risk of a change in value" between time of funding and time of transfer (whatever that has to do with step transaction)
- IRS did not appeal that decision (Full Tax Court opinion saying step transaction doctrine applies in concept)

Holman (8th Circuit)

- 2-1 panel split; 2-judge majority deferred to "reasoned judgment and fact-finding ability of the Tax Court;" Strong dissent
- §2703 not allow considering transfer restrictions *in the partnership agreement* in valuing this investment partnership.
  - No "bona fide business arrangement" of the entity (one of the requirements in the §2703(b) safe harbor exception)
  - Buy-sell agreement cases traditionally looked at whether there was a business purpose of the transfer restriction (St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982) ("maintenance of family ownership and control of [a] business")
- Buy-sell agreements generally would seem suspect under Tax Court "device" analysis (redistributive effect of purchasing at any formula price less than pro rata full entity value), which was not rejected in majority or dissenting opinions

Holman (8th Circuit)

- Valuation analysis: Major inroad on *hypothetical* willing buyer/willing seller valuation standard
  - Tax Court only allowed 12.5% marketability discount, observing that remaining partners would likely purchase the interest of any existing partner at a price higher than what a third party would pay
  - Seems contrary to cases holding that assuming entity will redeem interests to maintain family harmony violates hypothetical willing buyer standard. (Jung, TC; Morrissey, 9th Cir.)
- Petition for En Banc Review (filed May 21, 2010) was rejected

Pierre v. Commissioner, T.C. Memo. 2010-106 (May 13, 2010) ("Pierre II")

- Gifts and Sales of LLC interests moments apart to same parties (grantor trusts for son and daughter)
- Interests were aggregated for valuation purposes under step transaction doctrine
- Basic facts
  - LLC formed July 13, 2000
  - LLC funded September 15, 2000
  - September 27, 2000 9.5% LLC units gifted and 40.5% units sold to each trust — no time elapsed other than "the time it took four documents to be signed."
  - Sloppy documentation also — single journal entry that did not bifurcate units given versus those sold
- Two issues
  - Step transaction doctrine to aggregate gift and sale for valuation purposes
  - Amounts of discounts

Pierre II

Step transaction doctrine

- Court summarized step transaction doctrine and application in estate and gift area in two short paragraphs
- Application to facts
  - (1) Same day
  - (2) No time elapsed
  - (3) Taxpayer "intended to transfer her entire interest in [the LLC] without paying gift tax"
  - (4) Documentation glitch
- Conclusion: "We find that nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions."
- No aggregation of interests received by multiple recipients (Rev. Rul. 93-12)

Pierre II

Step transaction doctrine concerns

- 6th recent case discussing general application of step transaction doctrine in estate and gift tax area (Senda, Holman, Gross, Linton, Heckerman & Pierre II)
- Mil Hatcher: "Pierre II has to be viewed as the proverbial camel's nose under the tent. Beware of what follows."
- Application to "sliver gifts?"

Pierre II: Step Transaction Doctrine Concerns

Structuring gift/sale transactions

- Can meet the same day/no time elapse/and documentation issues
- Plan time delay (How long? Perhaps analogy to Holman analysis)
- Concern is the "intent" factor
- Linton: Donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability."
- If client desires to limit gift for economic reasons, document that intent
- Implement in a way to give credence to sale transaction separate from gifts (Make payments, etc.)
- Do not refer to "seed gifts"
- Give and sell different assets if that fits client's goals — that obviously avoids aggregation for valuation purposes

Pierre II: Step Transaction Doctrine Concerns

Possible application to section 2036?

- Bona fide sale for full consideration exception not apply if gift is aggregated with sale
- Retained interest issue perhaps bolstered
- Hopefully, this is making a mountain of a molehill — The key to Pierre may be merely that for valuation purposes the gift and sale transactions happened within "moments" of each other

Ludwick v. Commissioner, T.C. Memo. 2010-104 (May 10, 2010) — Undivided Interest Discount

Basic facts

- Husband and wife each transferred 50% interests in Hawaiian vacation home to their separate QPRTs
- Tenancy in Common Agreement (not mentioned in opinion) (1) removed the right of a co-tenant to partition, but (2) gave each co-tenant the right to sell his or her undivided interest to the other co-tenant at a pro-rata value of the whole, or, alternatively, to sell the property in its entirety
- Taxpayers applied 30% discounts on gift tax returns
- IRS deficiency notice allowed 15% discount; At trial IRS argued for 11% discount

More than just cost of partition

- For many years, IRS maintained that undivided interest discount is just cost of partition (Ex. TAM 9336002)
- Numerous cases over the last 20 years conclude that the cost of partition is merely one factor to consider
- Court recognized (after having been convinced by both experts) that the discounts should be something more than just cost of partition in order to reflect liquidity and marketability risks

Ludwick — Undivided Interest Discount

Two-pronged approach: (1) cost if partition necessary and (2) sale cost if partition unnecessary

- If partition necessary:
  - Assume two-year delay
  - 1% litigation costs, 6% selling costs, $350,000 annual operating cost, growth rate of 3%, discount-to-present value factor of 10%: 26.5% discount
- If partition not necessary:
  - Assume one year delay and no litigation cost: 16.2% discount
- Weighted approach:
  - Assume 90% likelihood no partition necessary. Weighted average is about 17.2%

Summary: Overall discount is in general range of prior undivided interest discount cases. But under court's analysis, the discount may have been significantly smaller if the property had not required higher annual maintenance costs ($350,000 per year) during the delay period before the property could be sold.


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