

**CURRENT DEVELOPMENTS IN ESTATE AND
GIFT TAX AUDITS AND LITIGATION**

HOUSTON BUSINESS & ESTATE PLANNING COUNCIL

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Anticipate the Dispute

- **Prepare for the audit at the planning stage**
- **The IRS is staffing up!**
- **Common IRS challenges**
 - Valuation
 - Formula transfers
 - QTIP Termination
 - Promissory notes
 - Installment sales to intentionally defective grantor trusts
 - GRATs
 - Penalties
 - Section 2036
 - Split-dollar life insurance

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

| <u>Case</u> | <u>Assets</u> | <u>Court</u> | <u>Discount from NAV/ Proportionate Entity Value</u> |
|---------------------------|---------------------------------|--------------|--|
| <i>Strangi I</i> (2000) | securities | Tax | 31% |
| <i>Knight</i> (2000) | securities/real estate | Tax | 15% |
| <i>Jones</i> (2001) | real estate | Tax | 8%; 44% |
| <i>Dailey</i> (2001) | securities | Tax | 40% |
| <i>Adams</i> (2001) | securities/real estate/minerals | Fed. Dist. | 54% |
| <i>Church</i> (2002) | securities/real estate | Fed. Dist. | 63% |
| <i>McCord</i> (2003) | securities/real estate | Tax | 32% |
| <i>Lappo</i> (2003) | securities/real estate | Tax | 35.4% |
| <i>Peracchio</i> (2003) | securities | Tax | 29.5% |
| <i>Deputy</i> (2003) | boat company | Tax | 30% |
| <i>Green</i> (2003) | bank stock | Tax | 46% |
| <i>Thompson</i> (2004) | publishing company | Tax | 40.5% |
| <i>Kelley</i> (2005) | cash | Tax | 32% |
| <i>Temple</i> (2006) | marketable securities | Fed. Dist. | 21.25% |
| <i>Temple</i> (2006) | ranch | Fed. Dist. | 38% |
| <i>Temple</i> (2006) | winery | Fed. Dist. | 60% |
| <i>Astleford</i> (2008) | real estate | Tax | 30% (GP); 36% (LP) |
| <i>Holman</i> (2008) | Dell stock | Tax | 22.5% |
| <i>Keller</i> (2009) | securities | Fed. Dist. | 47.5% |
| <i>Murphy</i> (2009) | securities/real estate | Fed. Dist. | 41% |
| <i>Gallagher</i> (2011) | publishing company | Tax | 47% |
| <i>Koons</i> (2013) | cash | Tax | 7.5% |
| <i>Richmond</i> (2014) | marketable securities | Tax | 46.5% (37% LOC/LOM & 15% BIG) |
| <i>Giustina</i> (2016) | timber company | Tax | 25% LOM |
| <i>Streightoff</i> (2018) | marketable securities | Tax | 18% LOM |
| <i>Grieve</i> (2020) | marketable securities | Tax | 35% (98.8% non-vot. LLC int.) |
| <i>Nelson</i> (2020) | equipment co. | Tax | 40.5% (stock); 31.6% (LP) |
| <i>Cecil</i> (2023) | real estate/hospitality | Tax | 20% LOC/19 – 27% LOM |

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** – “[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.”

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*

QTIP Termination

- **CCA 202118008**
 - Chief Counsel asserts that the termination of a QTIP trust followed by the distribution of QTIP to the surviving spouse results in a deemed gift from the surviving spouse under § 2519 followed by gift from remainder beneficiaries to surviving spouse
- **Treas. Reg. § 25.2519-1(a)**
 - “If a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) or section 2523(f), the donee spouse is treated for purposes of chapters 11 and 12 ... as transferring all interests in property other than the qualifying income interest.”
- **Rev. Rul. 98-8**
 - Surviving spouse’s purchase of remainder interest is a gift from surviving spouse to remainder beneficiaries

QTIP Termination

- **Treas. Reg § 25.2519-1(e)**
 - Exercise of power to appoint QTIP to donee spouse is **not** a disposition under § 2519
- ***Anenberg***
 - Judicial termination of QTIP trust and distribution to surviving spouse is **not** a gift
 - Bona fide sale of the assets that surviving spouse received upon termination of QTIP is **not** a gift
 - Gift from remainder beneficiaries to surviving spouse? (The “footnote 18” question)

Statute of Limitations – Adequate Disclosure

- **Adequate disclosure (other than §§ 2701-2702)**
- **Treas. Reg. § 301.6501(c)-1(f)(2)**
 - A transfer reported on the gift tax return as a transfer of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides:
 - (i) a description of the transferred property and any consideration received by the transferor,
 - (ii) the identity of, and relationship between, the transferor and transferee,
 - (iii) if the property is transferred in trust, certain information about the trust,
 - (iv) either a detailed description of the method used to determine the value of the property or a qualified appraisal, and
 - (v) a statement describing any position taken that is contrary to any proposed, temporary, or final regulation or revenue ruling.

Statute of Limitations – Adequate Disclosure

- **Preamble to adequate disclosure regulations**
 - “However, *it is not intended that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided.* 64 FR 67767-01, 67767 (Dec. 3, 1999).”
- ***Schlapfer v. Commissioner*, T.C. Memo. 2023-65 (May 22, 2023)**
 - Adequate disclosure requires substantial compliance, not strict compliance with adequate disclosure rules
 - **But** taxpayers must substantially comply with each requirement of the regulations, not substantially comply with the regulations overall

Statute of Limitations – Donee Liability

- Donee liability for donor's gift tax may exist under I.R.C. § § 6901 or 6324(b) if donor does not pay
- Important consideration in advising whether to file adequate disclosure gift tax return for sale transaction to start statute of limitations running
- Donee's statute of limitations does not expire until one year after donor's statute of limitations expires
- *U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015)
- Split in circuits on whether donee liability for gift tax is limited to value of gift received (3rd/5th/8th Circuits) or includes unlimited liability for interest (11th Circuit)

Promissory Notes

- **Application of § 7872**
 - Security
 - Balloon notes
- **Bona Fide Loan or Gift?**
 - Reasonable expectation of repayment
 - Factors examined
 1. Note
 2. Interest
 3. Repayment schedule
 4. Collateral
 5. Demand for repayment
 6. Records reflecting debt
 7. Actual repayment
 8. Borrower solvency
- **Equity or Guarantee?**

Installment Sales

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

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

GRATs

- ***Baty v. Comm’r*, Tax Court Docket No. 12216-21 (CCA 201939002)**
 1. IRS – value of publicly traded stock should consider merger negotiations
 2. IRS – gross valuation error results in inability to adjust annuity or, alternatively, a non-qualified annuity
 3. IRS conceded case entirely after taxpayer filed motion for summary judgment

Section 2036 - Most Litigated Issue

- **Section 2036 provides:**

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. 392 (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)

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

- *Morrisette 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

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

- In 2008:
 - Decedent created a life insurance trust (signed by her three attorneys-in-fact) with an independent/directed trustee. The trust’s “investment committee” consisted of a family business advisor who also served as one of her attorneys-in-fact.
 - Insurance trust purchased life insurance on the decedent’s daughter and husband. To pay the \$6.5 million premiums, the insurance trust borrowed funds through a split-dollar arrangement.
 - 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.

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

- 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 Comm’r*, 158 T.C. No. 2 (February 28, 2022)

- **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 policies 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.

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