Estate Planning for 2015 and Beyond

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Objectives of Presentation

• Overview of Current Estate, Gift, GST, and Income Tax Laws
  – American Taxpayer Relief Act and applicable exemption levels and rates
  – Portability
  – Obergefell v. Hodges

• Planning Strategies in this “new normal” post-ATRA world
  – Basis adjustment
  – Drafting for maximum flexibility

• Legislative Update, Proposed Regulations, and Case Law Update
  – Consistent basis reporting
  – Family Limited Partnerships and valuation discounts
  – Sale to Grantor Trusts
  – Self-canceling installment notes
  – Recent valuation cases
Overview of Current Estate, Gift and GST Tax Laws

– American Tax Relief Act of 2012 (ATRA):
  – Estate, Gift and GST provisions:
    • Applicable exclusion amount of $5 Million, increased for inflation, $5,43 Million applicable exclusion amount for 2015.
    • 40% maximum rate.
    • Portability of “Deceased Spousal Unused Exclusion Amount” (“DSUE” Amount).
    • Permanent – i.e. no sunset provision.

Overview of Current Estate, Gift and GST Tax Laws

– Income Tax: Dramatically Increases
  • Top rate on ordinary income increased from 35% to 39.6%
  • Capital gains rates increased from 15% to 20%, but only for those in the 39.6% ordinary income bracket
  • Let lapse the 2% payroll tax reduction
  • In 2015 the 39.6% top rate for trusts and estates is reached at $12,300 of taxable income (no 35% rate for trusts and estates).
  • While not an ATRA provision, the Health Care and Education Reconciliation Act of 2010 imposed a Medicare surtax of 3.8% on net investment income.
Overview of Current Estate, Gift, GST, and Income Tax Laws

- Portability:
  - The Executor of the first deceased spouse’s estate can elect to transfer to the surviving spouse the unused estate tax and gift tax exemptions of that first spouse to die.
  - The deceased spouse’s exemption from GST tax is not portable.
  - An executor still must file a timely filed Form 706 in order to claim the unused exclusion amount. The only relief provided to simplify that otherwise burdensome process is that if the estate would not otherwise be taxable, the executor may avoid reporting values of assets that qualify for the marital or charitable deduction (and instead may estimate the value of the gross estate).

Overview of Current Estate, Gift, GST, and Income Tax Laws

- Portability:
  - Only the DSUE amount from the last deceased spouse may be claimed. This sounds simple, but can get complicated:
    - Example in Estate Tax Context: Alex is married to Bonnie. Alex dies with a $5.43 Million DSUE amount. Bonnie remarries Clyde. Bonnie dies with a $5.43 Million estate that she leaves to her kids from her Alex marriage. Her estate can benefit from the DSUE coverage from Alex’s estate, and Clyde can still claim Bonnie’s $5.43 Million DSUE amount for his own estate.
Overview of Current Estate, Gift, GST, and Income Tax Laws

• Portability:
  • Example in Gift Tax Context: Ken marries Lucy and dies shortly thereafter. Lucy now has Ken's $2 Million DSUE amount, because he's the last deceased spouse. Lucy marries Ricky. During that marriage, Lucy gifts $2 Million to her children from Ken. She uses Ken's $2 Million DSUE amount to cover those gifts. Ricky then predeceases Lucy leaving a DSUE amount of $3 Million. Lucy dies shortly thereafter and her estate gets to add Ricky's $3 Million DSUE amount to her exemption.
  • The above example can apply to multiple predeceased spouses so a person could use multiple DSUE amounts for gifting (although not for estate tax purposes).

Overview of Current Estate, Gift, GST, and Income Tax Laws

• Impact of Obergefell case:
  – Windsor (2013) resulting in extension of federal rights, privileges and benefits to married same-sex couples because it held Section 3 of the Defense of Marriage Act unconstitutional.
  • Section 3 provided that in determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word “marriage” means only a legal union between one man and one woman as husband and wife, and the word “spouse” refers only to a person of the opposite sex who is a husband or a wife.
  • Windsor did not legalize same sex marriage but required the federal government to recognize legal same marriages.
Overview of Current Estate, Gift, GST, and Income Tax Laws

• Impact of Obergefell case:
  – In Obergefell v. Hodges, on June 26, 2015 the Supreme Court held that the Fourteenth Amendment requires a State to license a marriage between two people of the same sex and to recognize a marriage between two people of the same sex when their marriage was lawfully licensed and performed out-of-State.
  – Same-sex couples are now eligible for intestate succession rights, spousal rights of inheritance, spousal support (divorce or death), legal priority to act as guardian or executor and any other rights heterosexual couples enjoy.

Planning Strategies in the “New Normal”

• Statistics of the “New Normal” Post-ATRA World
  – In 2001 (when the exemption level was $675K), there were 120,000 estate tax returns filed.
  – In 2012 (when the exemption level was $5.12M), there were less than 4,000 706’s filed.
  – Estimates are that now only about 0.14% of decedents’ estates will be subject to estate tax.
Planning Strategies in the “New Normal”

• Where’s the planning focus?
  – Remember the Total Tax Environment:
    • High estate tax applicable exclusion amounts (i.e., a married couple can currently pass more than $10 million tax free) and
    • High income tax rates (Top rate on individuals and trusts of 39.6%, top capital gain rate of 20%, and Medicare surtax of 3.8%)
  • Income Tax Planning likely the focus
    – How do we plan for income tax as estate planners?

Planning Strategies in the “New Normal”

• Income Tax Planning:
  – What to consider: Balance estate taxes against future income tax savings and plan accordingly
    » Look to attributes of the assets (What are the assets? Are they low basis assets? High basis in comparison to fair market value? When will the assets be sold? Are they appreciating?)
    » Appreciated property with low basis will need to appreciate significantly from its date of transfer value for the estate tax savings to outweigh the cost of losing the step-up in basis
    » State income tax - look to states where beneficiaries reside
    » Based on income tax savings, possibly better for assets to remain in estate rather than be gifted
Planning Strategies in the "New Normal"

- Income Tax Planning (Continued):
  - Planning around *Basis* - Remember, step-up in income tax basis of assets at death
    » Identify assets that would most benefit from a step-up in basis and plan accordingly - develop transfer or hold strategies based on basis
  - Community property ("CP") opportunities:
    » Basis step-up occurs not just to the deceased spouse's CP, but also to the surviving spouse's one-half interest in CP. So this would ensure a basis step up regardless of the order of death, but . . .
    » The property now would be subject to liabilities of both parties and beware of consequences of future divorce

-- Planning around Basis - Remember, step-up in income tax basis of assets at death (Continued):
  » Avoiding valuation discounts
  » Gifts to trusts for the benefit of third parties who do not have estate tax issues where the trust assets will be included in the third parties' taxable estates
  » Transferring low basis assets to near-death person, and have them devise the assets back in his/her Will.
    » 1014(e) Rule: Step-up prohibited for appreciated property given within a year of death which passes from the decedent back to the donor.
  » Avoiding funding of a credit-shelter trust
Planning Strategies in the “New Normal”

– Distribution Planning for trusts and estates provides planning opportunities (Continued):
  • Consider tax rates of estate beneficiaries in connection with trust and estate distribution planning
    – Trusts and estates taxed at top rate (39.6%) at $12,300
    – Individuals taxed at top rate with AGI of $413,200 and are only subject to the Medicare Surtax with AGI of $200,000
    – Amounts distributed may reduce amounts subject to this tax plus income subject to 3.8% Medicare Surtax
  • Consider whether beneficiaries are subject to state income tax

Planning Strategies in the “New Normal”

– Distribution Planning for trusts and estates provides planning opportunities (Continued):
  • Capital Gain Planning:
    – Trust or estate generally taxed on capital gains (20%)  
    – Capital gains generally not included in Distributed Net Income (“DNI”)
    – But - capital gains included in DNI if (1) pursuant to the terms of the trust or (2) pursuant to a reasonable and impartial exercise of discretion by the fiduciary if not precluded by law
Planning Strategies in the “New Normal”

– Distribution Planning for trusts and estates provides planning opportunities (Continued):
  • Capital Gain Planning (Continued):
    – Four possible options for including capital gains in DNI
      1. Allocated to income:
        » Trust gives trustee discretion to allocate capital gains to income
        » Flexible approach- decision to allocate can be made year to year
        » Sometimes not appropriate . . .

Planning Strategies in the “New Normal”

– Distribution Planning for trusts and estates provides planning opportunities (Continued):
  • Capital Gain Planning (Continued):
    – Four possible options for including capital gains in DNI
      2. Allocated to principal and consistently treated as distributions:
        » Trustee has authority to treat principal distributions as capital gains
        » Trustee has discretion to treat capital gains as income or principal, or discretionary principal distribution as made from capital gains
Planning Strategies in the “New Normal”

– Distribution Planning for trusts and estates provides planning opportunities (Continued):
  • Capital Gain Planning (Continued):
    – Four possible options for including capital gains in DNI
      3. Allocated to principal and actually distributed
      4. Allocated to principal and used to determine amount to be distributed
  • 65 Day Rule: Can elect to treat distributions made during the first 65 days of the taxable year as if they had been made on the last day of the prior year.
    – Why? Because taxable income maybe not known by the end of the taxable year – provides ability to make distributions to avoid income being taxed at the estate and trust rates

Planning Strategies in the “New Normal”

• Focus on Flexibility
  – Use of flexible estate planning tools may provide the best means for maximizing overall tax savings opportunities
  – But, don’t let tax savings take priority over the client’s other estate planning goals – unless tax savings is client’s ultimate goal.
  • Don’t construct mechanisms to save taxes at the expense of client’s desires for disposition of his or her estate
Planning Strategies in the “New Normal”

- Portability vs. Bypass Trust Planning
  - Advantages to a Bypass Trust
    - Removes future appreciation from the surviving spouse’s estate for estate tax purposes.
    - Leverages available GST tax exemption for multiple generations.
    - Creditor protection for the surviving spouse (or children as the case may be).
    - The spouse who sets up the trust designates the beneficiaries of the trust. This can be a benefit with blended families.
    - Family members other than the surviving spouse can also be beneficiaries of the trust.
  - Potentially big disadvantage to a Bypass Trust
    - No second basis step-up.

Planning Strategies in the “New Normal”

- Portability vs. Bypass Trust Planning
  - Disadvantages to Portability
    - No inflation adjustment to the DSUE amount. Appreciation of assets would be subject to estate tax.
    - Spouse may not retain DSUE amount if they remarry and are widowed a second time.
    - There is no portability for GST exemption.
    - No creditor protection.
    - Necessity of filing a 706.
    - Spouse has unfettered access and control over assets. (Con?)
Planning Strategies in the “New Normal”

- QTIP Trust Planning
  - Advantages to a QTIP Trust
    - Control, Creditor Protection, Divorce Protection...just like in a Bypass Trust.
    - Less income tax exposure (All income is distributed out to spouse).
    - Basis step-up at the second spouse’s death.
    - Preservation of GST exemption (either if no QTIP election is made, or if a reverse QTIP election is made at second spouse’s death)
  - Disadvantages to QTIP Trust
    - No spray powers to other beneficiaries
    - Inclusion for estate tax purposes (no worse than outright gift)
    - Tax Apportionment Trap – Unless otherwise indicated in the Will, the marginal tax caused by including the QTIP assets in the second spouse’s estate will be paid by the QTIP. (Watch for different beneficiaries in QTIP vs. surviving spouse’s estate.)

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Planning Strategies in the “New Normal”

- QTIP Trust Planning
  - Disadvantages to QTIP Trust
    - Tax Apportionment Trap Example—Carol and Mike Brady each have a $10 Million estate. Mike dies, and his Will leaves his entire estate to a QTIP trust for Carol. The remainder of the trust at Carol’s death goes to Greg, Peter and Bobby. Mike’s executor files a 706 and makes the QTIP election for the trust. Carol then turns around and gifts her $10 Million estate to Marsha, Jan and Cindy. There’s no gift tax, because Carol uses her lifetime exemption plus the DSUE amount from Mike’s estate to cover the gift. Carol then dies, and the QTIP trust is taxable because she’s used up all of her exemption (or almost all of it if you account for the increased exemption due to the inflation adjustment). Just pretend that there is no appreciation and only income has been distributed, so the QTIP trust still had $10 Million in it. It will be charged with approximately $4 Million of tax. As a result, Greg, Peter and Bobby end up with $6 Million, and Marsha, Jan and Cindy with $10 Million. It might not be the happy Brady Bunch anymore!
Planning Strategies in the “New Normal”

- Disclaimer Trust Planning
  - Similar to a Clayton election, a Will may allow a surviving spouse to accept an outright gift or to disclaim the gift, in which case the assets will pass into a trust for the spouse’s benefit (either Bypass or QTIP).
  - This plan provides flexibility, as surviving spouse can decide whether to have assets pass to the trust or receive them outright (allowing for 2nd step-up in basis of the assets and possibly lower income tax rate on the income generated by the assets).
  - Because this is through a disclaimer, the surviving spouse would only have 9 months to decide.
  - The same issues regarding the control given to the surviving spouse are applicable here as were applicable with the Clayton election. Should a surviving spouse be given this power to control the direction the assets pass? What if the Bypass Trust has spray power for additional beneficiaries? What if it’s a blended family?

Planning Strategies in the “New Normal”

- Options for Basis Planning with Bypass Trusts
  - Funding Bypass Trust with high basis / fixed income assets. Low basis assets pass directly to spouse or to QTIP Trust. Draft carefully to accomplish this.
  - Distribute low basis assets out of a Bypass Trust to surviving spouse.
    - If the remaindermen of the Trust are the same people who would inherit from the surviving spouse, there’s no issue. If they are not, this could be a breach of the fiduciary’s duty to them.
    - Timing may be tricky (when is the spouse about to die?).
  - Third party’s ability to grant a general power of appointment to the surviving spouse.
    - It must have been included in the governing document.
    - The third party must be willing to do this.
    - Same timing issues as above.
    - The spouse may actually exercise the power and leave the assets to unintended beneficiaries.
Typical Plans in the “New Normal”

- The following represent general recommended estate plans for common situations.
- Variations of these recommendations will be caused by differences in family dynamics.
  - blended families (second marriages),
  - disabled or elderly family members, or
  - beneficiaries with creditor problems.
- Likewise the previously noted income tax issues/planning opportunities will trigger various differences and changes.

Married Couple with Small Estate and Minor Children

<table>
<thead>
<tr>
<th>Husband’s Estate</th>
<th>If Wife Survives*</th>
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</thead>
<tbody>
<tr>
<td>1. Personal Property</td>
<td>1. Specific Request</td>
</tr>
<tr>
<td>2. Home</td>
<td>2. Specific Request</td>
</tr>
<tr>
<td>3. Insurance, Retirement Benefits and/or all other property.</td>
<td>3. All to Wife unless she fails to survive, then to Children’s Trust**</td>
</tr>
</tbody>
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<thead>
<tr>
<th>Children’s Trust</th>
</tr>
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<tbody>
<tr>
<td>1. Separate Trusts: Separate Trust for each child for health, maintenance, support and education.</td>
</tr>
<tr>
<td>2. Termination: Trust terminates upon the death of the child. The child has limited power to redirect the assets between family members, but if not, then property passes equally to the deceased child’s children.</td>
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<tr>
<th>Grandchildren’s Trust</th>
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<tbody>
<tr>
<td>Similar to Children’s Trust.</td>
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* Wife has identical plan if Husband survives Wife.
** If Wife does not survive, property passes directly to Children’s Trust.
**Married Couple with Medium Size Stable Estate Below $5.43 mil.**

- **WILL OF FIRST TO DIE**
  - Personal Effects
  - Furnishings

- **SURVIVING SPOUSE**
  - REVOCA BLY FAMILY TRUST
    - TRUSTEE: Surviving Spouse
    - FUNDING: All assets unless any are disclaimed by Surviving Spouse
    - DISTRIBUTIONS: As directed by Surviving Spouse
    - TERMINATES: Death of Surviving Spouse

- **DISCLAIMER (BYPASS) TRUST**
  - Only exists if Surviving Spouse disclaims assets to trust
  - TRUSTEE: Surviving Spouse
  - FUNDING: Amount Disclaimed by Surviving Spouse – Not included in Estate of Surviving Spouse
  - DISTRIBUTIONS: To Surviving Spouse at Trustee’s discretion
  - TERMINATES: Death of Surviving Spouse

- **REVO CABLE FAMILY TRUST**
  - TRUSTEE: Surviving Spouse
  - FUNDING: All assets unless any are disclaimed by Surviving Spouse
  - DISTRIBUTIONS: As directed by Surviving Spouse
  - TERMINATES: Upon the death of each child

**Married Couple with Appreciating Estate from $5.43 mil. - $10.86 mil.**

- **Husband’s Estate**
  - 1. Retirement Benefits Pass Outright to Wife
  - 2. Insurance and/or All Other Property

- **Wife’s Estate**
  - 1. Retirement Benefits Pass to Wife
  - 2. Specific Request
  - 3. To TRUST A a residue of Estate Less Exemption Equivalent Amount Which Passes to Bypass Trust

- **Bypass Trust (TRUST B)**
  - 1. Assets: Exemption equivalent amount, value of property passing estate tax free to TRUST B
  - 2. Beneficiaries: Wife, Children, and Descendants of Children can be beneficiaries
  - 3. Distributions: Income and principal for Beneficiaries’ health, maintenance, support, and education
  - 4. Termination: Termination on death of Wife with property to issue without Wife given the power to redirect disposition between issue in Trust

- **Marital Deduction Trust (TRUST A)**
  - 1. Assets: Property equal to Optimum Marital Deduction Amount
  - 2. Wife’s community property interest
  - 3. Beneficiaries of TRUST A: Wife is sole beneficiary of each TRUST A with income and principal to Wife as she requests
  - 4. Termination: Each TRUST A terminates upon Wife’s death

**Children’s Trust**

- 1. Trusts: Separate Trust for each child for health, education, support, and maintenance
- 2. Termination: Trust terminates upon death of each child
- 3. Grandchildren’s Trust: Similar to Children’s Trust

**Grandchildren’s Trust**

- *A separate trust is created for each child.*

**Strasburger & Price, LLP**
**2015 Tax Symposium**
Married Couple with a Large Estate/Over $10.86 Mil.

**Husband’s Estate**

1. Personal Property and Home.
3. Insurance and/or All Other Property.

**Wife Survives**

1. Specific Request.
2. Specific Request.
3. To QTIP TRUST residue of Estate
4. Less Exemption Equivalent Amount

**Which Pass to Bypass Trust.**

**Bypass Trust (TRUST B)**

1. **Assets.** Exemption equivalent amount, value of property passing estate tax free to TRUST B. 5,430,000. Generation-Skipping Tax Exemption. Election made for this trust.
2. **Beneficiaries.** Wife, Children, and Descendants of Children can be the beneficiaries.
3. **Distributions.** Income and principal for Beneficiaries' health, maintenance, support, and education.
4. **Termination.** Termination on death of Wife with property to issue or Wife may be given the power to redirect disposition between issue in Trust.

**Marital Deduction Trust (QTIP TRUST)**

1. **Assets.** Property equal to Optimum Marital Deduction amount passes into the QTIP TRUST. The QTIP TRUST may be divided into two identical trusts with one holding an amount equal to unused Generation-Skipping Tax Exemption Amount, and the other holding non-exempt Generation-Skipping Tax Amount (total value of estate minus specific bequests and $5,430,000).
2. **Beneficiaries of QTIP TRUST.** Wife is sole beneficiary of each QTIP TRUST with all income being paid to the Wife and the Trustee paying principal to Wife as needed for support.
3. **Termination.** Each QTIP TRUST terminates upon Wife’s death with property to issue, or Wife may be given the power to redirect disposition between issue outright or in trust.

**Management Trust (TRUST A)**

1. A third trust may be established for Wife’s community property ½ interest. Wife is trustee and has full control.
2. Trust A terminates at Wife’s death and if she does not change plan by withdrawing or redirecting benefits, property goes to issue in Trust.

**Children’s Trust**

1. **Trusts.** Separate Trust for each child for health, education, support and maintenance.
2. **Termination.** Trust terminates upon death of each child. Upon the death of a child, property passes equally to the deceased child’s children in Trust. Children may be given power to redirect disposition between issue and/or income only to spouse.

**Grandchildren’s Trust**

Similar to Children’s Trust.

1. **Specific Bequest.**
2. **Specific Bequest.**
3. **To QTIP TRUST residue of Estate Less Exemption Equivalent Amount Which Pass to Bypass Trust.**

**Legislative Update**

- **Consistent Basis Reporting**
  - Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (July 2015).
  - Enacted IRC sections 1014(f) and 6035:
    - 1014(f): Basis of property acquired from decedent may not exceed the value of that property as finally determined for federal estate tax purposes, or if not finally determined the value of that property as reported on a statement made under section 6035.
    - Note: 1014(f) only applies when including the property in the decedent’s estate increases the estate tax.
Legislative Update

• Consistent basis reporting continued:
  – 6035: Requires providing a statement to the IRS and any person acquiring any interest in property included in the decedent’s gross estate for federal estate tax purposes, identifying the value of the interest in the property as reported on the estate tax return.
    • Only required if estate tax return is required to be filed
    • Does not apply for estate tax returns filed merely to elect portability

• Timing
  • The statement required by 6035 must be provided no later than the earlier of (i) 30 days after the date the return was required to be filed (including extensions) or (ii) 30 days after the date the return is filed.

• Effective Date Delayed
  • Notice 2015-57 states that for any statement Section 6035 requires to be filed with the IRS and estate beneficiaries before February 29, 2016, that due date is now postponed until February 29, 2016.

• Penalties
  • Accuracy-related penalties on taxpayer if reports higher basis than estate tax value basis under 1014(f)
  • Failure to file penalties imposed for failing to file the statements required by 6035
Proposed Regulations

– Valuation Discounts:
  • FLPs and LLCs common in estate planning and used for centralized asset management, creditor protection, and legacy planning.
  • FLP/LLC interests often discounted for gift and estate tax valuation purposes for limited marketability and lack of control.
  • Proposed Regulations under IRC § 2704 will impact such discounts
  • What is § 2704(b)?
    – Disregards “applicable restrictions” when valuing the interests in family controlled entities transferred to family members
    – Used to deny valuation discounts

Proposed Regulations

– Valuation Discounts (Cont.):
  • What is an applicable restriction? Restricts:
    1. Ability to liquidate a family-controlled entity that is more restrictive than would apply under state law, and
    2. By its terms, will either lapse or may be removed by the transferor or a family member of the transferor immediately after the transfer.

* View of the IRS: Case law and state statutory law have caused 2704(b) to be ineffective.
Proposed Regulations

– Valuation Discounts (Cont.):
  • Proposed regulations possibly to create new “applicable restrictions” to be disregarded – such as:
    – An owner’s right to liquidate a family entity interest that is more restrictive than a standard to be identified in regulations.
    – Assignee restrictions – restriction on transferee being admitted as a full partner/member.
    – Having certain charitable or other third-party (non-family) ownership whose consent is required to remove restrictions post-transfer.

Proposed Regulations

– Valuation Discounts (Cont.):
  • Proposed regulations might possibly create safe harbors to avoid the application of § 2704
– Take-Away:
  • Government’s goal = Minimizing or eliminating valuation discounts for FLPs/LLCs. Be aware of this and plan accordingly!
  • Possibly take advantage of possible “grandfathering” and engage in transfer planning with FLPs/LLCs prior to issuance of regulations.
Case Law Update

• Sale to Grantor Trust:
  – Overview:
    • Avoids recognition of income on the initial sales transaction as well as interest and principal payments made on the note.
    • Grantor's payment of trust income taxes allows the trust to grow much faster as well as depletes the Grantor's estate.
  – Debt vs. Equity Distinction:
    • For the sale to be effective for estate tax purposes, the note must be recognized as "debt" rather than "equity."
    • If seller retains a beneficial interest in the assets transferred (rather than being viewed as a creditor of the trust), the assets transferred will be included in the seller's gross estate.

• Sale to Grantor Trust Cont.:
  – Woelbing Estate Cases (Maker of Carmex skin care products):
    • Mr. Woelbing sold all his non-voting stock in a closely held company to a grantor trust in exchange for an interest bearing promissory note in the amount of $59 million.
    • The IRS challenged the sale in an audit of the estate tax return for Mr. Woelbing's estate and ignored the note, doubled the value of the stock at the time of the transfer, and increased the value of the stock at the time of Mr. Woelbing's death to $162 million.
  – IRS Arguments:
    • Gift Tax Issues: Notes have zero value under § 2702; alternatively, gift is difference between FMV of the stock less promissory notes; further, note has zero value under §2702.
    • Estate Tax Issues: the note is not an asset of the estate but the stock is included in the estate under §§2036 and 2038 at its date of death value (162.2 million).
  – Deficiency Alleged: Gift and estate tax liability over 125 million and penalties over 25 million.
Case Law Update

• **Karmazin v. Commissioner:**
  – Similar arguments were made in 2003 when the IRS attacked a sale of FLP units in a grantor trust.
    • IRS argued note payments should be treated as an equity interest.
    • The obligation of the trust to make payments was not a guaranteed annuity under the GRAT exception in §2702.
    • Note should be treated as having a zero value for gift tax purposes.
  – Case settled:
    • Favorable terms to the taxpayer.
    • Interest payments were characterized as interest, not as an annuity.
    • 2701 and 2702 did not apply.

Case Law Update

• **Sale to Grantor Trust Cont.:**
  – Proceed with Caution:
    • Will the IRS settle or drop the §§ 2702, 2036, and 2038 arguments in Woelbing?
    • The outcome could provide valuable court guidance on the requirements for a valid sale to grantor trust transactions.
    • Make clients aware the IRS is alleging in some cases that the note has a zero value and seller makes a gift of the entire value transferred.
  – Planning Suggestions:
    • Structure as Bona Fide Transaction so that the note is treated as debt vs. retained equity interest.
    • Factors provided in Miller v. Commissioner:
      – Promissory note or other evidence of indebtedness; interest was charged; security or collateral; fixed maturity date; demand for payment or actual repayment; ability to repay; records maintained reflecting transaction as a loan; manner in which the transaction was reported for Federal Tax purposes is consistent with a loan.
Case Law Update

• What is a Self-Canceling Installment Note (SCIN)?
  – SCIN is a debt obligation that cancels any future payments upon the death of the holder.

• Why you need to know about it?
  – An intra-family installment sale or sale to a grantor trust could potentially include the amount of the unpaid obligation in the seller’s estate.
  – SCINs can help avoid this.
  – Mortality Premium Required!

• Case Law:
  – The Tax Court previously held in Moss v. Commissioner that the remaining payments that would have been due upon maker’s death were not includable in the gross estate under § 2033 because the cancellation provision was part of the bargained for consideration and an integral provision of the note.

Case Law Update

• SCIN Continued:
  – Estate of Musgrove v. US (Fed. Ct.):
    • SCIN transaction not considered a bona fide transaction.
    • Outcome due to the absence of a real expectation of repayment
      – Evidenced by poor health of seller, lack of funds of purchaser, and declaration by seller that he was not likely to demand payment.
  – Estate of Costanza v. Commissioner (6th Circuit):
    • SCIN transaction considered a bona fide transaction.
    • Estate proved real expectation of repayment and intent to enforce the collection of the indebtedness.
  – Estate of William Davidson:
    • Decedent entered into various large sale transactions for SCINs. Mr. Davidson was 86 at the time, and his actuarial life expectancy was about 5.8 years. Shortly thereafter, Decedent was diagnosed with a serious illness and died.
    • IRS alleged gift, estate, and GST tax deficiencies exceeding 2.6 billion.
Case Law Update

- **Davidson continued:**
  - Was this a bona fide transaction?
    - Government’s Position: burden on estate to prove the SCINs are a bona fide debt, decedent had an expectation of repayment, and the trusts have funds to make payments on the SCINs.
  - §7520 Valuation Issue:
    - Position of IRS: 7520 applies only in valuing annuities and life estates.
    - Position of Estate: 7520 applies in valuing any interest for life or a term of years and that an SCIN involves both.
    - Where is the mortality premium?
  - Outcome:
    - Settlement – Davidson recently settled for 321 million vs. the 2.8 billion previously demanded by the IRS. Further guidance on how these numbers were reached is unlikely.

Case Law Update

- **Davidson and SCIN cont.:**
  - Take Away: Because Davidson settled there is uncertainty about SCIN transactions moving forward
    - Current Position via Chief Counsel Advice 201330033:
      - § 7520 should not apply in valuing SCINs.
      - Valuation based on willing-buyer, willing-seller standard in § 25.2512-8.
      - Decedent’s life expectancy and medical history on date of the gift should be taken into account.
  - If seller dies early, SCIN transaction will be closely examined.
  - Income tax issues to consider:
    - Deferred gain will be recognized on the estate’s first income tax return, Fran v. Commissioner.
Recent Valuation Cases

- **Richmond v. Commissioner**
  - Tax Court rejected approach of valuing 23.44% interest in C Corporation (closely held investment holding company) based on a capitalization of dividends reasoning the net asset value approach was more appropriate.
  - Professional valuation not used by taxpayer.
  - Court rejected 100% built in capital gains discount concluding portfolio would be sold over 20-30 years; reduced to present value of only a 43.16% discount.

- **Giustina v. Commissioner**
  - The Ninth circuit reversed and remanded Tax Court opinion dealing with valuation of a 41.1% interest in an FLP. Tax Court based its valuation 75% on the cash flow method using pretax cash flows and 25% on an asset method.
  - The Ninth Circuit held that (1) basing 25% of the valuation on liquidation (engaging in imaginary scenarios as to who a purchaser might be) and (2) cutting in half the Estate’s expert’s discount for a “company specific risk” was improper (the Tax Court failed to consider the wealth a potential buyer would need to adequately mitigate risk through diversification).

Recent Valuation Cases Continued

- **Elkins v. Commissioner**
  - The Tax Court allowed a 10% discount for undivided interests in art.
  - Ignored co-tenants agreement requiring unanimous consent to sell the art under §2703
  - Placed emphasis on subjective facts that a hypothetical buyer would know family members had sentimental and emotional ties to the art and would be willing to purchase the buyer’s interest at a much higher price than a disinterested buyer.
  - 5th Circuit reversed reasoning that IRS offered no evidence of appropriate discounts, opting to apply the estate’s discount instead.
    - No factual support for the Tax Court’s nominal 10% discount.
    - Estates uncontradicted, unimpeached, and eminently credible evidence in support of its proffered discounts was the only evidence offered.
      - Heirs testified that they would purchase a 3rd parties undivided interest, but only at a “fair price.”
      - The aggregate fractional interest discount was 67%.
  - No mention of 2703 at all.
Recent Valuation Cases Continued

• Strategic Buyer Issue:
  – Giustina and Elkins
    • Strategic buyer approach assuming particular purchasers or entities will redeem the interests of a prospective seller violates the hypothetical willing buyer/seller test.
    – Focus must be on what a hypothetical willing buyer would pay not what a strategic buyer would pay.

Questions?
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