

A VIEW FROM THE TRENCHES – CURRENT ISSUES IN ESTATE AND GIFT TAX AUDITS AND LITIGATION

Houston Estate and Financial Forum

SEPTEMBER 25, 2020

John W. Porter – Baker Botts L.L.P.

Stages of the Dispute

- **Prepare for audit at the planning stage**
- **Potential IRS challenges**
 - Valuation
 - Formula transfers
 - Section 2036
 - Installment sales to intentionally defective grantor trusts
 - GRATs
 - S corporation valuation
 - Loan or gift?
 - Penalties
 - 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*)**

Dance like no one is watching; email like it may one day be read aloud in a deposition.

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)

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*)

Potential Donees of the "Excess Amount" Under 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*

Formula Language – It Matters!

- **Wandry** – “I hereby transfer to _____ that number of shares of ABC Company with a fair market value as finally determined for federal gift tax purposes equal to \$ [X] .”
- **Petter** – “I hereby transfer X shares of XYZ 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 \$ [X] to [taxable transferee]; and (2) the remainder of the shares to [charity/QTIP/GRAT]
- **King** – “I hereby sell X shares of XYZ 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
- Taxpayers position -- transferred LP interests worth \$2,096,000 and \$20,000,000 based on values as finally determined (*Wandry/Petter*)
- IRS position -- transferred 6.14% and 58.65% LP interests
- Court’s analysis
 - *McCord, Petter, and Procter* look at the transfer documents rather than subsequent events to determine the property transferred
 - Taxpayers evidence of intent from subsequent actions irrelevant

Nelson v. Commissioner

- Looking at terms of transfer documents, “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*)
- Further:
 - “unlike 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....”

Formula Transfers - Gift Tax Reporting

- **Starts the statute of limitations**
 - Need to file to obtain "as finally determined value"
- **Report consistent with formula**
 - Avoid *Knight v. Comm'r* problem
 - Reflect formula in gift tax return schedule
 - Units initially allocated based on formula and appraisal
 - Attach formula transfer documents and appraisal
 - Satisfy adequate disclosure rules to start limitations running

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*)

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)(1) — Retained Right to Possess or Enjoy Assets Contributed or Income From Assets

- **Case-by-case analysis**
- **Factors considered by courts:**
 - Non pro-rata distributions (*Harper, Korby, Thompson*)
 - Personal expenditures with partnership funds (*Strangi, Hurford, Rector*)
 - Personal use assets in partnership (*Strangi*)
 - Payment of estate tax and expense when assets transferred to partnership close to death (*Miller, Strangi, Erikson*)
 - Accurate books and records not kept (*Harper*)
 - Insufficient assets outside of partnership (*Thompson, Miller, Strangi, Rector*)

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?

Sample Distribution Provision

1.01 No Other Distributions. Except as provided in this Article, the Partnership shall make no distributions of cash or other property to any Partner until its liquidation.

1.02 Distributable Cash. Distributable Cash includes only that cash held by the Partnership at the end of a Fiscal Year after reasonable reserves of cash have been set aside by the Partnership Management, subject to the duties imposed by this agreement, for working capital and other cash requirements, including current and reasonably projected expenses, current and reasonably projected investment opportunities, and reasonably anticipated contingencies. For purposes of this Section, any of the Partnership Assets that are contributed to the Partnership by the Partners, any borrowed funds, and any cash generated upon the sale of any of the Partnership Assets, including Partnership Assets that are purchased with borrowed funds and including the cash attributable to appreciation in value, shall be considered as necessary for investment purposes.

Sample Distribution Provision

1.03 Operating Distributions.

(a) From time to time during each Fiscal Year, the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute any part or all of the Distributable Cash proportionately to each of the Partners based on their Percentage Interests.

(b) During the course of a Fiscal Year, in lieu of making any determinations or distributions under Sections 1.02 and 1.03(a), the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute cash or other Partnership Assets proportionately to the Partners based on their Percentage Interests; provided that the total amount of distributions under this Section 1.03(b) in any Fiscal Year may not exceed five percent (5%) of the fair market value of the Partnership Assets (net of liabilities) as of the beginning of that Fiscal Year.

(c) No distributions under Section 1.03(a) or 1.03(b) shall have the effect of changing any of the Percentage Interests.

1.04 Income Tax Distributions. Regardless of the amount of Distributable Cash and in addition to any distributions under Section 1.03, the Partnership may distribute during the course of each Fiscal Year an amount of cash that would be sufficient for each Partner to pay the Partner's federal and state income taxes attributable to profit and loss allocations by the Partnership at the highest marginal income tax rate, including quarterly estimated tax payments. Any distributions under this Section 1.04 shall be made proportionately to the Partners

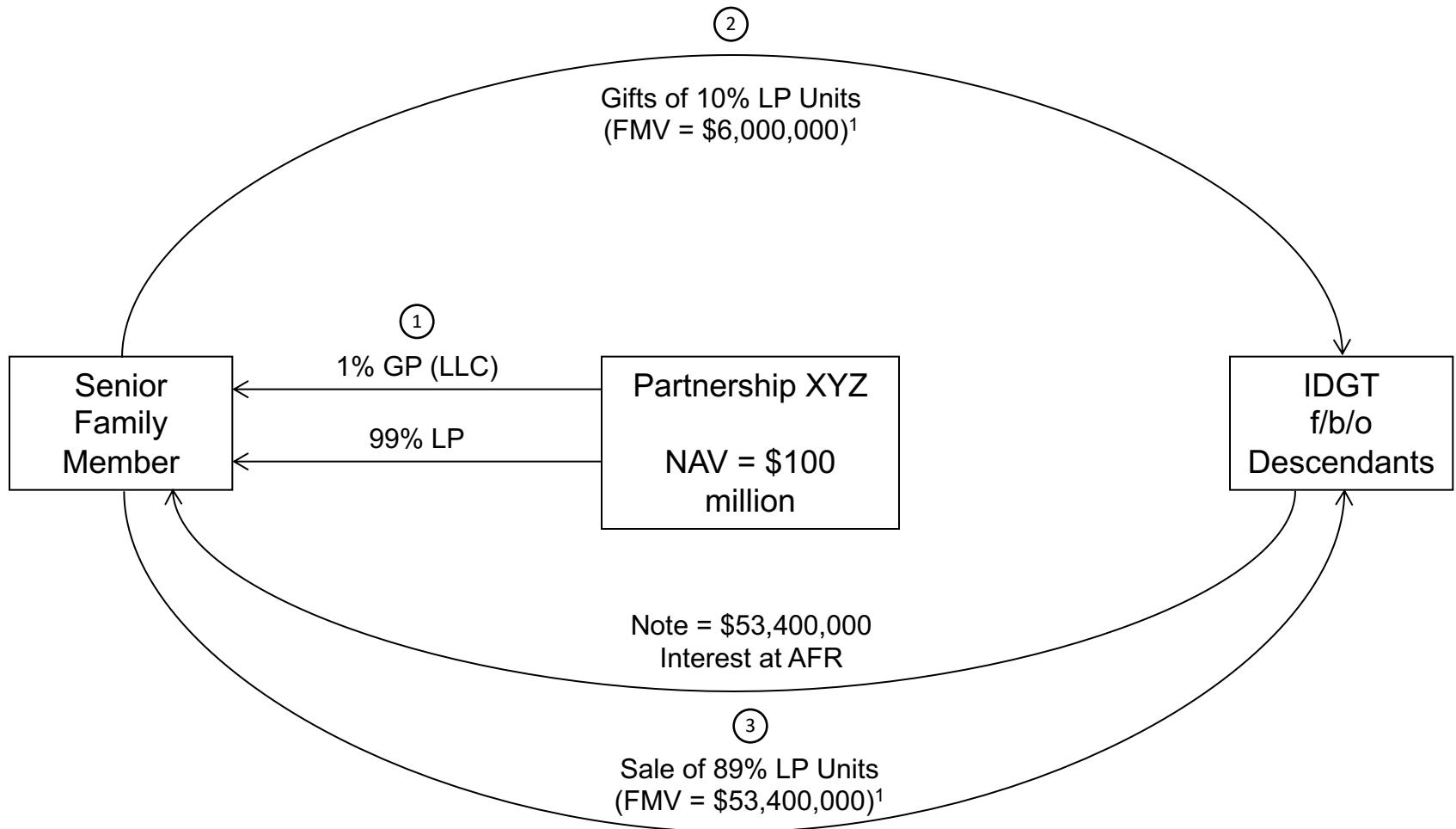
2036(a)(2) - *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017)

- Partnership created by son under a power of attorney nine days before decedent's death
- Sons received 1% GP interest, decedent received 99% LP interest
- Son, using power of attorney, contributed 99% LP interest to CLAT
 - Tax Court concluded power of attorney did not authorize contribution
- **2036(a)(2) holding:**
 - Majority and concurring opinions opine that § 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) Argument

1. Satisfy bona fide sale test
2. Create two classes of interests
 - One with vote on dissolution/amendment
 - One without vote on dissolution/amendment
3. 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)])
4. Terminate entity more than three years before death (potential income tax issues)

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
 - 2702?

2) Estate Tax Issues

- 2036/2038 with respect to interest sold
 - *Pierre* issue/adequate and full consideration?
 - Payment of note
- *Woelbing/Beyer* cases

GRATS

- **Terms Comply with § 2702 Regs?**
- **GRAT operated in accordance with terms?**
 - 1) Substantiation of annuity payments
 - 2) *Atkinson* analysis
- **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* type formula 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*, 78 T.C.M. (CCH) 201 (1999)
- 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 address 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*, T.C. Memo 2019-101 and *Kress v. United States* 16-C-795, 2019 WL 1352944 (E.D. Wisc. 2019)

Loan or Gift? -- Estate of Bolles v. Commissioner

- **Background Facts**
- Mary's son Peter had a variety of financial difficulties, including a default on \$600,000 in loans, yet Mary advanced him over \$1 million between 1985 and 2007
 - Peter made no repayments after 1988
- In 1989, in connection with additional planning by Mary, Peter acknowledged that he lacked the assets and earning power necessary to repay the outstanding advances
- After Mary's death, the IRS said the advances to Peter were gifts

Estate of Bolles v. Commissioner

- **Court's analysis**
- Tax Court examined whether there was a reasonable expectation of repayment when the loan advances were made to Peter, considering 9 factors:
 1. Promissory note or other evidence of indebtedness
 2. Interest
 3. Security or collateral
 4. Fixed maturity date
 5. Demand for repayment
 6. Actual repayment
 7. Ability to repay
 8. Records reflect transfer as a loan
 9. Reporting of transfer for tax purposes is consistent with loan

Estate of Bolles v. Commissioner

- **Court's Analysis**
- Tax Court stated that the question was when the advances became gifts
- Peter was an architect and could attract clients; thus, Mary probably expected that he would be successful
- On the other hand, Mary's 1989 planning included a revocable trust that specifically blocked Peter's receipt of assets
 - This realization made Mary's subsequent advances gifts, not loans (\$727,000 between 1989 and 2007)
 - Prior advances were loans, not gifts (\$337,000 between 1985 and 1989)

Estate of Bolles v. Commissioner

- **Lessons Learned**
- If your client intends for their loans to be treated as loans, satisfy as many of these factors as possible
 1. Promissory note or other evidence of indebtedness
 2. Interest
 3. Security or collateral
 4. Fixed maturity date
 5. Demand for repayment
 6. Actual repayment
 7. Ability to repay
 8. Records reflect transfer as a loan
 9. Reporting of transfer for tax purposes is consistent with loan

The Beneficiary Defective Inheritor's Trust - "BDIT"

- **Typical Structure**

- Trust created by third party and nominally funded
- Trustee has power to distribute principal and income to beneficiary on a standard
- Beneficiary holds a testamentary special power of appointment
- Beneficiary sells assets to the trust in exchange for note
- Beneficiary is treated as the owner for income tax purposes

- **Gift tax risk?**

- Typically low -- special power of appointment should make any "gift" incomplete

- **Estate tax risk?**

- § 2036 (a)(1) - did beneficiary retain the right to possess or enjoy the property sold or the income from property sold? (implied agreement analysis)
- § 2036 (a)(2) - did beneficiary retain the right to designate the persons who shall possess or enjoy the property sold? (special power of appointment)
- Is the sale a "bona fide sale for full and adequate consideration?"

Statue 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).

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

- Substantial valuation understatement -- value of item reported is 65% or less of value as finally determined (20% penalty)
- Gross valuation understatement -- value of item reported is 40% or less than value as finally determined (40% penalty)
- Reasonable cause exception § 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)

Split Dollar Life Insurance –

Cahill v Commissioner, T.C. Memo 2018-84

- Decedent's son was trustee of decedent's revocable trust and decedent's attorney-in-fact (decedent was 90 years old and unable to manage his affairs), and as attorney-in-fact, he established an irrevocable trust (trustees had close relationship to son) to purchase life insurance
- Decedent's revocable trust purchased life insurance policies on the lives of decedent's son and the son's wife and designated the irrevocable trust as the owner
- The trusts entered into split dollar agreements under which the revocable trust would be reimbursed for the \$10 million premiums it advance at the earlier of (i) the termination of the agreement, if the trusts agreed; or (ii) the insureds' death
- Gift tax return: \$7,578 gift (per economic benefits regime (Reg. § 1.61-22))
Estate tax return: \$183,700 reimbursement right under agreements
- Estate moved for partial summary judgment on §§ 2036, 2038, and 2703, which the Tax Court (J. Thornton) denied

Split Dollar Life Insurance – *Cahill v Commissioner*, T.C. Memo 2018-84

- **2036(a)(2)/2038(a)(1) holding:**
 - The right to terminate the agreement and recover at least the cash surrender value was a “right” (an ascertainable and legally enforceable power) within § 2036(a)(2) and § 2038(a)(1) (citing *Powell* and *Strangi*); neither statute requires decedent to have unilateral control
 - Unresolved fact issues precluded deciding whether there was a bona fide sale, although the transfer was not for adequate and full consideration by the estate’s admission (~98% discount)
- **2703 holding:**
 - The provisions of the agreements that prevented decedent from immediately withdrawing his investment and allowed the irrevocable trust to veto its termination were disregarded under § 2703(a)(1)-(2) when valuing the decedent’s rights under the agreements
 - No decision was made on the application of § 2703(b)

AUSTIN

BEIJING

BRUSSELS

DALLAS

DUBAI

HONG KONG

HOUSTON

LONDON

MOSCOW

NEW YORK

PALO ALTO

RIYADH

SAN FRANCISCO

WASHINGTON

bakerbotts.com

©Baker Botts L.L.P., 2020. Unauthorized use and/or duplication of this material without express and written permission from Baker Botts L.L.P. is strictly prohibited. Excerpts and links may be used, provided that full and clear credit is given with appropriate and specific direction to the original content.