

**DUPAGE COUNTY ESTATE PLANNING COUNCIL
GIFT & ESTATE TAX UPDATE**

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Holman Redux: Timing is Everything; No Indirect Gifts Under Step Transaction Doctrine

Judge Halpern is the author of another favorable taxpayer opinion, *Gross v. Commissioner*, T.C. Memo 2008-221; No. 9693-06 (Sept. 29, 2008), involving the transfer of marketable securities to a limited partnership shortly before gifts of the LP interests were made. Judge Halpern also issued the opinion in *Holman v. Commissioner*, 30 T.C. No. 12 (May 27, 2008), reported in September's update.

In *Gross*, the IRS pursued its theory that the step transaction doctrine should be applied to treat the taxpayer's gift to family members as a gift of a proportionate part of the underlying securities contributed to the partnership rather than as a gift of partnership interests. Recall, the step transaction doctrine, as argued by the IRS, generally treats a series of formal separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Thus, when a taxpayer makes a gift of a limited partnership interest shortly after the limited partnership was funded with assets the IRS considers this to be an indirect gift of the assets. Since the limited partnership is essentially ignored, the IRS then argues there shouldn't be any discounting of the asset value.

Again, Judge Halpern did not accept the IRS argument. Just as in *Holman*, the facts and timing of the gifts are important. There were some threshold issues about the formation of the LP pursuant to New York law, which applied to the *Gross* case. However, the conduct of the parties involved was consistent with formation of a partnership and Judge Halpern decided the partnership did exist under New York law on July 15, 1998. From October 15 through December 4, 1998, Mrs. Gross, the taxpayer, transferred securities to the LP, accurately recording the increases to her capital account. On December 15, 1998, the public securities were valued at \$2,158,646. On December 15, 1998, a transfer of a 22.25% LP interest was made to the taxpayer's daughters. The Form 709 Gift Tax Return was filed claiming a 35% discount value. The IRS didn't like this, claimed an indirect gift was made and assessed a deficiency based on the full value of the transferred securities.

The IRS argued that there was a step transaction and all of the actions taken by the taxpayer were not effectively completed until December 15, 1998. Significantly, Judge Halpern's opinion observed that 11 days passed between the time of trust funding and the actual gift of the LP interests. As a result, the step transaction doctrine was determined to not apply to the facts of the case. The 35% discount on the LP gifts was upheld. The valuation and the amount of the discount were not even at issue before Judge Halpern since IRS stipulated that if the donor was

found to have made gifts of LP interests to her daughters on December 15, 2008, the values reported on the gift tax returns, with the 35% discount, were correct.

Comment: As noted above, the facts are important. In *Gross*, Judge Halpern accepted 11 days between the funding and the gift of LP interests. In *Holman*, Judge Halpern accepted 6 days. Of note is a footnote in Judge Halpern's latest opinion, footnote 5: "We caution, however, in terms similar to those as we used in *Holman v. Commissioner*, 130 T.C. ___, ___ n.7 (2008) (slip op. at 31): "The real economic risk of a change in value arises from the nature of the Dimar securities [used to fund the LP] as heavily traded, relatively volatile common stocks. We might view the impact of a 11-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond."

Is it the time delay or the type of asset that is important? It appears it is likely a combination. *Holman* and *Gross* involved the use of securities that were publicly traded. Clearly, "heavily traded, relatively volatile common stocks" may not require a long period of time for a real economic risk of a change in value to take place. Obviously, the best scenario is to take as much time as possible between funding and gifting. Proper record keeping is also important to reflect the contributions and initial capital accounts of the initial partners.

US Supreme Court will not review the IRS appeal in the *Jelke* estate tax valuation case Estate of Frazier Jelke III, 507 F.3d 1317, (11th Cir. 2007)

Earlier this month the US Supreme Court declined the IRS petition for a writ of certiorari (see, --- S.Ct. ---, 2008 WL 2481919 (U.S.)), leaving intact the Eleventh Circuit's opinion in *Estate of Jelke v. Commissioner*, 507 F.3d 1317, (11th Cir. 2007). This is the case involving the valuation of a minority interest in a holding company that held securities with a capital gain tax. In *Jelke*, the taxpayer died owning a 6.44% interest in the holding company whose only business was making investments in marketable securities. If the securities held by the holding company were to be liquidated, a \$51 million tax liability would be incurred. However, there were no plans to liquidate the holding company's assets when the taxpayer died. The Eleventh Circuit held that in determining the estate tax value of the holding company stock, the company's value is reduced by the entire built-in capital gain tax liability as of the date of death. It also allowed a lack of control discount of 10% and a lack of marketability discount of 15%. This is a big ruling for taxpayers since the IRS had been successful in the Tax Court, pushing its position that the built-in capital gain tax liability should be discounted to reflect when it that liability is reasonably expected to be incurred. The difference to the taxpayer's estate was that holding company's value was decreased by \$51 million pursuant to the Eleventh Circuit ruling, while it would have only been reduced by about \$21 million following the Tax Court's valuation approach.

Special Needs Trusts

Estate of Special Needs Child Can Deduct Loan From Parent *Estate of Hicks*, TCM 2007-182.

In this case the Tax Court allowed the estate of a special needs child to deduct a loan made by the parent to a non-special needs trust established for the benefit of such child as part of a transaction designed to preserve the future eligibility of the child for Medicaid. The details are interesting and illuminating as to what techniques the Tax Court allowed under the circumstances.

The special needs child was three years old when she was involved in an automobile-train accident that made her a quadriplegic and dependent on a ventilator to breath, as well as in need of constant medical attention for the rest of her life. A lump-sum settlement resulted from a personal injury lawsuit against the railroad company by the child's father. This included the child's injury claims and the father's loss of consortium claim, including the father's legal obligation under Ohio law to support his daughter with his own property. The settlement had to be approved by the local probate court (this was an Ohio state court matter).

The attorney for the family suggested they creation of two trusts for the child, a special needs trust and settlement fund management trust. One million dollars went into the special needs trust. The management trust received \$450,000 of the settlement. The father was allocated \$1.0 million of the settlement funds.

The special needs trust was designed to comply with the Medicaid eligibility rules applicable to such trusts in Ohio. The management trust would be counted in determining Kimberly's eligibility for Medicaid. The family attorney recommended that the father loan his \$1.0 million settlement proceeds to the management trust. The loan was evidenced by a promissory note that required the payment of interest but did not require the payment of principal. The note was callable by the father if his daughter died or she was unable to obtain medical insurance at a reasonable premium after she was 18.

The settlement was approved by the probate court. The child lived for 4 ½ years after the probate court approval of the settlement. After the approval of the settlement, the management trust paid interest to Clyde, which he reported on his income tax return each year. After the child's death, an estate tax return was filed listing the total amount of assets in both trusts and claimed the \$1 million loan from Clyde as a deductible debt.

The IRS did not like this set up and argued the *bona fides* of the loan since the father never had control or possession of the \$1.0 million settlement allocated to him. This is because the probate court approval transferred the money directly to management trust. Since the probate court was required by law to approve the settlement of the personal injury case of a minor, the Tax Court rejected the IRS's argument. Therefore, since the probate court allocated the money to the father it didn't matter if the father never really had actual control or possession.

The IRS also argued that the allocation of the \$1.0 million to the father was a sham since he and his daughter did not have adverse interests regarding the allocation of settlement proceeds. Since it was a sham, the IRS contended that the allocation should be ignored and for tax purposes the \$1.0 million belonged to the child.

Again the Tax Court rejected the IRS argument. In this instance, the court observed that the loan created a stream of income for the father that had a value. Therefore, it was erroneous as a matter of economics for the IRS to contend that the loan had no value. Further, since the loan had value, it couldn't be ignored. The court also noted that the father could've died before his daughter and the present value of the note would be part of the father's estate.

There were other factors involved in the Tax Court's decision, most of which would likely be present in any such tragic case with similar facts, including (1) the state's interest in administering its Medicaid system; (2) it appeared that tax avoidance was not the primary motivation for the allocation of the settlement proceeds; (3) the parents statutory obligation to provide support for their children under Ohio law; (4) the potential for the family to lose its

medical insurance and (5) keeping the father's settlement funds out of reach of reach of future creditors. The court determined that given Clyde's obligation to support Kimberly until she was an adult, and in light of the fact that Kimberly's care was enormously expensive, it was reasonable for Clyde to receive a significant portion of the settlement.

The family involved in this case faced a lot of obstacles. Yet, aside from approval by the probate court, this method of preserving assets for the special needs child had to also be acceptable to the local Medicaid authorities.

Illinois Probate

In re Estate of Light, No. 3-07-0688 (3d Dist. Sept. 5, 2008)

With apologies to Gertrude Stein, a rose may not always be a rose until it has been ruled upon by a court of law. In a recent Illinois Appellate Court case from the Third District the testator bequeathed two residences "and the contents thereof, all personal and chattel property" to her friends, a husband and wife. These folks thought this meant they should receive the stock certificates found in the residences. Two charities who were supposed to receive the residue of the estate thought differently. The probate court ruled the testator intended for the securities represented by the certificates should be distributed to the charities pursuant to the residuary clause in the will.

The Illinois Appellate Court said that the phrase "personal and chattel property" used in the will had never been defined by an Illinois court, but the terms had been interpreted separately. After reviewing cases from other states, the appellate court found:

- The term "chattel" extends only to tangible articles of personal property that may be possessed and delivered.
- The term "chattel" does not include securities.
- When a testator conjoins a bequest of "chattel" to another bequest, this indicates intent to convey only tangible property.
- The bequest of "all my personal effects * * * and all other goods and chattels" showed decedent's desire to convey only tangible personal property.
- Illinois courts construe "personal property" and similar terms to include only tangible personal property.
- The expression "personal property" is ordinarily and popularly used in a restrictive sense embracing only tangible goods and chattel, not money, notes or securities.
- The testator intended for her friends to receive only the tangible property in her residences and not her securities.
- The stocks and securities would go to the charities named in the residuary clause of the testator's will.

Apparently the folks inheriting the houses also wanted the executor to pay certain real estate taxes on the house pursuant to the clause that requires the executor to “pay all taxes assessed or imposed against my estate.” The appellate court ruled that the real estate taxes on the properties are assessed and imposed on the real property and not the estate.

At the hearing before the probate court the attorney that drafted the will testified that he didn’t invent the language in the will, the language was found in virtually all of the wills prepared and was boiler plate language.

Power to Substitute Property of Equivalent Value PLR 200842007; Oct. 17, 2008

In this private letter ruling the IRS has again addressed the issue of a grantor’s power to substitute property in the trust. In this fact pattern where the grantor had the power to substitute property of equivalent value and the power could only be exercised in a fiduciary capacity. The IRS stated the following:

1. “In this case, under section 7.7 of Trust, Grantor has retained the power to acquire Trust property by substituting other property of equivalent value to the property acquired, measured at the time of substitution. Under the terms of Trust, the Grantor’s power to acquire Trust property under this section may only be exercised in a fiduciary capacity. Accordingly, based on the facts presented and the representations made, we conclude that the retention by Grantor of the power of substitution will not cause Trust property to be included in Grantor’s estate for estate tax purposes under §§ 2033, 2036(a), 2038, or 2039.”

2. “[T]he exercise by Grantor of the power of substitution will not constitute a gift to Trust for gift tax purposes if the total fair market value of assets transferred to Trust equals the total fair market value of assets transferred from Trust.”

3. “[T]he Trust will be a grantor trust all of which is treated as owned by Grantor under §§ 671 and 677(a), because all of the income and principal of Trust may be distributed to Spouse in the discretion of a non-adverse trustee. Therefore, Grantor’s exercise of the power to substitute Trust assets will not result in the recognition of any gain or loss by Grantor or Trust for federal income tax purposes.”

This ruling follows Rev. Ruling 2008-22, made earlier this year, in which the grantor retained the power of substitution, but in a non-fiduciary capacity. The Service said this will not, itself, cause the value of the trust to be included in the grantor’s estate (§§2036 and 2038) as long as the trustee has the fiduciary obligation to make sure the new assets acquired and/or substituted by the grantor are equal in value. Also, such transfers can’t change the benefits among the trust beneficiaries.

In both rulings the IRS cited and relied on the Tax Court’s long-time ruling in *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), in which it was held that the reserved power to substitute securities or property of equal value was not a power to alter, amend or revoke the trust within the meaning of section 2038(a)(2). The court concluded the substitution power was held in trust where the substituted property was required to be equal in value to the assets, and therefore exercisable in good faith and subject to fiduciary standards.

The key issues, then, are whether or not there are safeguards in place to protect the beneficiaries. When there is a power to substitute assets in a trust someone with fiduciary duties must be accountable to the beneficiaries.

Code Section 162

Business deductions for home office, legal fees, and farming were not substantiated. Edward N. Fadeley v. Commissioner, (2008) TC Memo 2008-235

When you don't file your income tax returns on time, take a number of business expense deductions, loss on farm business, fail to cooperate with the IRS in the audit and pretrial process, and, further fail to participate in good faith in the Tax Court's pretrial stipulation process you are not likely to be successful in your appeal.

The petitioner is a retired state supreme court judge from Oregon. Petitioner incurred legal expenses arising out of the settlement of disciplinary issues resulting in his retirement from the Oregon Supreme Court, but also in retaining his right to a judicial retirement pension. A parcel of real estate was sold in order to pay the legal fees related to the disciplinary matter.

Since his retirement the petitioner did a limited amount of legal work, with the work being performed out of his home. The income in question is primarily pension income and Social Security. Petitioner's wife also worked part time as an employee of a company. She could have requested and received reimbursement from her employer for the employee-related expenses she incurred.

Petitioner lived on an 80-acre farm where a number of animals are raised for personal consumption. None of the animals (or meat) is sold. Petitioner did not keep separate books and records relating to the farming activity. Petitioner had no profit from the farming activity for the 5 years for which evidence presented by Petitioner.

Petitioner did not file income tax returns for a couple of years. Only after audit and a court delay in the matter did petitioner file his tax returns reporting the pension income received in each year. Petitioner attached to his return a Schedules C related to his part-time law practice, a Schedules C related to his wife's employment and a Schedules F related to the farming activity.

The taxpayer's records and testimony failed to adequately substantiate expenses or establish that such were ordinary and necessary within meaning of IRC Sec, 162. Employee-related expenses for which his wife could have received reimbursement from employer weren't deductible; evidence was vague as to taxpayer's use of his home in his part-time legal work; and taxpayer didn't establish his entitlement to loss carryover of miscellaneous itemized deductions for legal fees paid in connection with settlement of dispute over his status as state Supreme Court justice. Also, claimed additional farm expenses were rejected where taxpayer earned no income from his farm activity and failed to show that such constituted trade or business; and claimed medical and horse casualty expenses weren't supported by credible evidence.

Code Section 7701

Sole corporate owner liable for unpaid payroll taxes Kandi v. U.S., 2008 WL 4429296 (9th Cir. 9/25/08)

In an opinion of limited scope due to new rules effective January 1, 2009 (see below), the U.S. Court of Appeals for the Ninth Circuit has ruled that the sole owner of a limited liability company (LLC) was personally liable for the LLC's unpaid payroll taxes, even though the Code did not clearly address how LLCs should be taxed. IRC Sec. 7701 defines a person, partnership and corporation, but it does not state whether an LLC fits under any of these definitions. After the IRS issued an assessment for unpaid employment taxes, the taxpayer challenged the validity of the "check-the-box" regs since the Code was silent on the taxation of LLCs. The Ninth Circuit ruled that IRS's interpretation of the Code in the "check-the-box" regs was reasonable. The Court said that "the regulations were a reasonable attempt to fill in gaps left in the statute regarding the taxation of LLCs and other new forms of business entities." The opinion recognized that new regulations have addressed the issue of taxation of single member LLC's. Since these new regulations do not take effect until January 1, 2009, it didn't apply to the case at hand.

Disregarded entities must pay their own employment taxes starting in 2009 Reg. §1.1361-4; Reg. §301.7701-2(c)(2)(iv)

IRS regulations effective January 1, 2009, require "disregarded entities" to pay their own employment taxes and file their own tax reports. Therefore, a disregarded entity is treated as a separate entity for purposes of employment taxes and related reporting requirements. Under the final regulations, the separate entity is treated as a corporation for purposes of employment taxes and related reporting requirements. Note: This will require an employer identification number (EIN) for these entities.

Code Sections 2631 and 2632

IRS Letter Ruling Says Generation Skipping Transfer Exemption Allocation to Trust is Invalid

In a recently released letter ruling, PLR 2008-38-022, the IRS ruled that an allocation of the generation skipping transfer (GST) exemption to a trust was invalid. Section 2631 grants every individual a GST exemption of \$2 million (for 2008) to be allocated to transfers that may have GST tax potential. Section 2632 provides methods by which an individual's GST exemption may be allocated during a person's lifetime (Reg. §26.2632-1(b)(4)(i)) (if an allocation is made during life) and Reg. Sec. 26.2632-1(d)(1) (if an allocation is made at death), the allocation of a GST exemption to a trust is void if the trust has no GST potential with respect to the transferor for whom the allocation is being made. The new ruling highlights a situation in which a GST exemption was allocated to a trust that had no GST tax potential (and therefore void) and was then reallocated to other trusts that may have GST tax potential.

Because the taxpayer had created a trust during his life and at his death that had GST tax potential, the IRS was asked the proper allocation of the taxpayer's GST exemption in light of the voided transfer. The IRS noted that Section 2632(e) provides that to the extent an individual's GST exemption has not been allocated within the time otherwise provided in Section 2632(a) (i.e., within the time required to file a taxpayer's estate tax return), such individual's

remaining GST exemption is allocated in the following order until exhausted: (1) to direct skips and (2) to trust with respect to which the individual is a transferor and from which a taxable distribution or taxable termination may occur at or after such individual's death. In light of Section 2632(e), the IRS ruled that the taxpayer's GST exemption was to be allocated pro rata to the two trusts created by the taxpayer that could have GST tax potential.

Child of Divorced or Separated Parents Can Now Be Dependent of Both Internal Revenue Bulletin: 2008-36; Rev. Proc. 2008-48

Rev. Proc. 2008-48 describes when a child of parents divorced, separated, or living apart is a dependent of both parents for Section 105(b) (employer-provided medical expense reimbursements), 106(a) (accident or health plans), 132(h)(2)(B) (excludable fringe benefits), 213(d)(5) (deductible medical expenses), 220(d)(2) (Archer Medical Savings Account), and 223(d)(2) (Health Saving Account), when the custodial parent hasn't released the claim to the Section 152(e)(2) exemption. Rev. Proc. 2008-48 is effective August 18, 2008, but taxpayers may apply it in any taxable year beginning after December 31, 2004, if the Section 6511 period of limitation on credit or refund hasn't expired as of August 18, 2008. Previously, a child could be treated as a dependent of the noncustodial parent only if the custodial parent released the claim to the exemption.

IRS Announces 2009 Inflation Adjustments

On October 16, 2008, the IRS issued Rev. Proc. 2008-66, setting for the inflation adjusted items that will be in effect for 2009. Chief among these items is the increase of the annual gift tax exclusion from \$12,000 to \$13,000 effective January 1, 2009. The tax code permits the gift tax exclusion, which has remained at \$12,000 since 2006, to rise when inflation would produce an increase of \$1,000 or more. This year's inflation figures pushed the amount above the next \$1,000 threshold.

Rev. Proc. 2008-66 also provides that personal exemptions and standard deductions will rise and tax brackets will widen because of inflation adjustments announced by the IRS. More than three dozen tax benefits, affecting all taxpayers in some way, have been adjusted for 2009, including the following:

- The value of each personal and dependency exemption, available to most taxpayers, is \$3,650, up \$150 from 2008.
- The new standard deduction is \$11,400 for married couples filing a joint return (up \$500), \$5,700 for singles and married individuals filing separately (up \$250) and \$8,350 for heads of household (up \$350). Nearly two out of three taxpayers take the standard deduction, rather than itemizing deductions, such as mortgage interest, charitable contributions and state and local taxes.
- Tax-bracket thresholds increase for each filing status. For a married couple filing a joint return, for example, the taxable-income threshold separating the 15-percent bracket from the 25-percent bracket is \$67,900, up from \$65,100 in 2008.
- The maximum earned income tax credit for low and moderate income workers and working families with two or more children is \$5,028, up from \$4,824. The income limit for the credit for joint return filers with two or more children is \$43,415, up from \$41,646.

And, the ubiquitous arrow shaft tax is also changing for calendar year 2009: the tax imposed under § 4161(b)(2)(A) on the first sale by the manufacturer, producer, or importer of any shaft of a type used in the manufacture of certain arrows will be \$0.45 per shaft (remember the Emergency Economic Stabilization Act also provided for an excise tax exemption for certain wooden practice arrows used by children).

New Form 990 Instructions; Not-For-Profits

The IRS has revised the instructions for filling out the new Form 990 - Return of Organizations Exempt from Income Tax - which must be filed starting with tax year 2008, filed in 2009. The new form includes (1) a new governance section; (2) enhanced reporting of executive compensation and the organization's relationships with insiders and other organizations; and (3) new reporting for noncash contributions, foreign activities, tax-exempt bonds, and hospitals. The old nine-page form, with two schedules, is now being replaced with an eleven-page form and 16 schedules. Each schedule is geared to a specific type of nonprofit activity. This is likely to be a new experience for NFP's. It will be in their interests to review this form in some detail in order to be ready for its preparation before facing any filing deadlines. Also, each NFP should consider how the required information might fit into its existing recordkeeping, modifying it as needed in order to be prepared each year. News Release IR-2008-98.

The IRS is phasing in the new returns during a three-year transition period, in order to allow organizations time to adjust to the new forms. During this transition the organization's annual filing requirement will depend on its financial activity. The IRS web site has information on the filing requirements during the transition period. See, <http://www.irs.gov/charities/article/0,,id=184445,00.html>.