2011 REGIONAL FORUMS - ESTATE AND GIFT DEVELOPMENTS

CA1 tosses estate's untimely refund suit, OKs reg limiting executor to one filing extension

Dickow v. U.S., (CA 1 08/19/2011) 108 AFTR 2d ¶2011-5202

The Court of Appeals for the First Circuit has affirmed a district court decision dismissing an estate's refund claim as untimely filed more than three years and six months (i.e., **Code Sec. 6511(a)** 's three-year period plus a six-month filing extension) after the date of payment. The Court upheld the validity of **Reg. § 20.6081-1** , and found that IRS lacked the authority to grant the executor's request for a second six-month filing extension. Also, the Court determined that IRS's failure to notify the executor that it denied his request didn't equitably estop IRS from denying the refund.

Background on time limit and look-back period for refund claims. Under **Code Sec. 6511(a)** , a taxpayer must file a claim for credit or refund of an overpayment "of any tax imposed by this title in respect of which tax the taxpayer is required to file a return" within three years from the time the relevant return is filed, or two years from the time the tax is paid, whichever period expires later. (**Code Sec. 6511(a)**) No credit or refund is allowed if a claim is not filed within these time limits. (**Code Sec. 6511(b)**)

In addition, a taxpayer's claim for refund or overpayment is limited to the amount paid during the relevant "look-back period." (**Code Sec. 6511(b)(2)**) For a taxpayer who filed his refund claim during **Code Sec. 6511(a)** 's three-year period, the look-back provision limits any requested refund to "the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to three years plus the period of any extension of time for filing the return." (**Code Sec. 6511(b)(2)(A)**) The **Code Sec. 6511** provisions are jurisdictional.

Background on automatic estate tax return filing extensions. Under **Reg. § 20.6081-1** , an estate is allowed an automatic six-month extension of time beyond the date prescribed in **Code Sec. 6075(a)** (i.e., the date that is nine months after the date of the decedent's death) to file Form 706, the estate and generation-skipping transfer (GST) tax return for estates of U.S. citizens and residents, if an application on Form 4768 is filed on or before the due date for filing Form 706.

The Form 4768 must include an estimate of the amount of estate and GST tax liabilities with respect to the estate.

Background on equitable estoppel. Equitable estoppel is a judicial doctrine that precludes a party from denying his own acts or representations which induced another to act to his detriment. To invoke the doctrine, three elements must be satisfied under Ramirez-Carlo v. U.S., (CA 1 2007) 496 F3d 41 :

> (1) the party to be estopped made a "definite misrepresentation of fact to another person having reason to believe that the other [would] rely upon it";
>
> (2) the party seeking estoppel relied on the misrepresentations to its detriment;
>
> (3) the "reliance [was] reasonable in that the party claiming the estoppel did not know nor should it have known that its adversary's conduct was misleading."

Deference afforded to Treasury regs. In Mayo Foundation for Medical Education and Research, et al. v. U.S. (S Ct 1/11/2011) **107 AFTR 2d 2011-341** , the Supreme Court held that IRS regs promulgated under **Code Sec. 7805(a)** 's general grant of authority are entitled to *Chevron* deference. Under *Chevron*, a court must first consider whether the intent of Congress is clear, and if so, give effect to Congress's unambiguous intent. If the statute is silent or ambiguous on a certain issue, than the court must determine whether the agency's answer is based on a permissible construction of the statute. An agency's regs are given controlling weight unless they are "arbitrary, capricious, and manifestly contrary to the statute."

Facts. Margaret Dickow died on Jan. 15, 2003, and the tax return for her estate was due Oct. 15, 2003. On Oct. 10, 2003, D. Charles Dickow (Mr. Dickow), as executor of the estate, mailed IRS a completed Form 4768 with a $945,000 check for the estimated estate tax due. The estate was granted an automatic six-month filing extension under **Reg. § 20.6081-1(b)** to Apr. 15, 2004.

On Mar. 23, 2004, Mr. Dickow submitted an altered Form 4768 which he characterized as a second extension request for an additional six-month filing extension. He attached a statement that he was requesting "an additional six month period of time to file [the federal estate tax return] ... because, despite due diligence on his part, he has not received an appraisal of a real estate asset which constitutes a large portion of the Estate." IRS denied the request because

“by law, extension of time to file may be granted for no longer than six months,” but did not send the estate a notification of its denial.

The estate's tax return was mailed to IRS on Sept. 30, 2004, and claimed a refund of $337,139.81 based on the estate's overpayment of estimated estate taxes in October of 2003. IRS refunded the requested amount on Nov. 1, 2003.

Years later, on Sept. 10, 2007, Mr. Dickow sent IRS an amended estate tax return in which he claimed a refund of $574,953.29, consisting of the $337,139.81 that had previously been refunded and an additional $237,813.48, which IRS denied on Oct. 15, 2007. Mr. Dickow filed suit on May 14, 2009, on the grounds that the estate was entitled to the refund under **Code Sec. 6511** or under a theory of equitable estoppel.

District court decision. The district court found that the refund request didn't comply with **Code Sec. 6511(b)(2)(A)** . The court also determined that, although **Code Sec. 6081(a)** was ambiguous as to whether IRS could grant more than one six-month extension, **Reg. § 20.6081-1** made it clear that it lacked the authority to do so. Thus, because the claim was filed more than three years and six months after payment, the refund request was untimely.

The district court also found that the time to file a tax refund claim couldn't be extended based on equitable estoppel. (See U.S. v. Brockamp, (Sup Ct 1997) **79 AFTR 2d 97-986** , at **Weekly Alert ¶ 1 02/20/1997**) And in any event, even if it could, Mr. Dickow failed to show that the government engaged in any “affirmative misconduct.” Accordingly, the case was dismissed for lack of jurisdiction.

First Circuit affirms. The First Circuit held that IRS correctly determined that it lacked the authority to, and did not, grant Mr. Dickow a second six-month extension.

Applying deferential *Chevron* analysis (see **Weekly Alert ¶ 19 01/20/2011**), the Court found that **Code Sec. 6081** was itself unclear as to whether IRS has the authority to grant successive extensions. The Court then turned to **Reg. § 20.6081-1** , which allows only a single extension under the facts of this case, and determined that such reflected a reasonable interpretation of the statute.

The Court also rejected Mr. Dickow's claim that IRS was equitably estopped from denying his refund based on its alleged misrepresentation, in that it failed to inform him that it denied his second extension request. The Court found that (i) **Code Sec. 6511** isn't subject to equitable exceptions under *Brockamp*, and (ii) Mr. Dickow failed to establish that the elements of equitable estoppel were met. Mr. Dickow's inaction-based argument was characterized by the Court as a “non-starter,” especially in light of the fact that there was no statute or reg requiring IRS to notify him of its denial.

References: For time limits and look-back period for filing refund claims, see **FTC 2d/FIN ¶ T-7500** et seq.; **United States Tax Reporter ¶ 65,144** et seq.; TaxDesk ¶ 803,048 ; TG ¶ 70901 . For automatic extension of time to file estate tax and GST tax return, see **FTC 2d/FIN ¶ S-5035.1** , **United States Tax Reporter ¶ 60,814** ; TaxDesk ¶ 783,510 ; TG ¶ 41806 .

Gross estate—trust assets—power of appointment—ascertainable standard—welfare.

IRS's determination that estate was required under **Code Sec. 2041** to include value of assets held in trust, which had been established by decedent's predeceased husband for her and other family members and over which she as co-trustee held POA, was rejected: POA was limited by ascertainable standard relating to decedent's health, education, support, or maintenance within meaning of **Code Sec. 2041(b)(1)(A)** 's exception to general POA rule. Although subject POA also included power to invade for reasons of welfare or other necessary expenditures, such didn't destroy exception/didn't take POA outside scope of exception's requisite purposes when considering operative Mississippi law and that subject welfare or other necessary expenditures language was bookended by “necessary” and “needed” qualifiers and as such, was just meant to refer to decedent's and other beneficiaries' maintenance and support according to their accustomed standards of living. (Estate of Ann R. Chancellor, et al. v. Commissioner, (2011) **TC Memo 2011-172** , 2011 RIA TC Memo ¶2011-172)

Estate denied deduction for claim relating to care provided decedent by her son

Estate of Emilia W. Olivo, TC Memo 2011-163

The Tax Court has held that an estate could not deduct as a claim against the estate a large amount supposedly owed by the decedent to her son for caretaking services he provided to her for several years before her death. The claim was based on an alleged agreement that had not

been reduced to writing, even though the son had been a practicing attorney before he became engulfed in caretaking. The only evidence the estate offered to prove the alleged agreement was the son's testimony, which the Court found to be improbable, self-serving, and uncorroborated.

Facts. Emilia W. Olivo died without a will on April 26, 2003. At the time of her death, she was a widow living in New Jersey. She was survived by two sons and two daughters. One son, Mr. Olivo, the administrator of the estate, lived with his mother at the time of her death. He cared for his mother and father for many years before their deaths. His caretaking starting in the fall of '94, when his mother fell and suffered a compression fracture of her lower spine that left her nearly paralyzed in both legs.

Mr. Olivo was a lawyer but his practice began to disintegrate during the mid '90s, in part because of the amount of time he devoted to his parents' health problems. He prepared durable powers of attorney for his parents and they executed them in '95 (father) and '96 (mother). His father died in the fall of '95 and the probating of his will was highly contentious. Family relationships became strained after that and remained so until 2000.

Emilia had numerous health problems during the last years of her life. The compression fractures to her spine left her incapable of caring for herself and basically paralyzed in both legs. Mr. Olivo purchased a Hoyer lift to move her from bed to her wheelchair and back. She also required assistance to use the bathroom, to get dressed, and to bathe. She had a number of other problems including incontinence, which required Mr. Olivo to clean up after her and change her clothes. She was a diabetic, which required Mr. Olivo to test the insulin levels in her blood several times each day and, if needed, inject her with insulin.

Mr. Olivo was also responsible for preparing all meals and doing general housekeeping. He employed home health aids to assist him, but the aids were not registered nurses and therefore could not administer Emilia's medications or do the blood sticks and insulin injections she required.

Mr. Olivo kept extensive records of his mother's medications, hospital visits, and diagnoses. He also kept a composition notebook where he recorded her blood sugar levels, blood pressure, pulse, and body temperature.

Caring for his mother took a toll on Mr. Olivo. At some point during '98, his brother, an M.D., became concerned about Mr. Olivo's health. After being criticized by a sister, Mr. Olivo offered to stop providing care and to hire round-the-clock nurses instead. His three other siblings, however, asked him to continue the care and he did so until his mother's death.

Mr. Olivo prepared an estate tax return before he was formally appointed as administrator (there was a delay because one sister initially refused to renounce her right to be appointed as administratrix). This return claimed a deduction of $1,240,000 as a debt the estate owed to him for the care he provided to his mother pursuant to an alleged agreement he had with her to compensate him for his services in caring for her (alleged agreement).

Regarding the alleged agreement, during the Tax Court trial, Mr. Olivo testified that at some point during '98, he learned that one of his sisters had commented that all he did was sit around and watch television while getting free room and board. He was upset by the remark, and he told his mother, who offered to pay him $1,000 per week for the care-giving. Mr. Olivo said that he suggested that $200 per day would be agreeable to him. However, he further testified that he became worried about his mother's finances, and he suggested that she defer the payment until her death. He said that, to avoid a complicated interest calculation, she agreed to pay him $400 per day with payment deferred until after her death.

However, Mr. Olivo never reduced the alleged agreement to writing. He acknowledged during his testimony that he "could have and should have" memorialized their agreement, but he was too distracted by the day-to-day details of caring for decedent. He explained that he was not thinking like a lawyer during that time.

Background. **Code Sec. 2053(a)** allows various deductions in arriving at the taxable estate including claims against the estate. (**Code Sec. 2053(a)(3)**)

No deduction. The Tax Court observed that the only evidence the estate offered to prove the alleged agreement was the testimony of Mr. Olivo. It stressed that Mr. Olivo never reduced the alleged agreement to writing, nor were there any other witnesses to the alleged agreement or any other corroborating evidence. The Tax Court said it did not have to accept testimony that is improbable, self-serving, and uncorroborated by other evidence.

The Tax Court also noted that, under New Jersey law, the oral promise of a decedent must be proved by clear and convincing evidence. However, it did not decide whether to apply that standard because it found that Mr. Olivo's testimony failed to satisfy even the less exacting preponderance standard normally applied by the Tax Court.

The Court said that Mr. Olivo's testimony recounting the facts surrounding the alleged agreement was highly questionable. Although the Court understood that he had a lot on his mind during the years when he was caring for his parents, his claim that he was unable to think like a lawyer during that period was belied by the fact that he prepared powers of attorney for both of his parents and had his parents execute them. Given his training and experience as an attorney, how contentious the probating of his father's estate had been, the apparent animosity between him and one sister, and his vested interest in ensuring that he would receive compensation from his mother pursuant to the alleged agreement, the Court did not believe that he would not have reduced the alleged agreement to writing or at least have some corroborating evidence beyond his self-serving testimony.

In light of the foregoing, the Court declined to accept Mr. Olivo's uncorroborated testimony regarding the alleged agreement. Accordingly, it concluded that the estate failed to establish that his mother entered into the alleged agreement with Mr. Olivo. Consequently, the Court held that Mr. Olivo's claim for compensation pursuant to the alleged agreement may not be deducted by the estate.

In the alternative, the estate contended that Mr. Olivo was entitled to some recovery under quantum meruit. Even in the absence of a contract, when one party has conferred a benefit on another and the circumstances are such that it would be inequitable to deny recovery to the party conferring the benefit, New Jersey courts allow recovery in quasi-contract. Quantum meruit is a type of quasi-contractual recovery that allows a plaintiff to recover the reasonable value of services rendered when the plaintiff conferring the services had a reasonable expectation of payment.

The Court stressed that Mr. Olivo's care for his mother during the last years of her life was extraordinary, and the efforts he expended on her behalf were commendable. However, it concluded that the estate did not show that Mr. Olivo was entitled to recover for that care

under quasi-contract because there is a presumption under New Jersey law that services rendered to a family member living in the same household are rendered gratuitously.

References: For the estate tax deduction for claims against an estate, see **Federal Tax Coordinator 2d ¶ R-5456** ; **United States Tax Reporter Estate & Gift ¶ 20,534.07** ; TaxDesk ¶ 776,046 ; TG ¶ 41251 .

Tax Court finds estate tax value of interest in publishing company was less than reported

Estate of Louise Paxton Gallagher, TC Memo 2011-148

An estate challenging an almost $7 million estate tax deficiency stemming from IRS's claim that the decedent's interest in a publishing company was undervalued has prevailed in Tax Court. Using the discounted cashflow method and applying minority and lack of marketability discounts, the Tax Court has found that the interest was worth about $2 million less than the reported value.

Background. A decedent's gross estate includes the fair market value (FMV) of all of the decedent's property at the time of his death. (**Code Sec. 2031**) FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. (**Reg. § 20.2031-1(b)**)

Under Tax Court precedent, if the property to be valued is stock of a closely held corporation, its FMV is best determined through arm's-length sales near the valuation date of reasonable amounts of that stock. If it is not possible to so value the stock, however, FMV is calculated by analyzing the value of publicly traded stock in comparable corporations engaged in the same or a similar line of business, as well as by considering certain factors that an informed buyer and seller would consider.

A generally accepted method for valuing stock of a closely held company is the guideline company method. It is a market-based valuation approach that estimates the value of the subject company by comparing it to similar public companies.

Facts. Louise Paxton Gallagher died on July 5, 2004 (the valuation date). Among the assets includable in her gross estate were 3,970 membership interests (units) in Paxton Media Group, LLC (PMG), a Kentucky limited liability company (LLC). Based on an appraisal, the units were reported on the estate tax return at a value of $34,936,000 or $8,800 per unit.

IRS issued a notice of deficiency asserting that the units were worth $49,500,000 on the valuation date.

Appraisals done on behalf of the estate after IRS began its examination and before trial found values of $26,606,940 and $28,200,000. An appraisal done by IRS before trial showed a value of $40,863,000.

W.F. Paxton formed PMG in 1896 in Paducah, Kentucky. The privately held and family-owned newspaper publishing company initially operated one newspaper. PMG grew by acquiring underperforming companies and improving their financial performance. Due, in part, to that strategy, by July 2004, PMG published 28 daily newspapers, 13 paid weekly publications, and a few specialty publications, and owned and operated a television station. PMG was carrying out that acquisition strategy as of the valuation date.

PMG served primarily small and mid-sized communities in the southeastern and midwestern U.S. It dominated the print media in those communities by reporting mostly local news, unlike its competitors. That dominance generated higher and more consistent revenue streams for PMG than were received by other companies in the industry.

Parties' valuations. IRS's expert valued the units using both a market approach and an income approach. He applied a 17% minority discount to the result under the income approach, and then applied a 31% marketability discount to the results under both approaches. After according both approaches equal weight, he derived a unit value for PMG of $10,293, concluding that the decedent's units had an FMV of $40,863,000.

The estate's expert relied primarily on the income approach in valuing the decedent's units, using the market approach only to establish a reasonable estimate of FMV. After certain adjustments and applying a 30% lack of marketability discount to his result, he concluded that the FMV value of the decedent's units was $28,200,000, or $7,100 per unit.

Among other items, the experts disagreed over the propriety of relying on a market-based valuation approach (specifically the guideline company method) in valuing the units, the application of the income approach (specifically the discounted cashflow valuation method), and the proper type and size of applicable discounts.

Tax Court's findings. The Tax Court found that IRS's expert improperly relied on the guideline company method because the four guideline companies he used alone were not similar enough to PMG to warrant application of that method.

Given the lack of public companies comparable to PMG, the Tax Court agreed that the discounted cashflow (DCF) method was the most appropriate method under which to value the units. The DCF method is an income-based approach whereby a company's value is measured by the present value of future economic income it expects to realize for the benefit of its owners. Both experts used it in their appraisals but disagreed as to various adjustments and other factors in applying it. The Tax Court resolved these disputes in some cases agreeing with IRS's expert and in others agreeing with the estate's expert.

The Court then went on to resolve disputes over discounts. Specifically, the Court determined a 23% minority discount to the equity value of PMG computed on a 30% controlling interest basis under the DCF method. It also found a 31% lack of marketability discount to be appropriate.

Accordingly, applying the foregoing methodology and discounts, the Tax Court determined that the value of the units as of the valuation date was $32,601,640.

References: For the valuation of property generally, see **FTC 2d/FIN ¶ P-6000** et seq.; TaxDesk ¶ 481,000 et seq.

No gifts triggered by trust transfers to resolve family discord

PLR 201119003

IRS has privately ruled that transactions between a marital trust and a decedent's children from his first marriage to resolve discord between his surviving spouse and her stepchildren won't trigger gifts and won't result in a deemed transfer of the remainder interest in the marital trust.

Facts. Decedent and Spouse 1 established Family Trust, a revocable trust. After the death of Spouse 1 and Decedent's remarriage to Spouse 2, Decedent amended and restated Family Trust. Upon Decedent's death, Family Trust became irrevocable. Decedent was survived by Spouse 2, Child 1, Child 2, grandchildren and great-grandchildren. Spouse 1 was the mother of Child 1 and Child 2.

Spouse 2 and Trustee (together, Trustees) serve as co-trustees of Family Trust as well as the trusts created thereunder upon the death of Decedent.

Along with cash and securities, Marital Trust was funded with ownership interests in entities holding commercial real estate. In nineteen of these entities, Marital Trust held only a partial interest, with the balance of ownership held or shared by Child 1, Child 2, and/or a trust for the benefit of Child 1. At the time of Decedent's death, Child 1 served as a manager, managing member, or general partner of at least eight of these entities.

More than 2 years after Decedent's death, Child 1 and Child 2 filed a petition in state court for an accounting by the Family Trust. Trustees filed a petition to establish ownership interests of Marital Trust in certain entities. Eventually, the parties negotiated a settlement agreement (Agreement).

Under the terms of Agreement, Marital Trust will purchase, at fair market value (FMV), the interests of the other parties in certain named entities so that Marital Trust will own an interest of 100% in these entities. Likewise, Child 1 and Child 2 will purchase, at FMV, Marital Trust's interest in certain named entities so that Child 1 and Child 2 and any trust for the benefit of Child 1 will own an interest of 100% in these entities. After these purchases, the entities previously-owned partially by Marital Trust and partially by Child 1, Child 2, and/or a trust for the benefit of Child 1 will be either wholly owned by Marital Trust or wholly owned by Child 1,

Child 2, and/or a trust for the benefit of Child 1. To the extent there is any difference in the aggregate FMV of the Marital Trust purchases and the Child 1 and Child 2 purchases, an equalizing payment will be made. FMV will be determined impartially, by two commercial appraisers selected by a retired judge (collectively, “FMV exchange”).

Marital deduction background. Qualified terminable interest property (QTIP) qualifies for the estate tax marital deduction under **Code Sec. 2056(b)(7)** . To qualify as QTIP, the decedent's spouse must get a qualifying income interest for life, an irrevocable election must be made, and other requirements must be met.

The QTIP is included in the donee spouse's estate on her death. (**Code Sec. 2044**) However, transfer tax is accelerated if the spouse makes a gift of her income interest. Under **Code Sec. 2519** , if a spouse makes a gift of *any portion* of her qualifying income interest in the QTIP trust, she is deemed to make a transfer of the entire value of the remainder. In addition, the transfer of the income interest itself is subject to gift tax under general principles. (**Reg. § 25.2519-1(a)**)

The conversion of QTIP into other property in which the donee spouse has a qualifying income interest for life is not treated as a disposition of the qualifying income interest. Thus, the sale and reinvestment of assets of a trust holding QTIP is not a disposition of the qualifying income interest, provided that the donee spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment. Similarly, the sale of real property in which the spouse possesses a legal life estate, followed by the transfer of the proceeds into a QTIP trust, or by the reinvestment of the proceeds in income producing property in which the donee spouse has a qualifying income interest for life, is not considered a disposition of the qualifying income interest. On the other hand, the sale of QTIP followed by the payment to the donee spouse of a portion of the proceeds equal to the value of the donee spouse's income interest, is considered a disposition of the qualifying income interest. (**Reg. § 25.2519-1(f)**)

Gift tax background. The gift tax is imposed on the transfer of money or other property by gift. (**Code Sec. 2501(a)**)

The gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. (**Code Sec. 2511**)

The gift tax does not apply to a transfer for full and adequate consideration in money or money's worth. (**Reg. § 25.2511-1(g)(1)**)

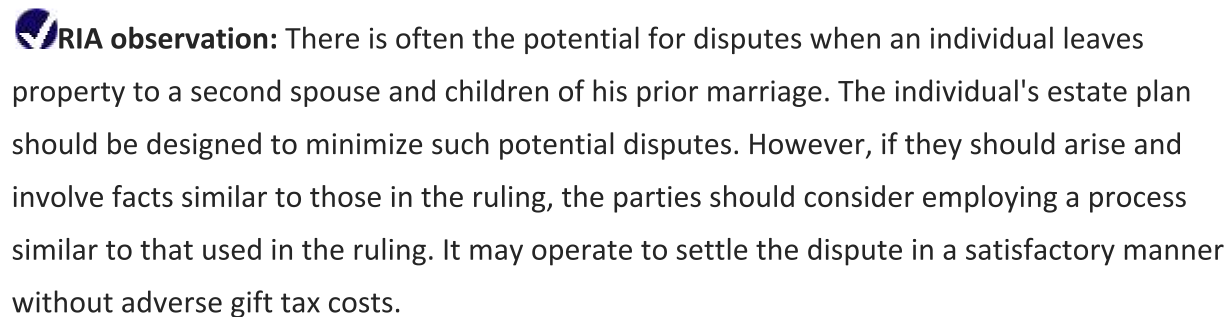
Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property transferred exceeds the value of the consideration received is considered a gift. (**Code Sec. 2512**) Transfers reached by the gift tax include sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration received. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), is considered as made for an adequate consideration in money or money's worth. (**Reg. § 25.2512-8**)

Favorable rulings. IRS observed that the FMV exchange process was the product of a court-ordered mediation proceeding presided over by a retired judge. The mediation proceeding was ordered to resolve the ongoing and, at times, contentious dispute between Trustees, Child 1, and Child 2 regarding (1) the administration of Family Trust and Marital Trust, (2) Marital Trust's management rights over certain properties, and (3) Marital Trust's ownership interest in entities owned partially by Marital Trust, Child 1, Child 2, and a trust for the benefit of Child 1.

IRS concluded that the FMV exchange procedures were the result of a bona fide adversarial proceeding and arms-length negotiations. Therefore, to the extent the payments made and received in the FMV exchange process are distributed in accordance with each party's respective ownership interest, as properly determined under applicable local law, IRS concluded that the transfers occurring pursuant to the FMV exchange will be made for adequate and full consideration in money or money's worth and will not be subject to the gift tax.

IRS further found that, upon the conclusion of the FMV exchange process, Spouse 2 will continue to possess a qualifying income interest for life in the assets of Marital Trust and Spouse 2's right to income will not be diminished or relinquished. Thus, it concluded that, under **Reg. § 25.2519-1(f)** , the sale and purchase of ownership interests in various entities held by Marital Trust and the payment or receipt of an equalizing payment pursuant to the FMV

exchange process won't be treated as a disposition of a qualifying income interest life under **Code Sec. 2519** .



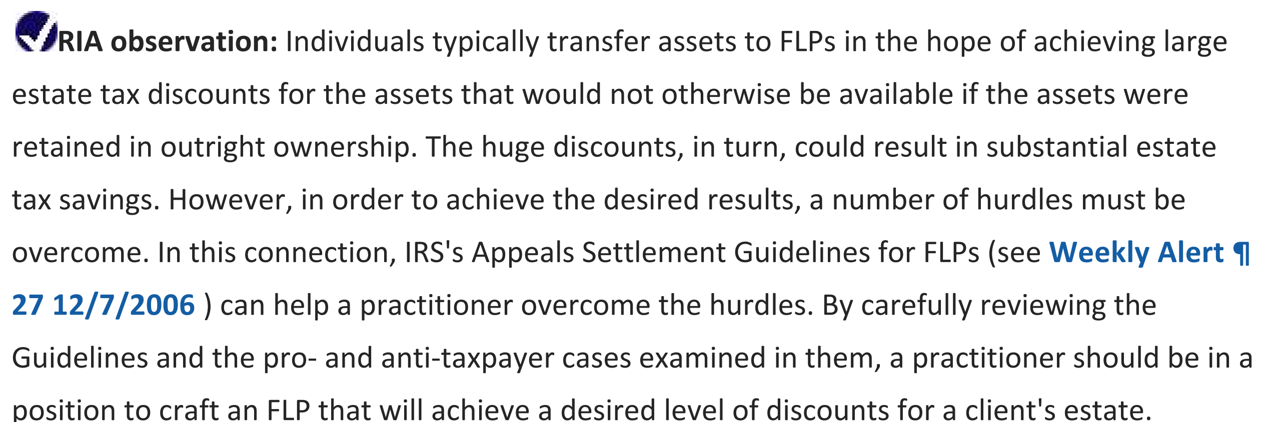
RIA observation: There is often the potential for disputes when an individual leaves property to a second spouse and children of his prior marriage. The individual's estate plan should be designed to minimize such potential disputes. However, if they should arise and involve facts similar to those in the ruling, the parties should consider employing a process similar to that used in the ruling. It may operate to settle the dispute in a satisfactory manner without adverse gift tax costs.

References: For gifts of income interests in QTIPs, see **FTC 2d/FIN ¶ Q-6315** ; **United States Tax Reporter Estate & Gift ¶ 25,194** ; TaxDesk ¶ 736,016 .

Ninth Circuit upholds inclusion of securities transferred to FLP in decedent's estate

Estate of Erma V. Jorgensen, (CA 9 5/4/2011) **107 AFTR 2d ¶ 2011-793**

The Court of Appeals for the Ninth Circuit has affirmed a Tax Court decision that assets transferred by an individual to two family limited partnerships (FLPs) were includible in her gross estate under **Code Sec. 2036** . The overall facts of the case, including that FLP funds were used to pay a significant portion of the decedent's personal income taxes, showed that she retained the economic benefits of such property and that the transfer wasn't a bona fide sale for adequate consideration.



RIA observation: Individuals typically transfer assets to FLPs in the hope of achieving large estate tax discounts for the assets that would not otherwise be available if the assets were retained in outright ownership. The huge discounts, in turn, could result in substantial estate tax savings. However, in order to achieve the desired results, a number of hurdles must be overcome. In this connection, IRS's Appeals Settlement Guidelines for FLPs (see **Weekly Alert ¶ 27 12/7/2006**) can help a practitioner overcome the hurdles. By carefully reviewing the Guidelines and the pro- and anti-taxpayer cases examined in them, a practitioner should be in a position to craft an FLP that will achieve a desired level of discounts for a client's estate.

Background. An individual's gross estate includes property he transferred during his life if he retained for life the possession or enjoyment of the property, or the right to the income from the property. (**Code Sec. 2036(a)(1)**) This requirement is met if there is an implied agreement among the parties to the transaction at the time of transfer that the transferor may retain the possession or enjoyment of, or the right to the income from, the transferred property.

No inclusion is required if the transfer was a bona fide sale for an adequate and full consideration in money or money's worth. (**Code Sec. 2036(a)**)

Facts. Erma V. Jorgensen (Ms. Jorgensen) was a resident of California when she died with a will on Apr. 25, 2002. In '95, Ms. Jorgensen and her husband, who died a year later, formed an FLP called the Jorgensen Management Association (JMA-I) by each contributing marketable securities valued at $227,644 in exchange for 50% limited partnership interests. Other family members were given interests in the partnership.

A second FLP, JMA-II was formed by Ms. Jorgensen on July 1, '97 when she contributed about $1.8 million of marketable securities in exchange for her initial partnership interest. Children and grandchildren received interests in JMA-II. Because the value of each of these interests exceeded the then available $10,000 annual exclusion, gift tax returns should have been but weren't filed.

Neither JMA-I nor JMA-II operated a business. The FLPs held passive investments only, primarily marketable securities, and neither maintained formal books or records.

Although the partnership agreements stated that withdrawals could only be made by general partners, Ms. Jorgensen was authorized to write checks on the JMA-II checking account, and she wrote checks on both the JMA-I and JMA-II accounts. Some withdrawals were used to make gifts, some of which should have been but weren't reported on gift tax returns.

In 2003 through 2006, JMA-I and JMA-II sold certain assets, including stock that Ms. Jorgensen had contributed to the partnerships during her lifetime. In computing the gain on the sale of those assets, the partnerships used Ms. Jorgensen's original cost basis in the assets, as opposed to a step-up in basis equal to the fair market value of the assets on Ms. Jorgensen's date of

death under **Code Sec. 1014(a)** . The JMA-I and JMA-II partners reported the gains on their respective Forms 1040 and paid the income taxes due.

Tax Court's decision. The Tax Court determined that Ms. Jorgensen's estate included the value of the securities which she contributed to both of the FLPs. The Court rejected the estate's argument that the transfers of securities weren't “transfers” under **Code Sec. 2036(a)** , concluding that this term encompassed any inter vivos voluntary act of transferring property, including the transfers at issue. The estate's claim that the transfers were bona fide sales for full and adequate consideration, because Ms. Jorgensen had several nontax reasons for making the transfers, including management of her assets and financial education of family members, was belied by overall facts and circumstances surrounding the formation, funding, and management of the partnerships.

The Court also concluded that there was an implied agreement at the time of the transfers that Ms. Jorgensen would retain the economic benefits of the property, even if the retained rights were not legally enforceable. However, the Court partially upheld the estate's equitable recoupment claim for income taxes paid by Ms. Jorgensen's children and grandchildren (JMA-I and JMA-II partners) on sales of stock that occurred in 2003 through 2006, the values of which the Tax Court held were properly included in the value of Ms. Jorgensen's gross estate. (For more details, see **Weekly Alert ¶ 12 04/02/2009**)

Ninth Circuit affirms. The Court of Appeals for the Ninth Circuit agreed with the Tax Court's decision to include the transferred amounts in Ms. Jorgensen's estate. The estate argued on appeal that, although Ms. Jorgensen retained some benefits in the transferred property, the amounts for which benefits were retained should be considered de minimis or should be limited to the actual amount accessed by decedent. However, the Ninth Circuit rejected these arguments, finding that the $90,000 in checks personally written by Ms. Jorgensen and the use of $200,000 FLP funds to pay her personal estate taxes weren't de minimis.

The Ninth Circuit also agreed with the Tax Court's conclusion that there was an implied agreement that Ms. Jorgensen could have accessed any amount of the transferred assets, and the fact that she only accessed a specified amount doesn't undermine that conclusion. Additionally, it found no clear error in the Tax Court's conclusion that the transfer wasn't a bona fide sale for adequate consideration. Noting that transfers to FLPs are subject to heightened

scrutiny, the Ninth Circuit agreed that the nontax reasons advanced by the estate were either weak or refuted by the record.

References: For the retained enjoyment rule, see **Federal Tax Coordinator 2d ¶ R-2400** ; **United States Tax Reporter Estate & Gift ¶ 20,364** ; TaxDesk ¶ 764,000 ; TG ¶ 40750 .

Settlement paid under botched will yields charitable deduction for estate

Estate of Antonio J. Palumbo, (DC PA 03/09/2011) 107 AFTR 2d ¶ 560

A district court has held that a large sum (almost $12 million) paid to a charity under a settlement agreement between the decedent's son and the charity qualified for an estate tax charitable deduction. The court rejected IRS's assertion that no deduction was allowable because the amount was not paid by operation of a residuary clause in the decedent's will. The court allowed the deduction because the will's draftsman acknowledged botching the will and there was no collusion among the parties to achieve a deduction.

Facts. Antonio J. Palumbo died on Dec. 16, 2002. In '74, he had created the A.J. and Sigismunda Palumbo Charitable Trust (the Charitable Trust).

Mr. Palumbo executed various wills and trust instruments with testamentary provisions during his lifetime. At the time of his death, his will executed on July 6, '99, together with its three codicils was in effect. The first paragraph stated that taxes were to be paid out of the residuary estate. The third paragraph of the will identified and defined the Charitable Trust, naming it as a remainder beneficiary in several places throughout the will and the three codicils.

The estate and IRS agreed that there was no express residuary provision in the will due to a scrivener's error on the part of Mr. Palumbo's attorney. Earlier iterations of the will had a residuary provision.

As a result of the lack of a residuary provision, Mr. Palumbo's son claimed that as the sole intestate heir, he alone was entitled to the residuary estate. However, the Charitable Trust contacted Mr. Palumbo's son and claimed that it was entitled to the residuary estate because the missing residuary clause in the '99 will was due to scrivener's error. Counsel for Mr.

Palumbo's son and the Charitable Trust entered into negotiations and eventually reached a settlement agreement with respect to the distribution of the residuary estate. The settlement was agreed to by Mr. Palumbo's son, the Charitable Trust, Mr. Palumbo's daughter-in-law, Mr. Palumbo's wife at the time of his death, and the Attorney General for the Commonwealth of Pennsylvania.

Under the terms of the agreement, the Charitable Trust received a portion of the residuary estate amounting to $11,721,141 and Mr. Palumbo's son received $5,600,000 and real property. The settlement agreement was approved by a July 10, 2003 Order of the Orphans' Court Division of the Court of Common Pleas of Elk County, Pennsylvania, upon the filing of a joint petition for approval of the settlement.

After entering into the agreement, the estate filed a claim for a federal estate tax charitable deduction in the amount of $11,721,141. IRS disallowed the charitable deduction, finding that the transfer had been made by Mr. Palumbo's son via a settlement agreement, and not by Mr. Palumbo through his '99 will.

The estate then sued in district court. The estate asserted that it was entitled to a return of the taxes paid on the $11,721,141 (plus interest), because this amount should be allowed as a charitable deduction under **Code Sec. 2055** .

Background. A deduction from the gross estate is allowed for the value of property included in the decedent's gross estate and transferred by the decedent during his lifetime or by will to qualifying organizations for public, religious, charitable, scientific, literary, educational, and certain other purposes. The amount of the deduction is the value of the property or interest transferred but may not exceed the value of the transferred property required to be included in the gross estate. (**Code Sec. 2055**)

District court sides with estate. IRS urged the Court to narrowly construe **Code Sec. 2055** to disallow the deduction. However, the court declined to do so because of the facts of the case and legislative history, which showed that **Code Sec. 2055** was designed to encourage charitable gifts.

IRS also argued that the court had to find in its favor because the Charitable Trust had no enforceable right to any portion of the residuary estate under Pennsylvania law. The court observed that Mr. Palumbo repeatedly manifested his intent to leave the residuary of his estate to the Charitable Trust as evidenced by earlier iterations of his will and other documents provided to the court by the parties. In addition, the court noted that the attorney who drafted the will admitted in a malpractice suit that he failed to include a provision concerning the residuary estate.

IRS countered that, under Pennsylvania law, the district court could not consider matters external to the '99 will. The court agreed that it is generally the rule of law in Pennsylvania to look only to the "four corners" of a document in order to ascertain the testator's intent. However, the court stressed that in Pennsylvania, there is a long-standing, case law-supported history which indicates that two general principles apply when interpreting a will: (1) when a person prepares a will, it is presumed that the person intended to dispose of the entirety of the estate and not die intestate as to any portion of it, and if possible to do so, a will must be construed to avoid an intestacy; and (2) the duty of the court is to ascertain, if possible, the intent of the testator.

Summarizing the situation, the court noted that there was no dispute that the '99 will was the last written iteration of Mr. Palumbo's intent. However, the parties agreed that prior testamentary documentation provided for a residuary estate, and that in all prior documentation, the residuary estate was left to the Charitable Trust. It was also uncontested that Mr. Palumbo's attorney admitted that he made a scrivener's error when preparing the '99 will, in that he failed to include a provision for the residuary estate. The parties also agreed that after the dispute arose, arm's length negotiations resulted in the settlement.

The court concluded that the negotiations were held at arms-length, that all of the legatees signed the settlement agreement (which was approved by the Orphan's Court), and there was no evidence of any collusion among the parties to the agreement nor any collusion on the part of their respective attorneys.

The court also found that the prior instruments showed Mr. Palumbo's intent to devise and bequeath his residuary estate to the Charitable Trust and that there was no evidence that he intended to disinherit the Charitable Trust. The court thus determined that the failure of the '99

will to provide for a residuary estate was not by design of the testator but due to human error on the part of his attorney. As such, the Court found that the estate was entitled to a charitable deduction under **Code Sec. 2055** in the sum of $11,721,141.

References: For estate tax deduction for charitable transfers, see **Federal Tax Coordinator 2d ¶ R-5700** ; **United States Tax Reporter Estate & Gift ¶ 20,554** ; TaxDesk ¶ 777,000 ; TG ¶ 41301 .

Ninth Circuit holds that palimony suit could qualify as a deductible claim against an estate

Estate of Bernard Shapiro, (CA 9 2/22/2011) 107 AFTR 2d ¶ 2011-483

The Court of Appeals for the Ninth Circuit, reversing and remanding a district court decision, has held that a palimony suit could be a sufficient claim to support an estate tax deduction under **Code Sec. 2053(c)(1)(A)** . The Court found that the district court's summary judgment holding an individual's homemaking services could not provide sufficient consideration to support a cohabitation contract was premised upon a misconstruction of Nevada law.

Background. Under **Code Sec. 2053(c)(1)(A)** , a claim based on a promise or agreement where the obligation is not imposed by law or legal process (other than for a charitable or similar pledge) is deductible for estate tax purposes only to the extent that the obligation was contracted in a bona fide agreement and for a full and adequate consideration in money or money's worth.

Facts. Bernard Shapiro and Cora Jane Chenchark lived together for twenty-two years, but they never married. During that time, Chenchark cooked, cleaned, and managed their household. When they broke up, she filed a palimony suit against him, claiming a breach of express and implied contract, breach of fiduciary duty, and quantum meruit (assumption that she deserved to be paid a reasonable amount for her services). Her complaint asserted that she and Shapiro had agreed to pool their resources and to share equally in each others' assets. While the suit was pending, Shapiro died.

Shapiro's estate filed an estate tax return and paid over $10 million in estate and generation-skipping transfer taxes. The Estate opposed Chenchark's claim, and a jury verdict in favor of the

Estate specifically found that Shapiro and Chenchark did not enter into any express or implied contract. Chenchark appealed, and while the appeal was pending Chenchark's claim was settled for approximately $1 million.

The Estate filed an amended estate tax return seeking, among other adjustments, to deduct $8 million from the value of the taxable estate under **Code Sec. 2053(a)(3)** for Chenchark's claim. The Estate claimed a refund of approximately $3.5 million. IRS disallowed any deduction for Chenchark's claims. The Estate brought a refund suit for $2 million based on an expert's valuation of Chenchark's claim at just over $5 million as of the date of Shapiro's death.

District court's decision. The district court concluded that, as a matter of law, Chenchark's homemaking services did not provide sufficient consideration to support a cohabitation contract between Shapiro and Chenchark. Accordingly, it found that an estate tax deduction for the value of Chenchark's claim was properly disallowed. The district court did not base its ruling on an application of **Code Sec. 2053(c)(1)(A)** 's requirement that the underlying promise or agreement be contracted "for an adequate and full consideration in money or money's worth." Rather, it rejected the deduction based on its reading of Nevada state law on contracts between cohabitating partners, as embodied in *Western States Construction, Inc. v. Michoff* (Nev. 1992), 840 P.2d 1220.

Court's conclusion. The Ninth Circuit concluded that the district court erred in its conclusion that Chenchark did not have a valid contract claim because her love, support, and homemaking services did not—as a matter of law—provide sufficient consideration to support a contractual agreement. The Court reasoned that the homemaking services, such as those provided by Chenchark, could be quantified and had a value attached to them. These services were not of zero value as a matter of law, as the district court apparently believed. While the Court agreed with IRS's contention that under **Code Sec. 2053(c)(1)(A)** , a claim founded on a promise or agreement, like Chenchark's claim, was only deductible to the extent it was contracted in a bona fide agreement and for adequate and full consideration in money or money's worth, the Court found that the district court never reached this issue.

The Ninth Circuit held that the district court misconstrued the holding in *Western States Construction,* finding that nothing in that decision supported the district court's conclusion that love, support, and management of a household could not, as a matter of law, constitute

consideration for a promise to share property under Nevada law. In *Hay v. Hay* (Nev. 1984), 678 P.2d 672, the Nevada Supreme Court ruled that unmarried cohabitants may sue to enforce contracts concerning property rights. The Nevada Supreme Court reaffirmed the right of cohabitants to contract in *Western States Construction.* Further, the Ninth Circuit considered it likely that Nevada would join those California and Arizona courts in holding that homemaking services could be adequate consideration for a property-sharing agreement between cohabitants.

The Court remanded the case to the district court. Even if a fact finder determined that Chenchark's claim was supported by "adequate and full consideration," the Estate still needed to prove the value of Chenchark's claim in order to get the deduction that it claimed. The value of the claim (and the corresponding allowable estate tax deduction) was a matter for the district court to determine on remand.

References: For a deduction for claims against an estate, see **FTC 2d/FIN ¶ R-5484** ; **United States Tax Reporter Estate & Gift ¶ 20,534** ; TaxDesk ¶ 776,056 ; TG ¶ 41252 .

Estate not entitled to fractional interest discount for land divided among children

Estate Of Axel O. Adler, TC Memo 2011-28

The Tax Court has held that the full value of an 1100-acre parcel of land that a decedent purportedly divided into one-fifth interests and transferred to his children, but which he continued to use and treat as his own during his life, was includible in his estate. In so holding, the Court rejected the estate's claim to apply fractional discounts since the decedent effectively retained a 100% interest in the property and transferred divided interests to his children at death.

Background. The gross estate of a decedent includes the value at the time of his death of all his property, real or personal, tangible or intangible, wherever situated (**Code Sec. 2031**), including interests in property owned at death (**Code Sec. 2033**). Under **Code Sec. 2036(a)** , a decedent's gross estate includes the value of any transferred property, or interest in property,

in which the decedent reserved or retained an interest for his life, for any period that cannot be measured without reference to his death or that doesn't actually end before his death. This provision prevents a taxpayer from reducing the value of his estate by making lifetime transfers that are essentially testamentary in nature.

The value of property included in the decedent's estate under **Code Sec. 2033** or **Code Sec. 2036** is the fair market value (FMV) of such property at the time of death or, if the executor elects, on the alternate valuation date (**Code Sec. 2032(a)**). When a person dies holding a fractional interest in property, it may be subject to valuation discounts for lack of marketability and control because holders of fractional interests often lack the ability to control the property or sell it freely. However, if the property is only split at death, then it is valued without any discount for split ownership since the decedent owned the whole property at the time of death.

Facts. On Dec. 8, '65, Axel O. Adler executed a grant deed gratuitously transferring undivided one-fifth interests in an 1100-acre property in California to his five children as tenants in common. However, the deed expressly reserved Adler “the full use, control, income and possession” of the property for his life.

After the transfer, Adler continued to use the property. None of his children resided there or otherwise interfered with his use, possession, or enjoyment. Adler paid all expenses associated with the property, including taxes, upkeep, and maintenance. Adler was not required to, and did not, pay rent to the children or seek their permission to alter or improve the property.

On Aug. 16, '91, one daughter executed a quitclaim deed transferring her interest back to Adler, but neither she nor Adler recorded the deed. Adler died on June 20, 2004. The daughter executed a grant deed transferring her interest in the property to the estate in May 2005. The parties stipulated that the date-of-death FMV of a fee simple interest in the entire property was $6,390,000.

On its Form 706, the estate reported a one-fifth interest in the property subject to a 32% marketability discount and a 16% minority-interest discount. On Form 706, Schedule G, Transfers During Decedent's Life, the estate reported four separate one-fifth interests in the property, each subject to a 22% marketability discount and a 16% minority-interest discount.

Conclusion. The Tax Court determined that no discount was allowable and that the full fee simple value of the property was includible in Adler's estate. It stated that, for tax purposes, the property should be considered to have been split up at his death because he effectively transferred a one-fifth remainder interest to each of his children with a retained life estate. Thus, it was as if Adler had retained the entire interest in the property during his life and transferred it to his children at death. Accordingly, the full $6,390,000 date-of-death value was included in Adler's gross estate.

References: For transfers with a retained life estate, see **FTC 2d/FIN ¶ R-2400** ; **United States Tax Reporter Estate & Gift ¶ 20,364** ; TaxDesk ¶ 762,001 ; TG ¶ 40750 .

Beneficiaries weren't entitled to estate's unused loss carryovers due to settlement

Chief Counsel Advice 201047021

In Chief Counsel Advice (CCA), IRS has concluded that beneficiaries of an estate, who wouldn't receive any of the estate's property under a settlement agreement dealing with the decedent's unpaid income taxes, couldn't succeed to the estate's unused capital loss carryovers. The beneficiaries weren't "beneficiaries succeeding to the property of the estate" under **Code Sec. 642(h)(1)** .

Background. Under **Code Sec. 642(h)(1)** , if on the termination of an estate it has a net operating loss carryover under **Code Sec. 172** or a capital loss carryover under **Code Sec. 1212** , then the carryover or the excess will be allowed as a deduction, as provided in regs, to the beneficiaries succeeding to the estate's property.

Under **Reg. § 1.642(h)-3(a)** , "beneficiaries succeeding to the property of the estate" means those beneficiaries upon termination of the estate who bear the burden of any loss for which a carryover is allowed, or any excess of deduction over gross income for which a deduction is allowed, under **Code Sec. 642(h)** . Under **Reg. § 1.642(h)-3(c)** , in the case of a testate estate (i.e., where there is a will), the phrase means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary

beneficiaries. The phrase doesn't include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it isn't payable in full. But, the phrase includes a beneficiary (including a trust) who isn't strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. With respect to testate estates, **Reg. § 1.642(h)-3(c)** states that the phrase includes “a beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.”

Illustration : Decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the estate's last tax year of $5,000, and a capital loss carryover of $15,000. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C. (**Reg. § 1.642(h)-4**)

Facts. Decedent's will provided that Decedent's spouse received the entire residuary estate in trust for life, with the residue divided equally among descendants of four named individuals at the spouse's death. At the time of death, Decedent had unpaid assessments arising from underpayments of income tax for joint returns filed for Year 1 through Year 4. Estate's Administrator entered into a settlement agreement with the U.S. By the time of the settlement agreement, Decedent's spouse had died and her executor consented to the agreement.

Under the settlement agreement, Estate was to be deemed insolvent and the U.S. was to receive all the proceeds of the Estate, less outstanding administrative expenses. Accordingly, under the terms of the settlement agreement, none of the individual testamentary beneficiaries were entitled to receive any property. Subsequent to the settlement agreement, the U.S. and Administrator entered into a stipulation and consent agreement reducing to judgment an amount plus interest in favor of the U.S. This consent judgment represented the assessed federal income tax liabilities for Year 2 through Year 3.

Estate anticipated reporting a capital loss carryover under **Code Sec. 1212** on its final income tax return. Estate's tax counsel concluded that the allocation of Estate's unused carryover loss

to the Estate's beneficiaries wasn't barred by the terms of the settlement agreement, by the fact that Estate was insolvent, or by the outstanding tax liability owed to the U.S.

IRS requested that Chief Counsel advise it whether the beneficiaries were entitled to Estate's unused capital losses under **Code Sec. 642(h)(1)** .

No loss carryover allowed. The CCA determined that Estate's beneficiaries weren't entitled to any of the estate's unused loss carryovers under **Code Sec. 642(h)(1)** . It reasoned that **Reg. § 1.642(h)-3(a)** provides that carryovers and excess deductions pass only to “beneficiaries succeeding to the property of the estate,” and the individual beneficiaries in this case should no longer be considered beneficiaries after Estate entered into the settlement agreement to transfer all the estate proceeds to the U.S. The CCA distinguished the present situation from that set out in the allocation example in **Reg. § 1.642(h)-4** . The beneficiaries in that example received a loss carryover despite not receiving any property, but could have received property if the estate had sufficient funds. In the present case, as a legal matter, the individual beneficiaries could no longer receive anything. Any losses incurred by the estate were to the detriment of the U.S. rather than the individual beneficiaries.

The CCA notes that for intestate estates (i.e., where there is no will), **Reg. § 1.642(h)-3(b)** provides that “beneficiaries succeeding to the property of the estate or trust” means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it hadn't been insolvent. However, the CCA finds the reg inapplicable because Estate is testate.

References: For unused deductions passed through to beneficiaries on termination of estate, see **FTC 2d/FIN ¶ C-9053** ; **United States Tax Reporter ¶ 6424.05** ; TaxDesk ¶ 665,022 ; TG ¶ 2774 .

Estate's credit for tax on prior transfers limited; protective QTIP election untimely

Estate of Lucien J. Le Caer and Estate of Marie L. Le Caer, 135 TC No. 14

In a decision dealing with a husband and wife who died three months apart, the Tax Court held that the **Code Sec. 2013(b)** and **Code Sec. 2013(c)** limitations applied to the **Code Sec. 2013(a)** credit for tax on prior transfers and that the estate of the second spouse to die could not claim the credit for state estate tax paid by the estate of the first spouse to die. The Tax Court also held on the facts that the protective QTIP claim filed by the estate of the first spouse to die was untimely.

*Background on **Code Sec. 2013** .* **Code Sec. 2013(a)** provides for a credit against estate tax liability of a decedent's estate where the decedent received property in a transfer from a person who died within 10 years before or 2 years after the decedent's death and the transfer is subject to estate tax in the transferor's estate. If the transferor died within 2 years of the death of the decedent, the decedent's estate may claim as a credit the amount determined under **Code Sec. 2013(b)** and **Code Sec. 2013(c)** . Under these provisions, the allowable credit is subject to the smaller of two limits:

The first limit is the amount of the federal estate tax attributable to the transferred property in the transferor's estate. This limit equals the value of transferred property multiplied by the transferor's adjusted federal estate tax divided by his adjusted taxable estate. “Adjusted federal estate tax” is the amount of federal estate tax paid with respect to the transferor's estate plus certain credits allowed the transferor's estate. The “transferor's adjusted taxable estate” is the amount of the transferor's taxable estate decreased by the amount of any “death taxes,” including Federal and State estate taxes, paid with respect to the transferor's gross estate.

The second limit is the amount of the federal estate tax attributable to the transferred property in the decedent's estate. The credit is limited to the difference between (1) the net estate tax payable with respect to the decedent's estate, determined without regard to any credit under **Code Sec. 2013** , and (2) the net estate tax determined as described immediately above but computed by subtracting from the decedent's gross estate the value of the transferred property adjusted by any charitable deduction, if applicable.

Background on QTIP protective election. Generally, under **Code Sec. 2056** , an estate may deduct from the value of the gross estate the value of property passing from the decedent to his or her surviving spouse (marital deduction), but there's no marital deduction for terminable interest property. **Code Sec. 2056(b)(7)** provides for an exception to the terminable interest

rule for a QTIP (qualified terminable interest property). Three requirements must be met for terminable interest property to qualify as QTIP: (1) the property passes from the decedent, (2) the surviving spouse has a qualifying income interest for life in the property, and (3) the executor of the estate of the first spouse to die makes an affirmative election to designate the property as a QTIP. Upon the death of the surviving spouse, the value of his or her gross estate includes the value of QTIP.

The executor of the estate must make the QTIP election with respect to property on the decedent's "return of tax imposed by **Code Sec. 2001** ." This is the last estate tax return filed by the executor on or before the due date of the return, including any extensions. If the estate does not file a timely return, the quoted phrase means the first estate tax return filed by the executor after the due date. An executor of the estate of the first spouse to die may make a protective election to treat property as a QTIP if the executor reasonably believes that there is a bona fide issue when the federal estate tax return is filed and it concerns whether an asset is includable in the decedent's gross estate or the amount or nature of the property the surviving spouse is to receive. The protective election must identify the specific asset, group of assets, or trust to which the election applies and the specific basis for the protective election. (**Reg. § 20.2056(b)-7**)

Facts. In '92, Mr. and Mrs. Le Caer executed a family trust agreement under which, upon the death of the first spouse to die, the corpus of the trust, including any additions to the trust from the will of that spouse, was to be divided into four shares. Also in '92, in conjunction with the trust, Mr. and Mrs. Le Caer executed wills. Each disposed of the testator's separate property and a one-half interest in the community property. After enumerated bequests, each testator devised the remainder of his or her estate to the trust. Each testator directed in the respective will that all estate taxes be paid out of the residuary estate.

Mr. Le Caer died on Jan. 19, 2004; his wife died on Mar. 29, 2004.

After Mr. Le Caer's death, his estate's timely filed Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return) reported a gross estate of $3,553,224. The trustees made a QTIP election with respect to $1,405,295 of the assets included in Mr. Le Caer's gross estate. Accordingly, a portion of one share of the family trust in the amount of $1,405,295 qualified for a marital deduction, and a portion of that share in the amount of $495,000 did not

qualify for a marital deduction. Mr. Le Caer's estate reported a taxable estate of $1,995,000. It paid $200,190 in federal estate tax and $24,810 in Nevada estate tax ($225,000 total).

On Mrs. Le Caer's Form 706 filed in 2004, her estate claimed the $225,000 total amounts that her husband's estate paid as Federal and State estate taxes as a credit for tax on prior transfers under **Code Sec. 2013** . Mrs. Le Caer's estate calculated the credit amount without taking into account **Code Sec. 2013(b)** and **Code Sec. 2013(c)** . Before the end of 2004, on an amended Form 706, her estate claimed a $225,000 deduction as part of Schedule K, Debts of the Decedent, and Mortgages and Liens. The estate claimed that the gross estate of Mr. Le Caer "was not reduced by his $225,000 Federal Estate tax liability/debt and no deduction was taken on the 706 Federal Estate Tax Return filed" for him. Mrs. Le Caer's estate claimed an overpayment of $101,700.

On Oct. 19, 2007, Mr. Le Caer's estate filed with IRS a "Notice of Section 2056 Schedule M Protective Claim". The estate made the protective claim "to preserve...the placing of and claiming of the personal residence" on Mr. Le Caer's Schedule M.

Credit for prior transfers. Mrs. Le Caer's estate took the position that the only portion of Mr. Le Caer's estate that was subject to estate tax was the nonmarital portion of one share of the family trust in the amount of $495,000. In her estate's view, the **Code Sec. 2013(b)** and **Code Sec. 2013(c)** limitations on the tax credit were not triggered when Mr. Le Caer passed no other property subject to the estate tax. IRS agreed that Mrs. Le Caer's estate was entitled to claim a credit under **Code Sec. 2013** , but said that the limitations of **Code Sec. 2013(b)** and **Code Sec. 2013(c)** did apply. IRS also maintained that the state estate tax does not qualify for the credit.

The Tax Court sided with IRS on both counts. It held that nothing in **Code Sec. 2013** or the regs conditions the application of **Code Sec. 2013(b)** and **Code Sec. 2013(c)** as suggested by Mrs. Le Caer's estate, and concluded that both limitations apply.

The Tax Court also rejected the estate's claim that the $24,810 in Nevada estate taxes paid by Mr. Le Caer's estate qualified for the credit for tax on prior transfers under **Code Sec. 2013** . Had Congress desired to extend the credit to amounts paid as state death taxes, it would not have used the phrase "federal estate tax" in **Code Sec. 2013(a)** .

Overpayment claim. In the amended return Mrs. Le Caer's estate increased allowable deductions by $225,000 and claimed an overpayment of $101,700. The estate contended that Mrs. Le Caer had paid $225,000 of Federal and State taxes with respect to Mr. Le Caer's estate and that his estate was not reduced by the tax liabilities. The Tax Court disallowed the estate's claim because it failed to prove that the value of Mrs. Le Caer's estate was overstated. The estate did not introduce any evidence to show that the federal and State estate taxes with respect to Mr. Le Caer's estate were in fact paid with assets of Mrs. Le Caer or of her estate or that the Form 706 filed on behalf of Mrs. Le Caer's estate incorrectly reported the estate's assets.

QTIP protective claim. The Tax Court agreed with IRS that the QTIP protective claim filed by Mr. Le Caer's estate was invalid. The regs explain in detail the time and manner for making the QTIP election and do not specify a different time and manner for a protective QTIP election. The Tax Court said that it was reasonable to conclude, therefore, that a timely protective election is one that is made with respect to property on a decedent's return of tax as required by **Code Sec. 2056(b)(7)(B)(v)** and the regs. In the case of a timely filed return, such as Mr. Le Caer's Form 706, the executor of the estate may make a protective election no later than the due date of the return. Generally, the due date of the return is 9 months after the date of the decedent's death.

Mr. Le Caer died on Jan. 19, 2004. The due date of his return was Oct. 19, 2004, which is when the Form 706 was mailed. The trustees of Mr. Le Caer's estate made a **Code Sec. 2056(b)(7)** election with respect to $1,405,295 of the assets that were a part of one share of the family trust, thereby qualifying that property for a marital deduction. The trustees did so by filing Schedule M, Bequests, etc., to Surviving Spouse, along with the Form 706. On Oct. 19, 2007, Mr. Le Caer's estate filed a document entitled “Notice of Section 2056 Schedule M Protective Claim”. Because the protective election was filed 3 years after Oct. 19, 2004, and was not made on the Form 706 as required by **Code Sec. 2056** , the Tax Court concluded that the protective election was untimely.

References: For the **Code Sec. 2013(a)** credit for tax on prior transfers, see **FTC 2d/FIN ¶ R-7301** ; United States Tax Reporter ¶ 20134 ; TaxDesk ¶ 782,501 ; TG ¶ 41704 . For protective

QTIP elections, see **FTC 2d/FIN ¶ R-6430** ; United States Tax Reporter ¶ 20,564.08 ; TaxDesk ¶ 778,105 ; TG ¶ 41417 .

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IRS Offers Filing and Penalty Relief for 2010 Estates; Basis Form Now Due Jan. 17; Extension to March Available for Estate Tax Returns IR-2011-91

WASHINGTON — The Internal Revenue Service announced 9/13/11 that large estates of people who died in 2010 will have until early next year to file various required returns and pay any estate taxes due. In addition, the IRS is providing penalty relief to certain beneficiaries of these estates on their 2010 federal income tax returns.

This relief is designed to give large estates, normally those over $5 million, more time to comply with key tax law changes enacted late last year. Revised versions of the estate tax forms are now available on IRS.gov, and the carryover basis form will be released this fall.

The IRS is providing the following relief:

Large estates, opting out of the estate tax, now will have until Tuesday, Jan. 17, 2012, to file Form 8939. This special carryover basis form, required of estates making this choice, was previously due on Nov. 15, 2011. Because this is a change in the specified due date rather than an extension, no statement or form needs to be filed with the IRS to have this new due date apply.

2010 estates that request an extension on **Form 4768** will have until March 2012 to file their estate tax returns and pay any estate tax due. Normally, a six-month filing extension is automatically granted to estates filing this form, but extensions of time to pay are granted only for good cause. As a result, most 2010 estates that timely file Form 4768 will have until Monday, March 19, 2012 to file **Form 706** or **Form 706-NA**. For estates of those dying late in 2010 (after Dec. 16, 2010 and before Jan. 1, 2011), the due date is 15 months after the date of death. No late-filing or late-payment penalties will be due, though interest still will be charged on any estate tax paid after the original due date.

Special penalty relief is provided to many individuals, estates and trusts that already filed a 2010 federal income tax return, or obtained an extension and plan to file by the Oct. 17, 2011 extended due date. Late-payment and negligence penalty relief applies to persons inheriting property from a decedent dying in 2010, who then sells the property in 2010 but improperly reports gain or loss because they did not know whether the estate made the carryover basis election. Details are in **Notice 2011-76**, posted today on IRS.gov.