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ESTATE PLANNING **REPORT**®

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PLANNING THOUGHTS

A deathbed FLP fails

Jeffrey Powell had a power of attorney for his mother, Nancy. On August 6, 2008, he created NHP Enterprises LP, a limited partnership. Jeffrey was the general partner. On August 7, 2008, two doctors at Marin General Hospital expressed their opinion that Nancy was incapacitated and could no longer act on her own. On August 8, under the power of attorney, Jeffrey transferred $10,000,752 from Nancy's living trust to the partnership in exchange for a 99% limited partnership interest. Next on August 8, again under the power of attorney, Jeffrey transferred the 99% partnership interest to a charitable annuity lead trust. An annuity was to be paid to the Nancy H. Powell Foundation for the rest of her life, with the balance to be divided between two trusts for Jeffrey and his brother at her death. Nancy died on August 15, 2008, one week after these transactions.

A gift tax return was filed for Nancy for 2008, reporting the transfer to the charity. The 99% partnership interest was valued at some $7.5 million, after applying a 25% discount for lack of control and lack of marketability. Nancy's actuarial life expectancy was used to value the annuity, which brought the taxable value of the remainder interest down to $1.6 million.

The $10 million used to acquire the limited partnership interest was not included on Nancy's estate tax return.

A notice of deficiency

The IRS had a multi-pronged attack on this arrangement. On the gift to the charity, the 99% partnership interest was valued by the IRS at $8.5 million. More importantly, the IRS did not use the actuarial tables to value the income interest, because Nancy already was terminally ill—in fact, she died just a week later. That change increased the value of the remainder interest to $8.3 million, generating a gift tax obligation of $2.9 million.

The Service also included in Nancy's estate the entire amount transferred to the partnership in exchange for the limited partnership interest, offering alternative theories for estate inclusion. Either she retained the right to the income from the property, under IRC §2036(a), or she had the power to change the enjoyment of the property or to alter, amend, revoke, or terminate it under IRC §2038(a). The fair market value of the limited partnership interest was determined without regard to any rights or restrictions identified in IRC §2703(a).

The total deficiency came to $12.9 million, because the amount of gift tax payable was added back to the estate under IRC §2035(b), which requires the estate inclusion of gift taxes paid within three years of death.

The structure falls apart

The IRS also argued that the bona fide sale exception found in IRC §2036(a)(2) does not apply, given that the estate immediately claimed a discount on the value of the 99% limited partnership interest. Obviously, Nancy did not receive adequate and fair compensation in the exchange.

Before the Tax Court, the estate conceded the IRS' arguments under §2036. It was left to claim that through the transfer to the charitable lead trust, Nancy no longer possessed those powers at her death.

That approach has two important flaws, according to the Tax Court. Although the three-year rule of estate inclusion for gifts in contemplation of death does not apply as broadly as it once did, IRC §2035(a)(2) continues to apply the rule to any transfers covered by IRC §§2036, 2037, 2038, or 2042.

More importantly, the power of attorney did not give Jeffrey an unlimited power to make gifts of Nancy's property. Gifts were limited to a specific

class of beneficiaries, and were further limited to the amount of the federal gift tax annual exclusion. Therefore, the transfer to the charitable lead trust was void.

The Tax Court also discussed the effect that IRC §2043 has on this situation, apparently the first time that the issue has been squarely before the Court. That Code Section prevents the possibility of double taxation, as it acts as a brake on §2036. "The illogic of including in the value of a decedent's gross estate both the assets transferred to a family limited partnership and the partnership interest received in return seems to have been widely recognized, but the precise legal grounds that prevent such illogical 'double taxation' have gone unarticulated," the Court stated.

It is IRC §2043(a) that resolves the conflict, as it works in tandem with the §2036(a)(2) test for adequate consideration. "[W]e conclude that, when section 2036(a) (either alone or in conjunction with section 2035(a)) requires the inclusion in the value of a decedent's gross estate of the value of assets transferred to a family limited partnership in exchange for an interest in that partnership, the amount of the required inclusion must be reduced under section 2043(a) by the value of the partnership interest received by the decedent-transferor. Consequently, when applicable, section 2036(a) (or section 2035(a)) will include in the value of a decedent's gross estate only the excess of the value of the transferred assets (as of the date of the decedent's death) over the value of the partnership interest issued in return (as of the date of the transfer)."

The only good news for the estate is that, because the Court ruled that there was no completed gift, there was no federal gift tax due [*Powell, Estate of Nancy H. et al. v. Commissioner*, 148 T.C. No. 18].

The decision was not unanimous

Tax Court Judge Lauber concurred in the result, but believed that the family limited partnership itself was invalid from its creation. He also rejected the Court's §2043 analysis as a "solution in search of a problem." He worried that this reading of §2043 might open a Pandora's box of new and overly aggressive estate planning strategies. Six of the Tax Court judges joined the concurrence.

CASES AND RULINGS

Extensions of time for portability elections are becoming routine.

Private Letter Ruling 201717011

Decedent died after the effective date of the addition to the tax code of the spousal portability of unused federal exemption amounts. Decedent's spouse and his two children were the administrators of his estate. Because the estate was below the filing threshold for the federal estate tax, they never filed a Form 706.

That means they forfeited the portable exemption for the surviving spouse, because the election to preserve it can be made only on a Form 706. Now the oversight has been discovered, so they have asked for an extension of time to make the election. No extenuating circumstances or other excuses are offered.

Because the estate was below the filing threshold, the IRS granted the request.

A remarkable number of letter rulings on this subject are being released every week. Perhaps as understanding of the portability election becomes more widespread, they will subside. Making a late portability election seems to suggest great optimism that the assets will grow quickly in the hands of the surviving spouse, or a belief that the amount exempt from the federal estate tax will be reduced in the future. It would not make sense to pay the professional fees for obtaining a private ruling if one believed that the federal estate tax is on the verge of being terminated.

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Unnecessary loan does not generate an administration expense deduction.

Est. of John F. Koons, et al. v. Comm'r; No. 16-10646; No. 16-10648, affirming T.C. Memo. 2013-94

John Koons and his father acquired shares in Burger Brewing Corp. Eventually, Koons became the company's president and CEO. In the 1960s the firm began bottling Pepsi soft drinks, and it also entered the vending machine business. In the 1970s the name was changed to Central Investment Corp. (CIC), and the brewing of beer was discontinued. Koons was the largest shareholder by the 1980s.

In 1997 a dispute emerged about whether CIC had the exclusive right to sell Pepsi fountain syrup directly to restaurants, movie theaters, and other customers in CIC's territories. A lawsuit followed. In 2004 Pepsi suggested that it would purchase CIC's soft drink and vending machine businesses as a way to settle the

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lawsuit. The eventual settlement included the purchase of business assets for $352.4 million and the payment by Pepsi of $50 million in cash to end the litigation. Through a series of transactions, the proceeds ended up in a successor company, CI LLC, and a revocable trust.

When Koons died in 2005, his estate was faced with an estate tax of $21 million and a generation-skipping tax of $5 million. Because the estate's liquid assets were about $19 million at the time, it borrowed $10,750,000 for CI LLC to meet the tax obligations. Principal and interest payments were deferred until the years 2024 through 2031. Because of the long deferral, the interest component of the payments came to over $71 million! The estate claimed the projected interest payments as an administrative expense.

The IRS objected, and the Tax Court agreed. The estate had access to other resources to meet its tax obligation. The Court also agreed that certain estate assets had been undervalued. In an unpublished opinion, the Eleventh Circuit Court of Appeals has now affirmed the Tax Court's judgment.

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Perjured testimony will not be sealed.

Est. of Michael Jackson, et al. v. Commissioner, No. 17152-13

In the Tax Court case concerning the value of Michael Jackson's taxable estate, the IRS called an expert witness. On cross examination, the witness was asked if he had worked on similar issues for the IRS in the Whitney Houston case, also before the Tax Court concerning the value of Ms. Houston's intellectual property rights. The witness denied doing any such work. However, when presented with documentary evidence, the witness recanted.

The IRS moved to strike the challenging testimony, or at least to seal it. The estate moved to strike all of the expert's testimony as tainted by perjury. That motion is pending, but in the meantime the Tax Court has refused to seal any portion of the testimony. The fact that the Houston estate is under audit is public information, not protected by the taxpayer privacy rules of IRC §6103.

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Extension granted to make GSTT election.

Private Letter Ruling 201711001

D created an irrevocable generation-skipping trust for his three children and their families. Later that year he made a substantial transfer of assets into the trust. D's CPA prepared a gift tax return, in which D and his spouse split the gift to the trust, so as to treat it as made one-half by each of them. However, no allocation of the generation-skipping transfer tax exemption was made for the transfer. The oversight was discovered after D's death. The estate of D and D's spouse now ask the IRS for an extension of time to make the election.

The IRS concludes that the family's reliance upon a qualified tax professional was reasonable, and it grants a 120-day extension for the GSTT election.

WASHINGTON TALK

Tax reform stalls. There has been surprisingly little progress on tax reform, given the high hopes that so many had last January. On May 17 Republicans and Democrats from the Senate Finance Committee met with Treasury Secretary Steven Mnuchin and National Economic Council Director Gary Cohn. The key takeaway seemed to be that the Senators want to pursue tax legislation on a bipartisan basis. That means committee hearings and, most likely, a very protracted process. Many already have suggested that tax reform can't happen until 2018. However, enacting major tax reform in an election year would be unusual, because so much attention must be invested in campaigning.

President Trump's tax proposals, rolled out at the end of April, included the elimination of the federal estate tax, so that remains a possibility. In a statement accompanying the presentation of the one-page proposal, economics adviser Gary Cohn said: "The threat of being hit by the death tax leads small business owners and farmers in this country to waste countless hours and resources on complicated estate planning to make sure their children aren't hit with a huge tax when they die. No one wants their children to have to sell the family business to pay an unfair tax."

Cohn clarified that the repeal of the estate tax would be immediate, not phased in over a period of years. Democrats are likely to resist changing or eliminating the federal estate tax.

We are no closer to knowing the fate of the federal gift tax or the generation-skipping transfer tax, however. It has been argued by some observers that the gift tax must be retained so as to protect income tax revenues. No indication as of May on the fate of basis step-up, or the possibility of taxing unrealized gains at death.

One of the major stumbling blocks to getting to tax reform is the issue of "revenue neutrality," the idea that all tax cuts must be offset by tax increases elsewhere in the Tax Code so that net federal tax collections remain unchanged. That was the model for the Tax Reform Act of 1986; it was *not* the approach used for the Economic Recovery Tax Act of 1981, which helped to break a long period of stagflation. In fact, ERTA turned into a bipartisan stampede once the ball got rolling.

The cause of tax reform may have been set back when Senate Majority Leader Mitch McConnell (R-Ky.) announced in May that only a revenue-neutral tax bill could pass the Senate. He did not identify any "pay-fors" to offset tax breaks expected to foster better economic growth. The proposal put forth by President Trump, even though it lacks critical details, has been judged to "lose" as much as $7 trillion over its first ten years.

Sisyphus had it easy.

When President Trump ordered a review in April of burdensome tax regulations, estate planners might have been hoping that the valuation Regs. proposed last year on closely held businesses could be candidates for extinction. The Proposed Regs. reportedly received over 10,000 negative comments, many from organizations that lobby for family businesses. Ways and Means Committee Chair Kevin Brady (R-Tex.) applauded the call for reducing tax regulations that impede economic growth, and mentioned estate tax regulations in addition to §385 regulations on debt and equity.

Agriculture and estate tax reform. An executive order signed by President Trump on April 25 established a task force on Agriculture and Rural Prosperity. The panel is charged with identifying laws and regulations to promote preservation of family farms.

Changes to the federal estate tax might be one avenue of inquiry. If the estate tax is repealed, family farmers would want to preserve the basis step-up at death for agricultural assets.

The Center on Budget Policies and Priorities has argued that making the family farm the poster child for estate tax repeal is misguided, because each year there are only about 50 estates large enough to be taxable that contain agricultural property. However, the Center's studies fail to account for all the farms that are sold before death to large agribusinesses, as part of an estate plan to provide liquidity to heirs to meet death tax obligations. The consolidation of agricultural resources, and the disappearance of family farms around the country, is beyond dispute.

Given the controversy over the IRS' targeting of conservative groups and the surprising hard drive failures that emerged during the Congressional investigations of that situation, there is support for restructuring the agency in order to prevent such occurrences in the future. However, that effort will not be included in the general tax reform legislation, according to House Ways and Means Tax Policy Subcommittee Chair Peter J. Roskam (R-Ill.). The IRS "needs to be reformed structurally, we're arguing, and it also needs to be reformed in terms of its disposition," Roskam told reporters on May 2, but that effort will happen after tax reform is completed.

The favorable tax treatment of "like-kind exchanges" under IRC §1031 has been frequently challenged in the past. For example, the Obama administration proposed restricting like-kind exchanges in every budget request since 2014, including a $1 million cap on exchanges in its fiscal 2017 budget proposal.

From the other side of the aisle, former Ways and Means Chair Republican Dave Camp's proposed Tax Reform Act of 2014 included elimination of tax favors for like-kind exchanges. The Camp bill was thoroughly developed and priced, so there is some thought that it may be the go-to document for finding revenue raisers as the 2017 tax reform efforts move ahead. Accordingly, advocates for preserving the long-standing tax benefit are gearing up to defend it.

The Joint Committee on Taxation estimated in January of this year a $90.2 billion revenue loss for the gains deferred on like-kind exchanges for fiscal 2016 to 2020.

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