Probate & Trust Section, Tax Committee
Tax Updates – February 2015
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GUIDANCE FROM THE IRS

Revenue Ruling 2015-3, 2015-6 IRB (February 9, 2015), February 2015 Rates:

- Section 7520 Rate: 2.0%
- Annual Short Term AFR (0-3 years): .48%
- Annual Mid Term AFR (3-9 years): 1.70%
- Annual Long Term AFR (over 9 years): 2.41%

GUIDANCE FROM HARRISBURG

The New PA 41 filing requirements enacted with the passage of Act 52 of 2013 provide that a nonresident estate or trust with a PA resident beneficiary is required to file a PA-41 whether or not there is any "PA Source Income." Previously, such an entity would only be required to file a return if there was "PA Source Income."

The "Who Must File" section now includes: "The fiduciary of a nonresident estate or trust received taxable income and the estate or trust has a Pennsylvania resident beneficiary."

The "Who Does Not File…" section now includes: "A nonresident estate or trust with no Pennsylvania-source income/loss AND no Pennsylvania resident beneficiaries."

If an estate or trust is required to file a PA-41, Fiduciary Income Tax Return, as outlined in and the estate or trust fails to file a return, the estate or trust is subject to a $250 penalty for failing to file a return, plus a $250 penalty for each RK-1 or NRK-1 for the beneficiaries of the estate or trust.

RECENT COURT GUIDANCE

Specht, (2015, DC OH) The attorney for an executor, who unbeknownst to her client suffered severe medical issues, failed to perform numerous duties with respect to the subject estate, including timely filing the estate tax return, and told the unsophisticated executor that she had received all necessary extensions when she had in fact not done so.

The consequences of the failure to timely file the return could have been mitigated by showing reasonable cause for the late filing and/or showing that no willful neglect by the taxpayer had occurred. The Court found that the executor failed both the reasonable cause and willful neglect tests here.

In order to meet the reasonable cause test, the executor had to demonstrate that she exercised ordinary business care and prudence but nevertheless was unable to file the return within the prescribed time. The Court said that, although a taxpayer may reasonably rely on advice received from an attorney on a matter of tax law, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. The executor may rely on the attorney as between them, but such reliance is not sufficient with respect to the estate's federal estate tax obligations.

The executor argued that she lacked the sophistication to single-handedly complete and file the estate's federal tax return. However, there was no evidence to suggest that she lacked the sophistication to understand the importance of the estate tax deadline or to ensure that deadline was met. The executor relied on an agent to file tax returns, and the agent failed to do so. But the reasonable cause analysis looks at the party with ultimate responsibility, the executor, for satisfying the tax liabilities, not the actions or medical conditions of his or her agent. Even if the attorney's medical condition led her to malpractice in the course of representing the estate, those facts did not render the executor "disabled" herself.

With respect to the willful neglect test, the Court said that a taxpayer must prove that his or her failure to file on time was the result neither of carelessness, reckless indifference, nor intentional failure. Here, there were many facts that were brought to the executor's attention that indicated that she did not meet this test. It should be noted that the executor received and ignored several notices from the local probate court that her attorney was not meeting deadlines.

Finally, the Court said that, while it found it difficult to hold the executor ultimately responsible for the attorney's malpractice, that result was required by precedent.

Estate of Ellen D. Foster, (2014, CA9) 113 AFTR 2d 2014-1519, cert denied (2014, S.Ct.) 2014 WL 4387200. The Supreme Court has declined to review a Ninth Circuit decision, which affirmed the Tax Court's estate tax valuation determinations, including a determination that litigation related claims against the estate didn't create valuation discounts for certain of the estate's assets and didn't meet the relevant tests for deductibility as liabilities of the estate.

The decedent and her husband founded a business, the majority of the stock in which the husband with other shareholders sold to an ESOP. The company financed the purchase by an unsecured borrowing from four lenders. One of the lenders was also hired as the ESOP's trustee. A significant portion of the sales proceeds were placed in the decedent's husband's revocable trust. The decedent's husband died and the revocable trust divided into three marital trusts.

Following the Decedent's husband's death, the company began experiencing financial trouble, causing it to violate the financial covenants of the ESOP loans. The ESOP lenders sought to restructure the loans to gain a security interest in the company's assets. The company then went bankrupt in 2001.

Just before the bankruptcy filing, beneficiaries of the ESOP filed suit alleging breaches of fiduciary duty committed by the decedent's husband (with decedent named as a defendant as executrix of her husband's estate) in connection with the ESOP transaction. They also sought restitution against the decedent as a co-trustee of the marital trusts, and requested the imposition of a constructive trust over the assets held by decedent as executrix of her husband's estate and co-trustee of the marital trusts. The trustee of one of the marital trusts froze the Decedent's wife's access to such trust due to the litigation. The ESOP beneficiaries lost in district court, but appealed. The decedent died while the appeal was pending.

The decedent's estate tax return showed values of roughly $1 million for marital trust #1, $35.5 million for marital trust #2, and $14 million for marital trust #3. The estate also listed a liability related to litigation against each trust in these amounts: negative $286,100 for marital trust #1, negative $10,373,046 for marital trust #2, and negative $4,017,769 for marital trust #3.

The case went to the Tax Court. At trial, the estate argued for discounts due to litigation hazards and lack of marketability (because of the freeze), and, alternatively, it argued that it had a liability as a result of the lawsuit.

The Tax Court ruled against all of the estate's arguments. As to the litigation hazards argument, it said that a willing buyer would not have insisted on a discount on the assets of the marital trusts because the lawsuit could not have affected a buyer's rights. As to the lack of marketability, it said that the freeze may have prevented the decedent from selling any of the assets of marital trust #3, but it did not affect the value of those assets. And as to the estate's liability resulting from the lawsuit, the court found that the estate failed to establish the amount of the liability with reasonable certainty, as required by the applicable reg.

The Ninth Circuit, using much the same reasoning as the Tax Court, affirmed all of the above-referenced Tax Court holdings.

On December 8, 2014, the Supreme Court declined to review the case. Thus, the decision is now final.