Philadelphia Bar Association, Probate and Trust Section
Tax Committee's Tax Update – May 2013
Prepared by Marguerite Weese, J.D., LL.M. (Tax), Wilmington Trust N.A.

GUIDANCE FROM THE IRS

Revenue Ruling 2013-11, 2013-20 IRB 1 (Apr. 18, 2013) –May 2013 Rates:

Section 7520 Rate: 1.20%
Short Term AFR (0-3 years): 0.20%
Mid-Term AFR (3-9 years): 1.00%
Long-Term AFR (over 9 yrs): 2.60%

CASES

Estate of Koons v. Commissioner, T.C. Memo, 2013-94, (April 9, 2013): John F. Koons, III, the decedent, owned an interest in a brewing company operated as an LLC. He and his four children, as well as a few various other family members, owned varying interests in the LLC. During his lifetime, the decedent had created revocable trusts, which held his LLC interests. After the decedent's death, the revocable trust borrowed $10.75 million from the LLC using a note, to pay estate taxes. The estate then claimed a deduction for the interest due on the note.

The first issue is whether this deduction is allowable. Under Reg. 20.2053-3(a), an estate may deduct "essentially expenses," therefore, the question is whether this expense is considered to be essential. The tax court determined that because of the various redemptions by the decedent's children, the trust actually held a 70.42% voting interest in the LLC, which held more than $200 million in liquid assets. Therefore, as the controlling owner of the LLC, the trust could have compelled the LLC to make distributions to the owners, which would have made the loan unnecessary. As a result, the tax court held that the loan was not essential and not deductible.

The second issue dealt with the valuation of the LLC interests. The estate claimed discounts for lack of control and lack of marketability. Upon his death, the decedent's revocable trust held 46.94% voting interest, but then his children redeemed their interests, giving the trust a 70.42% voting interest. The IRS appraiser used circumstantial evidence to prove there was specific intent on the part of the children to redeem as quickly as possible, thus making the change from 46.94% to 70.42% control interest a probable occurrence. As such, only a 7.5% discount was applicable to the LLC interest value for lack of marketability.

Knappe v. United States, 2013 WL 1339106 (9th Cir. April 4, 2013): The executor's CPA applied for a twelve month extension of time for filing the estate tax return. The IRS granted a six-month extension instead, but the executor did not notice the difference. The executor filed the return late, and the IRS imposed a late filing penalty. The executor claimed reliance on the CPA's representation that the estate had a twelve month extension. The Ninth Circuit Court held that the estate was responsible for late-filing penalties, despite reliance on the CPA's advice, because the extension period was clearly explained on the request forms and instructions and, thus, it is not a matter on which different views could exist.

Estate of Liftin v. United States, 2013 WL 1316533 (Ct. Fed. Cl. March 29, 2013): Morton Liftin, the decedent, died in 2003. The decedent's estate provided bequests to his surviving spouse, who at the time of his death, was a U.S. resident and a citizen of Bolivia. The surviving spouse told the executor that she was going to pursue U.S. citizenship, which would allow the estate to take a marital deduction. The executor requested a six-month extension of time to file the estate return and paid the taxes due as if the estate was unable to take the marital deduction. The extension was granted. When it was clear that the surviving spouse's naturalization process was not going to be completed prior to the extended deadline, the executor sought legal counsel. Counsel advised the executor that he could file the estate's return after the extended due date and preserve the estate's full marital deduction without triggering a penalty pursuant to regulation 20.2056A-1(b), as long as the return was filed within a "reasonable time" after the surviving spouse became a naturalized U.S. citizen and the related litigation involving the surviving spouse and the estate drew to a completion.

On August 3, 2005, approximately fourteen months after the extended deadline, the surviving spouse became a naturalized U.S. citizen. In early 2006, the surviving spouse and the estate entered into an agreement settling her claims against the estate. On May 9, 2006, the estate finally filed its estate tax return, reflecting a tax due, which ended up being less than the amount originally paid. On June 12, 2006, the IRS issued a Notice of Adjustment reflecting a penalty for late filing.

The Court of Federal Claims held that an estate was not responsible for a late-filing penalty when it relied on counsel's advice that the executor did not need to file until the surviving spouse became a U.S. citizen, because the law on the issue was unclear. However, the court held that the estate was responsible for a late-filing penalty when it relied on counsel's advice that the executor did not need to file until the ancillary issues were resolved, even after the surviving spouse became a U.S. citizen. This was an error regarding a point on which all courts and the IRS agree.

Estate of Elkins v. Commissioner, 140 T.C. No. 5 (March 11, 2013): Mr. and Mrs. Elkins held jointly an art collection consisting of approximately sixty-one pieces of art. During Mrs. Elkin's life, fractional interests of her share in a few pieces went to the three children. Upon Mrs. Elkin's death, all of her remaining interests went outright to Mr. Elkins. Mr. Elkins disclaimed a portion equal to the unused unified credit against estate tax available to Mrs. Elkins' estate, so the interests could go to the children estate tax free. This was approximately 26.945% of the collection. Mr. Elkins retained 73.055% interest in each item of the disclaimer art (his original 50% interest, plus the additional 23.055% interest he received from Mrs. Elkins, which he didn't disclaim). Mr. Elkins and his children entered into a co-tenants' agreement relating to this art, in which they all waived their right to institute a partition action with respect to the art. When Mr. Elkins passed away, his gross estate included the 73.055% as well as additional partial interests in art which he held with the children. His estate had the art collection valued by Sotheby's and then applied the 44.75% discount as calculated by Deloitte for lack of control and marketability.

The IRS argued that no discount was warranted because the restrictions provided in the co-tenants' agreement had to be disregarded under Internal Revenue Code section 2703(a)(2). The IRS also argued that no discount should be applied due to the decedent's fractional interests in the pieces of art, arguing that art is commonly sold at full fair market value and the fractional interest holder would merely receive his pro rata share of the sale proceeds. The tax court held under Internal Revenue Code section 2703(a)(2), when valuing the fractional interests, the co-tenants' agreement should be disregarded concerning the waiver of right to institute a partition action with respect to the art. The tax court did apply a 10% discount on the decedent's interests in the art to account for uncertainties, including, but not limited to, the children's unknown intentions about selling the art versus holding it.

PRIVATE LETTER RULINGS

PLR 201317010: (Apr. 26, 2013): This private letter ruling addresses the issue of trusts holding interests in corporations. The IRS stated that the trusts had not materially participated in the activities of the corporation, because the trustees had not materially participated. This position disagrres with the findings of Mattie K. Carter Trust v. U.S. , 256 F. Supp. 2d 536 (ND TX. 2003), which held that a trust establishes material participation for passive loss purposes based upon the activities of the trust's fiduciaries, employees and agents. To arrive at this conclusion, the IRS interpreted legislative history of the passive loss rules. The IRS stated that the trusts must establish material participation in the relevant activities of the corporation in which they held stock, by showing that their fiduciaries, acting as fiduciaries, were involved in the operations of the relevant activities of the companies on a regular, continuous, and substantial basis.

LEGISLATIVE NEWS

PA House Bill 440: Proposed legislation concerning PA income tax withholding for trusts with non-resident beneficiaries. Please find the proposed bill attached.

President Obama's FY 2014 Budget & Treasury Department's "Green Book" (April 10, 2013): Among other things, the revenue proposals included the following proposed tax changes:

- Beginning in 2018, return to the estate, generation-skipping transfer (GST) and gift tax exemption and rates to 2009 levels (top rate of 45% and exclusion of $3.5 million for estate and GST and $1 million for gift taxes)
- Requiring the GRAT to have a minimum term of ten years and a remainder interest value greater than zero at the time the interest is created
- Limiting the duration of GST tax exemption on the 90th anniversary of the creation of the trust