Recent Tax Bits and Pieces

By David R. Okrent

Can a Losing Claim by Co-Workers to Share in Winnings Reduce the Value of a Gift of Interest in Winning Lottery Ticket—Yes—*Tonda Lynn Dickerson*, T.C. Memo 2012-60 (Mar. 6, 2012)

In this case Ms. Dickerson, the winner of a lottery, was sued by her co-workers for a portion of the proceeds under an oral agreement to share; they lost and Ms. Dickerson was awarded the proceeds. However, Ms. Dickerson contributed her winning ticket to a corporation and the Internal Revenue Service (IRS) determined that she made a gift to the other shareholders. The most interesting part is that the Tax Court determined the value of the gift was reduced by 67% due to the potential liability of the claims of her co-workers who ultimately lost.

Tax Court Approves Two More Defined Value Gift Clause Cases

The first is *Joanne M. Wandry et al. v. Commissioner*, T.C. Memo. 2012-88 (March 26, 2012). In this federal gift tax case, the Tax Court determined in a memorandum opinion that the taxpayers' respective defined value gift clauses were enforceable under state law, were defined value gifts of LLC membership interests instead of gifts of percentage interests, and were to be respected for federal gift tax purposes. The case has a very good review of the law and description of what needs to be in the transfer documents. It is also makes it clear that a charity does not need to be involved.

The second defined value case is *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (Dec. 15, 2011). In this case the Tax Court here considered whether defined value clauses were the result of arm's-length transactions and whether they were void as against public policy. This case had the unique feature of including gifts to a charity which independently reviewed the appraisal. The valuation underlying the dispute was whether the taxpayers' transfers of the John H. Hendrix Co. (JHHC) stock were valued at fair market value. The court concluded in favor of the taxpayer on all issues.

IRS Allows Husband to Roll Over Proceeds from Deceased Spouse's IRA

In Private Letter Ruling [hereafter referred to as PLR] 201212021, the decedent fell ill before she could change the beneficiary designation within her IRA from her estate to her husband. The IRS did not apply the general rule here, which would treat the IRA as an inherited IRA to the husband, because the surviving husband was the only beneficiary and the sole executor of the estate. The IRS allowed the husband to roll over the proceeds into a separate IRA.

Insurance Policy Proceeds Are Includable in Estate But Deductible Because of Debt to Ex-Wife

In Estate of David A. Kahanic et al. v. Commissioner, T.C. Memo. 2012-81(March 21, 2012), the Tax Court concluded that the decedent possessed at his death incidents of ownership in a $2,495,000 life insurance policy, thereby making the policy proceeds includible in the value of decedent's gross estate under § 2042(2). However, when decedent died, an indebtedness existed, due to divorce proceedings and settlement agreements which were ultimately court ordered prior to his death, obligating him in respect of the policy proceeds which the Tax Court determined entitled the estate to a deduction of $1,995,000 under § 2053(a)(4). An additional set of issues were discussed in this case since the estate was illiquid at the time estate taxes were due and the estate had to borrow money from the divorced surviving spouse. The court discussed in this regard the validity of the debt and propriety of deducting interest to be paid on same.

Court Finds Estate Tax Special Use Valuation Regulation Invalid

Carolyn Finfrock v. United States, Docket No. 3:11-cv-03052, the U.S. District Court for the Central District of Illinois found Treasury Regulation 20.2032A-8 (a)(2) (26 C.F.R. § 20.2032A-8 (a)(2)) is an invalid regulation and is contrary to the underlying statute because it imposes an additional requirement that special use valuation be elected for qualified property constituting at least 25 percent of the adjusted gross value of the estate.

To qualify for the special use valuation, several conditions must be met. One of those conditions is that "25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A) (ii) and (C)." 26 U.S.C. § 2032A(b)(1)(B). The Treasury Regulations, however, provide that while an estate need not elect special use valuation with respect to all of the qualifying property, the property actually elected for the special use valuation must constitute at least 25% of the adjusted value of the gross estate. *See* 26 C.F.R. § 20.2032A-8(a)(2). It is this additional provision contained with the regulations that led the court to invalidate this regulation.

Property Transferred to FLP Not Included in Decedent's Estate

In *Estate of Beatrice Kelly et al. v. Commissioner,* T.C. Memo. 2012-73 (March 19, 2012), the Tax Court concluded that the decedent's transfer of assets to the limited partnerships was a bona fide sale for full and adequate consideration, and thus the value of the transferred assets is not includable in decedent's gross estate pursuant to I.R.C. sec. 2036(a). This is a very good case on what to do right in handling family limited partnerships.

IRS Rules a Testamentary Non-General Power of Appointment Does Not Make a Gift Incomplete, an Arbitration Clause Together with an in Terrorem Clause Interferes with "Crummey" Power of Withdrawal Rights, and Tops It Off with IRC § 2702

In Chief Counsel Advisory 201208026, "Delaware Incomplete Non-grantor" (DING) trusts were created by taxpayers who want to shift state income taxation to a tax-favorable entity without creation of a taxable gift. In this CCA, the IRS ruled that a transfer to a trust was complete for Federal gift tax purposes where the donors retained a testamentary (exercisable at death) special power of appointment but named someone other than the donor as trustee who had the authority prior to the donors' deaths to distribute all of the income and corpus of the trust to persons other than the donors, or to distribute it to charity.

The Trust emphasized that the Donors did not retain any powers or rights to affect the beneficial term interests of their children, other issue, and their spouses (and charities) during the Trust term. With respect to those interests, the Donors fully divested themselves of dominion and control of the property when they transferred the property to the Trust. Indeed, during the period extending from the creation of the Trust until the Donors' deaths, the trustee, Child A, has sole and unquestionable discretion to distribute income and principal to the beneficial term interests. He may even terminate the Trust by distributing all of the property.

This ruling has an interesting approach to valuing the gift by applying IRC § 2702.

Another Family Limited Partnership Taxpayer Victory

Estate of Stone v. Commissioner, T.C. Memo 2012-48. In this case the decedent and her husband owned woodland parcels near a lake developed by their family. They told their attorney that they wanted to give real estate to various family members and the attorney recommended using a limited partnership to simplify the gift-giving process, and to guard against partitions, though that factor was not addressed by the court. After creating the partnership and transferring the woodland parcels to the partnership, the Stones gave all of the limited partnerships to their children, their spouses, and their grandchildren over a four-year period.

The gifts of limited partnership interests were completed about five years prior to the decedent's death. No distributions were ever made from the partnership. There were a few situations in which appropriate formalities regarding the partnership were not followed, but those lapses in following formalities seemed rather benign. The IRS apparently contended that the portion of the property's value represented by the contribution from the decedent was included in the decedent's estate under § 2036. The court (Judge Goeke) disagreed, finding that the bona fide sale exception to § 2036 applied.

Long-Term Care Rider Is Treated as Life Insurance Contract

In PLR 201213016, the IRS concluded that a long-term care rider offered with certain annuity contracts constitutes an insurance contract within the meaning of § 7702B(b)(1). The taxpayer requested that: 1) the rider constitutes an insurance contract within the meaning of § 7702B (b)(1); 2) all long-term care benefits will be excludable from the Owner's gross income under § 104(a)(3); and, 3) the investment in the contract (within the meaning of § 72) of the Annuity Contract to which the Rider is attached will not be reduced by the payment of LTC Benefits. IRS granted (1) and (2) and declined to rule on number (3).

Estate Liability for Foreign Trust Filing and Penalties

In IRS Legal Memorandum 201208028, the IRS addressed the applicability of foreign trust filing and reporting penalties against a decedent's estate, conclud-

ing that the estate is responsible for paying § 6677(a) and (b) initial and additional penalties for some tax years ending prior to the Decedent's death.

Disability Planning for IRAs

This PLR 201150037 dealt with a unique IRA fashioned as part of a divorce agreement. Designed to protect a participant from the excessive spending that can be a byproduct of the mental illness known as bipolar disorder, the "restricted IRA" in PLR 201150037 may open a new path for all IRA owners who want to plan for the possibility of their own future disability. PLR 201150037 focuses on an IRA agreement in which the participant and the IRA provider agree to a series of "directions" that somewhat restrict the participant's access to the funds. Though the precise formula used in this PLR is not helpful for most clients, it suggests the potential for an irrevocable trusteed IRA under which distributions to the participant (beyond the required annual minimum distribution) are entirely in the trustee's discretion.

Trust May Receive Annuity Payments and Still Avoid Accrual Taxation

In PLR 201124008 the IRS reviewed IRC § 72, which provides deferral of income tax for qualified annuities. Section 72(u) disallows such favorable treatment when the annuity is owned by someone other than a natural person, such as a trust. In that situation, the owner is essentially put on the accrual basis of taxation and is taxed each year on the growth that occurs in the annuity policy (regardless of amounts distributed). An exception to the exception allows a trust or other entity to hold the annuity as an agent for a natural person.

In this ruling, a surviving spouse was a trustee and current beneficiary of a testamentary trust established by her deceased husband. The six remaindermen were descendants of husband and wife. The trustee wanted to purchase deferred annuity contracts on the respective lives of the remaindermen, with the trust as owner and beneficiary of the contracts. If a remainderman-annuitant died during the term of the trust, the proceeds of his or her contract would be paid to the trust. At the termination of the trust each remainderman will receive his or her annuity contract. While it is anticipated that no payouts on the annuities will occur during the term of the trust, it is possible that they may occur either by reason of reaching the annuity start date prior to the termination of the trust or the death of a remainderman-annuitant.

Form 706 Protective Refund Claim Guidance

In Revenue Procedure 2011-48, the IRS provides detailed and precise rules to address most of the basic protective claim filing issues. The ability to make a protective claim on a Schedule PC on the Form 706 is especially welcomed. This will make it easier for taxpayers to comply with the requirements and help taxpayers avoid statute of limitations deadline issues.

Presently, many estates adopt a wait-and-see attitude to see if claim and expense issues resolve themselves before the statute of limitations expires and hopefully avoiding the bother of a Form 843 filing. By easing the process for filing the protective claim, more taxpayers should take advantage of the procedure at the time the estate tax return is filed and thus avoid missing the deadline later. Indeed, the existence of the Schedule PC will likely educate some preparers who might not be knowledgeable of the protective claim procedure or its availability.

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