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ESTATE TAX MEMORANDUM

TO: **CPAs, Clients & Associates**

FROM: **David L. Silverman, Esq.**
Shirlee Aminoff, Esq.

DATE: **April 7, 2010**

RE: **2006 Regs., Rulings & IRS Pronouncements**

Since IRA accounts often reflect a lifetime of retirement savings, their inclusion in a QTIP trust is important. Rev. Rul. 2000-2 stated that IRA proceeds may qualify for a QTIP election if the surviving spouse may compel a trustee to make annual income distributions. Rev. Rul. 2006-26 added that (i) a separate QTIP election must be made for the IRA and the trust receiving the IRA payments; and (ii) income must be determined separately for the trust and the IRA.

Given the present estate tax uncertainty, few people will risk making gifts exceeding the $1 million gift tax exemption. Formula clauses could be employed as a "hedge" against the possibility of gift tax where the value of gift is uncertain, by imposing a $1 million "cap" on the gift. Historically, formula clauses have been viewed with disfavor. Com'r v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944) held that such clauses tend to "discourage the collection of the tax . . . since the only effect of an attempt to enforce the tax would be to defeat the

gift; and . . . the effect of enforcing the clause would be to obstruct the administration of justice by requiring courts to pass upon a moot case." However, other savings clauses may be less objectionable, particularly if they do not return transferred property to the donor as in Procter, but rather reallocate property among transferees.

To illustrate, assume property of uncertain value is sold to a grantor trust. Such sales are intended to be free of gift tax. If the property has an ascertainable value, the note would reference that value. However, if the property has an uncertain value, immediate gift tax liability will result unless a savings clause is used to reallocate the value of the property in excess of the note. Shifting any gift in excess of $1 million back to the grantor is not an option, since that would clearly violate Procter. However, the governing instrument could provide that any excess value be allocated to a nontaxable donee. If trust beneficiaries include the grantor's spouse, the excess could be shifted to the grantor's spouse without gift tax, since the gift would qualify for the unlimited marital deduction.

Recent rulings demonstrate the determination of the IRS to assert the applicability of IRC § 2036 in transfers to family entities. In PLR 200626003, A transferred real property to a family LLC, retaining a 25 percent interest. Following A's death, the IRS determined that A's retained right to income resulted in inclusion under IRC § 2036. The estate's request for 9100 relief to file a late IRC § 754 election was denied. However, since the property was includible under IRC § 2036, the LLC's inside basis in the assets was increased pursuant to IRC §1014. Thus, the IRC § 754 basis increase sought was achieved under IRC § 1014.

IRC § 6324 provides for a special 10-year estate tax lien. FSA 20061702F addressed the issue of priorities among lienors. After inheriting property, Son defaulted on a loan in which the property had been pledged as collateral. Lender was reluctant to foreclose believing that the estate tax lien might have priority. The FSA concluded that the pledge of the real estate as collateral constituted a "transfer" under IRC § 6324(a)(2), which divested the government's lien interest. However, the lien remained to the extent the value of the real estate exceeded the balance of loan. Son also remained personally liable for the portion of the unpaid estate tax equal to the value of the real property.

Whether to file an amended return often sparks a lively debate. Taxpayers may view them as a "cure all" for previous tax transgressions. Practitioners are less sanguine, sometimes concluding that their filing may do more harm than good. Generally, no duty exists to file an amended return. The Supreme Court, in Hillsboro National Bank v. Com'r., 460 U.S. 370 (1983), remarked that "the Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return; instead, an amended return is a creature of administrative grace and origin." Regs. § 25.2504-1(d) explicitly sanction an amended return if a gift was omitted from a previous return. It should be reported on Schedule B of Form 709 as part of gifts for previous years.

[Although the filing of a gift tax return is required only where a taxable gift has been made — and in the case of sales to grantor trusts that is usually not the case — filing a return (reporting the amount of the gift as zero) would start the running of the 3-year statute. If no gift tax return is filed, the IRS could many years later challenge the value of property sold to the trust.]

Circular 230 contains regulations governing the practice of Attorneys and CPAs before the IRS. Subpart B, §10.34(a), which addresses standards for preparing or signing returns, provides that a practitioner may not sign a return if the position taken does not have a "realistic possibility of being sustained on the merits." That standard is met if "a person knowledgeable in the tax law would . . . conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits." The possibility that a return will not be audited or that the issue would not be raised on audit may not be taken into account.

Authorities that may be taken into account in assessing the "realistic possibility" standard are those enumerated in the substantial understatement penalty regulations, §1.6662-4(d)(3)(iii). They include (i) Code provisions; (ii) Treasury Regulations; (iii) Rulings and Procedures; (iv) tax treaties; (v) case law (that has not been overruled); (vi) Committee Reports; (vii) Blue Book Explanations of Tax Legislation; and (viii) PLRs, TAMs, GCMs, Actions on Decision, Notices and Announcements. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not substantial authority. However, authorities underlying such

expressions of opinion where relevant may give rise to substantial authority for tax treatment of an item.

Creating wholly grantor trusts without risking estate inclusion is difficult. In PLR 200606006, the trust provided the grantor's spouse with a limited withdrawal right, and the grantor with the right to reacquire trust principal by substituting property of equal value. The ruling concluded the substitution power would not cause inclusion under IRC §§ 2033, 2036 or 2039, and the trust would be a wholly grantor trust as to the grantor. Although a beneficiary spouse may be treated as owner of the portion of the trust over which she has a withdrawal power, the trust is a fully grantor trust with respect as to the grantor since IRC § 678(b) trumps IRC § 678(a).

PLR 200620025 stated that an IRA may be transferred to a Supplemental Needs Trust (SNT) that is a grantor trust without income tax consequences. The ruling relied on Rev. Rul. 85-13, which holds that if a grantor is treated as the the owner of a trust, the trust is ignored for income tax purposes, and any transactions between the grantor and the trust are also ignored. Rev. Rul. 85-13 is one of the foundations upon which the technique of sales to "defector" grantor trusts relies.

Controversial legislation passed in 2006 limited deductions for Americans working abroad. Notice 2007-25 increased the housing expense limits in approximately twenty foreign cities, and permits Americans working abroad to exclude up to $82,400 of their foreign-earned pay. However, income in excess of that amount is subject to higher tax rates than before.

Announcement 2006-63 clarified rules relating to private collection agencies. PCAs may access non-IRS computer databases to obtain financial information, but may not inquire with the taxpayer's employer, bank, or neighbors concerning the taxpayer's financial condition. PCAs must safeguard taxpayer information and may not access unnecessary tax information. PCAs may not telephone the taxpayer in unusual hours, and may not threaten to harm the taxpayer's credit. Failure to respect taxpayer rights may subject the PCA to civil liability or criminal prosecution.