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ESTATE PLANNING MEMORANDUM

TO: **CPAs, Clients & Associates**

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

DATE: **April 9, 2010**

RE: **2007 Regs., Rulings & Pronouncements**

A. New Regs Govern Estate Deductions

All federal circuits, except the Eighth, have long adhered to the view that post-mortem events must be ignored in valuing claims against an estate. Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929) held that "[t]empting as it is to correct uncertain probabilities by the now certain fact, we are of the opinion that it cannot be done, but that the value of the wife's life interest must be established by the mortality tables." Proposed Regs. §20.2053-1(a)(1) state that post mortem events must be considered in determining amounts deductible as expenses, claims, or debts against the estate.

The proposed regs. limit the deduction for contingent claims against an estate by providing that an estate may deduct a claim or debt, or a funeral or administration expense, only if the amount is actually paid. An expenditure contested by the estate which cannot not be resolved during the period of limitations for claiming a refund will not be deductible. However, the executor may file a "protective claim" for refund, which would preserve the estate's ultimate right to claim a deduction under IRC §2053(a). A timely filed protective claim would thus preserve the estate's right to a refund if the amount of the liability is later determined and paid.

Although a protective claim would not be required to specify a dollar amount, it would be required to identify the outstanding claim that would be deductible if paid, and describe the

contingencies delaying the determination of the liability or its actual payment. Attorney's fees or executor's commissions that have not been paid could be identified in a protective claim. Prop. Regs. §20.2053-1(a)(4). A second limitation on deductible expenses also applies: Estate expenses would be deductible by the executor only if approved by the state court whose decision follows state law, or established by a bona fide settlement agreement or a consent decree resulting from an arm's length agreement. This requirement is apparently intended to prevent a deduction where a claim of doubtful merit was paid by the estate.

The proposed regs suffer from some problems. To illustrate one, assume the will of the decedent dying in 2008, whose estate is worth $10 million, designates that $2 million should fund the credit shelter trust, with the remainder funding the marital trust. Assume also the existence of a $3 million contested claim against the estate. If the executor sets apart $3 million for the contested claim and files a protective claim for refund, the marital trust would be funded with only $5 million, instead of $8 million. If the claim is later defeated, the $3 million held in reserve could no longer be used to fund the marital trust, and would be subject to estate tax.

Alternatively, the executor could simply fund the marital trust with $8 million, not set aside the $3 million, and not file a protective claim. If the claim is later determined to be valid, payment could be made from assets held in the marital trust. However, by proceeding in this manner, would the deduction for the marital trust be preserved if the IRS determined that the regulations were not followed? The existence of a large protective claim might also tempt the IRS to look more closely at other valuation issues involving other expenses claimed by the estate as a hedge against the possibility of a large future deduction by the estate.

B. Preparer Penalties Under IRC §6694

Under revised IRC §6694, a return preparer (or a person who furnishes advice in connection with the preparation of the return) is subject to substantial penalties if the preparer (or advisor) does

not have a reasonable basis for concluding that the position taken was more likely than not. If the position taken is not more likely than not, penalties can be avoided by adequate disclosure, provided there is a reasonable basis for the position taken. Under prior law, a reasonable basis for a position taken means that the position has a one-in-three chance of success. P.L. 110-28, §8246(a)(2), 110th Cong., 1st Sess. (5/25/07). This penalty rule applies to all tax returns, including gift and estate tax returns. The penalty imposed is $1,000 or, if greater, one-half of the fee derived (or to be derived) by the tax return preparer with respect to the return. An attorney who gives a legal opinion is deemed to be a non-signing preparer. The fees upon which the penalty is based for a non-signing preparer could reference the larger transaction of which the tax return is only a small part.

Notice 2008-13 contains new guidance concerning the imposition of return preparer penalties. It provides that until the revised regs (expected to be issued before the end of 2008) are issued, a preparer can generally continue to rely on taxpayer and third party representations in preparing a return, unless he has reason to know they are wrong. In addition, preparers of many information returns will not be subject to the new penalty provisions unless they willfully understate tax or act in reckless or intentional disregard of the law.

Revised IRC §6694 joins Circular 230, now two years old (which Roy M. Adams observed effectively "deputizes" attorneys, accountants, financial planners, trust professionals and insurance professionals) in "extend[ing] the government's reach and help[ing to] fulfill a perceived need to patch up the crumbling voluntary reporting tax system." The Changing Face of Compliance, Trusts & Estates, Vol. 147 No. 1, January 2008. The perilous regulatory environment in which attorneys and accountants now find themselves counsels caution when advising clients concerning tax positions. Although a taxpayer's right to manage his affairs so as to minimize tax liabilities is well-settled, Congress has signified its intention to hold tax advisers to a higher standard when rendering tax advice.

C. Other Developments

Final Regs. §301.6111-3(b)(1) under IRC §6011 impose substantial reporting and record-keeping requirements upon professionals who furnish advice relating to the filing of estate and gift tax returns. 72 Fed. Reg. 43146, 43154, 43157 (8/3/07). The final regs create a new category of reportable transactions, termed "transactions of interest," for which the taxpayer or advisor must file a disclosure form and maintain records. Transactions of interest identify those transactions which the IRS believes have the potential for tax avoidance. The final regs also impose disclosure and record keeping requirements upon "material advisors," who are persons providing any "material aid, assistance or advice regarding the organization, management, promotion, sale, implementation, insurance, or conduct of any reportable transaction, and derives substantial income from that aid, assistance, or advice."

The IRS stated that it may impose a gross valuation misstatement penalty against an appraiser for post-May 25, 2007, estate and gift tax appraisals under new IRC §6695A, as adopted by the Pension Protection Act of 2006. The penalty is the greater of $1,000 or 10% of the amount of the underpayment attributable to the misstatement (but not more than 125% of the gross income received by the appraiser for preparing the appraisal). TAM 2007-0017.

The IRS re-issued proposed regulations under IRC §6159 describing how installment payment arrangements are requested, accepted and administered. The regs clarify when the IRS can terminate an installment payment agreement and recommence collection action. REG-10084172 Fed. Reg. 9712 (3/5/07). The IRS may reject an installment agreement by notifying the taxpayer or the taxpayer's representative in writing of the reasons for the rejection and the taxpayer's right to appeal to the IRS Office of Appeals within 30 days.

The IRS may cancel an installment agreement for reasons which include (i) nonpayment of any required installment payment when due; (ii) inaccurate or incomplete information; (iii) a determination that the collection of tax is in jeopardy; (iv) a significant change in the taxpayer's financial condition; or (v) the failure of the taxpayer to pay any other federal tax liability when due. Prop. Regs. §301.6159-1(e)(4).

Notice 2007-90 provides guidance for estates seeking to defer payment of estate tax attributable to a closely held business under IRC §6166. The IRS will determine on a case-by-case basis whether security is required to protect the government's interest in obtaining full payment of the estate tax. A primary factor will be the nature of the business generating the income on which estate taxes are owed.

Proposed regs articulate expenses of a trust or estate that are subject to the 2% floor on miscellaneous itemized deductions. The regs state that those costs which could not have been incurred by an individual in connection with property not held in a trust or estate are exempt from the 2% floor. Examples of costs excluded from the 2% floor include costs associated with fiduciary accountings, judicial or quasi judicial filings required in trust or estate administration, or fiduciary income tax returns, since those costs could not have been incurred by an individual. Expenses subject to the 2% floor include costs associated with the custody or management of property, advice on investing for total return, the defense of claims by creditors of the decedent or grantor, or the purchase, sale and management of business property. Reg.-128224-06, 72 Fed. Reg. 41243 (7/27/07).