Advanced **Markets**

Central Intelligence

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INSURANCE PRODUCTS	MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED	
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LIFE-5115 10/24

Tax Court finds termination of QTIP trust results in taxable gifts by remainder beneficiaries

***McDougall v. Commissioner,* No. 2458-22 (U.S.T.C. September 17, 2024).**

Facts

Upon her death in 2011, Decedent's estate passed to a Trust, under which her Husband had a lifetime income interest and her two children (Children) had remainder interests. Husband made an election under §2056(b)(7) to treat Trust as qualified terminable interest property (QTIP). In 2016, Husband and Children entered into an agreement. The agreement commuted Trust and distributed assets to Husband; Husband then sold some of Trust's assets to new trusts created for Children, in exchange for promissory notes. Husband and Children filed gift tax returns, reporting the transaction and including statements explaining that the result was "a reciprocal gift transfer," and therefore no gift tax was due. The IRS audited the return, finding the commutation of Trust resulted in 1) a gift from Husband to Children under §2519 and 2) gifts of the remainder interest from Children to Husband under §2511. Husband and Children filed timely Petitions for redetermination. All parties then sought summary judgment regarding gift tax liability.

Holding

As to whether Husband made a gift to Children when the Trust was commuted, the Court cites *Estate of Anenberg v. Commissioner,* No. 856-21, 162 T.C. 9 (May 2024), a recent case involving the same issue. When property was transferred under §2519 upon commutation of Trust, Husband is not liable for gift tax under §2501 because Husband made no gratuitous transfers, as a requirement under §2501. Commuting the Trust and transferring Trust property for promissory notes also did not result in gifts from Husband to Children. Section 2519 deals with transfers; the commutation of a QTIP trust qualifies as a transfer under the statute. Section 2519, however, does not address gift taxes. That is covered in §2501 and requires a transfer *by gift* for gift tax to apply. Here, as in the *Anenberg* case, there was no gratuitous transfer because after the transfer, Husband had full ownership of the property subject to the transfer. While it was a deemed transfer under §2519, it was not gratuitous and therefore not subject to gift tax.

In contrast, the agreement to commute Trust did result in gifts from Children to Husband. This issue was not resolved in *Anenberg*. While §2519 creates a fiction that Husband transferred the remainder interest in Trust to himself, in reality, Children transferred their remainder interest in Trust to Husband. Children tried to argue that §2519 should be applied to their transfer, as well, which the Court rejects. Upon Decedent's death, Children's estates included their remainder interests in Trust. After signing the agreement to transfer all Trust assets to Husband, they had no remainder interests, and received nothing in return. The Court explains that §2519 functions to defer tax on the transfer of marital assets, not to reduce or eliminate that tax. The Court rejects Children's claim that the Trust commutation resulted in a deemed gift of the remainder interest from Husband to Children, pointing out that it was a deemed transfer under §2519, not a deemed gift. The Court similarly rejects Children's assertion that they could not transfer anything to Husband because under §2519 he was deemed to own all of it. Gift tax is imposed on the donor, not the donee, and is based on what the donor transfers, not what the donee receives. Here, Children indisputably made a gratuitous transfer of their remainder interest to Husband, so gift tax liability attaches.

Takeaway

It might surprise many to learn that the Tax Code includes a great deal of fiction. Nevertheless, IRS audits are based on facts that can constrain even the best storytellers.

Tax Court includes assets of partnership in Decedent's estate

***Fields v. Commissioner,* T.C. Memo 2024-90 (September 26, 2024).**

Facts

Decedent took over her husband's business after his death in 1963 and built it into a successful enterprise. She did not have children but took a special interest in her great nephew (Nephew), paying for his undergraduate and graduate degrees and providing mentorship. In 2010, she executed several estate planning documents, naming Nephew as her power of attorney, health care agent and executor of her estate. In her will, Decedent made 10 specific cash bequests, totaling $1.45 million, as well as a non-cash bequest of 6,000 shares of Bank. Decedent left the remainder of her estate to Nephew. In 2011, Decedent was diagnosed with Alzheimer's disease, and in 2012 her doctor wrote a letter stating that she lacked capacity. Nephew took care of Decedent, slowly taking over management of her financial and legal affairs. In 2015, Nephew met with an attorney regarding an investment for Decedent and was advised to set up an LLC to protect Decedent's other assets. On this advice, Nephew formed two LLCs in May 2015, signing on behalf of Decedent as the sole member, and on his own behalf as manager. In May 2016, Nephew met with another attorney to discuss estate planning for Decedent. By the end of May 2016, Nephew had executed multiple documents. He signed a company agreement, naming himself as sole member and manager of Company, and contributed $1,000 for a 100% interest. He also signed a limited partnership agreement (Partnership), naming Company as the general partner and Decedent as the sole limited partner. Company contributed $1,000 to Partnership for a 0.0069% interest, and Decedent contributed almost $17 million for a 99.941% interest. Nephew signed the partnership agreement as agent on behalf of Decedent, and as manager of Company. Nephew, as agent for Decedent, transferred the following assets to Partnership by the end of May: $10 million from a brokerage account; all of Decedent's shares of Bank (approximately 89,000, valued at $5.34 million); Tree Farm, a 350-acre property; and all of Decedent's interest in the two LLCs formed in 2015. After these transfers, which were all completed by June 6, 2016, Decedent's remaining property outside of the partnership was just over $2 million, of which about $1.5 million was liquid. Decedent's health began to decline rapidly in May 2016; she died on June 23, 2016. After Decedent's death, her estate did not have enough cash to pay all the bequests, and Nephew distributed assets from Partnership to the estate. He also made distributions directly to Decedent's legatees. Nephew hired an accounting firm to file the estate tax return and reported the value of Decedent's Partnership interest at $10,877,000, which included a 15% discount for lack of control and a 25% discount for lack or marketability. The resulting estate tax liability was over $4.6 million. Since the estate lacked cash, Nephew again distributed assets from Partnership to the estate to pay the tax. The IRS audited the return and issued a notice of deficiency, seeking to include the full value of the assets transferred to Partnership and assessing a penalty for underpayment.

Holding

The Court determines that, under §2036(a), the estate should have included the value of the underlying assets in Partnership, not just the value of Decedent's Partnership interest. Assets are included under §2036(a) if a decedent made an inter vivos transfer of property, retained an interest in the property and the transfer was not a bona fide sale for adequate and full consideration. In this case, the property was transferred during Decedent's lifetime. The Court concludes that Decedent retained an interest in the property transferred because she had the right to income from the property at all times (even though she received no income) and she maintained a present economic benefit to the assets transferred to the partnership. The Court notes that after transferring assets to Partnership, Decedent had just $2.15 million left in her name, which would not be enough to cover the $1.45 million of specific bequests in her will and her estate tax liability. These facts suggested an implicit agreement between Nephew and Decedent, and Nephew's payment of some of these liabilities from Partnership after Decedent's death further reinforced that conclusion. The partnership agreement also gave Decedent the right to dissolve the partnership (in conjunction with Nephew); upon dissolution, the assets would be distributed to the partners according to their capital accounts. Since Nephew's interest was less than 1%, this gave Decedent the ability "to designate the persons who shall possess or enjoy the [transferred] property or the income therefrom," causing estate inclusion under §2036(a)(2). Finding that Decedent retained interests under §2036(a), the Court next considered whether the bona fide sale exception applied. While the Court allows that Decedent received adequate and full consideration for the assets transferred to the partnership, it focuses on the motive behind the transfer and whether it "was objectively likely to serve a substantial nontax purpose." That nontax purpose must be the primary motivator, rather than a post hoc justification, and the Court may consider the age and health of the transferor. Nephew asserted four nontax motivations: to protect Decedent from further elder abuse, allow for succession management of assets, protect against third-party rejection of Decedent's power of attorney, and consolidate and streamline asset management. While the Court acknowledges that all of these are valid nontax reasons in theory, the estate offers little evidence in support beyond Nephew's testimony. The Court notes that the timeline of transfers coincides with Decedent's decline in health, with no evidence suggesting that these considerations had been raised previously. Decedent's asset composition remained constant over the years, did not include any business interests that required active management, and showed no benefit from pooling assets. Decedent was not involved in any of these transfers, and her estate was depleted as a result. While the Court acknowledged Nephew's care for Decedent, it concluded that these transfers were primarily motivated by estate tax concerns and therefore were not "bona fide." As such, the value of the assets underlying the partnership, to the extent not included in Decedent's partnership interest, are included in her estate for estate tax purposes. The Court also finds Estate liable for a 20% accuracy related penalty for the negligent underpayment of tax under §6662(a) and (b)(1).

Takeaway

As is frequently the case, last-minute planning resulted in a suboptimal outcome, at least for the estate. Those looking to take advantage of the current lifetime exemption before it sunsets should take heed.

District Court finds statute of limitations had run out on government's ability to collect unpaid estate tax

United States v. Dill, **134 AFTR 2d 2024-5581 (M.D. Fla. 2024).**

Facts

Decedent's estate (Estate), which included property owned in a family trust (Trust), filed an estate tax return in December 2006, as well as an election under §6166 to pay estate taxes in installments. In 2010, Estate failed to pay its installment; in May 2011, the Estate requested an extension of time to make the installment payment. The extension request was denied, as was the Estate's administrative appeal. As a result, the United States issued the Estate a Notice of Final Determination (Final Determination) in March 2012, terminating the Estate's §6166 extension. If the Estate did not appeal the Final Determination within 90 days, the termination would become final. The Estate did not appeal, and the termination became final in June 2012. In August 2012, the United States issued a Notice and Demand for Payment of the Entire Tax Liability (Notice and Demand). The Estate did not pay the outstanding tax liability, and the United States filed suit to collect the deficiency in August 2022 — 9 years and 364 days after the Notice and Demand was issued. The United States sought payment for the Estate's tax liability from Defendant as personal representative of Estate and individually, and from Trust. Defendant claimed that the United States' claims for unpaid estate taxes were barred by the statute of limitations.

Holding

The Court first reviews when the 10-year statute of limitations begins to run for estate taxes. Under §6502(a)(1), the statute begins to run on the date of assessment. However, when an estate is granted an extension under §6166, then §6503(d) applies and the statute of limitations is suspended "for the period of any extension of time for payment granted under" §6166. The question the Court must address is when the §6503(d) suspension ended and the 10-year statute of limitations begins to run. Defendant claimed it began running in June 2012, when the Final Determination became final, while the United States argued it was the date of the Notice and Demand in August 2012. The Court analyzes the language of §6503(d), finding it "incredibly simple and straightforward": the statute of limitations is suspended while the extension is in place, and not suspended when the extension is terminated. Further, the Final Determination set forth a date on which the extension was terminated — 90 days after the Final Determination, unless Estate appealed. Since Estate did not appeal, the extension was terminated in June 2012. The United States tried to rely on the acceleration clause of §6166(g)(3)(A), which provides that if an installment payment is missed, "the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary." However, as the Court points out, §6166 does not refer to the statute of limitations. While the issuing a notice and demand to accelerate payments under §6166 is one way to terminate a §6166 election, it is not the only way. The Final Determination clearly stated that the §6166 election would be effectively terminated as of June 2012 if the Estate did not appeal. As such, there was no requirement for a notice and demand from the Secretary under §6166 in this case.

Takeaway

While this decision might suggest another possible advantage to making a §6166 election, this was a case of first impression and one would expect the IRS to adjust their timing when suing to enforce unpaid estate taxes. In this case, the estate avoided much of their estate tax liability, but there are other cases where the §6166 election has led to personal liability for unpaid estate taxes (see *U.S. v. Paulson* covered in **June 2023 edition of CI**). The real takeaway was summed up nicely by the Court: "when a party waits until the last minute to file suit, it runs the risk of having miscalculated the statute of limitations."

IRS issues final regulations identifying syndicated conservation easements as listed transactions

RIN 1545-BP82, 89 FR 58886 (October 9, 2024).

The IRS finalized rules formally naming syndicated conservation easements (SCEs) and substantially similar transactions as "listed transactions." Listed transactions are transactions the IRS deems tax avoidance strategies and impose reporting requirements for certain participants and advisers. The final rule follows a series of efforts by the IRS to constrain these transactions. In 2016, the IRS issued a notice to identify SCEs as listed transactions, but a federal court invalidated the notice for failing to comply with the Administrative Procedures Act. In December 2022, Congress passed the SECURE 2.0 Act, which included a provision (§170(h)(7)) disallowing a deduction for certain contributions of a qualified conservation easement (see July 2024 edition of CI).

The final rules track closely with the 2022 proposed rules, although the IRS made some changes to make the final rule "more surgical" in light of Congress's addition of §170(h)(7). The purpose of §170(h)(7), however, differs from that of the final rule — while the former is to disallow a deduction, the latter is intended to help identify tax avoidance transactions. The new rule is intended to cover three broad classes of SCEs: (i) contributions made before December 30, 2022, which are not covered by §170(h)(7); (ii) transactions for which a deduction is not disallowed under §170(h)(7), either because they meet an exception under §170(h)(7)(C) through (E) or the contribution does not exceed two and a half times the partner's investment in the entity, but which could still be abusive; and (iii) arrangements where a fee simple in real property, rather than a conservation easement, is contributed. The final rules clarify aspects of the proposed rule and modify language to more closely follow the language in §170(h)(7).

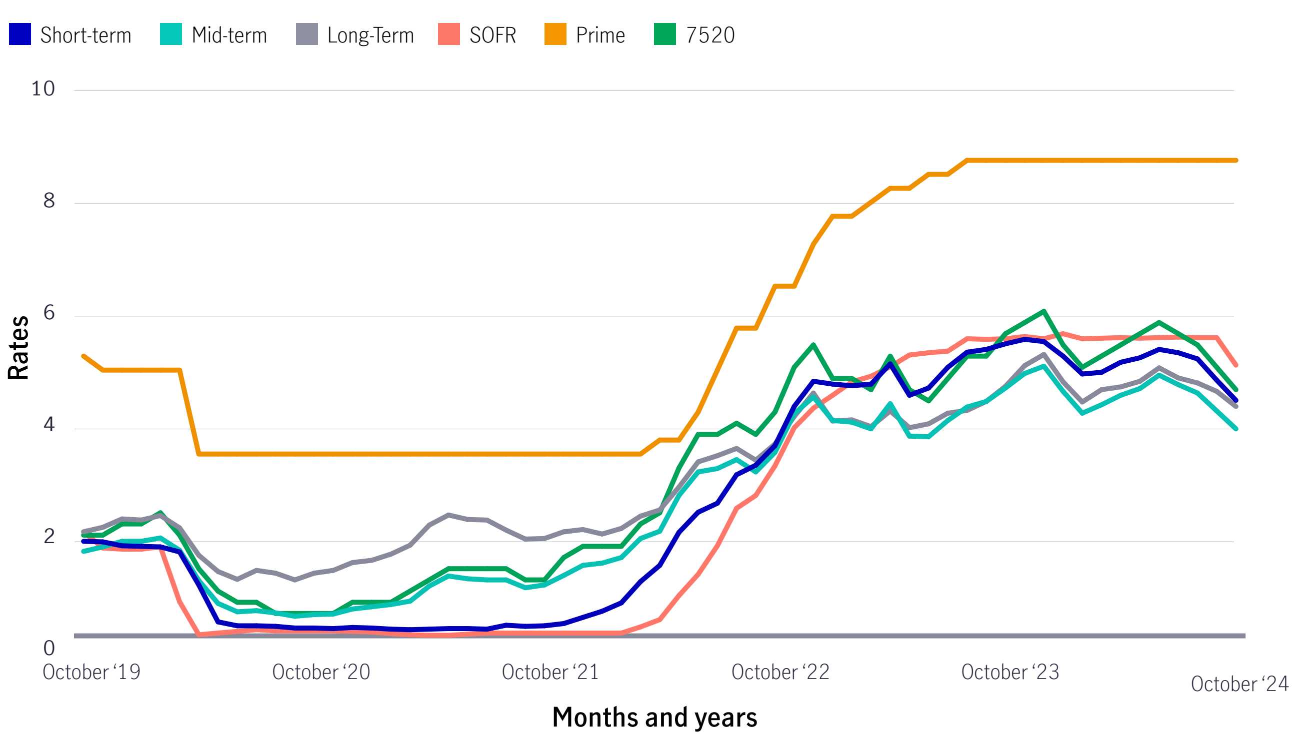
IRS issues final rules on consistent basis reporting

89 FR 76356, TD 9991, RIN 1545-BM97 (September 17, 2024).

In 2015, Congress passed a law requiring that basis of inherited property and its estate tax value be consistent. The law included reporting requirements and penalties. In 2016, Treasury and the IRS proposed rules implementing the new law. And on September 17, 2024, the IRS and Treasury finalized those rules. While the final regulations are largely consistent with the proposed rules, there were several revisions intended to make compliance easier for both taxpayers and the IRS, including; removing the zero basis rule for unreported property, modifying the reporting requirements for property received after the estate tax return due date, eliminating the subsequent transfer reporting requirement for all beneficiaries other than trustees, and creating additional exceptions for certain property interests. The final rules also clarify the duration of the consistency rule. The final rule does not provide a way for a beneficiary to offer evidence to claim a different valuation from the estate tax return, although the IRS and Treasury are considering future guidance on that point.

The following are historical graphs of various rates that are commonly used by the Advanced Markets group

Short, Mid, Long Term Applicable Federal Rate (AFR), 7520, SOFR, Prime Rates from October 2019 – October 2024



Take a look at how rates* compare this month to last month:

	Short-term AFR	Mid-term AFR	Long-term AFR	7520	SOFR	Prime
October 2024	4.21%	3.70%	4.10%	4.40%	4.84%	8.50%
September 2024	4.57%	4.02%	4.37%	4.80%	5.33%	8.50%

*For more information on these rates, please visit **https://www.irs.gov/applicable-federal-rates**

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