Courtesy of

ESTATE PLANNING **REPORT**®

March/April 2011

PLANNING THOUGHTS

How to opt out of the 2010 estate tax

On December 16, 2010, the IRS released a draft of Form 8939. Titled "Allocation of Increase in Basis for Property Acquired From a Decedent," this Form will be used by the executors for 2010 decedents' estates that wish to opt out of the federal estate tax. Beneficiaries of these estates will be subjected instead to carryover basis, and therefore the executor will need to allocate the $1.3 million basis increase that is permitted for such estates, as well as the $3 million basis increase for qualified spousal property.

The American Bar Association responded with comments and questions in a January 31, 2011, letter. Among the ambiguities:

The due date for the Form. The instructions for the Form had no due date. The ABA suggests having a specific date, as well as a procedure for extensions. Only larger estates are likely to be opting out of the estate tax, but these are the ones that take the longest to administer. It could be as long as two years before an executor knows which beneficiary acquired which asset, the ABA said.

Check a box. It appears that IRS wants the fact of filing of Form 8939 to act as the election out of the estate tax. To remove all ambiguity, the ABA suggests that the Form include an affirmative statement of the intention to opt for carryover basis, perhaps with a check box, circle selection or similar textual device.

Community property. The initial draft of the Form says nothing about community property, which seems like an obvious oversight. However, the ABA points out that more is needed than a space for community property. Some jurisdictions allow for agreements in which a spouse's one-half interest is determined in the aggregate, rather than on a property-by-property basis. The Service has asked for additional feedback on this issue.

Property that is sold. During the course of estate administration, property may be sold and the proceeds given to the surviving spouse. Is such property eligible for the additional spousal basis step-up?, asks the ABA. Although such a step-up is consistent with the spirit of the law, it may not meet the letter of it.

Allocation of the decedent's $5 million GSTT exemption. The generation-skipping transfer tax was restored retroactively for 2010 with a tax rate of zero. The ABA recommends providing a place on Form 8939 to allocate the decedent's GSTT exemption.

Depreciated property

Determining whether to opt out of the estate tax may be harder to do than one might think at first blush. Take this hypothetical.

D purchased a commercial office building for $10 million in 1980. He allocated $8 million to the value of the building, $2 million to the value of the land, and he has depreciated the building fully. Accordingly, D's adjusted basis in the building is $2 million.

Over the years D refinanced the building several times. At D's death in 2010, the building was worth $30 million, and it was subject to a mortgage of $20 million. Accordingly, his equity was $10 million.

Assume that the balance of D's estate comes to $5 million. If his executor chooses the estate tax, he will have to come up with $3.5 million very quickly. But if he chooses carryover basis, when the building is sold, the beneficiary will owe capital gains tax on $28 million, including tax on phantom gain (the excess of the liabilities over the adjusted basis). In addition, the portion attributed to the $8 million in depreciation will be taxed at ordinary income rates. For a California resident in the 10% tax bracket, this yields a combined tax rate of 45%. Selling the building might not produce sufficient proceeds to cover the tax bill!

Finally, if the estate tax is paid, the basis step-up creates a new depreciable basis for the property, which will generate tax deductions for 37½ years. So even if the property will not be sold in a few years, choosing to pay an estate tax could be a wise investment.

As this example makes clear, IRS will be working with the fallout from carryover basis for decades to come.

CASES AND RULINGS

Palimony claim may be the basis for an estate tax deduction.

Estate of Bernard Shapiro et al. v. United States, CA-9, No. 08-17491

Bernard Shapiro and Cora Jane Chenchark lived together for 22 years, but they never married. Over those 22 years, Chenchark cooked, cleaned and managed their household. In 1999 Chenchark learned that Shapiro was seeing another woman. When they broke up, she filed a palimony suit against him in state court. While the suit was pending, he died in 2000.

Shapiro's estate was substantial enough that it paid more than $10 million in estate and generation-skipping transfer taxes. The estate contested Chenchark's palimony suit and won in September 2001. However, when Chenchark appealed and also pursued a will contest, the estate settled for a payment to her of about $1 million.

After the settlement the estate filed an amended estate tax return, claiming a deduction for the liability associated with Chenchark's lawsuits. An expert put the value of those suits at $5 million at the time of Shapiro's death, which could have led to a tax refund of $2 million.

The District Court ruled that there was no contract between Shapiro and Chenchark, as she provided no consideration sufficient to support a contractual arrangement. The Ninth Circuit Court of Appeals now reverses, stating: "In recent decades, widespread social acceptance of non-marital cohabitation has triggered an expansion of cohabitants' legal rights." Chenchark's provision of household services was consideration, and she had a plausible claim under Nevada law. The case was sent back to the District Court to determine whether her claim was worth the $1 million of the settlement or some other value.

• • •

Agreement to resolve trust ambiguities avoids adverse tax consequences.

Private Letter Ruling 201101007

Testator created a trust that, apparently inadvertently, violated the rule against perpetuities. Testator's children, who would have inherited all the property via intestacy had the trust been declared void, reached an agreement modifying and saving the trust. However, in addition to removing the perpetuities error, the children converted the distributions from pro rata to per stirpes.

Although this resolution was satisfactory for the children, it was not for other trust beneficiaries, presumably the grandchildren and great-grandchildren. According to the statement of facts in this private ruling, litigation "over more than x decades" eventually ended up in the state's highest court, which held that the trust remainders were void and illegal as they violated the rule against perpetuities.

But that wasn't the end of the story. "Nearly y decades" after the court's decision, the state legislature amended its rule against perpetuities, adopting a "wait and see" approach instead. What's more, the amending legislation was made retroactive "to all interests heretofore . . . created." Some beneficiaries believed that the new legislation retroactively overruled the court decision, while others argued that the highest court's determinations were final. New litigation ensued, complicated by the actualities that the trust arrangement passed the "wait and see" perpetuities test; all the interests vested within the perpetuities period; and there were no additional grandchildren born after Testator's death.

Now a compromise has been reached by the trust beneficiaries in which distributions are part per capita and part per stirpes, and new trusts will be created. A sophisticated algorithm will carry the math out to 13 decimal places. The IRS holds that the settlement represents the resolution of a bona fide dispute, so no taxable gifts will be attributed to any of the parties, nor will the generation-skipping transfer tax apply.

• • •

Fractional interest discounts denied.

Estate of Axel O. Adler et al. v. Commissioner, T.C. Memo 2011-28

In 1965 Axel Adler gave each of his five children a one-fifth undivided interest in a 1,100-acre ranch that he owned in California, reserving a life estate for

© 2011 M.A. Co. All rights reserved.

himself. One child tried to return her share in 1991, perhaps in exchange for the cancellation of a loan, but the quitclaim deed never was recorded. After Adler's death in 2004, the executor claimed a fractional interest discount for the remainder interests in the ranch, which was then worth $6.39 million. *Held*, no discount is permitted under IRC §2036. Adler retained the unfettered use of the property until his death, including the right to alter or improve it without seeking permission from the children. Although the transfer was initiated in 1965, it effectively took place in 2004, and it will be so taxed.

• • •

Agents' error in policy application yields excess recovery by beneficiary.

Kristen Cox Morrison v. Paul Allen et al., Supreme Court of Tennessee, No. M2007-01244-SC-R11-CV

Morrison was concerned that his $300,000 term life insurance policy might not be enough protection for his family. He broached the issue with some golfing buddies who were financial planners. They were able to get him a new $1 million policy with premiums that were not higher than the policy that he surrendered.

Although the facts in the case are not entirely clear, it may be that one reason for the low premium was that on the policy application the agents had checked "No" to the question about whether the insured had a driving violation within the previous five years. In fact, Morrison had a DUI arrest. He was open and honest about the arrest. When a nurse came to do a physical, collecting blood and urine in connection with the new policy, he told her about the DUI when she ran through the questions on her form. Nevertheless, the accurate information did not reach the policy application.

Morrison was killed in a car accident two months after the $1 million policy was issued. When the insurance company learned that false information had been included in the application, it denied coverage. The widow then sued the insurance company and the agents for their failure to procure the policy requested by her husband.

Although the insurance company had a strong defense as a matter of law, it might have had a hard time getting much sympathy from a jury. The widow's lawsuit made a variety of claims in addition to the request for the $1 million in policy proceeds. In exchange for dropping all of those claims, the insurance company paid her $900,000, and it was excused from the lawsuit. The action against the agents proceeded.

The trial court found for the widow and awarded her $1 million. The damage award was not reduced by the settlement already reached with the insurance company, even though that meant the widow collected much more than her husband had bargained for. An appellate court upheld the ruling because the insurance company settlement covered more than just the contract claims.

• • •

Source of payment does not impair income tax deduction.

Judith F. Lang v. Comm'r, T.C. Memo 2010-286

Mother made a tax-free gift by directly paying $35,355 of Daughter's medical bills. Mother also paid more than $7,000 in state and local taxes and real estate taxes on Daughter's behalf. Daughter claimed an income tax deduction for both amounts, which IRS denied because Daughter did not pay them herself.

The Tax Court held that the deduction is allowable. In substance, this was a gift from Mother to Daughter, followed by payment by Daughter. There is no danger of a double deduction, because Mother has not and cannot claim an income tax deduction herself for the payments. Payment of the state and local taxes was a taxable gift by Mother, but it fell within the annual exclusion amount for the year in question.

WASHINGTON TALK

Speaking at the 2011 Tax Institute in Los Angeles, law professor Edward McCaffrey urged estate planners to shift their focus to the nontax purposes of estate planning. "For most Americans, the gift and estate tax is now moot, and will continue to be moot," he said. McCaffrey does not believe that the federal exemption will recede from the current $5 million per person level. He noted that at current levels, only 0.5% of decedents' estates will have to pay federal estate tax in 2011, compared to 10.5% back in 1977.

McCaffrey suggested a good case can be made for complete repeal of the federal estate tax, given that the revenue gained is more than offset by what is lost when taxpayers shift to tax-favored savings strategies.

Some economists have attempted to quantify the drag on capital formation and economic growth created by the estate tax. On the other hand, McCaffrey noted that the possibility of an estate tax generates more money for lobbyists and politicians. That could extend its life.

Still, McCaffrey told the audience to raise the possibility of estate tax repeal with their wealthy clients. Over time, he predicted, estate planning will move out of law firms and into private banks. "It's going to become an adjunct of financier relationships. It will just be an extra service you get," he concluded.

President Obama might take issue with Professor McCaffrey's predictions. The President's 2012 budget proposal does not include an assumption that the current $5 million federal transfer tax exemptions will be continued, nor does it project implementation of the current law as a baseline—estate taxation of estates larger than $1 million in 2013 and later years. Instead, the budget calls for the restoration in 2013 of the 2009 estate tax law, with its $3.5 million exempt amount. That could also mean the repeal of spousal portability of unused estate tax exemptions.

Domestic partners get a tax break. In its release of Publication 555 on community property, the IRS noted that in Nevada, Washington and California, registered domestic partners generally must report half of the combined community income earned by the individual and his or her same-sex spouse. The couple are not allowed to claim married filing jointly status, but neither are they required to use the most severe tax schedule, which applies to marrieds filing separately. Instead, registered domestic partners must file as singles or, if they quality, as heads of households.

Proving that opposition to higher estate taxes enjoys bipartisan support, Ways and Means Committee member Rep. Mike Thompson (D-Calif.) introduced H.R. 390, the Family Farm and Conservation Estate Tax Act. The Act would exempt qualified farmland from the estate tax, without a dollar limit, so long as material participation in farming continues by members of the decedent's family.

IRS is cracking down on people who have undisclosed income from hidden offshore accounts. It's a big job. To get a jump on it, in 2009 the Service offered reduced penalties for anyone who came forward to disclose voluntarily such accounts and bring those assets into the U.S. tax system. About 15,000 taxpayers came forward during the program, and another 3,000 have made voluntary disclosures since the program closed. Perhaps because of this success, a new voluntary disclosure program has been announced for 2011.

The overall penalty structure in the new program will be higher, which means that those who failed to take advantage of the 2009 program won't be rewarded for their delay. Participants will have to pay back-taxes and interest for up to eight years. A penalty of 25% may apply, but smaller offshore accounts may be hit with only a 12.5% penalty. In limited situations, taxpayers may qualify for a 5% penalty.

Taxpayers with unreported offshore accounts who do not come forward voluntarily face higher penalties and the possibility of criminal prosecution if they are caught. Tax advisors also face the possibility of sanctions from the IRS if they assist taxpayers who have hidden offshore accounts.

All paperwork in the new voluntary disclosure program must be filed with the IRS by August 31, 2011.

The Congressional Research Service [www.crs.gov] released "A History of Federal Estate, Gift, and Generation-Skipping Taxes" in January. The new report summarizes the modern estate tax going back to its creation in 1916, as well as death taxes and gift taxes dating back to the colonial era. Not included in the compilation of legislative changes are the costs to administer the estate tax, the cost of compliance, the cost of estate tax planning, or the net revenue raised by transfer taxes over the years.

Trust Department

Security Federal's Trust Department is committed to providing our clients with services that are personalized and responsive.
If we can be of assistance to you or your clients, please call our tenured and experienced trust professionals.

JON-MYCKLE PRICE
TRUST ADMINISTRATOR
jmp@secfedbank.com

SUZANNE CHILCOTT
SENIOR VICE PRESIDENT
TRUST OPERATIONS
suzanne@secfedbank.com

BARBARA ROADS
ADMINISTRATIVE ASSISTANT
barb@secfedbank.com

574-722-6261 • 314 Fourth Street, Logansport, IN 46947-0420