High Net Worth Family

TAX REPORT

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Congressional Super Committee Fails to Agree on Deficit Reduction Measures

A couple of weeks ago we reported to you about rumors then circulating that the Congressional Joint Select Committee on Deficit Reduction ("Super Committee") might recommend reducing the estate and gift tax exemption to $1,000,000 as early as November 23, 2011. That did not occur and, in fact, the mandate of the Super Committee expired on November 23 with no deficit reduction proposals being agreed upon by the Super Committee.

As of this time, the $5,000,000 lifetime exemption from estate and gift taxes will remain in effect through December 31, 2012. For 2012, the exemption has been inflation adjusted to $5,120,000. On January 1, 2013, the exemption will revert to $1,000,000 and the maximum estate and gift tax rates will increase from 35% to 55%. Similarly, the current $5,000,000 exemption from generation-skipping transfer ("GST") tax is currently scheduled to remain in effect through December 31, 2012, and revert to $1,000,000 (adjusted for inflation since 2001) on January 1, 2013, with the GST tax rate being equal to the highest estate and gift tax rate.

Over the next couple of weeks you may read of proposals being introduced in Congress to accelerate the date of those changes and make other changes to the estate, gift, and GST taxes. At this time, there is no reliable information that would justify decision-making on the basis of rumor and speculation. We will closely monitor all such proposals and alert you promptly if any appears to be gaining traction. Most experts consider that highly unlikely given how heavily divided Congress is currently.

Supreme Court to Resolve Statute of Limitations for Overstatements of Tax Basis

We have previously reported on several cases where courts have addressed the amount of time the Internal Revenue Service ("IRS") has to assess a tax deficiency if the taxpayer overstates the income tax basis of an asset that he has sold. Normally, the IRS has 3 years from the date on which a tax return is filed to assess additional tax

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with respect to the tax year covered by the return. If the taxpayer omits an amount of gross income from his tax return, however, that is more than 25% of the amount of gross income reported on the return, the IRS has 6 years within which to assess additional tax.

A number of tax-advantaged transactions that were popular in the late 1990s and early 2000s resulted in the income tax basis of an asset being increased before the asset was sold. These transactions have led to considerable litigation over whether the overstatement of tax basis is the same thing as an understatement of gross income. Over time, a split has developed among the various circuits of the United States Court of Appeals. In our last edition, we reported on two recent cases where the Court of Appeals upheld a regulation the government issued to help its own position on this issue.

When different circuits of the Court of Appeals take different positions on the same issue, the Supreme Court often accepts one of the cases to resolve the split and that is what has happened here. On September 27, 2011, the Supreme Court agreed to hear the case *Home Concrete Supply LLC v. United States*, where the Court of Appeals for the Fourth Circuit held in favor of the taxpayer that an overstatement of basis was not the same thing as an understatement of gross income. The Supreme Court will answer that question and will also determine the validity of the government's self-help regulation which says that an overstatement of basis is an omission of gross income. We will report on the outcome when the Supreme Court renders its decision.

IRS Rules That Gift to Charity of Non-voting Stock Is Not a Prohibited Split-Interest Transfer

If a donor transfers an income interest in property to a charity and retains the underlying property or transfers such property and retains the income interest, the donor does not receive any income tax deduction unless the interest that goes to the charity is in the form of a qualified remainder interest in a charitable remainder trust or a qualifying income interest in a charitable lead trust.

In *PLR 201129033*, the donor owned both voting and non-voting shares of stock of a corporation. He wanted to give a portion of his non-voting shares to a charity and asked the IRS for a ruling that the transfer of the non-voting shares would not be considered a prohibited transfer of a partial interest in property. The IRS ruled in favor of the taxpayer, finding that the voting shares and non-voting shares constituted separate and distinct property interests, rather than being fractional parts of a single property interest. The donor did arrange for the corporation to agree to pay an annual dividend on the non-voting shares so that the charity would receive some clear economic benefit. This may have assisted the taxpayer in getting the favorable ruling.

Court of Appeals Affirms Tax Court on Fifteen-Year Amortization of Covenant Not to Compete

In our August 2010 edition (Vol. 5, No. 2), we reported on the Tax Court case *Recovery Group, Inc.* The taxpayer had redeemed the stock of a 23% shareholder and separately paid him for a one-year covenant not to compete. The taxpayer deducted the cost of the covenant since its benefit was limited to one year. Historically, the cost of a covenant not to compete has been amortized over the term for which it is in force and the taxpayer's deduction would have been appropriate. In 1993, however, Congress enacted IRC Section 197 which provides that if intangible assets, such as a covenant not to compete, are acquired as a part of the acquisition of a trade or business, the intangible assets must be amortized over 15 years regardless of their useful life. The Tax Court held that the redemption of the shares of a corporation that is engaged in a trade or business constitutes the acquisition of a trade or business, so the 15 year rule applies.

The taxpayer appealed the Tax Court's decision to the United States Court of Appeals for the First Circuit. That court agreed with the Tax Court. Both the Tax Court and the First Circuit held that the percentage of the corporation's shares that are acquired in the transaction is not relevant. As long as the corporation is engaged in a trade or business, any covenant not to compete acquired in connection with any acquisition of its stock is subject to the 15 year amortization rule of IRC Section 197. This rule presents a potential trap for taxpayers and their advisors because the result is counter-intuitive. Of course, students of the tax law know all too well that many tax results are counter-intuitive.

Family Limited Partnerships: The Litigation Continues

The litigation over valuation discounts associated with family limited partnerships and limited liability companies shows no signs of abating. Additional cases have been decided since we last wrote to you in August. In *Estate of Clyde W. Turner, Sr. (August 30, 2011)*, the taxpayer formed a family limited partnership funded with investment assets and cash. Stock of Regions Bank made up 60% of the total assets of the partnership. The taxpayer retained $2 million of assets outside of the partnership. Gifts of limited partnership interests were made to the taxpayer's children.

Upon Clyde's death, the IRS took the position that the partnership's assets should be included in Clyde's gross estate for estate tax purposes under IRC Section 2036(a)(1) which includes assets that the decedent had transferred during his life but with respect to which he retained an interest. The court found that the decedent retained an interest in the assets because he paid himself excessive management fees from the partnership and he had stated that the Regions Bank shares should never be sold. The court also said that the assets would be includible in his estate under Section 2036(a)(2), which includes property where the decedent retains the right to determine who shall enjoy or possess the property. The decedent was the general partner and had discretion to determine when and if distributions would be made from the partnership. The decedent also had the right to amend the partnership agreement without any vote on the part of the limited partners. Even as to matters that did require a majority vote of the limited partners, Clyde and his wife retained more than 50% of the limited partnership interests.

The second case was *Estate of Paul H. Liljestrand (November 2, 2011)*. Again, the issue was whether assets transferred to a family limited partnership should be included in the transferor's gross estate for estate tax purposes pursuant to IRC Section 2036(a)(1). In this case, it was easy for the court to conclude that the taxpayer had retained an interest in the property that he transferred to the partnership. He retained a preferred return that was high enough to consume all of the partnership's income, he did not retain sufficient assets outside of the partnership to pay his bills, and he received non-pro rata distributions from the partnership.

IRS Issues New Proposed Regulations on Bundled Trustee Fees

In the case of *Knight v. Commissioner (January 16, 2008)*, the Supreme Court held that investment advisory fees paid by an estate or non-grantor trust are subject to the 2% of adjusted gross income floor on miscellaneous itemized deductions imposed by IRC Section 67. In general, IRC Section 67(e) provides that the adjusted gross income of an estate or non-grantor trust is computed in the same manner as it is for an individual. Deductions for expenses that an estate or non-grantor trust incur, however, that would not be incurred by an individual, are not treated as itemized deductions. This means that these expenses are deductible in full without regard to the 2% floor. An example of a deduction incurred by a trust that would not be incurred by an individual is for the fee charged by the trustee to administer the trust. Investment advisory fees, however, are incurred both by individuals and by trusts.

The Supreme Court did say that if the trust incurs investment advisory fees that are higher than those that would be incurred by an individual, the excess portion of the fee is deductible without regard to the 2% floor of Section 67. A trust might incur higher fees because it has an unusual investment objective or it incurs extra fees to balance the interests of the various beneficiaries of the trust. The IRS has now proposed regulations that acknowledge this aspect of the Supreme Court's opinion. The regulations also provide that where the trustee bundles its fee and the fee is not charged on an hourly basis, only the portion of the bundled fee attributable to investment advice is subject to the 2% floor. The entire balance of the fee may be deducted in full.

IRS Voluntary Worker Classification Settlement Program

A constant source of friction between the IRS and taxpayers is over the classification of workers. Are the workers employees or independent contractors? If they are employees, the employer must withhold income and payroll taxes from their wages and pay the employer's share of the applicable payroll taxes. The IRS has developed a new program, the Voluntary Classification Settlement Program (the "VCSP"), that allows employers to prospectively reclassify workers as employees instead of independent contractors or other non-employees.

The VCSP provides partial relief from past employment taxes by requiring eligible taxpayers to pay only 10% of the employment tax liability that would otherwise have been due on compensation paid for the most recently closed tax year as determined by reduced rates. According to the IRS, employers accepted into the program will pay an effective amount equal to just over one percent of the wages paid to the reclassified workers for the past year. If a taxpayer chooses to reclassify certain of its workers as employees, it must also reclassify all workers in the same class as employees for employment tax purposes.

A taxpayer is eligible to participate in the program if: i) the taxpayer has consistently treated the workers as non-employees; ii) has filed all required Forms 1099 for the workers for the prior three years; iii) is not currently under audit by the IRS; and iv) is not currently under audit concerning the classification of the workers by the Department of Labor or by a state government agency. A taxpayer that was previously audited by the IRS or Department of Labor concerning the classification of workers will be eligible for the VCSP if the taxpayer has complied with the results of that audit. Exempt organizations and government entities may participate in the VCSP if they satisfy the above requirements and are not undergoing a Form 990 series audit.

A taxpayer who participates in the VCSP will agree to prospectively treat the class of workers as employees and to extend the statute of limitations on employment taxes to six years for the first three years under the VCSP closing agreement. In exchange, the taxpayer will: i) pay 10% of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year as determined under reduced rates; ii) avoid liability for any interest and penalties on such amount; and iii) avoid any employment tax audit with respect to the classification of the workers for prior years.

To apply for the VCSP, the taxpayer must submit an Application for Voluntary Classification Settlement Program at least 60 days before the taxpayer wants to begin treating the workers as employees. If the IRS accepts the application, the taxpayer will enter into a closing agreement with the IRS to finalize the terms of the VCSP and will simultaneously pay any amount due under the closing agreement.

Some Developments of Interest to Our New York Readers

Changes to New York Offer in Compromise Program. The New York State Department of Taxation and Finance recently enacted legislation that expands the eligibility of taxpayers to participate in New York's Offer in Compromise Program and provides the Commissioner with more flexibility with respect to amounts that can be accepted in compromise of a tax liability. In addition to previously eligible taxpayers that have been discharged in a bankruptcy proceeding or are proven to be insolvent, eligible taxpayers now include individuals who can demonstrate that a full collection of any tax liability will cause the taxpayer undue economic hardship. An undue economic hardship occurs when a taxpayer is unable to pay reasonable basic living expenses. In determining whether an undue economic hardship exists, the Department of Taxation and Finance will look to the IRS's Collection Financial Standards to help determine a taxpayer's allowable basic living expenses and will consider other factors that can impact an individual's financial condition, *e.g.*, age, employment status, illness or disability, obligations to dependents, or extraordinary circumstances.

The amount that the Commissioner previously could have accepted in compromise of a tax liability could not have been less than the amount recoverable through legal proceedings. The new law generally permits the Commissioner to accept amounts in compromise that reasonably reflect collection potential or are otherwise justified by the proof offered by the taxpayer.

The new law retains the requirement of a New York State Supreme Court justice's approval for fixed and final liabilities where the amount to be compromised is over $100,000 (excluding penalties and interest), but raises the threshold from $25,000 to $50,000 (including penalties and interest) before requiring an opinion of counsel to finalize offers for liabilities that are not fixed and final.

New York Statute of Limitations for Collection of Tax Liabilities. New York recently amended the law that imposes a 20 year statute of limitations to collect tax liabilities to clarify that such 20 year period begins from the first date the Commissioner could have filed a warrant (a legal action against a taxpayer that creates a lien against the taxpayer's real and

personal property), without regard to whether the warrant is actually filed. Where there is no right to a hearing, the first date the Commissioner could have filed a warrant is the day after the last day specified for payment by the Notice and Demand and where there is a right to a hearing, such date is the day the opportunity for a hearing or review has been exhausted. In addition, the taxpayer's payment or acknowledgment of a debt in writing no longer extends the 20 year statute of limitations; however, the Commissioner and the taxpayer can agree to a longer statute of limitations. This new law applies to all tax liabilities that could have been warranted before August 17, 2011, and that can be warranted on or after such date.

Change in Filing Requirements for New York Same-Sex Couples. The Marriage Equality Act, signed into law on July 24, 2011, provides that all marriages will be treated equally under all laws of New York state, including the tax laws.

Effective for tax years ending on or after July 24, 2011, same-sex married couples (including those who were married outside of New York) must file New York personal income tax returns using a married filing status (*i.e.*, married filing jointly or married filing separately), even though their marital status is not recognized for federal tax purposes (see article on federal law in this edition) and they may have filed as a single or head of household status on their federal returns. To compute their New York tax, such married couples must re-compute their federal income tax as if they were married for federal purposes.

In addition, the New York taxable estate of an individual in a same-sex marriage must be computed in the same manner as if the deceased individual were married for federal estate tax purposes. The estate of an individual married to a same-sex spouse must begin by computing the gross estate on a pro forma federal return as if the marriage were recognized for federal estate tax purposes, including certain deductions and valuations.

Same-sex married employees may want to file new withholding certificates with their employer informing them of their married status and provide proof of their married status to have the employer stop withholding New York tax on the value of certain benefits (*e.g.*, health care coverage of their spouse).

Out-of-State Investment Company Limited Partner Lacked Nexus with New Jersey. The Superior Court of New Jersey held that a foreign investment corporation whose only connection with New Jersey was a 99% limited partnership interest in a limited partnership that does business in New Jersey does not give rise to sufficient nexus with New Jersey to subject the foreign limited partner to New Jersey's corporation business tax. The foreign limited partner had no place of business, property, employees, agents, or representatives in New Jersey.

New Jersey argued that the foreign limited partner had a unitary relationship with the business conducted by the limited partnership in New Jersey. The Court held that the foreign limited partner and the limited partnership did not have a unitary relationship and the partner did not have sufficient nexus with New Jersey because (1) unanimous consent of both partners was required to admit additional partners, merge or consolidate the partnership with another entity and consent to the sale or transfer of either partner's interest and the non-selling partner had the right of first refusal in a sale of a partner's interest and the general partner controlled the ongoing business activities of the limited partnership, (2) there was no indication that the foreign limited partner had a New Jersey address, (3) the sharing of some officers and office space is insufficient to show a unitary business, (4) the foreign limited partner's right to inspect books, records, reports and returns do not show that it controlled the limited partnership, and (5) the foreign limited partner was not in the same line of business as the partnership.

Tax Court Disallows Special Allocation and Imposes Self-Employment Tax on Law Firm Limited Liability Partnership

A recent Tax Court case, *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, disallowed a special allocation of a law firm limited liability partnership's net business income and held that income generated from the firm's legal practice that was allocated to the attorney partners was subject to self-employment tax.

The partnership originally consisted of three attorneys and an S corporation that was owned by an Employee Stock Ownership Plan of which the three attorneys were the beneficiaries. The partners

shared profits and losses as follows: 30% each to the three attorneys and 10% to the S corporation. The law firm specially allocated 87.5% of its net business income to the S corporation. The law firm did not report any of its business revenues from its law practice on its partnership return as net earnings from self-employment.

The IRS reallocated the partner's distributive shares of the firm's net business income in accordance with the profit and loss sharing percentages. The law firm argued that the special allocation was proper because it was made pursuant to the partnership agreement; however, the firm could not produce a partnership agreement to support such an allocation. As a result, the Tax Court looked at the partners' capital contributions, interests in profits and losses, cash flow and other non-liquidating distributions, and the partners' rights to capital on liquidation to determine the partners' interests in the partnership. In making such determination, the Court found that there was no indication that the S corporation ever made any capital contributions to the partnership, the S corporation only held a 10% profit and loss interest, there was no indication that the S corporation received any distributions from the partnership and there was no indication regarding the partners' rights to distributions of capital upon liquidation of the partnership.

The IRS determined that the attorneys' shares of such income were subject to self-employment tax. The law firm argued that the partners did not have to include their distributive share of partnership income in calculating net earnings from self-employment because they were limited partners in a limited partnership and the distributive share of an item of income or loss of a limited partner (other than certain guaranteed payments) is excluded from such calculation. The exception does not define the term limited partner so the Court looked to the legislative history for guidance. The legislative history indicates that the intent of the exception was to ensure that individuals who simply invested in a partnership and were not actively participating in the partnership's business operations would not receive credits toward Social Security coverage.

The legislative history does not support a finding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners from liability for self-employment taxes. The Tax Court determined that the partners' distributive shares of the law firm's income did not arise as a return on their investment and were not earnings of an investment nature. Thus, the distributive shares of the law firm partners arising from the legal services performed in their capacity as partners in the law firm were subject to self-employment taxes.

California Board of Equalization Determines Source of Income from Non-qualified Stock Options

In *Appeal of Eddie C. Davis and Cynthia L. Davis*, the taxpayer had received non-qualified stock options from her employer. During 2005, she exercised a number of the options and also moved from California to Texas while continuing to work for the same employer. At issue in the case was how much of the income from the options is attributable to her period of California residency. The taxpayer argued that only the period between the time the options vested and were exercised should be taken into account and the portion attributable to California should be based on the number of days she was a California resident during this period, compared to the total number of days in the period. Before the California State Board of Equalization, the Franchise Tax Board argued and the Board found that the counting of days should begin with the dates the options were granted, not the dates on which they vested. This resulted in a much larger share of the income having a California source and being taxable by California.

California Reminds Taxpayers That Not All Charges on Real Property Tax Bills Are Deductible

The California Franchise Tax Board ("FTB") has reminded taxpayers that only the portion of real property taxes that is based on the assessed value of the property may be deducted as an itemized deduction. Other charges added on to the real property tax bill may not be deducted. These include non-ad-valorem special assessments, Mello-Roos taxes, direct levies, fees and other charges. You can identify the non-deductible amounts on your real property tax bill as those charges that do not include a tax rate percentage. Beginning with the 2012 tax

year, the FTB will revise Schedule CA of Form 540 to request specific information related to the itemized deduction for real property taxes.

This limitation only applies to real property taxes that are deductible as itemized deductions, such as your home or other personal use real property. If you own real property that is used in a business or held for the production of rental income, these other charges are still deductible on the schedule for business or rental income. Additional information is available on the FTB website at http://www.ftb.ca.gov/aboutFTB/newsroom/Schedule_CA_Real_Estate_Tax_Deduction.shtml.

IRS Provides Filing Information for Registered Domestic Partners and Same-Sex Spouses

In a series of questions and answers, the IRS has provided tax return filing information for registered domestic partners in California, Nevada and Washington and same-sex spouses in California. These are all community states.

Federal tax law respects the state law characterization of income as community property. Therefore, registered domestic partners and same-sex spouses in these states must each report one-half of all community property income on their federal income tax return. Each partner receives a credit for one-half of any tax that is withheld on wages that are treated as community property under state law. Reporting of community income in this manner is mandatory beginning with the 2010 tax year. If taxpayers wish to do so, they may amend prior years' returns to report in accordance with these new guidelines; however, amending is not mandatory. California has recognized the community property rights of registered domestic partners since 2007, so returns filed for that year or any later year could be amended if the statute of limitations has not closed.

While the IRS requires each partner to report one-half of the community income, the partners are not permitted to file either joint returns or married filing separate returns. These filing categories are determined under federal law, which pursuant to the Defense of Marriage Act ("DOMA"), currently does not recognize either registered domestic partners or same-sex marriages. DOMA, however, is under attack on constitutional grounds in several courts. In April (Vol. 6 No.1), we reported that the United States Department of Justice issued a statement in February that it would no longer defend the constitutionality of DOMA in the courts. We will keep you apprised of the status of DOMA as it affects tax planning.

The questions and answers contain information on a variety of related subjects including the availability of the dependency exemption for a partner or a child of a partner. The partners are also permitted to make different choices on itemizing deductions versus claiming the standard deduction. If this subject is of interest to you, the full text of the questions and answers can be accessed on the IRS website using the following link: http://www.irs.gov/newsroom/article/0,,id=245869,00.html. IRS Publication 555 also contains tax information for registered domestic partners.

Two Cases Previously Reported Are Affirmed by the Ninth Circuit

Gift formula valuation clause. In December 2009 (Vol. 4. No.3), we reported on the *Petter* case, where the taxpayer made sales and gifts of limited liability company units to trusts for her daughters and to a charity. The terms of the transfer provided that the number of units that were to go to the daughters' trusts was the number of units whose value, as finally determined for tax purposes, was not in excess of a fixed sum that would not cause the taxpayer to become liable for gift taxes. The entire balance of the units went to the charity. Upon audit, the IRS established a higher value for the units than was used by the taxpayer. The taxpayer claimed an additional charitable contribution deduction for a larger gift to the charity and the IRS disallowed that deduction. The Tax Court held in the taxpayer's favor.

The Tax Court's decision has now been affirmed by the United States Court of Appeals for the Ninth Circuit. This is important because cases of taxpayers residing in California are appealed to the Ninth Circuit. In these cases, the IRS always argues that formula clauses violate public policy because such a clause insures that a gift tax will never be paid on this kind of transfer. Neither the Tax Court nor the Ninth Circuit agreed with the IRS on this point, although the Ninth Circuit did invite the IRS to amend its regulations if it wishes to change this result.

In August (Vol. 6 No. 2), we reported on the *Hendrix* case, where the Tax Court once again approved the use of a formula valuation clause. Similar to the facts of *Petter*, any excess value above a stated amount was to go to a charity. So far, taxpayers are prevailing where the excess valuation amount goes to a charity (*McCord, Petter, Hendrix*). The IRS, however, has prevailed where the excess value amount is returned to the donor (*Procter, Ward*).

Personal goodwill. Personal goodwill has become an important asset for tax planning purposes. In August 2010 (Vol. 5 No. 2), we reported on the case of *Larry E. Howard v. United States*. Dr. Howard was a dentist who practiced through a professional corporation. When he sold his practice, the corporation received $47,100 for its assets while Dr. Howard individually received $549,000 for personal goodwill and $16,000 for a covenant not to compete.

Corporations are not tax efficient in sale transactions because the buyer always wants to purchase the assets of the corporation so that it can allocate the purchase price to assets that can be depreciated or amortized for tax purposes. The sale of assets by a C corporation, however, results in both corporate level tax on the sale, as well as a second tax at the shareholder level when the corporation distributes the after-tax sales proceeds to the shareholders. It is more efficient for the shareholders simply to sell their stock and pay a single capital gain tax on the proceeds.

Tax advisors have attempted to get around this problem by claiming that the selling shareholder is possessed of "personal goodwill;" an intangible asset owned by the selling shareholder, but critical to the business of the corporation. An example might be relationships with key clients or customers that are important to the business. In Dr. Howard's case, the goodwill was his personal relationship with his patients.

The District Court held that the goodwill was an asset of the corporation which should be treated as though it sold the goodwill and then distributed the proceeds to Dr. Howard. The Ninth Circuit has now affirmed the District Court. In the view of the Ninth Circuit, Dr. Howard was tripped up by the employment agreement he had with the corporation. The agreement required Dr. Howard to render his full-time dental services to the corporation and prohibited him from competing with the corporation for three years after his employment terminated. The corporation retained full control over the acceptance of new patients and ownership of patient records. The court held that Dr. Howard had transferred the economic value of his patient relationships to the corporation.

It is interesting to think about whether Dr. Howard could have put himself in a better position. Suppose his employment had provided that he owned and retained the rights to any patient relationships he developed during the course of his employment? Since he was the only shareholder of the corporation, there was little economic risk in having such a provision in the employment agreement. While a provision of this nature may enhance the shareholder's position with respect to personal goodwill, it may also provide the IRS with a good argument that the income being received is really being earned by the shareholder and the corporation should simply be disregarded.

Tax Court Allows Estate Tax Deduction for All Interest That Will Be Due on a Loan to Pay Estate Taxes

Estate of Vincent J. Duncan (October 31, 2011), illustrates the successful use by the taxpayer of what estate tax lawyers refer to as a *Graegin* loan, named after one of the first cases to approve the technique. The expenses incurred in administering the estate of a decedent may be deducted from the amount of the gross estate to determine the taxable estate upon which the estate tax is imposed. If an estate can demonstrate that it must borrow money in order to pay the estate taxes that it owes, then the full amount of the interest that will be due over the term of the loan can be deducted from the gross estate as an administration expense.

In the *Duncan* case, the estate demonstrated that its assets were illiquid and could not be sold to pay the estate tax due. The estate (held through a trust that was revocable up to the time of the taxpayer's death) borrowed $6,475,515 from an irrevocable trust that had been set up for the decedent by his father. Northern Trust was the trustee of both trusts and following the decedent's death his children were the beneficiaries of both trusts. Interest on the loan was accrued and compounded and all principal and interest were payable in a single installment after 15 years. The loan prohibited the prepayment of interest or principal. The interest rate was set at 6.7% per annum at a time when the applicable federal rate was 5.02% and the prime

rate was 8.25%. The interest rate was recommended by Northern Trust's banking department as being a market interest rate for this type of loan in October of 2006 when the loan was made. On its estate tax return, the estate deducted $10,653,826 for the interest that would be due on the loan at the end of its 15 year term.

The IRS raised several objections to the loan including that it was not bona fide because the lender was a trust with the same trustee and beneficiaries as the borrower. The Tax Court rejected this argument because under applicable state law the trustee had a duty to administer each trust individually and without regard for the fact that the two trusts were essentially related. This meant that both the lending and borrowing trusts would be obligated under the law to recognize and enforce the terms of the loan.

The IRS next argued that the term was longer than needed because the borrower generated enough income in 3 years to pay off the loan. The court declined to second guess the judgment of the borrower's advisors who recommended the 15 year term because the trust's revenue stream was tied to oil and gas prices, which were unpredictable. The court also found that the loan was necessary because without the loan the trust would have to sell illiquid assets at depressed prices in order to pay the estate taxes. The cost incurred to protect against a forced sale is a reasonable expense of estate administration.

The IRS also challenged the interest rate. It argued that because the trust that was the lender and the trust that was the borrower had the same beneficiaries, the interest rate should not be higher than the applicable federal rate. The court rejected this argument as well, finding that the trust's cost of borrowing should objectively be higher than the applicable federal rate, which reflects the government's cost of borrowing.

The IRS then argued that the total amount of interest that would be paid over 15 years was uncertain because the loan could be prepaid. The IRS acknowledged that the note prohibited prepayment, but argued the restriction had no significance because the trustee and beneficiaries of both trusts were the same. The court rejected this argument as well, again noting the trustee was required to administer the trusts separately and in each case in the best interests of the beneficiaries of that particular trust. The court found that the two trusts had opposing interests regarding prepayment. If interest rates increased, it would not be in the best interest of the borrowing trust to prepay the loan. If interest rates decreased, it would not be in the best interest of the lending trust to accept prepayment.

The key to successfully deducting all of the interest that will accrue on a loan obtained to pay estate taxes is being able to show that without such a loan, assets would need to be sold at artificially depressed prices in order to raise funds to pay the tax.

Daughter Allowed Deduction for Her Medical Expenses That Were Paid by Her Mother

We thank one of our clients for bringing this case to our attention. In *Judith Lang v. Commissioner (December 10, 2010)*, a mother paid medical expenses that had been incurred by her adult daughter. She made direct payment to the providers of the medical services, for which she had no legal obligation. The daughter deducted the medical expenses on her own federal income tax return and, upon audit, the IRS disallowed the deduction on the basis that the daughter had not paid the expenses for which she was claiming a tax deduction. The Tax Court held in favor of the daughter. The court construed the transaction as though the mother had made a gift to her daughter and the daughter then used the proceeds of the gift to pay her medical expenses.

A second benefit that the parties enjoyed here was that the mother did not incur any gift tax liability as a result of paying her daughter's medical expenses, even though the court characterized the payment as a gift from the mother to her daughter. IRC Section 2503(e)(2)(B) provides a gift tax exemption for the direct payment of medical expenses on behalf of another individual.

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High Net Worth Families Group

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