2014 FEDERAL TAX UPDATE FOR ESTATE PLANNERS

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I. INFLATION ADJUSTMENTS, PLUS WHAT'S NOT ON THE TABLE FOR 2014 (YET)

A Visual Guide to the Federal Income Tax Rates for 2014
(from a format originally prepared by Crowe Horwath)

<table>
<tr><th colspan="2">Taxable Income exceeding</th><th colspan="4">2014 Federal Income Tax Rates for Individuals</th></tr>
<tr><td>Unmarried</td><td>Joint</td><td>Ordinary Income</td><td>Adjusted Net Cap Gain* & Qualified Dividends</td><td>Medicare Surtax on Earned Income (including 1.45% employer contribution)</td><td>Medicare Surtax on Net Investment Income</td></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,075</td><td>$18,150</td><td>15%</td></tr>
<tr><td>$36,900</td><td>$73,800</td><td>25%</td><td rowspan="5">15%</td></tr>
<tr><td>$89,350</td><td>$148,850</td><td>28%</td></tr>
<tr><td>$186,350</td><td>$226,850</td><td rowspan="2">33%</td></tr>
<tr><td>AGI over $200,000**</td><td>AGI over $250,000**</td><td rowspan="3">3.8%</td><td rowspan="3">3.8%</td></tr>
<tr><td>$405,100</td><td>$405,100</td><td>35%</td></tr>
<tr><td>$406,750</td><td>$457,600</td><td>39.6%</td><td>20%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).
** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

A number of benefits available to taxpayers in 2013 expired at the end of last year. Of the many now-expired provisions, here are those most relevant to estate planners:

• ***Above-the-Line Deduction for Teachers' Classroom Expenses.*** In 2013, K through 12 teachers could still deduct up to $250 of unreimbursed expenses in determining adjusted gross income. The expenses had to relate to books, equipment, supplies (except for nonathletic

supplies used in health or P.E. courses—read “condoms”), or computer equipment and related services or software. *Sections 62(a)(2)(D) and 62(d).*

• ***Exclusion for Discharges of Debt on Principal Residence.*** In 2007 Congress created a new exclusion for “qualified principal residence indebtedness” (QPRI), defined as up to $2 million of “acquisition debt” (any debt used to buy, build, or improve a principal residence). A taxpayer need not be insolvent to qualify for this exclusion, but the exclusion did not apply if the debt was discharged on account of services performed for the lender or for any other reason “not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.” The taxpayer’s basis in the principal residence had to be reduced (but not below zero) by the amount excluded from gross income under this rule. *Sections 108(a)(1)(E), 108(h)*.

• ***Deduction of Mortgage Insurance Premiums.*** Legislation in 2006 created an itemized deduction for premiums paid or accrued on qualified mortgage insurance. Generally, qualified mortgage insurance is mortgage insurance obtained in connection with acquisition debt on a qualified residence that is provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or certain private providers. *Section 163(h)(3)(E)*.

• ***Deduction for State and Local Sales Taxes.*** In 2013, individuals could still elect to deduct either state and local income taxes or state and local general sales taxes. Taxpayers electing to claim their sales taxes could deduct either the actual sales tax paid (as substantiated by all those receipts accumulated in a shoebox) or an amount determined under tables prescribed by the Service. The chief beneficiaries of this election were taxpayers living in states without an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. *Section 164(b)(5)*.

• ***50% Bonus Depreciation.*** Depreciable tangible personal property and computer software acquired and first placed in service in 2013 was eligible for an additional up-front depreciation deduction equal to the 50% of the asset’s adjusted basis after taking into account any §179 election made with respect to the property. The regular depreciation deductions were then computed based on whatever basis remains after the §179 election and the 50% bonus. This bonus 50% allowance was also available for alternative minimum tax purposes. The 50% bonus did not apply to intangibles amortized under §197 (with the limited exception of computer software), or start-up expenses amortized under §195. The bonus also did not apply to assets with a class life in excess of 20 years. *Section 168(k).*

• ***Expanded Limitations for Contributions of Qualified Conservation Real Property.*** Prior to 2006, a contribution of qualified conservation real property to a public charity was treated the same as any other contribution to public charity: to the extent the property was capital gain property in the hands of the donor, the most that could be deducted in any one year was 30% of the taxpayer’s contribution base (generally, adjusted gross income) with a carryover of up to five years. Legislation in 2006 permitted the current deduction of such contributions up to 50% of the taxpayer’s contribution base, and with a carryover of 15 years. Moreover, the 50% limitation was increased to 100% in the case of “qualified farmers and ranchers” (those whose gross income

from farming or ranching business exceeds 50% of their total gross incomes), provided the property is restricted to remain generally available for agriculture or livestock production. *Section 170(b)(1)(E).*

• ***Large Bonus Depreciation Election.*** The dollar limitation on the §179 expensing election continued at $500,000 for 2012 and 2013. This $500,000 maximum was not reduced until the total amount of §179 property purchased and placed in service during the taxable year exceeded $2 million. Now, the dollar limitation is $25,000 in 2014, with a phase-out that begins once the total amount of §179 property purchased and placed in service during the taxable year exceeds $200,000. *Section 179(b)*.

• ***Above the Line Deduction for Tuition.*** The above-the-line deduction for "qualified tuition and related expenses" was available in 2013. The deduction limit remained at $4,000, and the full deduction was available only to those taxpayers with adjusted gross incomes of $65,000 or less (or $130,000 for married taxpayers filing jointly). Individuals with adjusted gross incomes in excess of $65,000 but not more than $80,000 (and joint filers with adjusted gross incomes in excess of $130,000 but not more than $160,000) could claim a maximum deduction of $2,000. A taxpayer still could not claim both the deduction and the § 25A credits. *Section 222.*

• ***Qualified Charitable Distributions from IRAs.*** As in past years, individuals age 70½ or older could exclude from gross income up to $100,000 in "qualified charitable distributions" from either a traditional IRA or a Roth IRA completed in 2013. Such distributions were not deductible as charitable contributions, but the exclusion from gross income represented a better result over prior law. Under prior law, the retiree had to include a minimum distribution in gross income but could donate the amount to charity and claim a deduction under §170. The income tax deduction was subject to the overall limitation on itemized deductions, §68, as well as the other limitations applicable to all charitable contributions under §170. In many cases, therefore, the income tax deduction did not offset completely the amount included in gross income even though the entire distribution was paid to charity. The "charitable rollover" rule thus appealed to those required to take minimum distributions that had sufficient funds from other sources to meet their living needs. A qualified charitable distribution is any distribution from an IRA made by the trustee directly to a public charity (i.e., one described in §170(b)(1)(A)) to the extent such distribution would be includible in gross income if paid to the account holder. The distribution could be made on or after the date the account holder reaches age 70½. *Section 408(d)(8).*

• ***100% Exclusion for §1202 Stock.*** We all know that § 1202(a)(1) generally excludes half of the gain from the sale or exchange of "qualified small business stock" (generally, stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is engaged in an active business and has aggregate gross assets of $50 million or less) held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent under §1(h)(1)(F). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all). But for qualified small business

stock acquired in 2013, a 100% exclusion applies. This gives § 1202 some much-needed bite. Of course, it won't be until 2018 before taxpayers begin to feel the benefit of this increased exclusion, as the five-year holding period still applies. *§ 1202(a)(3).*

- ***Favorable Basis Adjustments for Charitable Contributions By S Corporations.*** When an S corporation contributes property to charity, the corresponding charitable deduction, like all deduction items, passes through to the shareholders. Generally, a shareholder's basis in S corporation stock is reduced by the amount of deductions passing through, but prior law provided that an S corporation's charitable contribution will only cause a shareholder's stock basis to be reduced by the shareholder's pro rata share of the adjusted basis of the contributed property. Thus, for example, if an S corporation with two equal shareholders donated to charity real property worth $100 in which the corporation's basis was $40, each shareholder could be eligible to claim a $50 charitable contribution (half of the $100 value) while only reducing stock basis by $20 (half of the $40 basis). This presents a tremendous benefit to S corporation shareholders, especially where the contributed property would have triggered liability for tax under §1374 as built-in gain property. Charitable contributions of such property do not trigger the §1374 tax, and now also have the chance to carry out a fair market value deduction to the shareholders at a cost equal only to the basis of the contributed property. *Section 1367(a)(2).*

- ***Recognition Period Reduced to Five Years.*** When a C corporation makes an S election, the §1374 tax looms. This corporate-level tax applies to any "net recognized built-in gains" during the "recognition period" (generally, the first ten years following the former C corporation's subchapter S election). For 2009 and 2010, however, the recognition period was shortened to seven years. Then, for 2011 and 2012, the recognition period was shortened to five years. ATRA has extended the five-year recognition period through 2013. So if the corporation made its S election effective for 2008, any net recognized built-in gains in 2013 will not be subject to the tax. Curiously, however, any net recognized built-in gains in 2014, the seventh year of S corporation status, would be subject to the tax. *Section 1374 (d)(7)(B).*

II. ONLY THOSE WHO DIED IN THE FIRST QUARTER OF 2014 ARE LOSERS: *Revenue Procedure 2014-18.*

Since 2011, the unused exclusion of a deceased spouse is "portable," i.e., transferable to the surviving spouse for use by the surviving spouse. In order for a surviving spouse to claim the deceased spouse's unused exclusion amount (what the regulations refer to as the "DSUE amount"), the deceased spouse's executor must timely file a Form 706. Normally, of course, the estate has nine months from the date of the decedent's death to file the Form 706. But an executor may claim an automatic six-month extension, effectively postponing the deadline to 15 months after the date of the decedent's death.

Regulations issued in 2012 surprised some practitioners because they confirmed that a federal estate tax return is required to claim the DSUE amount, even though a return would not otherwise be required. (Some had concluded that where an estate tax return was not otherwise

due, there was no formal deadline for making a so-called "portability election.") Since then, the Service has provided a number of ad hoc extensions under its broad discretion to offer so-called "9100 relief" under Regulation §301.9100-3. Now, the Service has provided a simple method for obtaining an extension of time to make the portability election with respect to the estate of a decedent who died in 2011, 2012, or 2013 with a surviving spouse. Estates qualifying for this simple method need not make a formal case for 9100 relief.

The relief offered in this Revenue Procedure only applies to decedents dying in 2011, 2012, or 2013. For these decedents, a late election is allowed by filing a Form 706 on or before December 31, 2014, with the words "FILED PURSUANT TO REVENUE PROCEDURE 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)" written across the top. If the estate does not have an executor or administrator, the election can be made by "any person in actual or constructive possession of any property of the decedent."

The Revenue Procedure does not apply to decedents dying in 2014. Thus, the normal deadlines will apply to decedents dying in 2014. Where no extension elections are made, then, it appears that the portability window for decedents dying in January and February of 2014 will close before that of decedents dying as early as 2011, an odd result to be sure. Of course, those estates of 2014 decedents that miss the deadline and fail to request an extension can still seek 9100 relief.

One group that benefits greatly from the Revenue Procedure are surviving spouses of same-sex marriages where the deceased spouse died in 2011, 2012, or 2013. The executors of these estates would not have made portability elections because it was not until the United States Supreme Court's decision in *United States v. Windsor* in June, 2013, that we even knew that same-sex couples were eligible for the federal portability election. Revenue Procedure 2014-18 provides relief for those executors who were not required to file an estate tax return, while Revenue Ruling 2013-17 itself provides relief if an estate tax return was filed without electing or using portability.

III. HOW TRUSTS "MATERIALLY PARTICIPATE" IN RENTAL ACTIVITIES: *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014).

Passive income is considered net investment income, and the statute defines passive income with reference to the passive loss allowance rules of IRC §469. Recall that under IRC §469, passive income is the income from a passive activity, and a passive activity is one in which the taxpayer does not "materially participate." Regulations under IRC §469 explain in detail how an individual can "materially participate" in an activity. Those regulations are silent when it comes to trusts.

The Service's position has long been that a trust materially participates only if the trustee personally does so. If a trust will hold an interest in a closely-held pass-through business, then, consideration should be given to naming an individual who materially participates in the business

as a co-trustee. In *Technical Advice Memorandum 201317010*, however, the strategy did not work. But the co-trustee in this ruling was a "special trustee" whose fiduciary power was limited to voting and selling the closely-held business's stock. Moreover, while the co-trustee was president of the company and actively involved in its operation, those activities could not be imputed to the trust. Just as a sole proprietor cannot count the activities of his or her employees to satisfy the material participation requirement, the work of someone serving as co-trustee and president "was as an employee of [the company] and not in [his] role as a fiduciary" and thus "does not count for purposes of determining whether [the trust] materially participated in the trade of business activities" of the company. Note that the Service treats individuals differently. A shareholder who works for the corporation can count those hours as employee toward the material participation threshold, but a trustee who works for the corporation cannot do so. There seems to be little basis for treating individuals and trusts differently on this point, but it's the position of the Service.

In issuing final regulations under IRC §1411 in November of 2013, Treasury had this to say about the material participation issue in the Preamble:

> Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.
>
> Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.
>
> A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which §1.469-5T(g) has been reserved.
>
> The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on

> material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

So for now, it seems, all we can do is wait for further guidance under IRC §469.

In the meantime, however, practitioners may find comfort with the Tax Court's decision in *Frank Aragona Trust v. Commissioner*. In that case, the Tax Court held that services performed by individual trustees on behalf of a trust may be treated as personal services performed by the trust, allowing the trust to qualify for the rental exception in IRC §469(c)(7). The case involved a trust with six trustees, three of whom were full-time employees of a limited liability company wholly owned by the trust. The LLC managed rental real estate. The trust had net losses for 2005 and 2006, which the Service disallowed in part on the grounds that the real estate activities of the trust were passive activities. IRC §469(c)(2) treats any rental activity as a passive activity, but IRC§469(c)(7) offers an exception from that rule where more than half of the "personal services" performed in trades or businesses during the year is performed in real-property trades or businesses in which the taxpayer materially participates and where the taxpayer performs more than 750 hours of services during the year in real-property trades or businesses in which the taxpayer materially participates.

The Service argued that a trust cannot perform "personal services," citing the regulation defining personal services as "work performed by an individual in connection with a trade or business." (Reg. §1.469-9(b)(4).) But the Tax Court rejected this contention, holding that "If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered" as personal services. If the IRC §469(c)(7) exception was supposed to be available only to individuals, reasoned the court, it would be limited to "any natural person," like other exceptions within IRC §469 that are so limited.

The court further held that the trust in the case bar materially participated in the rental real estate activities. It observed that because the regulations do not yet explain how a trust materially participates in an activity, "we must make the determination … in the absence of regulatory guidance." It went on to conclude that "the activities of the trustees--including their activities as employees of [the] LLC--should be considered in determining whether the trust materially participated in its real-estate operations." Just as trustees who also serve as directors of a corporation owned by the trust cannot divorce their actions as directors from their actions

as trustees, said the court, trustees who are employees of an LLC owned by the trust cannot separate their services performed as employees from their work as trustees. Thus the services performed by the employee-trustees count toward determining whether the trust materially participated. Under that rationale, the trust easily qualified for the IRC §469(c)(7) exception. Pending promulgation of regulations explaining how trusts materially participate, then, practitioners can rely on *Frank Aragona Trust* in imputing the services of a trustee-employee to the trust.

IV. FINAL REGULATIONS CLARIFY APPLICATION OF 2% HAIRCUT TO ESTATES AND TRUSTS: *Regulation §1.67-4* (May 8, 2014).

Section 67(e) provides that the so-called "2% haircut" (which limits the deduction for all miscellaneous itemized deductions to that amount by which the aggregate of such deductions for the taxable year exceeds two percent of the taxpayer's adjusted gross income) does not apply to "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." Six years ago, the Supreme Court held that investment advisory fees incurred by trusts are generally outside of this exception and thus subject to the 2% haircut. But while that case was pending, Treasury proposed regulations requiring, among other things, that where a trust pays a single fee for both services that are subject to the 2% haircut and services that are not, the trustee must "unbundle" that fee to determine the portion that is subject to the 2% haircut. But Treasury provided relief from this requirement until such time as final regulations are published.

That has now happened. The final regulations (effective May 9, 2014, for tax years beginning after 2014) retain the "unbundling" requirement, but provide that where the single fee "is not computed on an hourly basis," only the "investment advice component" must be unbundled, and the unbundling may be achieved by any "reasonable method." Likewise, legal and accounting fees that are not computed on an hourly basis only must be unbundled for amounts allocable to investment advice.

The final regulations contain additional guidance, like the general proposition that a cost is subject to the 2% haircut if it is included in the definition of miscellaneous itemized deductions, is incurred by an estate or a non-grantor trust, and would "commonly or customarily" be incurred by a hypothetical individual holding the same property.

The regulations also provide that so-called "ownership costs" (those chargeable to or incurred by an owner of property simply by reason of being the owner of the property, like condo fees, insurance costs, maintenance costs, landscaping, and vehicle registration) are subject to the 2% haircut unless they are deductible under other Code provisions that render them non-miscellaneous itemized deductions.

Importantly, the regulations clarify that the costs incurred in connection with preparing estate tax returns, generation-skipping transfer tax returns, fiduciary income tax returns and the

decedent's final returns are not subject to the 2% haircut (but the costs for preparing all other tax returns, including gift tax returns, are subject to the haircut). Similarly, appraisal fees to determine the fair market value of assets as of the decedent's date of death (or alternate valuation date), to determine the value of assets for purposes of making distributions, or to prepare the estate's or trust's tax returns are not subject to the 2% haircut.

V. NINGs AND DINGs WORK WHEN YOU WANT THEM TO: *Private Letter Rulings 201410001 – 201410010* (March 7, 2014).

The "Nevada Incomplete (Gift) Non-Grantor trust" ("NING trust") and its kissing cousin, the "Delaware Incomplete (Gift) Non-Grantor trust" ("DING trust"), are vehicles generally used to minimize state income tax. In the typical example, it is a self-settled trust created for the benefit of the grantor and other beneficiaries. The grantor may receive distributions of income and principal as determined by a distribution committee composed of the grantor and adverse parties (namely, the other discretionary beneficiaries). In addition, the grantor retains a limited power to appoint the trust property by will or other testamentary instrument. If it works, the trust is treated as separate taxable entity for income tax purposes but transfers to the trust are not completed gifts for gift tax purposes. If the trust sits in a state where there is no state income tax, then, a grantor can avoid state income tax liability on assets contributed to the trust while retaining some form of access to those assets.

In a series of ten nearly identical rulings, the Service said it indeed works. Specifically, it ruled that trusts structured as described above are treated as separate taxpayers for income tax purposes and that transfers to such trusts are incomplete gifts for gift tax purposes because of the retained power of appointment. The Service also ruled that distributions to the grantor would not be considered as gifts by any member of the distribution committee, but distributions to other beneficiaries would be completed gifts by the grantor. Finally, because the gift is incomplete, the assets of any such trust are includible in the grantor's gross estate.

Because Nevada does not impose a state income tax, this structure is helpful for income-producing assets where the grantor resides in a state that imposes income tax. Thus, for example, a New York resident could transfer income-producing assets to a Nevada trust and avoid the liability for New York state income tax since the assets are owned by the trust and not by the grantor. The structure would also work well where the grantor anticipates a sale of the subject property and wants to minimize the state income tax burden associated with the sale. There is also some thinking that NINGs and DINGs are also helpful as creditor protection devices, as they are established as domestic asset protection trusts.

VI. TAX COURT APPLIES NET ASSET VALUE METHOD AND BUILT-IN GAINS DISCOUNT TO HOLDING COMPANY: *Estate of Richmond*, T.C. Memo. 2014-26 (February 11, 2014).

At the decedent's death in 2005, she owned a 23.44% interest in a personal holding company that owned $52.1 million in dividend-producing marketable securities. The estate originally claimed that the decedent's interest in the company was worth about $3.15 million (though at trial it claimed the value was about $5 million). The Service assessed a deficiency when it concluded the value of the decedent's holdings to be about $9.22 million. In addition to a $2.8 million deficiency, the Service asserted a $1.1 million "gross valuation misstatement" penalty. At trial, the Service's expert set the value of the decedent's interest at roughly $7.3 million.

The Tax Court concluded that the decedent's interest was worth just over $6.5 million. This valuation included a 15% built-in gains discount, a 7.75% minority interest discount, and a 32.1% marketability discount. The court found too many faults with the taxpayer's valuation, including the fact it was never finalized, that it was prepared by an individual who, although a certified public accountant and certified financial planner, was not an expert appraiser, and that the valuation used the "capitalization of dividends" method instead of the court's preferred "net asset value" method.

The estate wanted a dollar-for-dollar reduction in the valuation for the built-in gains lurking in the company's portfolio. Instead, the Tax Court gave a discount for the present value of the future capital gains tax liability. And though the Service pointed to the company's history of exceptionally long holding periods for its investments (we're talking 70 years here), the court instead observed that the fair market value definition requires use of hypothetical parties that would rationally seek to diversify its portfolio and thus employ somewhat shorter holding periods, like say 20 – 30 years. That supports the 15% built-in gains discount.

As for a penalty, the court imposed a 20% accuracy-related penalty since the amount reported on the estate tax return was less than 65% of the correct value. It was not reasonable for the estate to rely on a draft appraisal from one lacking credentials of a professional appraiser. "In order to be able to invoke 'reasonable cause' in case of this difficulty and magnitude, the estate needed to have the decedent's interest … appraised by a certified appraiser. It did not."

VII. PERSONAL GOODWILL IS THE NEW BLACK: *Bross Trucking Inc. v. Commissioner*, T.C. Memo. 2014-17 (June 5, 2014).

Bross Trucking is a corporation engaged in hauling equipment and materials for road construction projects. It leased most of its trucking equipment from a related company. All of Bross Trucking's stock was held by Chester Bross through his revocable trust. Starting in the late 1990s, the company was audited by a state motor carrier safety agency. The agency found that the company failed to collect required information about its drivers, and ultimately the agency gave the company an "unsatisfactory" safety rating. Such a rating meant the company could have

lost its hauling authority within the state. As a result of this "negative attention" from regulators, Chester decided to cease Bross Trucking operations.

A few years later, Chester's three sons organized a new trucking business. None of the new company's assets was transferred from Bross Trucking, as the new company acquired all of its own equipment and licenses. Were it not for the fact that the new company hired several of the former employees of Bross Trucking, there would be no connection at all between the two entities. After formation, the new company started leasing most of the trucking equipment that had been leased by Bross Trucking. The new company also branched out into other operations, including the provision of GPS products to construction contractors and repair services to unrelated third parties.

The Service took the position that Bross Trucking distributed its goodwill (specifically, a revenue stream, customer base, established workforce, and supplier relationships) to Chester in a taxable distribution, followed by Chester's gift of those same assets to his sons. But the Tax Court observed that "[a] business can distribute only corporate assets and cannot distribute … intangible assets that are individually owned by its shareholders." Here, said the court, Bross Trucking's goodwill was primarily that of Chester because of his personal relationships. Thus "the company could not transfer any corporate goodwill" to him. Although the workforce belonged to the company and not to Chester, the court held that the value of any corporate goodwill was near zero by the time of the supposed transfer to Chester. There was good evidence that Bross Trucking was seen as a cursed brand, for the sons' new company wanted immediately to remove the Bross Trucking name from the trucks it leased so that they would not be stopped and subject to random inspection. If anything, the new company was trying to hide any alleged relationship with Bross Trucking. Further, it could not be argued that Chester transferred his personal goodwill to Bross Trucking as there was no employment agreement or noncompete agreement in place. Finally, there was evidence that new company had assembled its workforce independently and that there was no transfer of that workforce from Bross Trucking at all.

Thus, there was no transfer from Bross Trucking to Chester. Further, ruled the court, there was no transfer of personal goodwill from Chester to his sons. Chester was not involved in managing the new company. There was no evidence that the new company used Chester's relationships; instead, it appears that the sons leveraged their own, likewise close relationships with suppliers and customers to build their own brand.

Note, then, the difference between transferring assets and rights (taxable) and allowing junior family members to launch their own enterprises based on their own relationships with those dealing with the senior family members and their businesses. The case provides a helpful blueprint for transitioning a goodwill-laden business.

VIII. PERSONAL GOODWILL—IS THERE ANYTHING IT CAN'T DO?: *Estate of Adell v. Commissioner,* T.C. Memo. 2014-155 (August 4, 2014).

The decedent's revocable trust owned all of the stock in a C corporation that provided uplink equipment used in television broadcasting. The decedent's son was the company president and, by all accounts, the reason the company succeeded, though the company never had in place an employment agreement or noncompete agreement with the son. As a result of the son's relationship with assorted religious leaders, the decedent and his son formed "The Word," a nonprofit entity devoted to providing religious broadcasting. The Word became the company's only customer, and the company charged The Word 95% of The Word's net programming revenue for one month or its actual cost to provide services to The Word, whichever was less. Lots and lots of money flowed from The Word to the company, and the decedent's salary from the company was, to put it mildly, large. The company provided various personal benefits to the decedent and his son, including lavish cars and the payment of personal judgments.

Anyway, the decedent's estate valued the stock in the company at $9.3 million on the original estate tax return, but then on an amended return valued the stock at $4.3 million. In part the valuation was based on the appraiser's application of an "economic charge of $8 million to $12 million" attributable to the son's personal goodwill. The Service's initial appraisal was slightly higher: $92.2 million. At trial, it argued for a valuation of $26.3 million.

The Tax Court determined that the Service's appraisal lowballed the value of the son's personal goodwill. The company was successful because of the son's relationships with The Word and its constituents. Further, the son's goodwill had not been transferred to the corporation and thus was not a corporate asset. "The ministers conducted business with [the son] because they trusted him personally, not because he was a representative or employee of [the company]. In other words, [the company] could not own [the son's] goodwill because the customers did not readily realize that [the son] actually worked for [the company]. Thus, he cultivated personal goodwill with these professionals and he independently owned the asset of personal goodwill, not [the company]." The court also observed that because there were no employment agreements or noncompete agreements in place, the son was free to leave the company and use his relationships to compete against the company. This was further proof that the goodwill did not belong to the entity.

IX. NO DEDUCTION FOR CONTINGENT CLAIM, BUT DEDUCTION FOR SETTLEMENT AMOUNT ALLOWED: *Estate of Saunders* (9th Cir., March 12, 2014).

The decedent was the surviving spouse of an attorney who was accused of acting as a secret informant for the Service against the interests of one of his clients. The survivors of the client brought a $90 million malpractice action against the attorney's estate for breach of confidence, breach of the duty of loyalty, and fraudulent concealment. The lawsuit was brought only 64 days before the decedent's death in November, 2004. The attorney's estate engaged in

ongoing settlement conferences, but the case ultimately went to trial. In 2007, the jury determined that the attorney had breached duties to the client but that these breaches were not a legal cause of injury or damage to the client or the client's estate. The client's estate appealed, but the attorney's estate paid $250,000 in attorney's fee to the client's estate in exchange for a full settlement and mutual release of all claims.

On its federal estate tax return, filed in 2006, the decedent's estate claimed a $30 million deduction for the malpractice claim. In its notice of deficiency, the Service reduced the amount of the deduction to $1 (yes, one dollar), and this led the Service to assess a $14.4 million deficiency. The decedent's estate ran to the Tax Court to determine the deductibility of the contingent liability.

Regulations finalized in 2009 make clear that a deduction will only be allowed for claims actually paid (for amounts that are paid after the date the estate tax return is filed, the regulations permit the filing of a protective claim for refund). But the applicable regulations in effect at the decedent's death provided that a contingent claim could be deducted even "though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid." The Tax Court decided to pay no attention to the actual result of the litigation but to instead focus on the value of the claim as of the date of the decedent's death. The three appraisals submitted by the estate presented an array of different values, proving that the amount of the claim was not determinable with reasonable certainty. One report that valued the claim at $30 million was "fraught with vague and uncertain guesstimates, without any objectively reliable discussion of the strength of the defense." Further, there was no proof "that the $30 million claimed on the estate tax return or any specific lesser amount would be paid, as required by the applicable regulation." Thus the Tax Court limited the deduction to the amount actually paid during the administration of the decedent's estate ($250,000).

On appeal, the Ninth Circuit affirmed. Because the claim was in dispute at the decedent's death, observed the court, the lower court properly considered the post-death settlement amount in computing the value of the deduction. The court observed that the wide disparity of the valuations given by the estate's expert was a "prima facie indication of the lack of reasonable certainty" that the contingent claim had a definite value at the date of the decedent's death.

Again, if these facts arose today, the correct approach would be to deduct the amounts actually paid before the filing of the estate tax return, accompanied by a protective claim for refund in case more amounts are paid thereafter. Under the regulations, the protective refund claim generally may be filed any time before the expiration of the regular "three-two" statute of limitations (three years from when the return was filed or two years from when the estate tax is paid). The claim is filed by attaching a Schedule PC to the estate's Form 706. If the estate tax return has already been filed, the executor can file a Form 843 with the notation "Protective Claim for Refund under Section 2053" written across the top of the first page of the form.

X. PAINT OR GET OFF THE LADDER (OR PAY A LATE FILING PENALTY): *Estate of Liftin v. United States* (Fed. Cir., June 10, 2014).

We all know that the estate tax marital deduction is disallowed where the surviving spouse is not a United State citizen. A rarely-used Code provision, section 2056(d)(4), provides that if the surviving spouse *becomes* a United States citizen before the estate tax return is filed, the marital deduction is allowed, so long as the spouse was a resident of the United States at all times after the decedent's death and before becoming a United States citizen.

In this case, the decedent's surviving spouse was a United States resident but a citizen of Bolivia. When the decedent's estate tax return was due, the estate obtained an extension. Then, shortly before the extended return deadline, the spouse informed the executor that she intended to become a United States citizen. The executor was told by the estate's attorney that if the estate files the return before the spouse became a United States citizen, the marital deduction could not apply. So the advice was to file a late return, after the spouse became a citizen. Fourteen months later, the spouse became a United States citizen. You'd think the estate would then promptly filed an estate tax return. But no—the estate waited until after all of the spouse's claims against the estate had been settled before filing the return, and that was nine months after she became a United States citizen. Apparently the same attorney thought it would be better for the estate to file an accurate return that showed the precise amounts passing to the spouse, and this wouldn't be knowable until after her claims against the estate had been resolved.

Not surprisingly, the Service imposed a penalty for the late filing. (When you're 23 months late on a deadline that was already extended, that kind of thing happens.) When the Service denied the estate's claim for refund, the estate sued in the Court of Federal Claims. The court held that while the executor reasonably relied on the attorney's advice regarding waiting to file until after the spouse had become a United States citizen, there was no reasonable cause to wait another nine months following the spouse's awarding of citizenship before filing the estate tax return. On that issue, the attorney's advice was clearly wrong, so relying on that advice by definition cannot serve as reasonable cause. On appeal, the Federal Circuit affirmed without dissent. *Estate of Liftin v. United States* (Fed. Cir., June 10, 2014).

XI. IMPORTANT STATE DEATH TAX CHANGES

Two states made significant changes to their state transfer tax systems in 2014.

Minnesota: On March 21, 2014, Minnesota retroactively repealed its state gift tax which had been enacted in 2013 (that was quick). On the same date, Minnesota increased its exemption from state estate tax to $1,200,000 for 2014. The exemption will then increase by $200,000 each year until reaching $2,000,000 in 2018, at which point it will freeze. Under the new regime, tax rates begin at 9% and increase to 16%. There is also now a state-only QTIP election available.

Outsiders may recall that in 2013 Minnesota extended its estate tax to nonresidents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota. That rule has now been narrowed to exclude certain publicly traded entities. But it still applies to entities taxed as partnerships or S corporations that own closely held businesses, farms, and cabins.

New York: On March 31, 2014, New York made comprehensive changes to its state estate tax. Gone is the old $1,000,000 state estate tax exemption, replaced with rather bizarre amount that slowly increases over time:

For decedents dying on	The state estate tax exemption is
April 1, 2014 – March 31, 2015	$2,062,500
April 1, 2015 – March 31, 2016	$3,125,000
April 1, 2016 – March 31, 2017	$4,187,500
April 1, 2017 – December 31, 2018	$5,250,000
January 1, 2019 or after	Same as federal applicable exclusion amount

As was the case under prior law, the maximum rate of tax is 16%. But unlike prior law, the new tax contains a "cliff effect." If the value of the taxable estate is more than 105% of the applicable exemption, the exemption will not be available, meaning the entire estate will be subject to tax. If the value of the taxable estate is more than the applicable exemption but not more than 105% of the applicable exemption, a reduced exemption applies. In some cases, this will cause an increase in tax that exceeds the increase in the taxable estate. For instance, examples set forth in New York State Department of Taxation and Finance technical memorandum issued on August 25, 2014, posit a decedent dying in 2014 with a taxable New York estate of $2,062,500 and another decedent dying the same year with a taxable New York estate of $2,100,000. The first estate pays no state estate tax since the taxable estate equals the exemption amount. But the second estate pays tax of $49,308. So by having an extra $37,500 in the taxable estate, the tax liability increases by $49,308! Sharon Klein points out that an estate of $2,165,650 would pay $112,052 in New York state estate tax because the exemption would be completely lost (an estate that size is more than 105% of the 2014 exemption amount). In that case, an extra $103,150 of taxable estate generates $112,052 in estate tax.

In addition, in the case of decedents dying between April 1, 2014, and December 31, 2018, taxable gifts of real or tangible personal property located in New York made within three years of death will be added back to a decedent's estate for purposes of calculating the New York state estate tax.