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APRIL 2016 FOR THE PROFESSIONALS

Portability election errors

The increase in the amount exempt from federal estate tax to $5 million per taxpayer (plus inflation adjustments) has been a game changer for estate planners. Nearly as important, when it comes to estate plans for married couples, is the advent of the portability of the estate tax exemption, the Deceased Spouse's Unused Exemption (DSUE). By simply filing an estate tax return at the death of a spouse, even if no estate tax is due, the estate tax exemption for the surviving spouse may roughly double. Such a filing is not required, but it would be a good precaution to take. The future course of the family fortune as well as the federal transfer tax regime are difficult to predict, so any step that could save substantial tax dollars in the future should at least be considered.

But this is a brand new planning area with which we are becoming familiar. Lawyers Alan Gassman, Ed Morrow, Ken Crotty, Christopher Denicolo, Seaver Brown and Brandon Ketron have prepared "Ten Common Portability Mistakes and What You Need to Know to Avoid Them" as a guide [LISI Estate Planning Newsletter #2395 (February 29, 2016)]. Here are just four errors they highlighted to keep in mind.

Accidental election out of portability

Failure to file an estate tax return for the first spouse to die will forfeit the DSUE for the survivor. The estate tax return must be filed within nine months of death, but a six-month extension may be granted. Timely filing Form 4768 will gain an estate an automatic six-month extension.

Estates smaller than the statutory threshold for filing may apply for a discretionary extension of time even beyond the normal 15-month period. Many recent Private Letter Rulings have granted an additional 120 days for filing [see Private Letter Rulings 201610013 and 201608010, for example].

Given the relative newness of portability, we may expect many more such private rulings in the coming years. Eventually, more and more executors will recognize the need to file the estate tax return even when no taxes are owed.

Assuming that no estate tax planning will be needed

If total family wealth is about $5 million, a couple may assume that a single federal exemption amount will be sufficient to shield the family fortune from the federal estate tax. Thus, they might decide to forego planning for the portability election as not worth the expense of hiring a professional to file an otherwise unnecessary estate tax return.

There are two potential defects with this plan. First, the amount exempt from federal estate tax could be sharply reduced in the future—both of the Democratic candidates for President this year have endorsed that idea.

Second, the surviving spouse may live for decades, and may not consume all of the income from that $5 million. If asset appreciation plus savings comes to just 7.2% annually, the family fortune will grow to $10 million in ten years, $20 million in 20 years. At a 10% growth rate, it could reach $40 million in 22 years. Inflation adjustments to the exempt amount are unlikely to keep up with that.

Losing the DSUE through remarriage

A surviving spouse may have a DSUE only from his or her most recently deceased spouse. Assume, for example, that widow with $8 million in assets has a $5 million DSUE through her late husband. She remarries a widower who has $10 million, and through a prenuptial agreement they waive their marital rights to each other's assets. The second husband dies, leaving his entire estate to his descendants, using up his estate tax exemption. The widow's DSUE from her first husband will be extinguished at that moment. Her heirs now may be exposed to substantial estate taxes.

It is entirely possible that when she consulted her lawyers about the pre-nup, they might have recommended against the marriage at all, considering the tax consequences.

The authors suggest consideration of a credit shelter or bypass trust to mitigate this potential problem.

Not maximizing the DSUE with an irrevocable life insurance trust

Assume that Husband and Wife have a $5 million joint estate, and they each have $2 million life insurance policies. At Husband's death, his assets and the insurance proceeds pass into a credit shelter trust. That will use up $4.5 million of his exemption, leaving Wife a $950,000 DSUE. She has her own exemption amount, which will be inflation indexed, and the DSUE, which is not.

The better alternative may be to have the life insurance owned by an irrevocable life insurance trust. In that situation, the

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insurance proceeds may be excluded from Husband's estate, leaving Wife a much larger DSUE.

Summing up

The advent of portability, coupled with larger exemptions, has allowed much greater flexibility in estate planning. However, that is not quite the same as simplicity. There remains a wealth of considerations for clients and their advisors to weigh as they find the best way forward in a challenging environment.

CASES AND RULINGS

Unexpectedly strong post-death auction sale raises date-of-death death value.

Estate of Newberger v. Comm'r, T.C. Memo. 2015-246

Bernice Newberger died in July 2009. Her estate included three valuable pieces of art, for which it obtained appraisals from Sotheby's and Christie's. The valuation was complicated by the fact that the market for fine art took a steep dive in 2008, as the economy slipped into recession. For example, in October 2008 some 44% of pieces put up for auction failed to attract minimum bids, double the rate of a year earlier. They had to be returned to their owners. In 2009 Sotheby's revenue declined by 53% and Christie's by 46%. Bernice's death came at the trough of the slump.

Based upon the advice of appraisers, the estate valued two lesser pieces at $450,000 and $500,000. The real prize was a Picasso. Sotheby's offered a $3.5 million guaranteed price. Christie's offered the estate better guarantees and a professional estimate of date-of-death value of $5 million, which the estate duly included on its estate tax return, timely filed in October 2010.

The IRS challenged all three valuations. Perhaps to create some liquidity for paying taxes, the estate had accepted the terms from Christie's and put the Picasso up for auction in February 2010. The expected sale price was $4.7 million to $6.3 million, consistent with the appraisal. In the event, including the buyer's premium, the painting fetched over $12 million. The IRS cited that fact as it claimed that the Picasso had been undervalued by the estate.

Although events occurring after death are not to be taken into account to determine date-of-death values, the Tax Court held that the later sale may be used as evidence of value. The estate's argument that the high price was "a fluke" that was unforeseeable at the date of death was rejected. The Court accepted the IRS' downward adjustment to $10 million to reflect the changing market conditions. The estate's values for the two lesser pieces were sustained.

Had Newberger lived another seven months, her estate would have avoided all estate taxes, as 2010 was the year when the federal estate tax was optional. In the absence of estate tax, carryover basis would apply. In that event the heirs would have been exposed to a very large capital gains tax upon the sale of the art, as Newberger had acquired the Picasso for just $195,000 in 1981.

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Penciled changes to a photocopy of a will, including "void," does not revoke it. Downloaded will form fails for lack of two witnesses to testator's signature.

In re Estate of Sullivan, 868 N.W.2d 750 (Minn. Ct. App. 2015)

Esther Sullivan executed her will in January 2006. The will was properly notarized and had the required two witnesses. Esther divided her estate between her grandson, Joseph, a former employee, Tara Jean. The nature of the employment was not disclosed by the court, but Tara Jean was named as personal representative of the estate. She would be responsible for collecting the estate's assets, filing the tax and probate forms, and distributing the assets.

By 2008 Esther had a change of heart. On a photocopy of the original will, she wrote across the top "[t]he Will dated January 19, 2006 is void and to be replace[d] with this and all written in changes." A variety of alterations were penciled in, the most consequential of which was naming Joseph the personal representative instead of Tara Jean.

Not yet completely satisfied with her handiwork, in October 2010 Esther downloaded a will form and completed it by hand. This time, in addition to naming Joseph as personal representative, she made him the sole heir of all of her property, "after her debts are payed (sic)." Interestingly, Tara Jean witnessed Esther's signature on the 2010 will.

After Esther died, Tara Jean offered the 2006 will for probate. Joseph objected, and he submitted the 2008 and 2010 alternatives as being more consistent with Esther's final intentions for her property.

Both the lower court and then the appellate court held that the statutes governing wills must be strictly adhered to. The same formalities that apply to creating a will apply equally to its revocation. Neither the 2008 nor the 2010 will was executed

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with sufficient witnesses to Ester's signature, so they failed the test. Alternatively, the appellate court held, a will may be revoked by a "revocatory act on the will," including "burning, tearing, canceling, obliterating, or destroying the will or any part of it." Such an act must be done to the original will, not to a photocopy of it.

Without the required witnesses, the 2008 and 2010 documents amounted to nothing more than notes for making a future will.

During the appeal, Joseph argued that Tara Jean had breached her fiduciary duty to the estate by offering the 2006 will for probate when she herself was a witness to the 2010 attempted revocation. Unfortunately, the Court held, he brought that argument up too late to be considered.

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WASHINGTON TALK

Deadline deferred. On July 31, 2015, the President signed into law the *Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.* One minor component of the legislation implemented an idea that had been included in the President's earlier budget messages: requiring consistent basis reporting for income and estate tax purposes. To this end, executors of estates large enough to be required to file a federal estate tax return will have additional paperwork requirements. They have to inform both the IRS and beneficiaries of the tax basis of all bequests.

The law requires such filing within 30 days of the due date for the estate tax filing or 30 days after the actual filing. There was no transition rule, so the IRS created one with Notice 2015-57, 2015-36 IRB 294, which provided that no such filings would be due before February 29, 2016. Next the IRS further extended the deadline to March 31, 2016. Proposed Regs. had not yet been issued, and the Service suggested that executors wait for the Regs. before filing.

Temporary Regulations (T.D. 9757) were published codifying the delayed deadline to March 31, with an effective date of March 4, 2016.

Regulations proposed. On the same day as the temporary Regs. on the transition rule was published, the IRS issued the anxiously awaited Proposed Regs. on consistent basis reporting (REG-127923-15). The new rules apply only to property that increases the federal estate tax obligation. The proposed Regs. confirm that property that qualifies for the marital or charitable estate tax deduction is exempt from basis reporting, because it does not generate a federal estate tax obligation.

The Regs. cover the situation is which additional estate property is discovered after the time for submitting basis reports, as well as the application of the rules to property that is sold during the period of estate administration.

Early reactions to the proposed Regs. have been positive, and practitioners have found them helpful. However, some called for an additional extension of time for these filings. Form 8971 for reporting "Information Regarding Beneficiaries Acquiring Property From a Decedent" to the IRS was only released in January. The IRS has allowed less than a month for the filings, following release of the proposed Regs., and it comes at the height of the tax filing season to boot.

According to the preamble to the newly proposed Regs. on consistent basis reporting, only about 10,000 taxpayers are expected to be affected by the information reporting per year. According to the analysis of the fiscal effects of the new law created by the Joint Committee on Taxation (JCX-105-15), the change will raise $117 million this year alone. That comes to $11,700 per taxable estate. The increased revenue grows each year, reaching $173 million in 2025.

As seen on Craigslist. The following ad really appeared on Craigslist: "Wanted: kids to claim on income taxes -- $750 (Springfield, MO)[.] If you have some kids you aren't claiming, I will pay you $750 each to claim them on my income tax. If interested, reply to this ad."

The poster of that ad has now been indicted for filing false tax returns using real Social Security numbers for persons who were not his dependents.

While the candidates vying for the Republican presidential nomination have proposed a variety of tax reduction plans for promoting economic growth, Hillary Clinton has called for a wide range of tax increases. Among them:

- Implementing a 4% "millionaire's surcharge" on adjusted gross income above $5 million.
- Requiring a 30% minimum tax on individuals making more than $1 million, the so-called Buffett rule named after billionaire investor Warren Buffett, who contends many of the wealthy are not taxed enough.
- Limiting the value of deductions and exclusions to 28%. While this would limit the home mortgage interest deduction, it would not apply to the deduction for charitable contributions.
- Requiring the wealthy to hold assets for six years to benefit from the preferential 23.8% capital gains tax rate—20% plus the 3.8% net investment income tax enacted under the Affordable Care Act. Assets held less than six years would be taxed on

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a sliding scale that goes upward from 23.8%. Those holding assets less than one year, for instance, would face a capital gains rate of 43.4%.

Reducing the tax threshold on estates to $3.5 million ($7 million for married couples), along with increasing the top estate tax rate to 45% from the current 40% and setting a lifetime limit on the gift tax exemption at $1 million.

The entire Clinton tax proposal was projected by the Urban-Brookings Tax Policy Center to increase tax revenue by $1.1 trillion over the first decade of implementation. The current proposal does not include the elimination of stepped-up basis at death, which the President had proposed and sources in the Clinton campaign said will be forthcoming.

The Tax Foundation's analysis came to a different conclusion, finding that just $498 billion would be raised. They use a dynamic scoring model. As the tax increases would be likely to slow economic growth, that development gets factored into their tax math.

Harper Lee's will remains a mystery. The author of *To Kill a Mockingbird* and, more recently, *To Set a Watchman*, Lee died in February. Her estate is estimated to be worth tens of millions of dollars, and there is considerable interest in what will happen to her personal papers. Lee never married and had no children, so her only living relatives are nieces and nephews. However, we may never know the terms of her will because, at the request of the attorneys for her estate, the Alabama probate judge ordered it sealed. He ruled: "The court finds by clear and convincing evidence that information contained in the will and associated court filings pertains to wholly private family matters; poses a serious threat of harassment, exploitation, physical intrusion, or other particularized harm to persons identified in those documents or otherwise entitled to notice of this proceeding; and poses potential for harm to third persons not entitled to notice of this proceeding."

WealthManagement.com reported that Lee had apparently taken steps to prevent Hollywood from ever remaking *To Kill a Mockingbird*.

Scorecard. According to the Congressional Budget Office, the federal budget deficit through February 2016 was $352 billion. That's $34 billion less than the year earlier period. Individual income and payroll tax collections were up 6%, and spending was up 2%. Spending on Social Security was up 4%, primarily due to an increase in the number of beneficiaries.