**Recent Developments in Estate Planning**

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# I. Legislation Relating to Estate and Gift Tax

**A. American Taxpayer Relief Act of 2012.** On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (ATRA”) into law. The highlights (as they affect the estate tax, gift tax and generation-skipping transfer tax):

1. **Exemption equivalents stay “permanent” at $5 million, indexed for inflation.** ATRA set the exemption equivalent amounts for the estate tax, gift tax and GST tax at $5 million—but the moment the law went into effect in 2013, an inflation adjustment brought the exemption equivalents to $5,250,000. Thus, while the exemption equivalents are now "permanent," they are virtually certain to increase on an annual basis. ATRA further provides that if gift tax or estate tax must be paid, the tax rate is 40 percent.

2. **Portability of unused exemption equivalent of last deceased spouse**. “Portability,” introduced by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“TRUIRJCA”), was made permanent. Portability allows a surviving spouse to use the unused portion of his or her last predeceased spouse's unused exemption for estate and gift tax purposes, but only if a portability election is made at the deceased spouse’s death.  As before, there is no portability for any unused GST exemption of the last deceased spouse.

**B. Obama administration’s Fiscal Year 2014 Budget Proposal.** In early April 2013, the Treasury Department published its Fiscal Year 2014 Budget Proposal (“the Greenbook”), explaining the president’s budget proposals for 2014. Several of the proposals relating to transfer taxes were golden oldies, carried over from earlier Greenbooks, but a few of them are new.

1. **Lower the exemption equivalent to $3.5 million and increase tax rate to 45 percent—in 2018.** The Greenbook notes that “ATRA retained a substantial portion of the tax cut provided to the most affluent taxpayers under TRUIRJCA that we cannot afford to continue. We need an estate tax law that is fair and raises an appropriate amount of revenue.” The proposal would raise the transfer tax rate to 45 percent, and would lower the estate tax exemption equivalent the GST exemption to $3,500,000, and the gift tax exemption equivalent to $1,000,000, with no indexing for inflation—effective January 1, 2018.

2. ***Certain* grantor trusts would be includible in grantor’s gross estate**. The most contro-versial transfer tax provision in the 2013 Budget Proposal was one that would conform the estate inclusion rules to the federal income tax grantor trust rules, by including the value of assets of a grantor trust in the grantor’s gross estate. This proposal was shockingly overbroad because, if left unchanged, it would make virtually all life insurance trusts subject to the estate tax, and would impact trusts structured as grantor trusts (*e.g*., to make a S corporation election).

a. At an ACTEC meeting in Hawaii in March 2013, Ron Aucutt (McGuireWoods, McLean, Virginia) observed that in making this proposal, the administration must have had a more targeted concern in mind—in particular, installment sales to “defective” grantor trusts, because this proposal was estimated to raise only $910 million over 10 years, which in today’s world is small potatoes.

b. This turned out to be the case. The 2014 Budget Proposal seeks to “Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts.” If a deemed owner under a grantor trust “engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes … the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction)” will be includible in the deemed owner’s gross estate, will be subject to gift tax if during the deemed owner’s life the grantor trust treatment is terminated, and will be treated as a gift by the deemed owner as to any distribution to another person during the deemed owner’s lifetime. “The transfer tax imposed by this proposal would be payable from the trust.”

3. **Provide reporting on a consistent basis between estate tax valuation and income tax basis in the heir’s hands.** Under IRC §1014, the decedent’s assets receive a new basis at death, for income tax purposes, equal to their date-of-death value. The value of property as reported on the decedent’s estate tax return raises a rebuttable presumption of the property’s basis in the hands of the heir—but in more than a few cases heirs have successfully rebutted that presumption. Treasury’s concern is that the executor may take a low valuation to reduce estate taxes, yet the heirs would argue that the reported value was low-balled to save transfer taxes. The proposal, carried over from prior years, would provide that the basis for income tax would be the same as values “as determined for gift or estate tax purposes.”

a. It is curious that Treasury is still concerned about this issue, when few estates must file estate returns because of the current law’s $5.25 million exemption equivalent.

4. **Require minimum—and maximum—term for GRATs**. The Budget Proposal once again includes a provision that would kill off short-term grantor retained annuity trusts [*cf. Walton v. Commissioner*, 115 T.C. 589 (2000)] by requiring a 10-year minimum GRAT term, requiring that the GRAT remainder interest must have a value greater than zero, and providing that the amount of the annuity payout could not be decreased during the GRAT term. Additionally, the proposal would impose a *maximum* term on GRATs—to the grantor’s life expectancy plus ten years.

5. **Limit GST-exempt trusts to 90 years**. Carried over from earlier proposals is a provision under which the GST exemption would expire after 90 years. The 90-year period is inspired by the Uniform Statutory Rule Against Perpetuities (USTRAP), which has been enacted in about a dozen states.

6. **Extend duration of lien in Section 6166 deferral**. Under current law,if a §6166 election is made to defer taxes relating to a closely held business, the §6324(a)(1) lien continues for ten years. However, the deferral of payment of the tax can continue for up to fifteen years and three months after the decedent’s death. The proposal would extend the lien throughout the §6166 deferral period.

7. **What isn’t there: valuation discounts.** The 2013 Budget Proposal proposed an amendment to §2704 (the “disappearing rights and restrictions” special valuation rule) that would add a new category of “disregarded restrictions” relating to interests in family-controlled entities such as family limited partnerships and limited liability companies. Interestingly, this proposal does not appear in the 2014 Greenbook.

**C. Annual exclusion for 2013 is $14,000** (up from $13,000 in 2012), thanks to an inflation adjustment.See Rev. Rul. 2012-41.

**D. Another take on lifetime gifts of assets likely to increase in value: The “new basis at death” rule.** We now have a $5 million “permanent” estate and gift tax exemption equivalent—$5.25 million in 2013 (and $10.5 million in the case of spouses), which is likely to increase every year thanks to the annual inflation adjustment. As a result, one of the traditional estate planning techniques has been turned on his head: Lifetime gifts of assets with appreciation potential. In the past, the objective has been to make lifetime transfers of such assets, to remove the potential appreciation from the client’s gross estate. But now, when even low-millionaires’ estates are not likely to be subject to estate tax, the greater tax benefit to the heirs may be to hold the assets until death, in order to obtain a basis step-up under §1014.

1. **Transfers by the grantor**. Is it possible to have the best of both worlds? One possibility that has been suggested is for the grantor to transfer assets to an irrevocable trust as a completed gift, but authorize a third party to give the grantor a special testamentary power of appointment. If such a power is given to the grantor, this will cause the assets to be included in grantor’s gross estate under §2038. The authority would be exercised if down the road it turns out that the benefits of a basis step-up will be greater than the disadvantage of a gross estate inclusion. (The gross estate inclusion would override any adjusted taxable gift that resulted from the transfer.)

2. **Bypass trust**. The same approach could be taken with respect to a bypass trust that benefits a spouse or a child. A third party would be given the authority to give the beneficiary a general testamentary power of appointment. This would cause the assets to be included in the beneficiary’s gross estate under §2041, in situations where the benefits of a basis step-up would be greater than the disadvantage of a gross estate inclusion.

3. **Would a third party be willing to take on that authority?** Is there any potential liability to that third person, given that the assets could be diverted to other beneficiaries if the power is exercised? At least in the grantor situation, the answer appears to be no for two reasons. First, it would be the grantor who made the decision to divert the assets to new beneficiaries, or to change the current beneficiaries’ shares. Second, the trust would be drafted in such a way that if the grantor does not exercise the power of appointment, the “gift in default of appointment” will leave the property in the trust.

a. Giving the beneficiary a general power of appointment would appear to be dicier—but not if the class of permissible appointees is limited to creditors of the beneficiary’s estate.

**E. Estate planning in a high-exemption world**.For 2013, the estate and gift tax exemption equivalents are $5.25 million (and $10.5 million for married couples)—and with inflation adjustments, these amounts are destined to increase on an annual basis. What should we be telling clients, for most of whom federal (but not state!) transfer taxes have been functionally repealed?

Thanks to ATRA 2012, estate planning professionals will see their clients falling into one of three categories (and I am broadly oversimplifying here): (1) Mega-wealthy—over $6 million to $8 million—clients for whom sophisticated estate planning will continue to be called for; (2) couples in the (say) $6 million range (or single clients in the $3 million or so range), for whom transfer taxes may or may not be a concern down the road, and (3) modest estates—say, a married couple with an estate of “only” $4 million or less.

1. **Bypass trusts for spouses remain important**. For a couple in their 40s—or 50s, or 60s, or 70s, bypass trusts continue to be important even if there are not going to be any estate taxes to “bypass.” It must be conceded that clients like two-page wills because they can understand them: "to my [spouse] if he survives me, otherwise to my children in equal shares"—or, perhaps, “to my descendants per stirpes.”

a. A major concern is that if the surviving spouse later becomes incapacitated, the result will be a costly and a cumbersome guardianship or custodianship administration. If instead the client’s estate is left in trust, with the spouse serving as trustee for as long as he or she is able and so inclined, a guardianship administration will be avoided.

b. A bypass trust gives creditor protection via a spendthrift provision.

c. A trust settlement assures that on the spouse’s death, the remainder interest will pass to the children, rather than to that dreaded second husband, or that trophy second wife.

d. Such a trust should *always* give the spouse a special testamentary power of appointment, which has the benefit of tending to insure filial devotion. “It doubtless occurred to the testator that by restraining a disposition of his property except by will, which is in its nature revocable, [his widow] would, to the end of her life, retain the influence over, and secure the respect of, the several objects of his bounty.” Hood v. Haden, 82 Va. 588 (1886).

2. **“Bypass” trusts for children (or other objects of client’s bounty) also remain important**. Should a client’s will ever say something like this? “If my [spouse] does not survive me, to my children in equal shares,” or “to my descendants per stirpes.” Not good. There are very real advantages in creating trusts for the children's benefit rather than giving them outright ownership. Moreover, each child can be the trustee of his or her own trust, giving the child the power to make management and investment decisions (just as an outright owner can do) while also providing the following advantages.

a. **Covering the contingency of divorce**. Today, over one-half of all marriages end in divorce. In Texas, only community property is subject to equitable ("just and right") division in a divorce proceeding. The rules in the other community property states are essentially the same—but when it comes to divorce, ***every state in the country is a community property state***, only they call it, in North Carolina, Virginia, etc., etc., “marital property” as distinguished from “non-marital property,” with the definitions almost identical to what in California and Texas we call community property and separate property. In Texas and the other community property states, any property on hand at the time of divorce is presumptively community property; in non-community property states, it is presumptively marital property. To keep its separate property or non-marital property status, the property cannot be commingled with community or marital property, and good records must be kept. Otherwise, it may not be possible to establish separate ownership so as to overcome the community (or marital) property presumption.

A trust (even one with the child serving as trustee) is a useful vehicle for segregating the assets and maintaining their separate property status.

b. **Spendthrift provisions—protection from creditors' claims and malpractice suits**. If the child is in a profession or line of work in which malpractice suits are a concern (and, in today's litigious society, that includes just about everybody!), property left to a child in a trust can be given spendthrift protection, meaning that no creditors (other than for certain creditors such as for child support and federal tax liens) can reach the child's interest in the trust—even if the child declares bankruptcy.

c. **Protection from in-law’s bad business deals—“son-in-law trusts.”** Even if the child’s marriage is solid and the likelihood of divorce is remote, parents may be concerned that the child’s spouse might take some action that places the child’s inheritance at risk. (Several lawyers have told me that, in explaining the pros and cons of trusts for clients’ children, this is the scenario that catches the clients’ attention.)

*Example 1*: Donna, having inherited $750,000 from her parent’s estate, carefully places the inherited funds in a Paine Webber investment account. Donna has the account titled in her name as her “sole and separate property,” to segregate the assets from her and her husband Steve’s other assets. Donna and Steve have been married five years, their marriage is solid, and they have a young child. Steve has decided to start a business, and has negotiated a $575,000 loan from First State Bank. Steve tells Donna that the bank won’t make the loan unless Donna co-signs the note (or, perhaps, unless the loan is secured by Donna’s Paine Webber account), and Steve asks her to co-sign.

Stop the camcorder! What is Donna going to tell Steve? “Sorry, Steve; I know this is important to you, but I’m not going to help you out by signing the note”? It’s fair to say that Donna is in a rather dicey situation—as is her inheritance.

Need I continue the story? Donna co-signs the note. A year later, Steve’s business folds—after the borrowed funds have been expended in leasing an office and purchasing supplies. Donna, having co-signed the note, is personally liable. There goes Donna’s inheritance.

*Example 2*: Same facts, except that the $750,000 that Donna inherited was left in a trust of which Donna is the trustee. The trust contains a spendthrift clause. Again, Donna co-signs Steve’s note. She is personally liable on the obligation, but the trust assets cannot be reached because of the spendthrift provision.

*Example 3*: Same facts as in Example 2, except that Steve, instead of attempting to borrow money from the bank, asks Donna, as trustee, to either (i) loan the funds to Steve or (ii) invest trust funds in his business. Here, Donna has no choice but to point out that, in view of her fiduciary duties as a trustee, (i) a loan to a relative would constitute impermissible self-dealing, and (ii) investing the bulk of the trust funds in a start-up company would likely be an imprudent investment under the “prudent investor” standard.

d. Avoids guardianship if the child, years and years from now, loses her capacity.

e. Saves estate taxes if the child turns out to be very successful in life, to the point that federal or state estate taxes are a concern.

# II. Section 401—Qualified Plans and IRAs

**A. Waiver of 60-day rollover requirement**

1. **If financial institution makes the mistake, rollover permitted**. Happily, this result is well-established. See, for example, Ltr. Rul. 201247020, where a distribution from a pension plan was not timely rolled over due to the death of P (the plan participant) and the accepting bank’s delay in processing the wire transfer of a lump-sum payment to an IRA.

2. **Taxpayer relied on tax advisor’s advice, but made the error himself—no relief**. In Ltr. Rul. 201250031, P’s advisor at Financial Institution advised P that he could get a better yield at banking institutions other than Financial Institution was able to offer. Acting on that advice, P transferred funds from his Financial Institution IRA to his checking account, and acquired CDs at other banks. Oops! The checks were deposited in non-IRA accounts, and 60 days had passed before P discovered the error. No relief, said the Service. Although P was acting on professional advice, the professional advice had nothing to do with the improper rollover.

5. **Extension granted for medical reasons.** In Ltr. Rul. 201139011, on the advice of a financial advisor P planned to roll over his IRA to another institution. The evidence showed that P suffered from medical and mental conditions before, during and after the 60-day rollover period, which led to his death. The Service concluded that the facts satisfied the test for granting an extension.

6. **Extension granted in part on call to military service**. In Ltr. Rul. 201220055, P, having terminated his employment and receiving a distribution from a qualified plan, failed to make a rollover within the 60-day period. A waiver was granted, in part because P had been involved in providing care for his seriously ill child, and in part because he had been called into active military service by the Army National Guard.

**B. Disclaimer funded a valid see-through trust.** In Ltr. Rul. 201202042, P had named a revocable trust as designated beneficiary of his IRA, and was receiving required minimum distributions at his death. On P’s death, the trust became irrevocable, and wife S became the sole income beneficiary. S died 11 days after P, and Daughter and Grandson became the trust beneficiaries. S’s executor disclaimed any interest that S had in the trust, including the IRA. The trustee divided the IRA into two separate inherited IRAs, and amended the Trust to create separate sub-trusts.

1. The good news, said the Service, is that the sub-trusts were valid see-through trusts, thereby avoiding the five-year rule with respect to post-death distributions. The mildly bad news is that the sub-trusts were established after P’s death, not during P’s lifetime, meaning that the life expectancy of the oldest beneficiary (Daughter) is to be used in calculating required minimum distributions.

**C. What to do when participant’s “estate” (or a trust) is named as beneficiary.** As a general rule, a surviving spouse can make a rollover to his own IRA only if the decedent’s qualified plan or IRA designated the spouse as beneficiary. When assets in a decedent’s plan or IRA pass to a trust or the decedent’s estate, which then distributes the assets to the surviving spouse, the spouse is treated as having received the IRA assets from a third party and not the decedent, precluding a spousal rollover.

1. **If will or trust benefits spouse and gives broad distribution powers, there's an escape hatch**. A number of rulings have approved rollovers where the surviving spouse had the unrestricted power to distribute P’s IRA or plan benefits to herself. In Ltr. Rul. 201225020, P had named the trustee of his revocable trust as beneficiary of his IRA. Upon P’s death, the trust was divided into two trusts: A marital trust and a bypass trust, and his spouse S had an unlimited power of withdrawal over the marital trust. That’ll do it, said the Service. If S withdraws the entire proceeds of the IRA from the marital trust, she will be treated as having acquired the IRA directly from P, and she can make a rollover.

# III. Section 2031—Definition of Gross Estate—Valuation Issues

**A. Fractional interest in paintings: discount limited to 10 percent where other cotenants had strong emotional ties to the paintings.** That’s what the Tax Court ruled in Estate of Elkins v. Commissioner, 140 T.C. No. 5 (2013). Here’s the background: E and his wife W acquired 64 works of art from noted artists, including Picasso, Cezanne, Jackson Pollock, Jasper Johns and Robert Motherwell, among others. In 1990, they created Grantor Retained *Income* Trusts (remember those?) with each spouse’s one-half community property interest in three of the paintings. The trusts were for 10-year terms, during which period E and W retained possession of the paintings. The remainder interest was to pass to the couple’s three children. W died in 1999, leaving one-half of her undivided interests in the GRIT to E. Because E survived the 10-year term of his GRIT, his original undivided interests in the GRIT paintings passed to the children. W’s will bequeathed her one-half community interests in the other 61 works of art to E, but E made a formula disclaimer of a portion of those interests equal in value to W’s unused unified credit, and the disclaimed portion passed to the Elkins children. E died in 2006, and the estate tax return for his estate reported an estate tax liability of $102 million. The Service assessed a deficiency of $9 million.

1. The Tax Court held that the special valuation rule of §2703(a)(2) applied, and that the value of E’s interest for tax purposes was to be determined without regard to any restrictions on the right to sell or use the property. Judge Halpern concluded, however, that a 10 percent discount should be applied in valuing E’s interests in the artwork.

2. The court rejected the government’s argument that no discount should be allowed. However, because E’s children had a strong sentimental and emotional attachment to the artwork, treating them as “a member of the family,” the value of E's fractional interests was determined under the assumption that a hypothetical buyer would be in a good position to persuade E's children to purchase its fractional interest at little or no discount.

3. How interesting! That analysis is quite inconsistent with decisions in several circuits that have rejected the Service’s attempt to put a “face” on the hypothetical willing buyer. See, *e.g*., Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001), where the Ninth Circuit Court of Appeals, in reversing, stated that “[t]he facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be…. [A]ll of these imagined facts are what the Tax Court based its 3% premium upon.” Also see Morrissey v. Commissioner, 243 F.3d 1145 (9th Cir. 2001): “[t]he law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular.”

4. See in particular Estate of Jameson v. Commissioner, 267 F.3d 366 (5th Cir. 2001), where the court reversed the Tax Court decision because “the court should not have assumed the existence of a strategic buyer.… Fair market value analysis depends instead on a hypothetical rather than an actual buyer.” The Service’s position is supported by Holman v. Commissioner, 130 T.C. 170, aff’d, 601 F.3d 763 (8th Cir. 2010)—but Estate of Elkins v. Commissioner is appealable to the Ninth Circuit, not the Eighth Circuit, and the estate has filed an appeal. Stay tuned.

**B. Gifts of artwork to LLC were completed gifts, meaning no gross estate inclusion**. Apparently, there is a new “procedure” at the Tax Court: If the case involves works of art, Judge Halpern writes the opinion. In Sommers v. Commissioner, T.C. Memo. 2013-8, D had a valuable collection of artwork, including works by Calder, Dali and Miro. D had no children but he had three nieces, and he wanted to transfer the artwork to his nieces without incurring any gift tax. The problem he faced was that the art was valued in the range of $1.75 million, but the exemption equivalent in 2001 was only $675,000. D’s attorneys suggested that D and the nieces form an LLC that would include restrictions on transferability. On December 27, 2001, three days after D and the nieces signed the LLC operating agreement, D executed gift documents, each signed by one of his nieces indicating acceptance. While the documents purported to transfer LLC units, the number of units transferred was left blank, awaiting appraisal figures.

1. The appraisal received in March 2002 set the value of the LLC at $1.76 million, and indicated that D would retain 15 percent of the nonvoting interests in the LLC. The attorney changed the clause containing the blank number of units to a clause that provided for the transfer to each niece of “a number of Voting and Non-Voting capital units of the [LLC] that is equal to” $233,417. At that point, the nieces were unhappy with the prospect of being tenants in common with D’s soon-to-be second wife, who was expected to be the beneficiary of D’s estate. They met with an attorney, who suggested that they pay gift tax on the transfer of D’s remaining LLC interests, which would result in net gift treatment.

2. D’s relationship with his nieces soured. In June 2002, following D’s marriage to S, D sued the nieces in an Indiana court, contending that his transfer of the art collection was revocable. The court ordered mandatory arbitration. D died in November; in September 2005 the arbitrator ruled that the gifts were complete and irrevocable, and the Indiana Court of Appeals affirmed.

3. In 2007, S as executor of D’s estate filed a separate action in New Jersey, contending that the gifts were revocable and thus includible in D’s estate when he relinquished his power to revoke within three years of his death. As a result, S argued, under the New Jersey tax apportionment statute the nieces had to reimburse the estate for their proportionate share of estate taxes. The New Jersey court also ruled in favor of the nieces.

4. Before the Tax Court, S argued for an estate tax inclusion in order to apportion some of the estate tax to the nieces instead of her effectively being taxed on the gifted interests. The government argued for a higher value on the transferred LLC units, which would result in a larger gift tax liability and a lower marital deduction.

a. Noting that the Indiana and New Jersey courts had held that the transfers were completed gifts, the court ruled that under these circumstances S was collaterally estopped from contending otherwise before the Tax Court.

b. The court then addressed S’s contention that by leaving the blank spaces in the gift documents, the gifts were incomplete. Not so, said Judge Halpern. Although D and the nieces did not know the precise number of transferred LLC units, the parties had agreed to the transfers’ completion. “[T]he parties’ intent with respect to the blanks was to have [the attorney] carry out the terms of the original agreement, not to grant decedent the right to alter, amend, revoke, or terminate it.”

c. As a result, the Tax Court did not have to redetermine the estate tax liability. However, because the gifts were made within three years of death, §2035(b) would require the estate tax inclusion of any gift tax paid on those gifts if the court later determined that the decedent had undervalued them.

**C. Bad news in an LLP case**. In Estate of Lockett v. Commissioner, T.C. Memo. 2012-123, L and his revocable trust contributed assets to a limited partnership. The trust was revoked, and L became the owner of the trust’s LP interests. L’s two sons were named as general partners in the partnership agreement, but neither son contributed assets to the LP in exchange for their interests. As a result, under Arizona law the sons were not general partners. Nor was there any evidence of gifts of general partnership interests to the sons. The estate produced no evidence memorializing the gifts, L never reported them on gift returns, and the partnership agreement left the sons’ interests in the partnership blank. Under Arizona law and the partnership agreement, the partnership dissolved, and L became the legal owner of all of the partnership assets.

1. After the partnership was funded, several transfers had been made to L’s sons. Two of the transfers were memorialized by promissory notes. Based on the facts surrounding the transfers, the court concluded that a creditor-debtor relationship existed with the sons. As a result, the transfers were loans and not gifts, and the promissory notes were assets of the estate. With respect to another transfer to one of the sons, the estate failed to establish a creditor-debtor relationship, and the transfer was determined to be a gift.

# IV. Section 2033—Property In Which Decedent Had Interest

**A. Wife’s will was found, meaning that decedent didn’t own all of those shares after all**. In Richard v. Commissioner, T.C. Memo. 2012-173, the executors filed an estate tax return that valued 740 shares of preferred stock at $740,000 (par value). R originally owned 600 shares, and had received 140 shares upon his wife’s death in 1997. The Service assessed a deficiency based on their valuation of the 740 shares at $142,000,000 (kind of a difference of opinion there!). Wait a minute, said the estate; R only owned 600 shares. W’s will, which bequeathed her 140 shares to a credit shelter trust, was discovered in 2010 and now had been admitted to probate. As a result, under Florida law 140 shares passed to a credit shelter trust under W’s will. Thus, R never owned the 140 shares, and their value was not includible in R’s gross estate. The estate was not bound by the position taken on the estate tax return because the estate had provided cogent proof that R was not the owner of the stock. (There is ongoing litigation over the valuation of R’s 600 shares.)

# V. Sections 2036 and 2038—Retained Interests and Powers

**A. You can sue a trustee in federal district court; “probate exception” does not apply.** In Curtis v. Brunsting, 704 F.3d 406 (5th Cir. 2013), the Court of Appeals for the Fifth Circuit held that a claim of breach of fiduciary duty did not implicate the “probate exception” and that, under diversity jurisdiction, a federal district court could hear the claim.

1. **Background: the probate exception**. For many years, federal courts (including the United States Supreme Court) granted jurisdiction to cases involving various probate issues. See, *e.g*., Eaton v. Brown, 193 U.S. 411 (1904), a leading case on conditional wills. The will provided: “I am going on a journey and may not return. If I do not, I leave everything to my adopted son.” The testator died several months after returning from the trip. The court held that the quoted provision did not make the will conditional, but merely showed the motivation for writing a will in the first place. But then a series of cases held that federal courts had no jurisdiction to construe a will or address issues relating to an estate administration. See, *e.g*., Sutton v. English, 246 U.S. 199 (1918): “By a series of decisions in this court it has been established that since it does not pertain to the general jurisdiction of a court of equity to set aside a will or the probate thereof, or to administer upon the estates of decedents in rem, matters of this character are not within the ordinary equity jurisdiction of the federal courts; that as the authority to make wills is derived from the states, and the requirement of probate is but a regulation to make a will effective, matters of strict probate are not within the jurisdiction of courts of the United States.”

2. **The Supreme Court put the probate exception in perspective**. In Markham v. Allen, 326 U.S. 490 (1946), involving German legatees and the Trading With the Enemies Act, the Supreme Court, in reversing the Court of Appeals for the Ninth Circuit, reined in the probate exception: “The effect of the [district court] judgment was to leave undisturbed the orderly administration of decedent's estate in the state probate court and to decree petitioner's right in the property to be distributed after its administration. This, as our authorities demonstrate, is not an exercise of probate jurisdiction or an interference with property in the possession or custody of a state court.”

a. Marshall v. Marshall, 547 U.S. 293 (2006), involved the tortious interference claim of Vickie Lynn Marshall (a.k.a. Anna Nicole Smith) against Pierce Marshall, the son of Texas millionaire J. Howard Marshall. Reversing a Bankruptcy Court decision in favor of Vickie, the Court of Appeals for the Ninth Circuit, while acknowledging that Vickie's claim “does not involve the administration of an estate, the probate of a will, or any other purely probate matter,” nonetheless ruled that the probate exception barred a federal court of jurisdiction in any “probate related matter.”

b. The Supreme Court reversed, concluding that “the Ninth Circuit had no warrant from Congress, or from decisions of this Court, for its sweeping extension of the probate exception.” The court acknowledged that “when one court is exercising in rem jurisdiction over a res, a second court will not assume in rem jurisdiction over the same res…. [T]he probate exception reserves to state probate courts the probate or annulment of a will and the administration of a decedent's estate; it also precludes federal courts from endeavoring to dispose of property that is in the custody of a state probate court. But it does not bar federal courts from adjudicating matters outside those confines and otherwise within federal jurisdiction.”

3. **The Fifth Circuit follows suit.** In Curtis v. Brunsting, the parents of three siblings (Candace, Anita and Amy) had created a Family Living Trust that became irrevocable on their deaths, with Anita and Amy serving as co-trustees. The parents’ wills made pourover gifts to the trust. Candace, a resident of California, filed suit in federal district court in Houston based on diversity jurisdiction. The suit alleged that the co-trustees had misappropriated trust property, had failed to provide document relating to the trust administration, and had failed to provide accurate and timely accountings. The district court concluded that, because of the probate exception, it lacked subject matter jurisdiction.

a. The Court of Appeals reversed. After discussing Markham v. Allen and Marshall v. Marshall, the court concluded that “the probate exception only applies if the dispute concerns property within the custody of a state court. The federal court cannot exercise in rem jurisdiction over a res in the custody of another court…. However, nothing suggests that the Texas probate court currently has custody or in rem jurisdiction over the Trust. It likely does not. Assets placed in an inter vivos trust generally avoid probate, since such assets are owned by the trust, not the decedent, and therefore are not part of the decedent’s estate…. [B]ecause the assets in a living or inter vivos trust are not property of the estate at the time of the decedent’s death, having been transferred to the trust years before, the trust is not in the custody of the probate court and as such the probate exception is inapplicable to disputes concerning administration of the trust. The record also indicates that there would be no probate of this Trust’s assets upon the death of the surviving spouse. Finding no evidence that this Trust is subject to the ongoing probate proceedings, we conclude that the case falls outside the scope of the probate exception.”

# VI. Section 2041—Powers of Appointment

**A. Power to appoint among settlors’ “issue” did not include son; bypass character of trust preserved**. In Ltr. Rul. 201229005, Settlors had established an irrevocable trust for the benefit of Settlors’ Son. On Son’s death, the trustee was to distribute the principal and accrued income to one or more of the Settlors’ “issue.” Oops! Son is one of Settlors’ issue! No problem, said the Service. Because Son’s power of appointment was a testamentary power, he could not appoint any part of trust to himself or his creditors during his lifetime. Furthermore, “the references to ‘Settlors’ issue’ as a permissible class of appointees of Son’s testamentary power of appointment is properly viewed as not including Son’s estate or creditors of Son’s estate after Son’s death.” Thus, son did not hold a general power of appointment.

# VII. Section 2042—Life Insurance

**A. Insured’s right to receive policy dividends not an incident of ownership**. Under the facts of CCA 201328030, life insurance policies were acquired for the benefit of the insured’s former spouse in connection with a divorce settlement. The insured paid all premiums and could not borrow against or pledge the policies, but was entitled to policy dividends. That’s not an incident of ownership, said the Office of Chief Counsel. The term “incidents of ownership” includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to borrow against the policy’s surrender value. The right to dividends is nothing more than a reduction in the amount of premiums paid, and is not a right to the income of the policy. Policy dividends merely reduce the premiums due to keep the insurance in force.

# VIII. Section 2053—Administration Expense Deduction

**A**. **This was not a *Graegin* loan; projected future interest not deductible.** Laying a predicate:The use of a Graegin loan to pay estate taxes, inspired by Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, was dramatically illustrated in Estate of Duncan v. Commissioner, T.C. Memo. 2011-255. To pay federal and state estate taxes, debts and expenses, D’s revocable trust borrowed $6.5 million from an irrevocable trust (of which D’s father was grantor) that was established by D’s exercise of a testamentary power of appointment. The loan was evidenced by a 15-year balloon note that prohibited repayment. The estate claimed a $10.7 million deduction for the interest that would be paid at the end of the 15-year term of the loan, which the Tax Court (following Estate of Graegin v. Commissioner) allowed in full. Although the lender and borrower trusts had the same trustees and the same beneficiaries (!), this was a bona fide debt between two separate entities. The loans were actually and reasonably necessary, because the revocable trust could not meet its obligations without selling assets at discounted prices. On the facts presented, the 15-year term of the trust and the interest rate were reasonable, and the court refused to second-guess the trustees’ decision in making the loan.

1. This strategy was unsuccessful in Estate of Koons v. Commissioner, T.C. Memo. 2013-94. To pay estate tax liabilities, the trustee of Koons’ revocable trust borrowed $10.75 million from an LLC in which (as discussed below) the trust held a majority interest. Under the terms of the loan, the interest and principal payments were to be deferred for over 18 years. This deferral resulted in over $71 million in interest payments. The Tax Court concluded that the estate was not entitled to a deduction for the projected interest expense. With a 70.42 percent voting interest in the LLC, the trust could have forced the LLC to distribute apportion of its $200 million in liquid assets. Thus, it was unnecessary for the trust to have borrowed the money from the LLC in order to pay the estate tax.

2. **The case primarily involved valuation issues**. The LLC had presented Koons’ four children with an offer to redeem their LLC interests, which they had accepted prior to Koons’ death. Following his death, the children’s redemption increased the trust’s voting interest to 70.42 percent. The Tax Court was persuaded by the government’s valuation expert, who took the children’s redemption into account when he calculated the value of the trust’s ownership in the LLC, as the children were legally bound under Ohio law to redeem their interests at the time of Koons’ death.

**B. Nice try, but that undeposited $200,000 check was not a debt**. In Estate of Derksen v. United States, 2012-2 U.S.T.C. ¶ 60,657 (E.D. Pa. 2012), nine months after her husband’s death, D, at the direction of Daughter, wrote a check to the husband’s estate for $200,000, apparently to help equalize the estates. The check was never deposited, and Daughter, in her capacity as executor of D’s estate, claimed a deduction for the $200,000 “debt.” No go, said the court. There was no evidence outside of a phone call to Daughter that the couple had agreed to equalize their estates. Also, there was no evidence that the purported agreement was part of an arm’s length transaction. Thus, the agreement was not bona fide, meaning no deduction.

**C. Settlement payment was in satisfaction of beneficiary’s distributive share of estate, not a claim**. In Estate of Bates v. Commissioner, T.C. Memo. 2012-314, two wills were offered for probate. Under the 1997 will, the residuary estate passed to a trust (the First Trust) that benefited Bates’ grandchildren, Sheri, Kenneth and Scott. (Scott was in prison in Missouri.) The will, which named Sheri as executor, also made a bequest of $100,000 to Bates’ close friend Lopez, “with whom she had an extremely close relationship.” In 2004, Bates was diagnosed with Alzheimer’s disease, and Lopez began serving as her caretaker. In January 2005, Bates executed a second will and restated the trust (the Second Trust). Lopez was named executor and trustee of the Second Trust, the income from which was to be distributed equally between Lopez and the incarcerated grandson Scott. Bates died five weeks after executing the second will. Litigation between the parties led to a court-approved settlement under which the Second Trust was invalidated and Lopez received $575,000 in satisfaction of his claims.

1. A late-filed estate tax return (which resulted in a penalty) claimed the payment to Lopez as a deductible claim. Not so, said the Tax Court. Lopez had been paid for the services he provided during Bates’ lifetime, and no part of the settlement payment was a claim for unpaid services. “In short, Mr. Lopez’s claim represented a beneficiary’s claim to a distributive share of the estate rather than a creditor’s claim against the estate.”

2. **No deduction for payments made to beneficiary’s private investigator**. Scott had retained a private investigator to monitor the litigation. The court ruled that payments to the private investigator were not deductible. These were expenses incurred to protect a beneficiary’s personal interest, and did not relate to the estate’s administration.

# IX. Section 2055—Charitable Deduction

**A. Property passing to charities under settlement of contest qualified for deduction**. In Ltr. Rul. 201236022, D’s will provided that her attorney, who drafted the will, was to make distributions from D’s estate to charities that preserved and cared for orphan animals. So far, so good. However, D conveyed her interest in her home and a brokerage account to herself and the attorney as joint tenants with right of survivorship. Not surprisingly, this led to litigation. The contest was resolved by a settlement under which the residuary estate was divided among several charities and the attorney. The ruling notes that if the charities had been successful on an undue influence claim, they would have an enforceable right to receive the residuary estate. The settlement agreement was negotiated in a bona fide will contest, and the payments did not exceed what the charities would have received if they had pursued their rights in litigation. Under these circumstances, the estate was entitled to a charitable deduction.

**B. Beneficiary’s exercise of lifetime limited power of appointment qualified for charitable deduction**. So ruled in Ltr. Rul. 201225004, where an irrevocable trust named A and B as the primary income beneficiaries. A was given a power to appoint trust income and principal to qualified charitable organizations. The Service ruled—without any real discussion—that A’s exercise of the power would qualify for a charitable deduction.

1. **Result would be different if testamentary power or trust reformation was involved**. Under Reg. §1.642(c)-1(a)(1), a trust distribution to charity is deductible only if (i) it is made from trust income and (ii) it is made “pursuant to the terms of the governing instrument.” In Brownstone v. United States, 465 F.3d 525 (2d Cir. 2006), the court ruled that a trust was not entitled to a charitable deduction for income passing to charity by a beneficiary’s exercise of a testamentary power of appointment because the will establishing the trust was the governing instrument.

2. In CCA 200848020, the National Office concluded that a trust was not entitled to deduction for accelerated payments to charities under a court reformation. There, the income payments were not made pursuant to the governing instrument as originally drafted. In Ltr. Rul. 201225004 the central distinction, apparently,wais that the distribution will be made pursuant to a limited lifetime power. A charitable deduction was allowed under virtually identical facts in Ltr. Rul. 200906008.

# X. Section 2056—Marital Deduction

**A. Profit-sharing plan benefit awarded to same-sex spouse**. In what appears to have been the first reported decision following the Supreme Court’s ruling in United States v. Windsor, 570 U.S. \_\_\_, 2013 WL 3196928 (2013), a district court in Pennsylvania ruled that a same-sex spouse of a deceased participant in a profit-sharing plan governed by ERISA was entitled to spousal death benefits under the plan. Cozen O’Connor, P.C. v. Tobits, No. 2:11-cv-00045-CDJ (E.D. Pa. 2013). Sarah Farley, who worked at the Cozen O’Connor law firm, married Jean Tobits in Canada in 2006. Shortly after the marriage, Farley was diagnosed with cancer; she died in 2010. Tobits laid claim to Farley’s interest in the firm’s profit-sharing plan, as did Farley’s parents. Cozen O’Connor filed an interpleader. While the action was pending, the Supreme Court handed down United States v. Windsor, which ruled that the Defense of Marriage Act was unconstitutional, and allowed a marital deduction for interests passing to a same-sex spouse.

1. The parents had submitted a Designation of Beneficiaries form (whose authenticity was disputed) naming the parents as beneficiaries. Under the ERISA plan, however, a beneficiary designation was valid only if the plan participant’s spouse had waived a pre-retirement survivor annuity by signing the beneficiary designation form.

2. “There can be no doubt that Ms. Tobits is Ms. Farley’s ‘surviving Spouse’ under the Plan in light of the Supreme Court’s decision in Windsor. Ms. Tobits and Ms. Farley were married in Toronto, Canada in 2006, just a year before Edith Windsor and Thea Spyer wed in Ontario. Ms. Tobits possesses uncontroverted evidence of a valid Canadian Marriage Certificate solemnizing that marriage. Ms. Tobits and Ms. Farley celebrated that marriage with another ceremony in Illinois, where the couple lived together until Ms. Farley’s untimely death in 2010. Post-Windsor, where a state recognizes a party as a ‘Surviving Spouse,’ the federal government must do the same with respect to ERISA benefits—at least pursuant to the express language of the ERISA-qualified Plan at issue here…. [T]his Court finds that Ms. Tobits is Ms. Farley’s ‘Spouse’ pursuant to the terms of the Plan.”

**B. Talk about post-mortem planning! Lots of repair work was effective**. In Ltr. Rul. 201243004, an extension was granted to (i) make a QTIP election for a trust, (ii) divide the trust into GST exempt and non-exempt trusts, and (iii) make a reverse QTIP election with respect to the exempt trust and allocate D’s available GST exemption to it.

1. **But wait! There’s more!** The ruling also concluded that the surviving spouse’s proposed assignment to his children of his income interest in the further-divided non-exempt QTIP trust will result in a gift to the children. The full value of the non-exempt trust will be a gift of (i) the spouse’s income interest under §2511 and (ii) the remainder interest under §2519.

# XI. Section 2056A—Qualified Domestic Trust

**A. What to do when one of the spouses is not a United States Citizen**. You don’t have to have an LL.M. in Taxation to handle the situation where one of your clients is married to a non-citizen of the United States. The two most important things you need to know are these:

1. **First and foremost, identify the situation in the initial client interview**. (Or, if you have been retained to represent the decedent’s estate, make an initial confirmation that the surviving spouse is—or is not—a United States citizen.) You should always ask: “Are both you and Ann United States citizens?”—that should be part of your standard client interview questionnaire. In the vast majority of cases, the answer will be “of course.” But don’t assume that this is going to be the answer even if you have known the couple for years.

a. Another (perhaps more tactful) way of handling the issue: “Where were you and Sally born?”

2. **No marital deduction for property passing to non-citizen spouse unless left to a Qualified Domestic Trust**. The objective of the unlimited marital deduction is to defer estate taxation on qualifying dispositions until the death of the spouse. The premise of the deduction is that property left to the spouse will be subject to estate tax on the spouse’s death, to the extent not consumed or disposed of during the spouse’s lifetime. But what if the non-citizen spouse moves back to France, taking the inherited property with him? The property for which a marital deduction was allowed would escape the United States transfer tax system.

a. Under §2056(d), no marital deduction is allowed (and the qualified joint interest rule of §2040(b) does not apply) for property passing to a non-citizen spouse unless (i) the spouse becomes a United States citizen before the date on which the decedent’s estate tax return is due, *or* (ii) the property passes to a qualified domestic trust (a QDOT). To meet the tax deferral objectives the marital deduction, at least one QDOT trustee must be a United States bank or citizen, security and withholding provisions must be included to insure that any distributions of principal are subject to tax, and the trust must be in a form that is subject to estate tax on the spouse’s death. As for the latter, the QDOT must take the form of a marital deduction trust: A §2056(b)(5) marital deduction power of appointment trust, an estate trust under which the remainder interest passes to the spouse’s estate, or a QTIP trust for which a QTIP election is made. Finally, an election to treat the trust as a QDOT must be made on the decedent’s estate tax return.

b. But what if property is left outright the spouse, and not to the trustee of a QDOT? The spouse can transfer the property to a QDOT (under detail rules prescribed in the regulations), *and* the decedent’s executor must make a QDOT election on the estate tax return.

**B. What happens if the “citizenship” route is not completed in time?** In Estate of Liftin v. United States, 2013-1 U.S.T.C. ¶60,660 (Fed. Cl. 2013), after D’s death his spouse S decided to apply for United States citizenship in order to take advantage of the marital deduction. The estate requested an extension of time to file the estate tax return, but the naturalization process had not been completed by the extended deadline. The estate’s attorney assured the executor that the estate would not be subject to penalties as long as the return was filed within a reasonable time after the spouse obtained citizenship and various ancillary issues had been resolved. The executor filed the estate tax return nine months after S obtained citizenship and her claims against the estate had been settled.

1. That was too late, said the court, and a late-filing penalty was imposed. In granting the government’s motion for summary judgment, the court concluded that the executor’s failure to file the return until after S had obtained her citizenship was due to reasonable cause. However, the nine-month delay in filing the return after the spouse’s citizenship had been obtained was not reasonable.

**C. Despite delays, IRA rollover from 401(k) treated as transfer to qualified domestic trust**. In Ltr. Rul. 201243012, the executor timely filed the estate tax return and elected QDOT treatment for D’s interest in a 401(k) plan. The spouse S agreed to report to the IRS all annuity payments received from the 401(k) or from any IRA to which she transferred the 401(k). Due to intervening events beyond S’s control, delays were encountered in irrevocably assigning the 401(k) to the IRA. The executor filed a supplementary estate tax return that provided all of the required information. That will do it, said the Service. An extension was granted to treat the IRA as a qualified domestic trust.

# XII. Section 2503—Annual Exclusion

**A. Gifts of FLP income interests qualified for annual exclusions.** In recent years, the Service has mounted attacks on gifts of interests in family limited partnerships and limited liability companies, as to whether such gifts qualified for annual exclusions. The amounts involved can be quite substantial, if gifts have been made to a number of donees over a period of years. That was the situation in Wimmer v. Commissioner, T.C. Memo. 2012-157, involving gifts by H and W to five adult relatives and a Grandchildren’s Trust over a five-year period. The six minor beneficiaries of the Grandchildren’s Trust were given Crummey withdrawal powers. In three of the five years, each donee made taxable gifts (totaling $152,000), meaning that gift tax returns were filed and the statute of limitations had commenced to run. An indication of the amount of the gifts is reflected by the fact that the gift tax deficiency was $236,711.

1. H and W had created the FLP and were the initial general and limited partners. The FLP’s only business was investing in marketable securities, and it was funded with publicly-traded and dividend-paying stock. “The partners intended the partnership to: increase family wealth, control the division of family assets, restrict nonfamily rights to acquire such family assets and, by using the annual gift tax exclusion, transfer property to younger generations without fractionalizing family assets.” All partnership profits were to be allocated to the partners according to their proportional interests.

a. The FLP generally restricted transfers of partnership interests and limited the ability of a transferee to become a substitute limited partner. However, the FLP permitted transfer of a partnership interest by gift or as the result of a partner’s death without the consent of the general partners if the transfer benefited another partner or a related party. The partnership agreement gave the general partners full and exclusive power to manage, control, administer and operate the FLP’s business and affairs, subject to fiduciary duties and the continuing duty to advance the partnership’s purposes and best interests.

2. **The income interests were present interests, said the Tax Court**. The court stated that for an income interest to qualify as a present interest under §2503(b), the estate must prove that (1) the partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of the income can be readily ascertained.

a. The first prong of the test was satisfied because quarterly dividends had been received and distributed from the inception of the partnership, as was expected from the outset.

b. The second prong was satisfied because the general partners, while given broad powers, were “subject, in all events, to fiduciary duties to Limited Partners and the continuing duty to advance the Partnership's purposes and best interests.” The Grandchildren Trust’s only assets were the FLP interests which, due to the transfer restrictions, could not be liquidated or exchanged for cash. As a limited partner, the trustee was allocated its proportionate share of the dividends paid each year. “Because the Grandchildren Trust had no other source of income, distributions of partnership income to the trustee were necessary to satisfy the Grandchildren Trust's annual Federal income tax liabilities. The Court holds that the necessity of a partnership distribution in these circumstances comes within the purview of the fiduciary duties imposed on the general partners. Therefore, the general partners were obligated to distribute a portion of partnership income each year to the trustee.”

(1) [Hackl v. Commissioner, 118 T.C. 279 (2002)](http://web2.westlaw.com/find/default.wl?mt=208&db=0000999&tc=-1&rp=%2ffind%2fdefault.wl&findtype=Y&ordoc=2027832344&serialnum=2002212591&vr=2.0&fn=_top&sv=Split&tf=-1&pbc=E1F8C697&rs=WLW12.04), aff'd, [335 F.3d 664 (7th Cir. 2003)](http://web2.westlaw.com/find/default.wl?mt=208&db=506&tc=-1&rp=%2ffind%2fdefault.wl&findtype=Y&ordoc=2027832344&serialnum=2003489151&vr=2.0&fn=_top&sv=Split&tf=-1&pbc=E1F8C697&rs=WLW12.04), and [Price v. Commissioner, T.C. Memo. 2010–2](http://web2.westlaw.com/find/default.wl?mt=208&db=1051&tc=-1&rp=%2ffind%2fdefault.wl&findtype=Y&ordoc=2027832344&serialnum=2020972034&vr=2.0&fn=_top&sv=Split&tf=-1&pbc=E1F8C697&rs=WLW12.04), were distinguished. Unlike the taxpayers in those cases, “decedent, in his fiduciary capacity as general partner of the partnership, made distributions each year at issue and was required to do so.”

c. With respect to the third prong, the portion of income flowing to the limited partners could be readily ascertained. “The partnership held publicly traded, dividend-paying stock and was thus expected to earn dividend income each year at issue. Because the stock was publicly traded, the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership.”

# XIII. Section 2511—Transfers in General

**A. Tax Court tells Commissioner to go fly a *Kite*: Aggressive private annuity passed muster, as did an aggressive capital gain laundering transaction**. Estate of Kite v. Commissioner, T.C. Memo. 2013-43, involved the estate of a member of a prominent Oklahoma banking family. Mrs. Kite was the beneficiary of numerous trusts (a footnote tells us that there were 70 trusts for the benefit of Kite and her children), but only four of the trusts were involved in the case: three marital deduction trusts worth a combined $15.2 million and Kite’s revocable trust. The decision dealt with a number of interests and sophisticated transactions: in addition to the marital trusts (and some issues related to them), an Oklahoma limited partnership that was restructured in Texas to avoid state income taxes, a general partnership, gifts and later sales (on secured notes totaling $12.5 million) to Kite’s children or trusts for the children, a private annuity transaction—those are the highlights. (As the above brief summary suggests, reading the court’s finding of facts is a slog.) To my mind, two issues—only one of which was addressed by the court—are attention-getters.

1. **Balloon private annuity for a 75-year-old**. On March 30, 2001, a week before her 75th birthday, Kite sold assets valued at $10.6 million to her three children in exchange for an annuity under which each child would make an annuity payment of $1.9 million—beginning in 2011. (The court called this a “deferred annuity.”) The value of the annuity was determined by Kite and her advisors on the basis of the §7520 term interest tables, under which Kite’s life expectancy was 12.5 years. Kite died three years later, shortly after her 78th birthday. As a consequence, the annuity terminated, and the children never made any annuity payments.

a. **No taxable gift because use of the §7520 term interest tables was appropriate**. In a private annuity transaction, if the value of the property transferred exceeds the discounted value of the annuity received in exchange, the party will have made a taxable gift. The government argued that this was the situation here; in view of Kite’s age and her deteriorating health, use of the §7520 term interest tables was not appropriate, as Kite’s death within ten years was foreseeable.

b. However, “[b]efore the annuity transaction, Mrs. Kite received a letter from her physician attesting to her health and longevity. He affirmed that Mrs. Kite did not have an incurable illness or other deteriorating physical condition that would cause her to die within one year. The physician further opined that Mrs. Kite had at least a 50% probability of surviving for 18 months or longer.” The fact that Kite had 24-hour home health care “[does] not suggest, let alone prove, that Mrs. Kite had a terminal illness or an incurable disease. Rather, Mrs. Kite’s increased medical costs merely demonstrate that Mrs. Kite was a wealthy, 75-year-old woman who, when faced with certain health problems, decided to employ health care aids at her home. Her decision to hire home health care was not unusual for a woman who was accustomed to hiring personal assistants.”

c. “[B]ased on the unique circumstances of the case and, in particular, Mrs. Kite’s position of independent wealth and sophisticated business acumen … the annuity transaction was a bona fide sale for adequate and full consideration.” As a result, the private annuity transaction did not produce a taxable gift.

2. **Inter vivos QTIP trust used to secure step-up in basis**. As a general proposition, the inter vivos QTIP trust has been used to advantage primarily in one situation: to utilize the credit shelter of a non-propertied spouse to cover the contingency that he or she may predecease the propertied spouse. For example, wealthy W transfers assets to an irrevocable trust: Income to H for life, and on H’s death income to W for life, and on W’s death in further trust for descendants. W files a gift tax return that makes a QTIP election, securing a marital deduction. On H’s death, the trust’s value is includible in H’s gross estate under §2044, and utilizes H’s exemption equivalent via a credit shelter trust for the benefit of W and her descendants. (If the value of the trust exceeds H’s available exemption equivalent, H’s executor makes a QTIP election, securing a marital deduction for H’s estate.)

a. That was not the motivation here, because Mr. Kite was also quite wealthy, had more than enough assets to utilize his credit shelter—and, apparently, was in poor health. Rather, it is quite apparent that the motive was to obtain a step-up in basis. In 1995, Kite transferred stock with a basis of $41,000 and a fair market value of $4.25 million to a QTIPable trust and, in reporting the gift, made a QTIP election. Mr. Kite died a week later. (The opinion does not mention the state of Mr. Kite’s health at the time of the QTIP transfer, but it would appear that he was in poor health.) Judge Paris’s opinion discusses this inter vivos QTIP transaction in the Finding of Fact, but does not mention the consequence: With the §2044 inclusion in Mr. Kite’s gross estate, the stock obtained a new basis, wiping out unrealized gain of $4.09 million.

b. **But what about §1014(e)?** Apparently, the government didn’t raise the issue. Under §1014(e)(1), the “new basis at death” rule does not apply if

“(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death, and (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor).”

c. Perhaps the reason the Service did not raise this issue was that on Mr. Kite’s death the property did not pass to the donor of the property (*i.e*., it didn’t pass into Kite’s outright ownership), but instead passed to a trust that gave the donor only a life estate. In Ltr. Rul. 9321050, the facts (as to this issue) were essentially the same as in Estate of Kite v. Commissioner: W transferred property to a QTIP trust that benefitted H, and then H died. The ruling concluded that only W’s income interest was affected by §1014(e), and that the trust’s remainder interest qualified for a step-up in basis.

**B. Self-canceling “balloon” installment note transaction resulted in taxable gift**. Under the facts presented to the Office of Chief Counsel (CCA 201330033), in the year before he died D made major revisions in his estate plan. Under the prior estate plan, Charity was the primary beneficiary of his estate. The revised estate plan, involving a series of transfers of Y Company common and preferred stock to newly created grantor trusts, primarily benefited D’s family members. The revised plan included two GRATs; because D died during the GRAT terms, their value was included in D’s gross estate, as reported on the estate tax return. (There were no issues as to those transactions.)

1. **The SCIN notes**. In one set of transactions, D transferred Y stock to grantor trusts in exchange for promissory notes bearing interest at [???], with a [???] term based on D’s life expectancy as determined under the §7520 term interest tables. (The CCA is heavily redacted as to key facts.) The notes required interest-only payments until the end of the term, at which D would receive the face value of the notes. If D died during the note term, the notes would be cancelled. “The total face value of the self-cancelling notes was … almost double the value of the stock. The higher value of the notes supposedly compensated the decedent for the risk that he would die before the end of the note term and neither the principal nor a significant amount, if not all, of the interest would be paid. In fact, the decedent died less than six months after the transfer, and therefore, received neither the interest payments nor the principal due on the notes.” In another set of transactions, D transferred Y stock to another GRAT, and to other grantor trusts in exchange for interest-only self-cancelling notes bearing a considerably higher interest rate, another method of compensating for the risk that D might die during the note term.

2. **The gift tax return**. After D’s death, the estate filed a gift tax return that reported the GRAT gifts and disclosed the SCIN transactions, “but did not report any taxable gift as a result of those transactions.”

3. **The decedent’s health**. “Very shortly after the fourth and fifth set of transactions [involving the high-interest SCIN notes and the second GRAT], the decedent was diagnosed with [???]. After [that] diagnosis, he survived for less than six months. He died on Date 2.”

4. **Section 7520 tables should not be employed**. “We do not believe that the §7520 tables apply to value the notes in this situation…. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in §25.2512-8. In this regard, the decedent’s life expectancy, taking into consideration decedent’s medical history on the date of the gift, should be taken into account…. Because of the decedent’s health, it was unlikely that the full amount of the note[s] would ever be paid. Thus, [each] note was worth significantly less than its stated amount, and the difference between the note’s fair market value and its stated amount constitutes a taxable gift.”

a. The CCA cites and discusses §§ 2033 and 2038, and discusses Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), acq. in result, 1981-2 C.B. 1 (the seminal case on SCINs), and Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995), both of which involved estate tax issues. However, the CCA does not give any discussion or conclusion regarding the estate tax ramifications of the SCINs, beyond noting that that they were disclosed on the Form 706.

5. Compare Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003). D decided to retire at age 73 and move back to his native Italy. He sold real estate and his restaurant to Son for an 11-year self-canceling installment note that was secured by a mortgage on the properties. The note provided that if D died before the note was paid, no further payments need be made. However, D never made it back to Italy. He had been suffering from heart disease for 15 years. Five months after the sale, and after three monthly payments had been made on the note, D died during bypass surgery. The Tax Court ruled that the conveyance was not a bona fide transaction for full and adequate consideration. Son’s inconsistency in making payments due under the SCIN failed to establish that there had been a valid arm’s length sale. Moreover, there was no showing that either D or Son intended to enforce the note payment provisions. T.C. Memo. 2001-128.

a. The Court of Appeals reversed. The court noted that “there was no evidence that either Michael or Duilio presumed that Duilio would die within a few years of signing the SCIN, let alone within five months of the signing.” The medical evidence at the Tax Court trial was to the effect that Duilio’s life expectancy was between 5 to 13.9 years and not that he was in imminent danger of death. The court concluded: “Under these facts, taxpayer rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment…. As such, we conclude that the Tax Court clearly erred in finding that the execution of the SCIN was not a bona fide transaction.”

b. The CCA distinguishes Estate of Costanza v. Commissioner. “In Estate of Costanza, had the decedent lived, he would have received monthly payments consisting of income and principal throughout the term of the note. The decedent required the payments for retirement income and, thus, had a good reason, other than estate tax savings, to enter into the transaction. In contrast, the decedent in this case structured the note such that the payments during the term consisted of only interest with a large payment on the last day of the term of the note (balloon payment). Thus, a steady stream of income was not contemplated. Moreover, the decedent had substantial assets and did not require the income from the notes to cover his daily living expenses. The arrangement in this case was nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock.”

(1) Keep the above CCA discussion in mind! Isn’t the Office of Chief Counsel in effect giving tacit approval to the Costanza SCIN transaction?

c. The CCA also distinguished Estate of Moss v. Commissioner, involving an ESOP, where “[a]t the time of sale, the physical and mental condition of the decedent was average for a man of 72 years of age. There was nothing to indicate that his life expectancy would be shorter than the approximate ten years of life expectancy that was indicated by generally accepted mortality tables.” Rather, “[t]here are similarities between the decedent in the subject case and the decedent in Estate of Musgrove. In each case, the decedent who received a promissory note with a self-cancelling feature was in very poor health and died shortly after the note was issued. In addition, there is a legitimate question as to whether the note would be repaid in each case.”

# XIV. Section 2518—Disclaimers

**A. Estate of deceased spouse could disclaim retirement accounts, but not distributions already received.** In Ltr. Rul. 201125009, required minimum distributions from an IRA and three 403(b) plans were automatically deposited in the joint bank account of D and his wife S. D died, having named S as designated beneficiary on the four accounts. The beneficiary designations provided that if S survived and disclaimed her interest, the trustee of a testamentary trust was to be the contingent beneficiary. S survived D, and quarterly RMDs from the four accounts were automatically deposited in the bank account. S died intestate, and Daughter as administrator sought the Service’s blessing of a disclaimer on behalf of S. (The dates are not given in the letter ruling, but S’s death obviously must have taken place within nine months after D’s death.)

1. Citing Rev. Rul. 2005-36, 2005-1 C.B. 1368, the Service ruled that S was deemed to have accepted the RMDs deposited in the bank account and could not disclaim them. However, S “may make a qualified disclaimer of the balance of the Retirement Accounts if the requirements of § 2518 have been met.”

**B. Proposed state court reformation not given retroactive effect**. In Ltr. Rul. 201243001, an amendment to Parent’s revocable trust provided that on the death of Parent, a percentage of the trust would pass outright “to [Son], if surviving, but he shall have the right to disclaim all or any part of his share of said assets.” If Son disclaimed, the disclaimed interest would pass to a separate trust, of which Son and his descendants were beneficiaries. Son as trustee could make distributions to or for the benefit of the beneficiaries for their health, education, maintenance and support.

1. After Parent died, Son petitioned the local court to reform the trust to remove the outright distribution and disclaimer provision and, instead, provide that a percentage of the trust property would pass directly to the trust. The objective was to allocate Parent’s GST exemption to the trust. In the ruling request, Son contended that the amendment created an ambiguity or a scrivener’s error due to a mistake of law or fact, and that the reformation should be recognized retroactively for federal tax purposes.

2. No way, said the Service. In granting the reformation, the local court did not conclude that there were any ambiguities, and there was insufficient evidence to establish that Parent intended that Son’s share of the trust property was to be distributed to the irrevocable trust.

# XV. Section 2519—Disposition of QTIP Life Estates

**A. Net gift treatment upon spouse’s renunciation of QTIP interest**. In Ltr. Rul. 201303003, a QTIP trust was divided into two separate trusts as part of a settlement agreement. The spouse S then renounced her interest in Trust 1, which resulted in a taxable gift by S. Her renunciation was conditioned upon her three sons paying all gift taxes, which resulted in a reduction of the amount of the gift.

1. **Donees took carryover basis**. The ruling notes that as a result of S’s renunciation, under §1015 the donees took the property with a carryover basis, increased by the amount of gift tax paid by the recipients.

# XVI. Section 2601—Generation-Skipping Transfer Tax

**A. Service gives favorable treatment to a formula bequest tied to old (and long since repealed) GST.** In Ltr. Rul. 201322025, a will (drafted many years before) provided that at the death of the survivor of D and his wife, the greater of $250,000 or an amount specified in §2613 (the old GST exemption statute) was to be distributed to a trust for the benefit of D’s son and his descendants. Slight problem: When that time arrived, §2613 had been repealed and replaced by the current GST. A state court found an ambiguity, and concluded that D intended to take full advantage of the GST exemption available at his death. We’ll buy that, said the Service. The court’s order resolved a bona fide issue, and was consistent with applicable state law as it would be interpreted by the highest court of the state. Accordingly, the distribution did not cause the inclusion ratio of the trust to be greater than zero.

# XVII. Section 6161—Extension of Time for Paying Tax

**A. Extension of time to file, by itself, is not enough: $999,000 penalty (!) affirmed**. In Estate of Thouron v. United States, 2012 U.S.T.C. ¶60,656 (E.D. Pa. 2012, the executor made a timely submission of a request for an extension of time to file and included an estimated estate tax payment, but did not request an extension of time to pay tax. Six months later, the executor filed the estate tax return and requested an extension of time to pay the tax. Too late, said the court. The instructions for Form 4768 clearly state that a request for an extension of time to file does not relieve the estate of its obligation to also request an extension of time to pay the tax. The fact that the executor relied on an attorney was no excuse. A late-payment penalty of $999,072 was affirmed.

# XVIII. Section 6166—Extension of Time to Pay Estate Taxes

**A. Election could not be made after deficiency was assessed on account of non-business properties**. In CCA 201302037, the Chief Counsel’s Office concluded that when an estate failed to make a §6166 election on its estate tax return, the estate could not later pay a deficiency in installments because the deficiency was not attributable to the closely held business. The estate had paid the estate tax due in full and did not make a regular or protective election under §6166. A deficiency was assessed, but none of the deficiency related to the closely held business. Only that portion of the deficiency attributable to a closely held business can be paid in installments.

1. Similarly, in CCA 201304006 an estate was not allowed to expand its installment payment election to the entire interest in a business after the assessment of a deficiency that was not attributable to the business portion of the estate.

**B. Election has to be made on estate tax return, not in an accompanying letter**. In CCA 201226027, the election to pay taxes in installments under §6166 was made in a letter accompanying an extension request, and not on the estate tax return that was filed. Not good enough, said the Chief Counsel’s Office. Because the election was not made on the return, the payment submitted was not an installment payment under §6403. The payment did not exceed the total tax due and therefore there was no overpayment of tax that could be refunded.

# XIX. Section 6511—Limitations on Credits or Refunds

**A. Decedent may have owned only a remainder interest and not fee simple title, but the refund claim had to be timely filed**. In Davis v. United States, 2012-2 U.S.T.C. ¶60,650 (8th Cir. 2012), the estate tax return filed (late) in February 2003 reported D as owning fee simple title to a tract of land. An estate tax of $407,000 was paid in April 2003. In November 2003, the state’s chancery court ruled that D owned only a remainder interest in the land. The decision was affirmed by the Mississippi Court of Appeals in January 2005, and the Mississippi Supreme Court denied certiorari on March 2, 2006. The estate filed a refund claim in November 2008 based on the difference in value between the remainder interest and the fee simple interest.

1. The estate contended that equitable tolling should be applied because the statute of limitations expired before the refund claim and its value came into existence on March 2, 2006, when the underlying property dispute ended in the Mississippi courts. The court affirmed the Service’s denial of the claim, finding that it was untimely, and also ruled that equitable tolling does not apply to the time limitations under §6511.

2. D’s argument was foreclosed by United States v. Brockamp, 519 U.S. 347 (1997), said the court. That case held that courts could not “toll, for nonstatutory equitable reasons, the statutory time (and related amount) limitations for filing tax refund claims set forth in §6511 of the Internal Revenue Code of 1986[.]” In Brockamp, plaintiffs consisted of mentally disabled individuals who, by reason of their disability, were unable to meet §6511’s filing requirements. The Supreme Court expressly rejected the contention that courts have equitable power to ease §6511’s time constraints where the taxpayer was ignorant of the basis of his refund claim prior to the time limit’s expiration.

a. The court dismissed D’s argument that §6511 violated his right to due process under the Fifth Amendment because it barred his access to a forum in which to litigate his meritorious claim. Statutes of limitations necessarily have this effect, said the court, and they have long been upheld as constitutional.

# XX. Section 6601—Interest on Underpayment or Nonpayment of Tax

**A. When does interest start to run on unreported gift that used up some of donor’s unified credit?** Under the facts of CCA 201249015, Donor made a taxable gift in Year 1 but did not file a gift tax return. As a result, Donor did not utilize any of her available unified credit to offset the gift. In Year 2, Donor made additional taxable gifts, which were reported and which exhausted her available unified credit. After Donor’s death, the Year 1 taxable gift was reported on the estate tax return for her estate. Well, then: When did §6601 underpayment interest start to accrue on the Year 1 gift tax deficiency?

1. The Chief Counsel’s Office advised that interest on the underpayment interest began to run on the due date for the Year 1 gift tax return. Under §6501(a), “the amount of any tax … shall be assessed within 3 years after the return was filed,” but if the taxpayer fails to file a return, under §6501(c)(3) “the tax may be assessed … at any time.” That was the situation here, because Donor never filed a gift tax return disclosing the Year 1 gift. “It is the Service’s position that the available unified credit for an unreported gift must be reduced to reflect the use of the credit in a subsequent year for a reported gift.” As Donor used the entire §2505 unified credit with respect to the reported Year 2 gifts, there was no unified credit available to apply to the unreported Year 1 gift. Consequently, said the CCA, interest on the assessed deficiency began to accrue on the due date for the gift tax return.

# XXIV. Section 6651—Failure to File Tax Return or to Pay Tax

**A. No; an extension to file is for six months, not one year**. In Knappe v. United States, 2013-1 U.S.T.C. ¶ 60,663 (9th Cir. 2013), when it became apparent that several appraisals would not be completed in time to file the estate tax return before its due date, the estate’**s** CPA advised the executor to request an extension of time to file and pay the estate tax. Relying on the CPA’s advice that the Service had granted a one-year extension, the executor filed the estate tax return several months after the six-month deadline. Slight problem: the Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate Taxes states quite clearly that the maximum available extension to file is six months. In this situation, the executor’s reliance on his CPA was not a reasonable cause, and the Service’s assessment of a late-filing penalty was affirmed.

**B. They should have filed that return, even if “erroneous.”** In Estate of Young v. United States, 2012-2 U.S.T.C. ¶60,658 (D. Mass. 2012), the estate timely requested and was granted a six-month extension of time to file its return and a one-year extension to pay the estate tax. Prior to the extended due date for the return, but after the original due date, the estate paid its estimated estate tax liability. The Form 706 had been prepared and could have been filed on time, but the appraised values of the estate’s real property holdings were thought to be too high. The estate’s attorneys and accountants believed that because the estate had already paid its estate tax liability, it would not be subject to penalties. Relying on that advice, the estate delayed filing until the properties were sold; they did not want to file an inaccurate return.

1. **It’s penalty box time**. The court concluded that because the estate deliberately filed a late return, the late filing constituted willful neglect. Although the estate had relied on an attorney and an accountant, the reasonable cause exception did not apply. It is not reasonable, said the court, to rely on advice that you don’t have to comply with the law because noncompliance won’t be subject to a penalty.

**C. Health problems did not constitute reasonable cause**. So held in Stine v. United States, 2012-2 U.S.T.C. ¶60,655 (Fed. Cl. 2012), where Stine made gifts of $2 million to each of her two daughters in early 2007 but did not file a gift tax return until September 2008. S’s health problems included pneumonia, recurrent upper respiratory infections, knee replacement surgery, a thyroid growth, heart palpitations, and cataract surgery. However, these health problems did not lead to any long hospital stays, nor was she incapacitated on a continuous basis. Moreover, in April 2008 Stine was able to complete certain financial transactions, including transferring properties to a revocable trust, filing her federal and state income tax returns, and making an estimated income tax payment. Bottom line: Stine’s health problems were not severe enough to establish a reasonable cause for her failure to timely file that gift tax return.