

IRS Presentation

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Discussion Topics

- Repeal of the Estate Tax – what does this mean to you
- Red Flags: How to avoid an Estate Tax audit
- Discounts
- Tips on how to get the best Results if audited
- 2036 – Bona fide sale exception - recent cases
- Preparer Penalties

Repeal of the Estate Tax

What does it mean to you

- Estate and GST taxes repealed for decedents dying between Jan 1 and Dec 31, 2010
- No Form 706 Estate and GST tax return need be filed. Watch for new reporting guidance.
- Basis Rules changed from Step-up Basis to Carryover Basis

Gift Tax Rules

- Gift Tax retained
- Tax Rate: 35%
- Exemption amount: \$ 1 million
- For 2011, Estate and Gift will be reunified at \$1 million and top tax rate will be 55% (plus a 5% surtax on certain large estates)

Modified Carryover Basis

- No more Step-up Basis. Replaced with a **modified carryover basis** system
- Instead of taking the FMV of the property at the date of the decedent's death, beneficiaries will take the *lesser* of:
 - (1) the **adjusted basis** of the property in the hands of the decedent, or
 - (2) the **fair market value** of the property on the date of the decedent's death.

Increase in Basis Rules

- Can allocate up to \$1.3 million (increased by unused losses and loss carryovers) to increase the basis of assets, AND
- Can also allocate up to \$3.0 million to increase the basis of assets passing to a surviving spouse, either outright or in a QTIP Trust (this means spouses get \$4.3 million increase)
- This is an increase in *basis* of \$1.3 and \$3.0 million, not assets having a value of \$1.3 or \$3.0 million.
- The carryover basis provisions would no longer apply after the estate tax returns in 2011.

Carryover Basis and Gifts

The modified carryover basis provisions

- DO NOT apply to property acquired by a decedent by gift during the 3-year period before death.
- DO apply to property received by the decedent from his or her spouse during the 3-year period, provided that the spouse did not acquire the property in whole or in part by gift
- DO NOT apply to stock or securities in a foreign holding company, stock of a current or former domestic international sales corporation, or stock of an active or passive foreign investment company.

Red Flags: How to Avoid an Estate Tax Audit

- Follow Directions – Include all requested forms and documentation with the return
- Substantiate reported values with full Appraisals and include all attachments and exhibits (do not provide statement that says Appraisals and supporting documents will be provided upon request)
- Fully disclose all discounts taken and do not take excessive discounts

How to Avoid an Estate Tax Audit

- Match Line 4 Adjusted Taxable Gifts on Form 706 with F709's filed. Call CSC to obtain info on F709s filed at 866-699-4083 or fax request to 859-699-3005
- Look at return as an auditor would – if you see a potential red flag, we will see it also
- File gift tax returns. We are actively working with a number of states and other agencies to help identify potential gift tax non-filers

What are Excessive Discounts

- What is reasonable varies due to differences in:
 - Facts and circumstances, and
 - Subjective opinion of the appraiser
- Just because a discount was allowed in an audit or court case or uncontested return filing, does not mean it is allowable for the subject interest

Discount Red Flags

This is Not Official IRS Policy - My Opinion - Expected Discount Hierarchy (highest to lowest discounts) with no special circumstances:

- LP interest in Partnership holding commercial/business assets
- LP interest in Partnership holding marketable securities and cash
- Fractional interest in commercial property
- GP interest in Partnership
- 50% fractional interest in residence
- S-Corporations - No Tax affecting

How to get best results if audited

- Provide all information requested timely
- Provide everything asked on IDRs, don't hide or exclude documents or facts, it only makes the auditor more curious and determined
- Act professional at all times, no personal attacks

FLPs and 2036

For the bona fide sale exception of Section 2036 to apply:

- Existence of a **legitimate and significant nontax** reason for creating FLP
- Value of property transferred **proportional** to FLP interests received

Legitimate and Significant nontax reason (Recent TP wins)

- Estate of Miller (2002 transaction)
 - Decedent's desire to continue her deceased husband's investment philosophy
- Keller v United States
 - Long discussions regarding the creation of the partnership,
 - Primary purpose of partnership's formation was to protect family assets from depletion by ex-spouses through divorce
- Estate of Murphy
 - Pooling family's business assets into one entity to be centrally managed in a manner consistent with decedent's long-term business/investment philosophy of acquiring and maintaining the family's historical assets

Legitimate and Significant nontax reason (Recent TP wins)

➤ Estate of Black

- Centralized long-term management,
- Preserves decedent's buy-and-hold investment philosophy
- Pools family's stock so it could be voted as a block and protects it from creditors, divorce and grandson's actions

➤ Estate of Shurtz (California)

- Preservation of the family business,
- Management efficiency of actively managed assets

Legitimate and Significant nontax reason (Recent IRS Wins)

- Estate of Jorgensen (California)
 - Transactions not at arm's length
 - Partnerships held a largely untraded portfolio of marketable securities
- Estate of Miller (2003 transaction)
 - Decline in decedent's health
 - The decision to reduce her taxable estate
- Estate of Malkin
 - Court "unable to identify a legitimate and significant nontax reason for the transfers."
 - Only decedent had contributed to the FLP
 - No pooling of family assets.

Preparer Penalties

- Beware: We are starting to look at section 6694 preparer penalties that now apply to estate and gift tax returns, as well as at section 6695A appraiser penalties.