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Estate Planning Review

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TAX PROVISIONS INCLUDED IN WAR SUPPLEMENTAL

When the Democrats took control of the 110th Congress in January one of their first goals was passage of an increase in the federal minimum age. However, actually achieving that goal turned out to be a difficult task. The first hurdle that had to be surmounted concerned how much small business tax relief would be necessary to overcome opposition to the minimum wage legislation in both the House and Senate. As the months passed, the two bodies produced two fairly divergent pieces of legislation with no clear indication of which version would ultimately prevail. Beyond that point, the minimum wage and tax relief were caught up in the larger controversy concerning whether a funding package for the Iraq War should include definite troop withdrawal dates or "benchmarks" for the fledgling Iraqi government. Finally, on May 24, with the Memorial Day holiday and a congressional recess fast approaching, the Small Business and Work Opportunity Tax Act of 2007, included as part of the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007 (P.L. 110-28), passed the House by a vote of 280 to 142 and the Senate by a vote of 80 to 14. It was swiftly signed by the President on May 25.

With the Memorial Day holiday and a congressional recess looming, legislators from both parties and the White House were able to coalesce around a compromise funding agreement for the Iraq War. Ultimately, the legislation would tie together the first increase in the federal minimum wage in many years with tax breaks for small (and some large) businesses along with a number of revenue raisers.

The Small Business Tax Act of 2007 is certainly not as large as the recent Pension Protection Act of 2006 (P.L. 109-280) or the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222)(TIPRA). However, its impact, both positive and negative, will be felt by many taxpayers. As anticipated, a number of provisions are aimed at sweetening the pot for small businesses and hurricane victims. Last minute additions to the larger Act encompass a number of provisions related to qualified retirement plans, including those belonging to commercial airlines. However, in recognition of the Pay-Go rules imposed by the current Congress, the new law also includes several revenue offsets in the form of limitations and penalties. Among the revenue raisers are more severe limitations applicable to the "kiddie tax" and some rather onerous new rules for tax preparers and taxpayers in general.

Small Business Tax Relief Provisions

Expensing.—Probably the most significant provision aimed at small business is an increase in the Code Sec. 179 expensing limit, to $125,000, as well as the phase-out amount, to $500,000. Previously, the inflation adjusted limits for 2007 were $112,000 and $450,000, respectively. The expensing provision is also extended through 2010. For areas in Louisiana and Mississippi that qualify for bonus expensing, the limits are even higher—$225,000 and $1,100,000, respectively. A provision aimed squarely at owners of restaurants and bars allows food and beverage providers who are entitled to the Federal Insurance Contributions Act (FICA) tax credit to continue to calculate the credit based on the old minimum wage of $5.15 per hour. In addition, the work opportunity tax credit is extended through August 31, 2011, and expanded to include additional targeted groups such as veterans with service-connected disabilities and designated community residents up to 40 years of age. In addition, the

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maximum qualified first-year wages on which the credit is calculated is doubled from $6,000 to $12,000 for veterans with service-connected disabilities. Accordingly, the maximum credit will increase from $2,400 to $4,800 for hiring qualified disabled veterans. Rural employers in communities with declining populations may also now be able to take advantage of the work opportunity tax credit. Finally, both the work opportunity tax credit and the FICA tax credit will now be allowed for alternative minimum tax (AMT) purposes.

GO Zone Relief.—Homeowners in the Gulf Opportunity Zone (GO Zone) whose property suffered damages as a result of Hurricanes Katrina, Rita, or Wilma will also benefit from relief provided in the Small Business Tax Act. Specifically, the Act provides that a qualified Go Zone repair or reconstruction loan is to be treated as a qualified rehabilitation loan for purposes of the qualified mortgage bond rules. Accordingly, these loans financed with proceeds from qualified mortgage bonds and GO Zone bonds may be used to acquire or replace an existing mortgage, without having to comply with the ordinary rules requiring that (1) at least 20 years have to have elapsed between the date the building was first used and the date the rehabilitation begins and that (2) a certain percentage of the existing external walls of the building be retained. The provision applies to owner financing provided after May 25, 2007.

The Small Business Tax Act makes several modifications to liberalize the Code Sec. 1400N provisions relating to availability of the low-income housing credit for eligible buildings in the various GO Zones. The first change allows owners of qualifying buildings to more easily carry over a credit installment if the building receives a credit allocation in 2006 through 2008 and the building is placed in service before January 1, 2011. The new law also extends the period for treating GO Zones as difficult development areas so that the placed-in-service date for property in the Go Zone, Rita Go Zone, and Wilma Go Zone extends through December 31, 2010. In addition, for qualifying buildings placed in service from January 1, 2006, through December 31, 2010, community development block grants will not be taken into account and the loan will not be treated as a below-market federal loan for purposes of the low-income housing credit.

Qualified joint venture.—Beginning in 2007, the Small Business Tax Act will allow a qualified joint venture, whose only members are a husband and wife filing a joint return, to elect *not* to be treated as a partnership for federal tax purposes. Both spouses must materially participate in the trade or business, as determined under the passive activity limitation rules (except for the rule that permits participation of a spouse to be taken into account), and both spouses must make an election to have the new provision apply. If the election is made, all items of income, gain, loss, deduction, or credit would be divided between the spouses according to their respective interests in the venture.

This election would effectively eliminate two problems that currently plague married business owners who file a Schedule C in lieu of a partnership return. The first problem involves one spouse not being properly credited for paying Social Security or Medicare taxes because spouses filing a single Schedule C report all of the income from the business under only one spouse's name. The second problem involves divorce and the issue of the non-reporting spouse having to argue that his or her tax returns do not accurately reflect his or her actual interest in the business.

S Corporations.—The Small Business Tax Act includes several provisions directed at helping certain S corporations preserve their status. In particular, passive investment income for purposes of calculating the tax on excess net passive income will no longer include capital gains. Electing small business trusts (ESBTs) will now be able to deduct interest on debt incurred to acquire S corporation stock when calculating the taxable income on the S portion of the ESBT. If a sale of qualified subchapter S subsidiary (QSub) stock terminates the QSub election, the stock sale will be treated as a sale of an undivided interest in the assets and liabilities of the QSub, equal to the percentage of stock sold, followed immediately by the deemed creation of a new corporation in a transaction that can qualify for tax-free treatment under Code Sec. 351. S corporations that were S corporations prior to 1983 may now eliminate any pre-1983 accumulated earnings and profits, thus eliminating the requirement that the corporation also be an S corporation for its first tax year beginning after December 31, 1996.

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In addition, provisions were included in the legislation to assist banks operating as S corporations. A bank changing from the reserve method of accounting for bad debts for its first tax year for which it is an S corporation may elect to take into account all Code Sec. 481 adjustments in the last tax year that it was a C corporation. Restricted bank director shares will not be treated as a disqualifying second class of S corporation stock, the bank director will not be treated as an S corporation shareholder, and the restricted bank director shares are disregarded in allocating items of income and loss among the S corporation's shareholders.

Pension Relief

A provision of the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007 concerns transfers of excess pension assets to retiree health accounts. The provision allows an employer having aggregate retiree health benefit costs for 2005 equal to or greater than five percent of its gross receipts for that year to satisfy the minimum cost requirement by meeting the minimum cost requirement previously allowed only for collectively bargained transfers.

A provision that retroactively amends the Pension Protection Act of 2006 (P.L. 109-280) allows a qualified plan to designate the year in which revocation of an election not to be treated as a multiemployer plan would take effect rather than being required to use the plan year beginning after August 17, 2006. This change, coupled with a related change in the three-year lookback rule, provides relief to plans that would have had difficulty meeting the threshold of three consecutive plan years being in compliance with the multiemployer plan requirements.

Certain commercial airlines and catering companies serving them who elect to amortize their shortfall amortization base over a 10-year period will be able to use a fixed (8.25 percent) interest rate in computing their funding target for each of those years rather than an interest rate based on the yield curve for corporate bonds. In addition, the alternate deficit reduction contribution rule can now be applied to any plan year beginning after December 27, 2003, and before January 1, 2008.

The Bad News

As noted above, the Small Business Tax Act is not all about tax relief. In trying to achieve a revenue neutral package, Congress was forced to look to some obvious and not so obvious targets. Recent reports of wealthy parents gaming the system by shifting unearned income to children in their upper teens and lower twenties in anticipation of the zero-percent capital gains rate in 2008 for those in the lowest bracket precipitated further tweaking of the "kiddie tax" rules. In addition, horror stories about fraudulent tax returns and refund claims resulted in some significant changes to IRS practices and procedures.

Reach of Kiddie Tax Expanded.—For families with teenage children who sought to reduce overall family taxation by having their children receive unearned income, the kiddie tax has long been a major impediment. Prior to passage of TIPRA, the kiddie tax exposed unearned income of children under age 14 above a certain inflation-adjusted amount to taxation at the parents' presumably higher income tax rate. TIPRA raised the upper age limit of the kiddie tax for tax years after 2005. This had the effect of exposing unearned income above $1,700 (for 2006 and 2007) of children under age 18 to taxation at the parent's income tax rate. Now, the Small Business Tax Act has further eroded that strategy, beginning in 2008, by expanding the reach of the kiddie tax to children who are age 18 and students, aged 19 through 23, unless the child provides more than one-half of his or her support with earned income. The kiddie tax continues to apply to children age 17 or younger regardless of the amount of support he or she supplies with earned income.

Although technically the effective date of this provision is for tax years beginning after May 25, 2007, practically speaking this will not have an impact on individual taxpayers until 2008. Consequently, students and 18-year olds who are potentially targeted by this change should consider incurring unearned income during the remainder of 2007.

New Penalties and Procedures

Tax preparers were definitely in the crosshairs of legislators drafting the Small Business Tax Act. In what can best be described as a major change, the Act expands the scope of tax return preparer penalties to include not just income tax returns, but also estate and gift tax, employment tax, excise tax, and returns filed by exempt organizations. The amount of the penalty imposed for understatement of a tax liability goes up from $250 to the greater of $1,000 or 50 percent of the income received (or to be received) by the preparer for preparation of the return or refund claim. Similarly, the penalty for an understatement of tax due to willful or reckless conduct increases from $1,000 to the greater of $5,000 or 50 percent of the income received (or to be received) by the preparer for preparation of the return or refund claim. In addition, the Small Business Tax Act changes the standard of conduct necessary to avoid imposition of the penalty for undisclosed positions from a "realistic possibility" standard to an "unreasonable position" standard. These changes are effective for returns prepared after May 25, 2007.

The Small Business Tax Act also creates a new 20-percent penalty for erroneous income tax refund or credit claims

made in an "excessive amount." The term "excessive amount" is basically the excess of the amount of refund or credit claimed for a tax year over the amount allowable for that tax year. This new penalty is applicable for claims filed after May 25, 2007, but will not apply to refund claims or credits relating to the earned income credit, which has its own set of rules.

It remains to be seen exactly what these changes will mean for estate planning practitioners, but Robert S. Keebler, a partner in Virchow Krause & Company, LLP, Green Bay, Wisconsin, and a member of the CCH Financial and Estate Planning Advisory Board, thinks the impact will be significant. "First, the quality of care on estate and gift tax returns will need to improve dramatically. The fear of a preparer penalty will force many lawyers to obtain an outside Circular 230 covered opinion to protect the lawyer/preparer. Further, a small percentage of lawyers will eliminate the formal preparation (versus review) of estate and gift tax returns from their practice."

With respect to the preparation of fiduciary income tax returns, Mr. Keebler is no less cautious. "The business/practical issue is that many 1041s are prepared by paraprofessionals with limited detailed numeric and tax law review by the lawyers in charge of the engagement. In the past, with a 1/3 standard, lawyers had very limited risk when preparing these returns. However the greater than 50-percent standard will require either considerably greater review by lawyers or the fiduciary returns will be referred to CPA firms. Why so much caution; because if a lawyer accumulates several preparer penalties he or she risks the loss of the right to practice before the Service."

However, at least in Mr. Keebler's viewpoint, every cloud has a silver lining. Specifically, he sees CPAs and attorneys having an increased opportunity to develop referral relationships that will enhance the profitability and quality of work for both professions. "From many lawyer's perspectives, the statutory changes in the return preparer penalties will accelerate the estate planning business model to one closer to a `medical model.' Logically, the lawyer will often be the lead practitioner in this model (i.e., equivalent to the skilled surgeon in the medical model). What this model means is that when coupled with the simple demographic that the number of people over the age of 65 will double in the next 12 years, thereby vastly accelerating the estate planning curve and the probate curve (i.e., the death curve), the demographic/economic situation will dictate that more and more of a lawyer's time will be spent on engagements comprising the `highest and best use' of the attorney's time." According to Mr. Keebler, this will result in lawyers increasingly outsourcing return preparation while filling the time with additional estate planning work. They will also have a greater opportunity to draft Circular 230 opinion letters for other lawyers or CPAs preparing estate tax returns.

Responding to these statutory changes, the IRS has rushed to issue transitional relief in the form of Notice 2007-54. The Notice indicates that for returns or refund claims pertaining to estate, gift, and generation-skipping transfer taxes due before December 31, 2007, the reasonable basis standard set forth in the regulations under Code Sec. 6662 (without regard to the disclosure requirements) will be applied in determining whether a penalty will be imposed pursuant to Code Sec. 6694(a).

In yet another change made by the Small Business Tax Act, the period after which the accrual of certain penalties and interest is suspended unless the IRS sends the taxpayer a specific notice of the amount and basis for the tax liability has been doubled. Effective for IRS notices issued after November 25, 2007, the applicable period will be 36 months rather than 18 months.

The statutory authority allowing the IRS to charge a fee when a request is made for a letter ruling, determination letter, etc., which was scheduled to expire after September 30, 2014, has been permanently extended. Finally, for checks or money orders received by the IRS after May 25, 2007, the minimum penalty for a bad check tendered in payment of amounts due under the Code is increased to $25 from the prior amount of $15. The penalty is applicable to checks or money orders in an amount less than $1,250, up from $750. ✦

ESTATE TAX

Regs Would Determine Value of Retained Interests

Recently proposed regulations are aimed at determining the value of assets includible in a grantor's gross estate if the grantor dies during the term of an annuity or unitrust. The regulations would eliminate a discrepancy that has existed between several private letter rulings and at least two long-standing revenue rulings.

In planning for certain types of annuity or unitrusts in which the grantor retains the right to an annuity or unitrust payment (e.g., a GRAT or a GRUT), a question that often arises is, what portion of the assets in the trust is includible in the grantor's gross estate if he or she dies during the trust term? This was one of the

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issues addressed in IRS Letter Rulings 9345035 and 9451056. In those private letter rulings, the IRS took the position that the amount includible in the deceased grantor's gross estate was the full value of the trust corpus on the date of the grantor's death. The authority cited by the IRS for this conclusion was Code Sec. 2039.

However, these private letter rulings are inconsistent with the position the IRS took previously with regard to the amount includible in the estate of a donor who had retained a life annuity interest in a charitable remainder annuity trust (CRAT). In Rev. Rul. 82-105, 1982-1 CB 133, the IRS stated that the amount includible in the donor's gross estate under Code Sec. 2036(a), was the amount of trust principal necessary to generate the annual annuity payments, given the applicable interest rate (this would currently be determined under the rules of Code Sec. 7520) for the date of the donor's death. The following example is adapted from the facts of Rev. Rul. 82-105.

Example 1: Tom Smith transfers property with a fair market value of $500,000 to a CRAT and retains the right to receive an annuity of $30,000 per year for life. Tom dies in a month when the applicable Code Sec. 7520 rate is 5.6 percent. As of Smith's death, the corpus was valued at $600,000. The amount of corpus necessary to generate an annual annuity of $30,000 given an 5.6-percent interest rate is $535,714 ($30,000/.056). Thus, $535,714 is the amount includible in the grantor's gross estate. This would also be the amount deductible as a charitable contribution under Code Sec. 2055.

A similar conclusion was reached in Rev. Rul. 76-273, which involved a charitable remainder unitrust (CRUT). However, in that ruling, because the equivalent income interest of the unitrust payment exceeded the equivalent income interest necessary to produce that unitrust payment, it was determined that the grantor retained an interest in the entire corpus of the trust, and thus, the entire trust corpus was includible in grantor's gross estate. Note that the amount includible is not a concern in the case of a CRAT or CRUT where the decedent was the sole annuity or unitrust recipient because the estate can deduct the full value of the interest anyway. However, the choice of calculation method could have very important implications in other cases, such as that of a GRAT.

Example 2: Agnes Jones transfers property with a fair market value of $500,000 to a GRAT and retains a $30,000 per year annuity interest for a 10-year term. At the end of the seventh year, Agnes dies. Assume that the trust assets have increased in value to $1,000,000 at the time of her death and that the applicable Code Sec. 7520 rate is 6.2 percent. Under the IRS position espoused in the private letter rulings, the full $1,000,000 value of the trust assets would be includible in the estate. On the other hand, if the logic of Rev. Rul. 82-105 is used, the amount includible would be only $483,871 ($30,000/.062).

More recently, in Field Service Advice 200036012, the IRS cited both Code Sec. 2036 and Code Sec. 2039 as alternative authority for determining the amount that would be includible in a grantor's estate upon the grantor's death prior to the end of a GRAT's term.

Proposed Regulations

Proposed regulations issued June 6 (NPRM REG-119097-05) would amend Reg. §20.2036-1 to incorporate the rationale of Rev. Rul. 76-273 and Rev. Rul. 82-105. The proposed regulations would provide that, if a decedent transfers property during his or her life to a trust and retains the right to an annuity, unitrust, or other income payment from, or retains the use of an asset in, the trust for the decedent's life, for a period that does not in fact end before the decedent's death, or for a period not ascertainable without reference to the decedent's death, the decedent has retained the right to income from all or a specific portion of the property transferred as described in Code Sec. 2036. Computation of the portion of trust corpus includible in the decedent's gross estate is determined by that portion of the trust corpus, valued as of the decedent's death (or the alternate valuation date, if applicable) necessary to yield the annual payment (or use) using the appropriate Code Sec. 7520 interest rate (i.e., the Code Sec. 7520 rate in effect on the decedent's date of death or on the alternate valuation date, if applicable).

Although the preamble to the regulations indicates the IRS's belief that both Code Sec. 2036 and Code Sec. 2039 could be applied, the proposed regulations concede that, in the interest of ensuring consistent tax treatment, it is appropriate to provide regulatory rules under which only one of these two potentially applicable Code sections will be applied in the future. The proposals favor treatment under Code Sec. 2036 because, for one reason, Code Sec. 2039 appears to have been intended to address annuities purchased by or on behalf of a decedent and annuities provided by a decedent's employer. On the other hand, the interests retained by grantors in GRATs and CRATs, for example, are more similar to the interests addressed under Code Sec. 2036. However, the IRS did

indicate that the proposed regulations should not be construed to imply that only one section of the Code may apply to a particular situation or interest. "These proposed regulations are not intended to foreclose the possibility that any applicable section of the Code (sections 2035 through 2039, or any other section) properly may be applied in the future by the IRS in appropriate circumstances beyond those described in these proposed regulations."

Further Examples

The proposed regulations include several examples of how the valuation rules would work in the case of charitable annuity and unitrusts, GRATs, grantor retained interest trusts (GRITs), and qualified personal residence trusts (QPRTs). The following examples are derived from those found in the regulations.

Example 3: In 2000, Dan Adams transferred $100,000 to a CRAT. The trust is to pay Adams an annual annuity of $12,000 for his life, then to Debbie Adams, Dan's child, for her life, with the remainder to be distributed to a qualified charity upon the survivor's death. The annuity is payable annually on December 31st of each year. Dan died in 2006, survived by Debbie, who was then age 40. On Dan's death, the value of the trust assets was $300,000 and the Code Sec. 7520 interest rate was six percent. Dan's executor did not elect to use the alternate valuation date.

The amount of corpus with respect to which Dan retained the right to the income, and thus, the amount includible in his gross estate under Code Sec. 2036, is the amount of corpus necessary to yield the annual annuity payment. In this case, the formula for determining the amount of corpus necessary to yield the annual annuity payment is: annual annuity/Code Sec. 7520 interest rate = amount includible under Code Sec. 2036. The amount of corpus necessary to yield the annual annuity is $12,000/.06 = $200,000. Therefore, $200,000 is includible in Dan's gross estate under Code Sec. 2036(a)(1). Note that the result would be the same if Dan had irrevocably relinquished his annuity interest no more than three years prior to his death because of the application of Code Sec. 2035. Dan's estate is entitled to a charitable deduction under Code Sec. 2055 for the present value of the charity's remainder interest in the CRAT. The applicable annuity factor (based on Debbie's age at Dan's death and the Code Sec. 7520 rate applicable on that date) is 14.1646. Therefore, the present value of the annuity is $169,975 (14.1646 × $12,000). As a result, the allowable charitable deduction for Dan's estate is $30,025 ($200,000 - $169,975). Under the facts presented, no amount would be includible in the estate under Code Sec. 2039.

Example 4: Tammy Tuttle transferred $100,000 to a GRAT that pays her an annuity of $12,000 per year for a term of ten years or until her earlier death. The annuity amount is payable at the end of each month in twelve equal installments. At the expiration of the trust term or on Tammy's earlier death, the remainder is to be distributed to Tommy, Tammy's child. No additional contributions were made to the trust after Tammy's transfer at the creation of the trust. Tammy died prior to the expiration of the ten-year term at which time the value of the trust assets was $300,000 and the Code Sec. 7520 interest rate was six percent. Tammy's executor did not elect to use the alternate valuation date.

As in the previous example, the amount of corpus with respect to which Tammy retained the right to the income and, thus, the amount includible in her gross estate, is the amount of corpus necessary to yield the annual annuity payment. In this case, the formula for determining the amount of corpus necessary to yield the annual annuity payment is: annual annuity (adjusted for monthly payments)/Code Sec. 7520 interest rate = amount includible under Code Sec. 2036. The Table K adjustment factor for monthly annuity payments in this case is 1.0272. Accordingly, the amount of corpus necessary to yield the annual annuity is ($12,000 × 1.0272)/.06 = $205,440. Therefore, $205,440 is includible in Tammy's gross estate under Code Sec. 2036(a)(1) and nothing under Code Sec. 2039.

With respect to the effective date of the proposed regulations, the IRS has indicated that the first, second, and fourth sentences in Proposed Reg. §20.2039-1(a) and the provisions in Proposed Reg. §20.2036-1(a)(1), (a)(2), and (c)(1)(i) are applicable to the estates of decedents dying after August 16, 1954. The fifth sentence of Proposed Reg. §20.2039-1(a) is applicable to the estates of decedents dying on or after October 27, 1972, and to the estates of decedents for which the period for filing a claim for credit or refund of an estate tax overpayment ends on or after October 27, 1972. The provisions of Proposed Reg. §20.2036-1(c)(1)(ii) and (c)(2), Proposed Reg. §20.2039-1(e), and the third, sixth, and seventh sentences of Proposed Reg. §20.2039-1(a) apply to the estates of decedents for which the valuation date of the gross estate is on or after the date the final regulations are published. ✦

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Valuation Planning

Estate Tax Valuation Update

At the time of her death, the decedent, Lois Stone, owned an undivided one-half interest in an art collection consisting of 19 paintings (*R. Stone*, DC Cal., 2007-1 USTC ¶60,540). On Schedule F of the decedent's timely filed federal estate tax return, the estate valued her undivided interest in the collection at $1.42 million. The estate arrived at this value by taking 50 percent of the appraised value as calculated by Sotheby's ($5.1 million) and applying a 44-percent fractional interest discount, the result of which was then rounded to the nearest ten thousand dollars. The IRS, however, determined that the value of the decedent's one-half interest was $2.77 million, $1.35 million more than reported by the estate. The IRS attributed the difference in value to the estate's undervaluation of two paintings, both of which were painted by Camille Pissarro, and that no fractional interest discount should apply.

In the first of two recent cases regarding the valuation of assets for estate tax purposes, the value of an estate's fractional interest in an art collection was determined and a cost-to-partition discount applied. In the second case, the valuation of lottery payments were at issue. The annuity tables under Code Sec. 7520 were found to have produced an unrealistic and unreasonable result, but whether there is a more realistic and reasonable means to determine the value must be established.

In adopting the valuation of the two paintings as determined by the IRS, the court found the valuation to be credible and unbiased because it was arrived at by the IRS Art Advisory Panel based on comparable sales of similar paintings near the decedent's date of death (September 1999). The estate's valuation, on the other hand, was less persuasive because the Sotheby's appraisal on which it relied did not contain a description of how the values were determined and no expert testimony was introduced at trial to support the valuation. The court further rejected the estate's argument that a November 2005 sale of one of the paintings for $464,000 demonstrated that its valuation of $500,000 was more accurate than the IRS's valuation of $750,000 because the later sale was too far removed from the valuation date to be relevant. Rather, the government's expert testimony that the painting simply declined in value during that five-year period was found to be credible.

The estate then argued that the IRS previously accepted the Sotheby's appraisal during processing of the decedent's predeceased husband's estate tax return. However, the court concluded that when the husband's estate tax return was closed by the IRS, it was not an acceptance of the Sotheby's appraisal or that a fractional interest was applicable. Instead, the IRS attorney who handled the returns for both estates explained that the husband's estate tax return was closed because the statute of limitations was about to expire and their intent was to revisit the value of the art collection and each fractional interest in that collection at the time the decedent's estate tax return was examined.

A fractional interest discount was not applicable to the estate's undivided one-half interest because, the court concluded, it is more likely that a hypothetical willing seller would sell the entire collection and split the proceeds with the co-owners than it would sell the undivided fractional interest in the art collection at a discount. Alternatively, since the hypothetical seller would have the right to partition the collection, the hypothetical seller would not accept less than he or she could obtain via a partition action. The IRS argument that a fractional interest discount only applied to interests in real property was rejected by the court. Not only did the IRS ignore the statements of its own expert that a two-percent discount was warranted for the costs to sell the art collection at auction, but it misrepresented the holding in *J. Propstra*, CA-9, 82-2 USTC ¶13,475, 680 F.2d 1248. The U.S. Court of Appeals for the Ninth Circuit held that valuation is affected any time the consent of a co-owner must be secured to sell property, whether the property involved is real or *personal*.

The estate was entitled to a two-percent discount for the estimated costs associated with a court-ordered sale by auction of the art collection as a result of a partition action. The court agreed that the costs attributable to a court-ordered partition also affect the fair market value of the estate's interest. Thus, the cost-to-partition discount should include the estimated legal fees related to bringing the partition action. The estimate offered by the estate in the amount of $50,000 was considered reasonable.

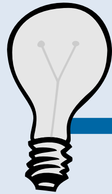
Additionally, because of the volatility in the art market, a discount associated with the uncertainties involved in waiting to sell the collection following the resolution of the hypothetical partition action was appropriate. The court did not, however, determine the amount of the discount as it preferred that the parties meet and determine the appropriate discount for such uncertainties.

Valuation of Lottery Winnings

On January 19, 1991, Mary Susteric and Mildred Lopatkovich won the Ohio Super Lotto jackpot prize and began receiving annual payments of $256,410. According to Ohio law, the lottery winnings could not be assigned or used as collateral by the winners. Just over ten years later, within one month of each other, Susteric and Lopatkovich died leaving 15 annual payments due to their estates. On their respective estate tax returns, the payments were reported as assets of their estates and valued at the amount the estates received as a lump sum distribution from the Ohio Lottery Commission ($2,275,867). The IRS, however, determined that the value of the payments based on the Code Sec. 7520 annuity tables were $2,668,118 and $2,775,209, respectively.

The issue of how to value remaining lottery payments for estate tax purposes remains the subject of a split among the circuits. The U.S. Courts of Appeals for the Second Circuit, (*P. Gribauskas*, CA-2, 2003-2 USTC ¶60,466, rev'g 116 TC 142, CCH Dec. 54,267) and Ninth Circuit (*T. Shackleford Est.*, CA-9,2001-2 USTC ¶60,417, aff'g 99-2 USTC ¶60,356) concluded that similar restrictions on marketability of lottery winnings justified deviation from the tables because the right to transfer was essential and any restriction on it must be taken into account when valuing the interest. On the other side are the Fifth Circuit, the Tax Court, and a district court in Massachusetts (*G. Cook Est.*, CA-5, 2003-2 USTC ¶60,471, aff'g 82 TCM 154, CCH Dec. 54,401(M), TC Memo. 2001-170, the Tax Court decisions in *Gribauskas* and *Cook*, and *J. Donovan, Jr. Est.*, DC Mass., 2005-1 USTC ¶60,500) that have concluded that the nonmarketability of the lottery winnings is an underlying assumption of the annuity tables, thus further discounting the value for lack of marketability would be inappropriate.

In the present case, the court agreed with the reasoning of the Second and Ninth Circuits that the transferability of the annuity affects its fair market value and the value as determined under the annuity tables was unrealistic and unreasonable. However, the court could not determine the value on summary judgment because the estate failed to establish the existence of a more reasonable and realistic method to determine the fair market value. ✦



BRIEF IDEAS

Florida Moves Against Viatical Provider

On May 10, the Florida Office of Insurance Regulation issued a Notice and Order to Show Cause to Coventry LLC, a viatical provider operating in Florida since 1999. Florida insurance regulators allege that the company has engaged in "fraudulent or dishonest practices" and has violated provisions of the Florida Insurance Code. This is not the first instance of alleged wrongdoing by Coventry, which was sued in 2006 by then New York Attorney General Eliot Spitzer concerning payments purportedly made to suppress competitive bidding in that state.

The Notice cites several instances of allegedly corrupt practices including one case in which a 73-year old woman who had life insurance with a face value of $19.4 million was paid less that $1 million for the policies while the brokers involved in the transaction collected over $1 million and Coventry received a bonus of just under $250,000 for keeping the total cost of the deal under $2.5 million. The Notice also alleges that Coventry paid brokers not to seek other competitive bids, made payments to brokers who were not involved in a specific transaction, and paid one broker to encourage another broker not to seek a competitive bid for sale.

No Extension for Installment Payment

The IRS has privately ruled that a decedent's estate was not entitled to an extension of time to elect deferral and installment payment of estate tax under Code Sec. 6166 (IRS Letter Ruling 200721006). Installment payment of estate taxes is available where an interest in a farm or other closely-held business comprises at least 35 percent of the value of the estate's adjusted gross estate. In denying the extension, the IRS noted that the election to pay estate tax in installments is a statutory rather than a regulatory election. Accordingly, the IRS ruled that it could not extend the due date under the regulatory election provisions of Reg. §301.9100-3. Furthermore, the IRS concluded that the "substantial compliance" doctrine does not apply within the context of making an election under Code Sec. 6166. Therefore, an extension on the basis of that doctrine was not allowed.

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