GUTTER CHAVES JOSEPHER RUBIN FORMAN FLEISHER MILLER P.A.

TAX, BUSINESS, & ESTATE AND TRUST LITIGATION UPDATE

March 7, 2020
An Electronic Newsletter of Gutter Chaves Josepher Rubin Forman Fleisher Miller P.A.

CONTENTS

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Tax Court Rejects IRS Valuation Theory Aimed at Reducing Nonvoting Interest Discounts

BY CHARLES (CHUCK) RUBIN

In a recent Tax Court Memorandum decision, the taxpayer undertook two inter vivos gifting transactions - one to a GRAT, and one to an irrevocable trust. The latter was a part sale/part gift transaction. The transferred items were LLCs holding securities, limited partnership interests, and promissory notes. The taxpayer's transferred interests were 99.8% nonvoting class B member interests, with 0.2% of the member interests being voting class A interests retained by a management entity owned and controlled by the taxpayer's daughter.

Traditional appraisal methodologies were applied to yield lack of control discounts in the 13-14% range, and lack of marketability discounts at 25%.

Rather than engage in a direct attack on these discounts, the IRS' primary approach was to say that the nonvoting members in selling their interests would seek to buy the voting member interests so as to be able to sell their nonvoting interests along with control and receive a much higher purchase price. The IRS calculated the additional premium that the nonvoting members would need to pay to the class A 0.2% voting member to buy the voting interests. The net value of the nonvoting member interests that were gifted were determined to be 99.8% of the undiscounted net asset value of the subject LLC, less the premium required to purchase the 0.2% voting member interest. Compared to the values computed under the taxpayer's traditional appraisals, the IRS' discount for the nonvoting member was close to de minimis.

In reviewing the IRS' methodology, the Tax Court noted that as a factual matter, the taxpayer's daughter had no intention of selling the class A voting units controlled by her. She also testified that if she did, the premium would be much higher than the IRS estimate.

The Tax Court was concerned about assuming a subsequent event into the valuation process on the date of the gift (i.e., the sale of the class A voting units to the class B members). It noted:

> "We are looking at the value of the class B units on the date of the gifts and not the value of the class B units on the basis of subsequent events. . ."

MORE ABOUT OUR FIRM

The firm and its attorneys have been recognized in numerous peer rating guides, such as U.S. News & World Report law firm rankings, Best Lawyers, Martindale-Hubbell, Chambers, Who's Who in American Law, Florida Trend's Legal Elite, Superlawyers, and South Florida Legal Guide Top Lawyers.

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It did note that events affecting value that depend upon events within the realm of possibility can be applied, but only if they are "reasonably probable." It found such reasonable probability absent:

> "The facts do not show that it is reasonably probable that a willing seller or a willing buyer of the class B units would also buy the class A units and that the class A units would be available to purchase. To determine the fair market values of the class B units we look at the willing buyer and willing seller of the class B units, and not the willing buyer and willing seller of the class A units."

The court ruled in favor of the taxpayer and allowed the taxpayer's claimed discounts.

Some thoughts/observations:

1. Perhaps if the IRS had focused its challenge on the size of the taxpayer's discounts in lieu of the above alternate and untested valuation theory, it might have gotten something for its efforts.

2. The IRS' theory, if validated, would deal a blow to gifting structures that are often employed. Since it is only a memorandum decision, its precedential value is limited, but at least it is a good precedent for taxpayers. Perhaps we may hear more about this if there is an appeal.

3. There is no mention of Powell and its successful approach to reduction of discounts where the taxpayers do not control the vote. That is a good thing for taxpayers, but since it was not mentioned it doesn't mean it was a rejection of Powell.

4. One often doesn't see IRS challenges to GRAT valuations, since an adjustment in value doesn't result in an immediate gift because of the adjustment provisions built into GRATs. Perhaps the IRS challenged the value only because it was already litigating the irrevocable gift made by the taxpayer. Or was the IRS intentionally playing the long game - requiring more assets to be paid back to the taxpayer from the GRAT, thus building up the taxpayer's estate for a later estate tax at death?

Grieve, TC Memo 2020-28

Basis in a Life Insurance Policy

By Charles (Chuck) Rubin

Life insurance contracts may be sold for many reasons, including among family members as circumstances change, between trusts when it is desired to move a policy out of an irrevocable trust to one that has more desirable terms (although oftentimes that is nontaxable if it is a sale between grantor trusts), or changes in business relationships and coverages.

Previously, the IRS had adopted the position that an owner's basis in a life insurance policy was the total premiums paid, ***less the portion of premiums paid attributable to mortality, expense or other insurance coverage (except when the policy was not owned for purposes of insurance protection)***. This was based on its reading of Code §1016. Thus, persons selling an existing policy could not use a higher basis equal to gross premiums paid in calculating their gain or loss.

Many practitioners disagreed with this interpretation of the law. Happily, the 2017 tax act modified Code §1016(a) to specifically provide that the above basis reduction for mortality, expense, or other reason charges under the insurance contract does not occur. Further, the change was made retroactive to 2009.

There were still some Revenue Rulings in force that were contrary to the new law. So in Rev. Rul. 2020-05, the IRS revised Rev. Rul. 2009-13 and Rev. Rul. 2009-14 so that the examples included in them no longer have a basis reduction.

The old rulings were mooted by the new law, so this ruling is more in the nature of Treasury Dept. housekeeping. Nonetheless, it is a good reminder of the beneficial change enacted in 2017, and may educate some that missed picking up in the revision that occurred in 2017.

Rev. Rul. 2020-05

PROPORTIONATE MEANS PROPORTIONATE

BY CHARLES (CHUCK) RUBIN

If a taxpayer contributes a conservation easement in land to a qualified organization, to obtain an income tax deduction the contribution must be in perpetuity. However, the law recognizes that sometimes the easement must be unwound (for example, if the land is taken by the government under eminent domain). In that case, a portion of the value of the property must be given to the qualified organization for conservation purposes.

As to how much the qualified organization must receive, Treas. Regs. § 1.170A-14 (g)(6)(ii) says the property right given to the qualified organization at the time of the donation must have

> "a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at that time. * * * [T]hat proportionate value of the donee's property rights shall remain constant. "

It goes on to provide

> "[T]he donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction * * *"

In a recent Tax Court case, a contributor included this language in its instrument of conveyance:

> "(2) This Conservation Easement gives rise to a real property right and interest immediately vested in SERLC. For purposes of this conservation Easement, the fair market value of SERLC's right and interest (<u>which value shall remain constant</u>) shall be equal to the difference between(a) the fair market value of the Conservation Area as if not burdened by this Conservation Easement and (b) the fair market value of the Conservation Area burdened by this Conservation easement, as such values are determined <u>as of the date of this conservation Easement</u>. If a change in conditions makes impossible or impractical any continued protection of the Conservation Area for conservation purposes, the restrictions contained herein may only be extinguished by judicial proceeding. Upon such proceeding, SERLC, upon a subsequent sale, exchange or involuntary conversion of the Conservation Area, shall be entitled to a portion of the proceeds <u>at least equal to the fair market value of the Conservation easement as provided above</u>. SERLC shall use its share of the proceeds in manner consistent with the conservation purposes set forth in the Recitals herein.(3) Whenever all or part of the Conservation Area is taken in exercise of eminent domain by public, corporate, or other authority so as to abrogate the restrictions imposed by this Conservation Easement, Owner and SERLC shall join in appropriate actions at the time of such taking to recover the full value of the taking and all incidental or direct damages resulting from the taking, <u>which proceeds shall be divided in accordance with the proportionate value</u> of SERLC's and Owner's interests <u>as specified above</u>. All expenses, including attorneys' fees, incurred by Owner and SERLC in such action shall be paid out of the recovered proceeds to the extent not paid by the condemning authority. (emphasis added)

The instrument of conveyance does include some language and concepts required by the Regulation. Do you think it met the proportionality requirement of the Regulation? The Tax Court did not, and denied a $16 million deduction.

The Court interpreted the taxpayer's instrument to require the computation of a fair market value of the easement at the time of contribution, and to require the donee to receive no less than that value at the termination of the easement. It also interpreted the Regulation as instead requiring that a proportion be determined at the time of the contribution with the numerator being the value of the easement and the denominator being the value of land as of the date of contribution – the donee must then receive on termination an amount equal to the current value on termination multiplied by that fraction – that is, a variable amount based on the original fraction/proportion. So if the value of the land went up over time, so would the amount that must pass to the donee on termination. Since the taxpayer's instrument was not a variable amount based on value at the time of termination, no deduction was allowed.

The Regulation does talk about the "proportionate value" remaining constant. However, it appears in context of the language that this only means that the ratio must remain constant, not the result of the math computation that computes the minimum amount due to the donee.

Qualifying for charitable deductions for property contributions is a minefield, both as to substantive requirements such as these for easements, and more general appraisal requirements and reporting requirements. When material amounts are at issue, all efforts need to be made to comply with the statutory and regulatory requirements.

Query whether the original value of the easement sets a floor on what the donee must receive – that is, will the proportion formula be applied to reduce that amount if the value of the property declines since the contribution date? I haven't researched the issue as to case law, rulings or other regulatory provisions, but the above regulatory language does not appear to me to rule out such a possible reduction.

Railroad Holdings, LLC v. Comm., T.C. Memo 2020-22 (February 5, 2020)

NEW "NO RULE" AREAS

BY CHARLES (CHUCK) RUBIN

Every year the IRS publishes a list of areas where the IRS will not issue a private letter ruling. Items on the list can provide a warning to taxpayers that the IRS may not agree with the conclusion that would be sought in the 'no rule' area.

For 2020, the IRS added to the 'no rule' list or the 'will not ordinarily be issued' list:

1. Whether any portion of the items of income, deduction, and credit against tax of the trust will be included in computing under § 671 the taxable income, deductions and credits of grantors when distributions of income or corpus are made – (A) at the direction of a committee, with or without the participation of the grantor, and (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse; or (3) all of the committee members are not beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee or (B) at the direction of, or with the consent of, an adverse party or parties, whether named or unnamed under the trust document (unless distributions are at the direction of a committee that is not described in paragraph (A) of this section).

2, Whether a trust which is not exempt from tax under § 501(a) is described in § 4947(a)(2) where a grantor, trustee, executor, administrator, donor, or beneficiary has represented that the trust has no amounts in trust for which a deduction was allowed under § 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, because no grantor, trust, estate, donor, or beneficiary has taken or plans to take any such deduction.

3. Whether a split-interest trust is described in § 4947(a)(2) because it has no amounts in trust for which a deduction was allowed under § 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

Rev.Proc. 2020-3

Private Foundations Gain a Small Tax Break on Investment Income

By Charles (Chuck) Rubin

The SECURE Act stole all of the end of year thunder regarding changes in federal taxes. However, other changes were enacted. One of these was the repeal of Code Section 4940(e).

Code Section 4940 previously imposed a 2% excise tax on the investment income of private foundations. Section 4940(e) reduced that tax to 1% for foundations that increased their qualifying distributions over the average for the prior 5 years.

So as to simplify this small corner of the tax universe, this 2%/1% arrangement is now history. In its place the Taxpayer Certainty and Disaster Tax Relief Act of 2019 provides for a flat 1.39% rate.

Florida Case Law Update - Trust, Estate & Guardianship Litigation

By Jenna Rubin

Lovest v. Mangiero, 279 So.3d 205 (Fla. 3d. DCA 2019)

This decision illustrates some of the difficulties that arise when guardianship and estate proceedings intersect. Here, after the ward died, the guardian and then personal representative sought to pay some of the ward's creditors using artwork done by the decedent, an artist. One of the beneficiaries of the ward's estate objected, arguing that the guardianship court's orders violated her due process rights, the guardianship court lacked subject matter jurisdiction and the guardian should have provided proper accountings.

The Court held that the beneficiary's due process rights were not violated because notice was sent to her of the petition to pay the debts with the artwork by certified mail (even though it was returned as undeliverable). It noted that FPR 5.060(a) allows an interested person who desires notice to file a written request for notice of further proceedings, which then allows the trial court the opportunity to determine whether that person is interested. Because the beneficiary failed to file this request, the court could not determine whether she was an "interested party" and thus she was not entitled to notice.

The Court also held that the guardianship court retained subject matter jurisdiction even after the ward had died because F.S. 744.527(2) allows the guardian to retain funds for the final costs of administration regardless of the death of the ward.

Lastly, the Court held that even though the guardian had not filed timely annual reports, F.S. 744.3685 puts the burden on the court to order the guardian to file the delinquent reports. Because the court had never ordered the guardian to provide the accountings, a beneficiary could not argue that the accountings were not timely.

Reid v. Guardianship of Reid, 277 So.3d 1053 (Fla. 4th DCA 2019)

It is well established that under Florida law, the most important aspect of guardianship law is the protection of the ward. This basic philosophy must be taken into consideration in all aspects of guardianship administration, including awards of attorney's fees. Accordingly, F.S. 744.108(2) provides the criteria that a court must consider in determining reasonable attorneys' fees in guardianship proceedings. The list of criteria includes the time and labor required, the novelty and difficulty of the questions involved and the skill required, the fee customarily charged, and the nature and value of the incapacitated person's property.

Here, in determining a reasonable award of attorney's fees for an appellate lawyer in a guardianship proceeding, the trial court did not consider the nature and value of the guardianship assets (there were none). The Court held that by approving the reasonableness of the fees, regardless of the ability of the guardianship to pay the fees and provide the basic care of the ward, "the protection of the ward may have taken a back seat to the attorney's compensation in violation of the public policy of the guardianship law."

Cantero v. Estate of Caswell, --- So.3d --- (Fla. 3d DCA 2019)

This decision involves an appeal of a trial court's order striking a claim as untimely. The claimant argued that his claim was timely because he was a reasonably ascertainable creditor who was not served with notice. The Court disagreed.

The claimant argued that the estate should have known about his claim based on several conversations he had with the personal representative and the personal representative's attorneys. He was claiming an ownership interest in the decedent's real property because he paid for the property and paid the mortgage premiums over 20 years prior to the decedent's death for a 5 year period of time while he has in a relationship with the decedent. In his calls to the personal representative, the claimant apparently only mentioned that he had left some car parts in the garage and never said anything about an ownership interest in the property. He argued that he inquired, "What was going on with the house?," which should have been enough to put the personal representative on notice of his claim.

The Court upheld the trial court's decision to strike his claim as untimely. The claimant's "basic inquiry" was not enough to trigger the personal representative to serve him with Notice to Creditors.

Did You Know?

Mosquitoes have teeth.

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