Estate Planning Council of St. Louis

Estate and Gift Tax – the Obligations, Costs of Noncompliance, and Avenues to Relief

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Returns, Estates and Gifts – what are the basics?

- Decedent's Personal Income Tax Return (Form 1040)
  - IRC Section 6012(b)(1) – Decedent's executor, administrator, or other person charged with the decedent's property must make final return
  - Due at the same time the decedent's return would have been due had they still been alive
- Estate Income Tax Return (Form 1041)
  - IRC Section 6012(b)(4) - If an estate has more than $600 in a taxable year (or if at least one beneficiary of the domestic estate is a nonresident alien), the personal representative must file a return.
  - Due by 15th day of the fourth month after the close of the estate's tax year
- Estate Tax Return (Form 706)
  - IRC Section 6018 – executor or administrator must file a return when the "gross estate" at death exceeds the basic exclusion amount (see also Treas. Reg. § 20.6018-2)
  - 2025 Lifetime Federal Gift/Estate tax exemption is $13.99 million
    - Exemption applies to cumulative gifts made over lifetimes plus estate value
    - Return required if deceased spouse's estate elects portability of any unused exclusion amount for use by the surviving spouse, regardless of size of estate
  - Due within nine months after the date of the decedent's death. § 6075.
  - Gross estate includes the value of all property the decedent owns partially or in full at the time of death.
  - Executor Liability
    - IRC Section § 6901(a) and 31 USCA § 3713(b): A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

            - *Estate of Paulson*, 68 F.4th 528 (9th Cir. 2023) – Allen Paulson died with an estate of almost $200M. Most of the value was held in trust and the trust document provided for the payment of estate taxes. The estate elected to make payments of the estate tax through installments per 26 USC § 6166, but then failed to make timely installment payments. The IRS sued the heirs, arguing that they were trustees and/or they received assets from the estate as transferees or beneficiaries. The IRS sought to collect against the estate and the individuals, as trustees/transferees/beneficiaries. The Ninth Circuit determined the beneficiaries and trustees personally liable.
- Gift Tax Return (Form 709)
    - IRC Section 6019
    - Donor has the filing obligation. If the donor dies before filing his return, the executor or administrator of his estate shall file the return. Treas. Reg. § 25.6019-1.
        - Gift tax is an excise tax; obligation of the donor imposed on the donor's act of giving a gift
        - If donor does not pay tax when due, donee *may* become personally liable for the tax
    - Due on or before the 15th day of April following the close of the calendar year. IRC §6075(b)(1)
        - If calendar year includes death of the donor, filing shall not be later than the time for filing the estate tax return. IRC § 6075(b)(3).
    - Generally, a gift tax return must be filed if:
        - IRC Section 2501 - Gift – gratuitous inter vivos transfer of property by an individual to a donee in exchange for less than adequate and full consideration (money or something of value)
        - Gifts were given to at least one person (other than the donor's spouse) that are more than the annual exclusion for the year
            - In 2025, the annual exclusion is $19,000 per person
    - Non-taxable gifts include:
        - Gifts less than the §2503(b) annual exclusion
        - Tuition or medical expenses paid directly to an educational or medical institution for someone else (§2503(e))
        - Gifts to your spouse, if a U.S. citizen (§ 2523)
        - Gifts to a political organization (§ 2522)
        - Gifts to charities (§ 2522)

When does a gift arise?

- Was a gift made? One Family, Two Decisions:
  - Edward Redstone and Sumner Redstone (brothers) worked at a family business with their father, Mickey. The company eventually became a holding company in which each held 100 shares. Edward was forced out of the business and wanted to transfer his 100 shares to his two sons. Mickey and Sumner refused to give Edward his shares and the family litigated the issue. In 1972, they ultimately settled, after which Edward received 66 2/3 shares (which the holding company immediately purchased for $5M) and an irrevocable trust held the remaining 33 1/3 shares for Edward's kids. After the settlement, Sumner also created a trust to give 33 1/3 of his own shares to his two children (even though the settlement did not require such a transfer). Neither Edward nor Sumner filed a gift tax return reporting the transfer of shares as a gift to their children.
  - *Estate of Redstone v. Commissioner*, 145 TC No. 11 (2015) – the IRS argued that Edward made a gift in 1972 and proposed gift tax and 30+ years of interest. The Tax Court determined that there was a genuine controversy between the family members and the resulting trust to Edward's kids was the result of an adversarial negotiation; thus, the transfer of shares in trust to his children was the result of an arms-length transaction and not made with pure donative intent. Further, the Tax Court determined that the transferor (Edward) received consideration for the transfer and thus, there was no gift in 1972 and no gift tax due.
  - *Sumner Redstone v. Commissioner*, T.C. Memo. 2015-237 – Similarly, the IRS argued that Sumner made a gift in 1972 and proposed gift tax and 30+ years of interest. Sumner argued that his creation of a trust for his children was the result of an overall reconfiguration of stock and only made as a result of the litigation with Edward. The Tax Court disagreed, finding that there was no dispute of Sumner's ownership in the stock and that his transfer of the stock to a trust was completely voluntary. The Tax Court concluded that Sumner did make a gift to his children and the gift tax applied. The IRS also asserted a § 6653(b) fraud penalty, or in the alternative § 6551(a)(1) failure to file and § 6653(a) negligence penalties. The Tax Court determined that the IRS did not prove fraud and that Sumner had reasonable cause based on his reliance. Namely, Sumner relied on legal advice regarding the tax consequences of transferring stock and presented a letter from his tax advisor that no gift tax return was required to be filed.

- _*Estate of Galli v. Commissioner*_, T.C. Nos. 7003-20, 700-20 (2025) – in 2013, Mom transferred $2.3M to Son. At the time, they signed a simple note designating the transfer as a 9-year-term, 1.01% interest loan. Mother and son treated it as a loan and mom did not file a gift return in 2013. When Mother died, Son filed an estate tax return reporting the loan as a part of the estate. The IRS argued that the transfer was a gift and proposed assessments of gift tax and underpayment of estate tax. Son challenged the assessment and presented evidence (loan documents, bank statements showing payment of interest, and the terms of the loan) that the transaction was, in fact a loan. The IRS did not provide evidentiary support beyond the notice of deficiencies. The Tax Court determined that the note contained all of the terms necessary to create a valid loan agreement and, even though the terms were more favorable than Son could obtain at a bank, it was still created a legally enforceable obligation to repay.

Valuation of Estates

- Valuation as of date of decedent's death. IRC Section 2031.
- But executor can choose an "alternate value date" if the result lowers the estate's value and sum of estate and gift taxes. IRC Section 2032(c).
- _*Estate of Michael J. Jackson v. Commissioner*_, T.C. Memo. 2021-48
    - Michael Jackson passed away in 2009 and his Estate filed a return reporting, among other items, three assets worth a total of $2.21M:
        - His right of publicity ("image and likeness"), valued at $2,105
        - New Horizon Trust II (held 50% ownership in Sony/ATV), valued at $0
        - New Horizon Trust III (held Mijac Music), valued at $2.21M
    - The IRS disputed the value, arguing that these three assets were worth $963.96M. The Tax Court trial became a "battle of the experts", in which the Court considered (a) the tax attributes of the asset being valued; (b) historical data versus forward looking data; (c) the reliance on information known as of the date of the valuation; and (d) the credibility of the experts. The Tax Court determined the three assets should be valued at $4.15M
- _*Estate of Prince R. Nelson v. Commissioner*_ (Dkt. No. 11442-20)
    - After Prince passed away in 2016, his Estate filed an Estate Return, Form 706, reported an estate value of $82M. The IRS disagreed with that value, assessing estate taxes and a § 6662(g) substantial understatement penalty ($32.4M and $6.4M, respectively) based on a valuation of $163M. The disputed valuations included: Undeveloped land, an industrial building, and residential lots; Prince's interests in Paisley Park Enterprises Inc. and NPG

Records; and Prince's personal property, writer's share of music compositions, and rights of publicity. The case settled in March 2022.

- *Connelly v. United States*, 144 S. Ct. 1406 (2024)
    - Supreme Court case from last session (appealed from the 8th Circuit) in which the Court determined that a closely held corporation's redemption obligation (related to a life insurance policy) does not diminish the fair market value of the corporation's shares for federal estate tax purposes. Michael and Thomas were brothers and sole shareholders of a corporation. The corporation took out a $3.5M life insurance policy on each brother/owner so that, upon the death of one brother, the corporation would have the funds to buy out the shares. Michael died in 2013, the corporation received the life insurance policy proceeds and bought out Michael's shares for $3M. Thomas, as executor of Michael's estate, filed an estate return reporting the value of the shares at $3M. He later obtained a valuation of the shares in which the accounting firm excluded the $3M in insurance proceeds on the basis that its was offset by the company's redemption obligation. The IRS disagreed, arguing that the redemption obligation did not offset the life insurance proceeds and the company's value should have been $3M higher. The Supreme Court determined that a corporation's obligation to redeem shares is not a liability that reduces a corporation's value for purposes of federal estate tax and upheld the IRS's determination.

Penalties

- **Section 6651** Failure to File Tax Return or Pay Tax
    - Penalty assessed for failure to timely file a return or pay the amount due, unless the failure to file is due to reasonable cause and not due to willful neglect.
        - Penalty is 5% per month for each month, or fraction of a month, that the return is not filed up to 25% (§ 6651(a)(1),(2))
        - Reasonable cause defense available.
    - Increased penalty for fraudulent failure to file
        - 15% per month, or fraction of a month, up to 75% (§6651(f)).
- **Section 6662** Accuracy Related Penalty on Underpayments
    - Penalty assessed for underpayments of estate taxes due to negligence or intentional disregard of rules and regulations
    - Also penalty assessed if there is a substantial understatement of tax that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000.

        - A substantial valuation understatement occurs when the value of property reported on the return is 65% or less of the actual value of the property.
        - This penalty increases if there is a gross valuation misstatement. A gross valuation misstatement occurs if any property on the return is valued at 40% or less of the value determined to be correct
    - Reasonable cause defense generally available.
- **Section 6663** Fraud Penalty
    - Penalty of 75% of the portion of any underpayment of tax assessed if the underpayment is attributable to fraud.
- **Section 6166(g)(3)** Failure to Make Payment of Principal or Interest
    - If the estate consists of interests in closely held businesses, IRC § 6166 allows the estate to pay interest only and/or installment payments toward the estate tax liability because the estate is likely not liquid. If the estate fails to make an interest or principal payment timely, it will be subject to a late installment penalty of 5% per month, up to 30%
    - There is no reasonable cause defense to this penalty, although, the estate may proactively seek an extension of time to pay in order to avoid the assessment.
- Penalties against professionals
    - **Section 6694** Understatement of Taxpayer's Liability by Tax Return Preparer
        - Return preparer is someone who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of a tax return or claim for refund.
    - **Section 6695A** Appraiser Penalties
        - Penalty imposed on any person who prepared the appraisal for a valuation that subsequently results in a substantial or gross valuation misstatement under IRC 6662, and and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund. Should not be applied if value "more likely than not" was correct.
- Reasonable Cause Defense
    - Taxpayer exercises ordinary business care and prudence, but unable to comply with filing, reporting, paying obligation
    - Relief for some penalties (§ 6662) require good faith or (§ 6651) lack of willful neglect
    - Taxpayer had the burden to prove reasonable cause based on preponderance of the evidence.

- The reasonable cause and good-faith determination is made on a case-by-case basis, taking into account all of the pertinent facts and circumstances (See, e.g., Treas. Reg. § 1.6664-4(b)(1)). Consider:
  - Taxpayer's reason
  - Compliance History
  - Length of Time between event and subsequent compliance
  - Circumstances beyond Taxpayer's control
- Reliance on a Professional
  - *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43
  - Did the Taxpayer: (a) reasonably believed that the advisor was a competent professional who had sufficient expertise to justify reliance; (b) gave to the advisor the necessary and accurate information; <u>and</u> (c) actually relied in good faith on the advisor's judgment?
- Other bases for reasonable cause:
  - Other reliance – on IRS written advise; information return
  - Honest misunderstanding of the law
  - Uncertainty in the law
  - Good-faith mistake
  - Death, Serious Illness, or Unavoidable Absence
  - Fire, Casualty, Natural Disaster or Other Disturbance
  - Inability to Obtain Records

- *<u>United States v. Boyle</u>*, 469 U.S. 241 (1985)
  - Robert was the executor of his mother's estate and hired an attorney to handle the administration. Robert contacted attorney multiple times to inquire about the progress of the tax return and his attorney assured Robert they would be notified when it was due and that it would be filed "in plenty of time." The attorney forgot to calendar the filing deadline and filed the estate tax return three months late. After the IRS assessed a late filing penalty under Section 6651(a), Robert argued reasonable cause existed because he relied on his attorney. The Supreme Court determined that a taxpayer (or executor) has a nondelegable duty to ensure that returns are filed timely and cannot rely on an agent to excuse a late filing. failure to timely file a tax return is not excused by the taxpayer's reliance on an agent
  - The Supreme Court noted: "It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under § 6651(a)(1)."

- *Leighton v. United States*, 155 Fed. Cl. 543 (2021)
  - Frank was the executor of his father's estate and hired an attorney to advise him as to compliance with his estate tax obligations. The attorney told Frank that "an estate tax return needed to be filed only if the value of the Decedent's estate exceeded $5,490,000" and that the estate was worth about $1-2M. Two years later, Frank's brother told him that the father established various trusts worth over $5M. Frank contacted the attorney, who prepared and filed late estate tax returns. The IRS assessed a late filing penalty of $257,712, which the estate paid and then filed a claim for refund, arguing reasonable cause, based on Frank's reliance on the attorney. The government filed a motion to dismiss, which the Court denied. The Court found that Frank sufficiently alleged that he could establish a basis for reasonable cause. The Court noted that additional facts needed to be presented in order to decide the key issue: Should the Executor or his tax advisors have known about the Decedent's funded trusts? The case was ultimately settled and dismissed, so the Court never had the opportunity to decide.
- *Estate of Anne Milner Fields v. Commissioner*, T.C. Memo. 2024-90
  - Anne was suffering from Alzheimer's and her great nephew (also her power of attorney, agent) transferred assets to a family limited partnership. Upon her death, he engaged an accounting firm to prepare an estate tax return, which did not include the assets transferred to the family limited partnership. The Tax Court determined that Anne retained the effective benefit and control (via her agent) over the assets until her death and they should be included in her estate. The Tax Court also determined that discounts for marketability and lack of control were improper. Finally, it upheld a § 6662(a) negligence penalty, finding that the estate did not proved that it relied on a professional as to the reporting of the assets or their value.