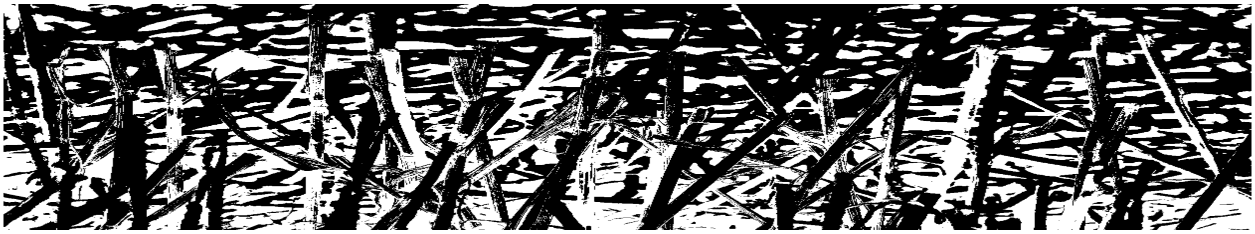

Jack Straw Fortnightly*

party like it's 2010

We are not even going to talk about how it has been more than ten weeks since the previous issue. A couple of quick housekeeping items and then down to business.

The slide deck from my presentation at the national conference in October is posted here. Also, the slide deck for a three-hour talk I gave last week in Fargo, North Dakota for the local estate planning council is posted here. Thoroughly enjoyed my brief visit, many thanks to my gracious hosts.

Much of what follows I wrote or at least sketched out in airports and in a hotel room in Fargo. Narrowly escaped getting grounded for ice on the return flight. Made the connection in Denver with only minutes to spare.

Still have not had time to write up that "viewpoint" article for Tax Notes on PLR 201825007, expanding on the analysis I gave in issue seven. Finishing that and putting out at least one more issue of Jack Straw -- after this one -- are among my targets for the remaining weeks of calendar 2018.

So let's get to work.

Extremely soft deadline

The temporary repeal of the federal estate tax in 2010 continues to reverberate. Eight years out, despite multiple extensions of the filing deadline, we are still seeing the occasional request for 9100 relief for the late filing of Form 8939, to allocate up to $1.3 million in aggregate basis increase to property acquired from a decedent who died that year.

In a letter ruling released a couple of weeks ago, numbered PLR 201845012, IRS granted relief to an executor who claimed the accountant who had been engaged to prepare "the necessary tax filings" had failed to prepare a Form 8939 timely for filing by the extended deadline of January 17, 2012.

And then some. The letter requesting relief was dated December 14, 2017. The favorable ruling said nothing about the lengthy delay, nor did it give any indication what might have triggered the request -- likely, a distributee suddenly realizing she was going to owe considerably more in gains tax on a sale or exchange than if the allocation had been timely made. Or not be able to claim as large a loss.

The fact that the decedent was a nonresident was mentioned only in passing, *i.e.*, not as an extenuating circumstance.

Although IRS had cautioned in Notice 2011-66 that "the amount of time that has elapsed since the decedent's death" might indicate "a lack of reasonableness and good faith and/or prejudice to the interests of the government," precluding 9100 relief, the present ruling makes no express findings on these matters, but simply recites the rule at reg. section 301.9100-3(b)(1)(v) that a taxpayer who has relied "reasonably" on a "qualified tax professional" has *per se* acted "reasonably and in good faith."

Apart from the boilerplate reference to "information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party," no mention is made of any affidavit from the accountant acknowledging her error.

The ruling does close with the usual recital that IRS has not "verified" any of the submitted materials, leaving open the possibility that the distributee might still lose out on an examination of her return reporting the sale or exchange.

Eating your cake and having it

Already three hundred some-odd words in, and I have not yet begun to talk about what I came here to talk about. Which is this.

On October 9, in a case styled *Matter of Seiden*, the surrogate's court in New York County vacated a notice of deficiency issued by the state taxing authority to an executor who had excluded from both the state and federal estate tax returns for the estate of a surviving spouse the value of a trust that would have qualified as QTIP in the estate of her predeceased husband, had his executor filed a 706.

The husband had died in 2010, when there was, briefly, no federal estate tax. New York still had an estate tax that year, with a credit equivalent -- what we now call an "applicable exclusion" amount -- of $1 million and a top marginal rate of 16 pct. In 2014 the exclusion was increased to $5 million, indexed for inflation.

So while the husband's executor chose not to elect into the retroactively reinstated federal estate tax, and did not file a 706 making a QTIP election,[fn. 1] she did file a state return, incorporating a pro forma federal 706. That return indicated a QTIP election as to a stated percentage of what would otherwise be a "bypass" trust, and the executor claimed a marital deduction in calculating the state tax due.[fn. 2] The state tax department issued a closing letter.

Step forward a few years. The surviving spouse has died, holding at most a limited power to appoint the trust remainder.

The executor for the surviving spouse now takes the position on a federal return that the value of the trust is not includible in her estate because she did not have a general power to appoint the remainder, and there had been no QTIP election made on a federal return for the predeceased spouse. IRS gives her a closing letter.

She takes an analogous position on the state return, but the tax department disagrees and assesses a deficiency of not quite half a million dollars.

In vacating the notice of deficiency, the surrogate's court notes that section 954 of the New York tax statute defines a decedent's "gross estate" for state estate tax purposes with reference to the federal tax Code. And since section 2044 of the federal Code does not include a trust over which the spouse does not have a general power unless a marital deduction was "allowed" on a federal QTIP election, the survivor's "gross estate" does not include the value of the trust.

Reverting to the past tense.

The court rejected the tax department's argument that a "duty of consistency" required the survivor's executor to include the value of a trust for which the executor for the predeceased spouse had claimed a marital deduction under a state QTIP election.

As paraphrased by the court, the "duty of consistency" is a form of estoppel that prevents a taxpayer from "benefiting from its error or omission on a tax return, only to take a contrary position on a subsequent return, after the statute of limitations has expired on the first." Close enough.

Here, the court noted, there was no "error or omission" in the reporting of the predeceased spouse's estate, and the executor for the surviving spouse was not taking a "contrary" position. The state legislature simply had not clearly expressed an intention to cover this one-off anomaly in the federal statute.

The consistency of random forests

The duty of consistency has come up a couple of times in the Tax Court in connection with the federal estate tax marital deduction, but in a somewhat different form.

In *Estate of Letts v. Commissioner*, 109 T.C. No. 15 (1997), the executor for a decedent's predeceased husband had claimed a marital deduction for amounts left in trust for her benefit, but had not made a QTIP election -- impliedly asserting that the surviving spouse had a general power to appoint the trust remainder. The executor did not attach a copy of the trust instrument to the return, IRS did not examine the return, and the limitations period expired.

At the death of the surviving spouse, her executor asserted that the value of the trust remainder was not includible in her estate because she did not in fact have a general power and no QTIP election had been made.

The Tax Court held that the executor for the surviving spouse had a sufficient identity of interest with the executor for the estate of the predeceased husband to be bound by a duty of consistency, and that the duty applied here because IRS "did not know or have reason to know the operative facts and circumstances underlying the position taken on [the earlier, closed] return."

By contrast, in *Estate of Posner v. Commissioner*, T.C. Memo 2004-112, the executor again argued that the survivor's estate should not be taxed on the value of a trust for which the executor for the predeceased spouse had claimed a marital deduction, again because the survivor did not in fact have a general power to appoint the trust remainder, but here the Tax Court determined that the duty of consistency did not apply.

Unlike the situation in *Letts*, here the executor for the predeceased spouse had attached a copy of the trust instrument to the return claiming the marital deduction, and it appears that the surviving spouse herself, and the various contingent remainder beneficiaries, believed that she did have a general power.

After her death, however, when it emerged that she had exercised her supposed power to disinherit two of her daughters, the beneficiaries engaged in fiercely contested litigation, which resulted in a state court declaratory judgment, affirmed by an appeals court, that the survivor in fact had no power to appoint the trust remainder at all.

In these circumstances, the Tax Court determined that the executor for the survivor's estate was not bound by a duty of consistency.

What we meant to say

A somewhat similar problem arises where the executor for the predeceased spouse claimed a QTIP marital deduction in one state, but the surviving spouse has died resident in another state. But here we at least arguably have the additional problem of the authority of a state to tax a transaction that occurred elsewhere.

In *Estate of Brooks v. Commissioner*, 325 Conn. 705, 159 A.3d 1149 (2017), the Connecticut supreme court affirmed the decision of a trial court, on cross-motions for summary judgment, that the state does have authority to tax the value of a QTIP trust in the estate of the survivor, despite the fact that she had only a limited power to appoint the remainder -- *i.e.*, she arguably did not "own" the trust assets within the meaning of the relevant tax statute --, and despite the fact that the trust had been created under a will that had been probated in another state.[fn. 3]

The executor had taken an extension on the return, paying an estimated tax, and then sought a refund, claiming the trust was not includible in the decedent's estate for purposes of the Connecticut estate tax. Because the estate of the predeceased spouse had been taxed in Florida, he argued, the survivor had not received a "tax benefit" from the state of Connecticut that would justify inclusion. And her limited power over the trust remainder would not otherwise require inclusion.

And there was an additional wrinkle here.

The statute in effect at the date of the survivor's death in 2009 appeared to tax only the transfer of property "owned by" a decedent. That language was amended in 2013 to define the tax base with reference to a decedent's "gross estate" for federal estate tax purposes, but on its face the amendment appeared to apply prospectively only.

It was only later, in a subsequent session, that the legislature adopted language stating that the 2013 amendment was intended to "clarify" existing law, and applied to "all open estates."

The state supreme court rejected the executor's argument that this amounted to a retroactive substantive change in the law, contravening the fourteenth amendment due process clause. The legislature said it was "clarifying," not changing the law, and we will take them at their word. [fn. 4]

The fictional transfer

Finally, the court rejected the executor's argument that allowing Connecticut to impose a tax on a "fictional transfer" by the surviving spouse, where the "actual transfer" had occurred years previously in another state, would in itself violate the due process clause. The discussion on this point comprises not quite half the length of a twenty-page opinion (not counting three pages of footnotes).

The executor cited a 1931 decision, *Coolidge v. Long*, 282 U.S. 582, in which the federal Supreme Court had ruled that both the due process clause and the "contracts clause" precluded the state of Massachusetts from imposing an inheritance tax on the "succession" to the remainder beneficiaries of a trust that was already irrevocable when the statute was enacted.

The remainders were vested, the Court said, albeit subject to defeasance if a remainderman did not survive the preceding life interests reserved by the trust settlors, so that there was no "transmission" at the death of the surviving settlor on which the state could properly impose an excise after the fact.

The Connecticut court acknowledged that *Coolidge* has never been expressly overruled, but said the rationale of that decision had been "sharply criticized" in later cases, notably *Fernandez v. Weiner*, 326 U.S. 340 (1954), in which the Court ruled that the federal estate tax could properly be imposed on the share of community property already held by the surviving spouse,[fn. 5] reasoning that the tax was not a tax on "transfers" as such, but on "the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property."

Numerous decisions are cited in *Fernandez*, incidentally, to the effect that the federal estate tax is not a "direct" tax, a nonuniform excise, etc., and upholding the imposition of the tax on joint tenancies, tenancies by entireties, etc. The seminal case on the authority of a state to tax a "succession" where the successive interest had already vested before the tax statute was enacted is probably *Moffitt v. Kelly*, 218 U.S. 400 (1910), affirming a decision of the California supreme court validating an "inheritance" tax on the survivor's interest in community property.

But then we still have the question whether a state may tax a "succession" occurring at the death of a resident, where the vested successive interest had been created in another state and affected only intangible assets, which have no physical situs.

The *Brooks* court cited *State Tax Commission of Utah v. Aldrich*, 316 U.S. 174 (1942), in which the Supreme Court ruled that the state of Utah could properly tax a bequest by a New York decedent of stock he had held in a closely held Utah corporation. That decision expressly overruled *First National Bank of Boston v. State of Maine*, 284 U.S. 312 (1932), which the Court had decided only a decade earlier.

Here, the decedent had lived in Connecticut for sixteen years, and had received income from the trust throughout that interval. "This nexus," said the *Brooks* court, "is sufficient for due process."[fn. 6]

But of course, the analogy is inexact.

In *Aldrich*, the intangible property had a situs in the taxing state, but the decedent was a nonresident. In *Brooks*, the situation is reversed.

The logic of the *Aldrich* decision was that the closely held corporation owed its existence to the state of Utah, whose law defined the nature and extent of the shareholders' interests and afforded protection for those rights. But the only meaningful connection between the Brooks trust and the state of Connecticut was that the decedent's will exercising her limited power to appoint the remainder was probated in that state. And the court pointedly did not include this as a factor in its "nexus" analysis [again see fn. 6].

On the other, other hand

A few months back, the intermediate appeals court in Maryland reached the opposite result on the nexus question, where the surviving spouse apparently had no power to appoint the trust remainder.

The case was *Comptroller v. Taylor*, No. 2198 (07/25/18). The court of special appeals affirmed a trial court decision which had reversed the decision of the state tax court affirming the comptroller's assessment of tax and interest, but waiving late payment penalties.

The executor had subtracted the value of a QTIP trust -- which he had reported on the federal return -- from the Maryland estate for the surviving spouse. He attached a statement to the state return, noting that the estate of the predeceased spouse had been taxed twenty-odd years earlier in Michigan and asserting that because no QTIP election had been made on a Maryland return, the survivor's estate should not be taxed in Maryland on the trust remainder.

Specifically, the executor argued that section 7-309(b)(6) of the Maryland tax code expressly conditions inclusion in the estate of the survivor on the QTIP election having been made "on a timely filed Maryland estate tax return" for the predeceased spouse. Why this is something of a misreading we will get to in a moment.

In any event, the state tax court was not buying it, and instead agreed with the comptroller that section 7-301(c) of the state tax code defines the "Maryland estate" with reference to the "federal gross estate," which per section 2044 includes the value of a QTIP trust for which a federal election was made, period.

But the circuit court reversed, the comptroller appealed, and the court of special appeals affirmed. No inclusion because there had been no QTIP election on a Maryland return.

Or, well, no, it was not quite as simple as that. No inclusion because the state did not have authority to tax a trust remainder over which the decedent had "no power of disposition," if the only reason it was included in her federal gross estate was because of a "fiction" created by the QTIP election, but there had been no corresponding tax benefit derived from an election on a Maryland return.

Let's break this down a little.

What section 7-309(b)(6), the statute the executor cited, says is that if a QTIP election was made on a Maryland return for the predeceased spouse this is sufficient to cause inclusion in the estate of the survivor. It does not expressly state whether such an election is or is not a necessary condition. Dim memories here of propositional logic 101.

This language was enacted in 2006 as part of a larger bill responding to the phaseout and repeal of the federal credit for state succession taxes paid and its replacement with a deduction, and anticipating the repeal of the federal estate tax altogether -- which might have been permanent, who knew. Section 3-709(b)(3) disconnects the state exclusion amount from the federal exclusion amount.[fn. 7]

The provisions at issue, paragraphs (5) and (6) of subsection (b), deal with the situation in which an executor for the predeceased spouse might have made a QTIP election on a Maryland return but not on a federal return. This could happen whenever the gross estate is larger than the state exclusion amount but smaller than the federal exclusion amount, and it could happen if there were no federal estate tax. And these are the scenarios the legislature had in mind.

Specifically what these two paragraphs say is that while the executor need not make consistent elections on the state and federal returns, if she makes the election on a Maryland return this will be "deemed" to be an election on a federal return, causing inclusion in the estate of the survivor under section 2044 -- regardless what is the actual reporting on a federal return for the survivor. And section 3-701(b) completes the circle by increasing the survivor's "federal gross estate" to reflect this inclusion.

None of this directly implies anything about the effect of a QTIP election that was made on a return in another state.

The limits of state taxing power

However. Section 7-301(c) does say the "Maryland gross estate" is only that part of the federal gross estate that the state "has the power to tax." Which brings us back to nexus. And here it must be said that the opinion in *Taylor* is perhaps not a model of clarity.

On the one hand, the court expressly declines to take up the constitutional question, and instead purports to decide the case as a matter of statutory construction. On the other hand, the court does talk about what the legislature may have understood the limits of the state's taxing power to be.

And it arguably misreads section 7-309(b)(6) as setting a necessary condition, rather than merely a sufficient condition, for inclusion of a QTIP trust in the Maryland estate of the surviving spouse.

But despite all this, the court may have reached the "right" result.

On the question what limitation might be implied by the reference at section 7-301(c) to the state's "power to tax," the court cites *Safe Deposit & Trust Co. of Baltimore v. Bouse*, 181 Md. 351 (1943), in which the state's high court had determined that a state inheritance tax could apply to the vesting of contingent remainders in a testamentary trust, where the decedent had died some years before the tax statute was enacted.[fn. 8]

Here we are concerned with an estate tax -- that is, a tax on the deemed transfer of the trust remainder by the surviving spouse -- not an inheritance tax, which would be a tax payable by the remainder beneficiaries on the privilege of receiving trust remainder.[fn. 9] But the point the appeals court was trying to make is that the equitable interests of the surviving spouse and of the remainder beneficiaries were established and enforceable under Michigan law, and that apart from "the fiction created by the QTIP election," the surviving spouse did not have a taxable "power of disposition" over the trust remainder.[fn. 10]

Bottom line, the Maryland court takes a decidedly different view from the Connecticut court on the question whether the mere fact that the surviving spouse lived in Maryland for twenty years while she was drawing income from the trust was enough to subject the remainder at her death to a state succession tax. [fn. 11]

It appears the comptroller has not petitioned the Maryland appeals court for review.

digressions

[fn. 1]

In a footnote, the court observed that the executor for the predeceased husband also did not elect "certain income tax benefits in lieu of the benefits of estate tax repeal," *i.e.*, did not file Form 8983 allocating basis increases as mentioned above.

[fn. 2]

This manner of reporting was consistent with a technical memorandum the state tax department had issued in 2010 specifically to cover the issue. The memorandum asserted that if a QTIP election were made for purposes of the state tax, the trust remainder would be includible in the survivor's estate.

The surrogate's court noted that the memorandum was "merely a statement of the tax department's position and has no legal effect."

[fn. 3]

On the same day as the lower court decision in *Brooks*, the same trial court also entered a decision in a case styled *Terrell v. Commissioner*, again concluding that a QTIP trust was includible in the gross estate of the surviving spouse, here despite the fact that the then present value of the remainder had already been taxed in the estate of the predeceased spouse under a "succession" tax regime, since repealed, that did not allow a marital deduction.

The court rejected the argument that this amounted to a "double" tax. Apparently the executor in that case did not appeal.

[fn. 4]

Jack has not yet been able to retrieve legislative history for the 2013 bill, but would note that the issue had come up at least twice in contested cases, *Brooks* and *Terrell* (see fn. 3 above), before the legislature acted to "clarify" that "owned by" does not mean "owned by."

[fn. 5]

It should be noted that *Fernandez* did not involve a tax that was enacted after the relevant property interests had already been created, *i.e.*, we are not concerned here with retroactivity. But see *Moffitt*, below.

[fn. 6]

In a footnote the court mentioned three additional factors: the decedent had acted as trustee of the QTIP trust, she had exercised her limited testamentary power to appoint the remainder, and the will exercising the power was probated in Connecticut. But by relying only on the fact of her residence, the court in effect said these additional factors were not necessary to establish a taxable nexus -- thereby pre-empting some future case in which the survivor either did not have a limited power to appoint the trust remainder or did not not exercise it.

[fn. 7]

The legislative history available online is rather sparse. The language at issue here was added to the bill after the initial hearing before the senate budget and taxation committee. But we have no hearing transcripts or drafting committee reports.

[fn. 8]

Unfortunately, the text of the *Bouse* decision is not available online, so we have no link to share.

What the *Taylor* court omits to note is that in response to that decision, the state legislature immediately -- while the case was still pending on remand -- adopted an emergency measure disclaiming its intention to apply the inheritance tax statute retroactively to "estates of persons dying prior to" its enactment. See, Charles G. Page, Maryland Death Taxes, 25 Md. L. Rev. 89 (1965).

[fn. 9]

Maryland does also have an inheritance tax, but it applies only to property that has a tax situs in the state.

[fn. 10]

In this latter connection, the court cited *Graves v. Elliott*, 307 U.S. 383 (1939), a five to four decision in which the majority ruled that New York could properly tax a trust holding intangibles said to have a Colorado situs, where the settlor, who at her death was a resident of New York, had retained powers to change the beneficiaries, to replace the trustee, or even to revoke the trust, revesting the title in herself.

The dissent, authored by Justice Holmes, observed that the result was to allow two states to tax the same transfer.

[fn. 11]

By saying the surviving spouse had "no power of disposition," the court seems to imply that she had not even a limited power to appoint the remainder. Jack does not have information to the contrary. The tax court decision does not say anything on this question, and the full text of the circuit court's decision is not available online.

But again, the Connecticut court in *Brooks* made a point of not relying in its analysis on the fact that the surviving spouse there did have a limited testamentary power and had exercised it in a will probated in Connecticut.

postscript

Just as we were going to press, IRS published proposed regulations that would forgo "clawback" in the estate of a taxpayer who dies after 2025 of gifts she might have made while the applicable exclusion amount is temporarily doubled. The comment period closes February 21.

Jack is inclined to say "this is an outrage," but of course nothing is ever quite as simple as it might at first appear.

In enacting this temporary amendment to section 2010(c)(3), the Congress did give the Treasury authority to "prescribe such regulations as may be necessary or appropriate to carry out this section" -- the Joint Committee commentary says "to carry out *the purposes of* the section" (emphasis supplied), but this distinction is not expressed in the statutory language -- "with respect to any difference between" the exclusion amount in effect at the date of a taxpayer's death and the amount in effect when a gift is made.

The "clawback" issue is within the range of concerns of the Greystocke Project, and it is likely an upcoming issue of Jack Straw will include at least a draft text of formal comments we will be submitting.

Jack says,
when Black Friday comes, gonna wear no socks and shoes