**DELAWARE TAX INSTITUTE NOVEMBER 2015
RECENT DEVELOPMENTS IN THE FEDERAL
ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX AREAS**

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# **Estate of Donald Woelbing v. Commissioner (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013) and Estate of Marion Woelbing v. Commissioner (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013)**

Donald Woelbing owned the majority of the voting and nonvoting stock of Carma Laboratories, Inc., the maker of Carmex skin care products. In 2006, Mr. Woelbing sold all of his Carma nonvoting stock to a trust in exchange for an interest-bearing promissory note in the amount of $59 million, which was the fair market value of the stock determined by an independent appraiser, bearing interest at the appropriate applicable federal rate.

The note contained a defined value provision stating that if the value of the transferred stock was later determined by the IRS or a court to be higher or lower than that set forth in the appraisal, then the number of shares of stock purchased would automatically adjust so that the fair market value of the stock purchased equaled the amount of the note.

The estate took the position that the trust had the financial capability to repay more than 10% of the face value of the promissory note without using the stock itself or its proceeds. Two of Mr. and Mrs. Woelbing’s sons, who were beneficiaries of the trust, executed personal guarantees for 10% of the face value of the promissory note. Among the assets of the trust were three life insurance policies on Mr. and Mrs. Woelbing’s lives which had a combined value of more than $12 million. It is not certain whether the trust’s stated ability to repay 10% of the note was based in part on the guarantees or entirely on the trust’s other assets.

Mr. Woelbing died in July 2009 and Mrs. Woelbing died in September 2013. The IRS challenged the 2006 sale in connection with its audit of Mr. Woelbing’s estate tax return. For gift tax purposes, the IRS stated that the note should be valued at $0 because section 2702 applied and it contested the value of the underlying value of the stock (stating that the stock was worth $116.8 million at the time of transfer rather than $59 million).

For estate tax purposes, the IRS stated that the note should not be treated as an asset of Mr. Woelbing’s estate. Instead, Mr. Woelbing should be treated as having retained the possession or enjoyment of the stock or the right to designate the persons who shall possess or enjoy the stock and that the stock under section 2036 and the right to alter, amend, revoke or terminate the enjoyment of the stock under section 2038. The IRS also argued that the value of the stock at the time of Mr. Woelbing’s death was $162.2 million.

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**II. Cavallaro v. Commissioner, T.C. Memo 2014-189 (September 17, 2014)**

Mr. Cavallaro was a began a career in the tool making industry, first as a janitor, and eventually as a production manager at Northeastern Tool Co. In 1979, Mr. and Mrs. Cavallaro started Knight Tool Company, a machine shop that made tools and machine parts primarily for defense, aerospace and industrial customers. Knight primarily built single, custom tools, at the request of a customer.

After noticing the way in which circuit board were created by adding liquid adhesive to attach parts to the boards, Mr. Cavallaro and his son, Ken, saw an opportunity for Knight to produce a machine that could more efficiently dispense the liquid neatly and repetitively. They hoped such a machine would expand Knight’s business,

Mr. Cavallaro and Ken developed the automated liquid dispensing machine, which they called CAM/A LOT in 1982. In 1987, Mr. and Mrs. Cavallaro’s three sons incorporated Camelot Systems, Inc., with each son receiving an equal 1/3 interest in the new company. Camelot was dedicated to marketing and selling the CAM/ALOT machines, which were made by Knight. The two companies operated out of the same building, shared payroll and accounting services, and collaborated in the further development of the CAM/ALOT product line. Knight funded the operations of both companies and paid the salaries and overhead costs for both.

In 1994, after the CAM/ALOT machines became successful, the family agreed to merge the two companies primarily for estate planning purposes. A valuation prepared by the Cavallaros’ accountants that determined that the combined entity was worth between $70-$75 million, and only allocated $13-$15 million to the value of Knight; the balance of the value was in Camelot due to the CAM/ALOT technology. As a result of the merger, Mrs. Cavallaro received 20 shares of the combined company, Mr. Cavallaro received 18 shares, and their three sons, Ken, Paul, and James, each received 54 shares. Therefore Mr. and Mrs. Cavallaro, as the former shareholders of Knight, received 19% of the combined company, and their sons, as the founding shareholders of Camelot, received 81% of the combined company. The Tax Court determined that Knight, rather than Camelot, owned the CAM/ALOT technology, and, as a result, the Court found that the accountant overstated the relative value of Camelot and understated the relative value of Knight at the time of the merger, and that Mr. and Mrs. Cavallaro conveyed disproportionate value to their sons in amounts totaling $29.6 million.

In 1996, Camelot was sold for $57 million in cash with a contingent additional amount of up to $43 million in potential deferred payments based on future profits. No further payments were made after the 1996 sale.

Several valuations were presented and reviewed by the Court but the primary factor was the Court’s determination that, contrary to the taxpayers’ arguments, the CAM/ALOT technology was owned by Knight rather than Camelot.

This case has been appealed to the First Circuit.

**III. Specht v. U.S., 2015 WL 74539 (S.D. Ohio 2015) (January 6, 2015)**

In this case, the Ohio district court held that an estate was liable for $1.2 million in late filing penalties and interest relating to its estate tax return, despite the executor's having relied on an attorney who was suffering from brain cancer and who erroneously failed to file the return. The attorney was an experienced trusts and estates practitioner, and the executor was unaware of her illness. As a result of the malpractice, the attorney voluntarily relinquished her law license and was declared incompetent.

Plaintiffs filed this case on behalf of the estate of Virginia Escher, seeking to recover the sum of $1,198,261.38 in penalties and interest, which the IRS imposed upon the Escher estate as a result of its failure to timely file its estate tax return and to pay the tax owing in a timely fashion. The legal question for the Court was simple: Whether plaintiffs' failure to timely file the estate tax return and to timely pay the taxes was due to reasonable cause and not willful neglect. However, as the Court noted, the factual circumstances were complex and sad.

Virginia Escher died at the age of 92 with an estate valued at just over $12.5 million. Ms. Escher’s cousin, Janice Specht, was asked to be the executor of Ms. Escher’s estate. Mrs. Specht was then age 73, was “a high-school-educated homemaker who had never served as an executor, held no stock, and had never been in an attorney's office.” Mrs. Specht hired the decedent's attorney, Mary Backsman, to assist with the administration of the estate.

Ms. Backsman had over 50 years of experience in estate planning, but unbeknownst to Specht, was battling brain cancer, and she deceived Mrs. Specht (whether intentionally or unintentionally), as to the status of an extension regarding the filing of the estate's tax returns. That deception eventually led to malpractice claims and the voluntary relinquishment of the attorney's law license. In a separate proceeding, Ms. Backsman was declared incompetent and subject to a guardianship over her person and estate.

The plaintiffs argued that because they relied on their attorney, the failure to timely file the return and pay estate taxes was due to "reasonable cause". The Court noted that reasonable cause is not defined in the Internal Revenue Code but that the Treasury Regulations require the estate to demonstrate that it exercised ordinary business care and prudence but nevertheless was unable to file the return within the prescribed time. In United States v. Boyle, 469 U.S. 241, 246 (1985), the U.S. Supreme Court held that "[t]he 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 Section 6651(a)(1)." In Boyle, the Court recognized a distinction between a taxpayer’s reliance on the advice of counsel concerning a question of law and the reliance on an attorney to attend to "an unambiguous, precisely defined duty to file" a return by a certain time.

In addition, under Boyle, to escape penalties under Section 6651 of the Code, the estate was also required to meet the heavy burden of proving that the late filing and payment did not result from willful neglect, which is "a conscious, intentional failure or reckless indifference." However, mere carelessness is enough for a taxpayer to be denied a refund based on the exceptions in Section 6651 of the Code. According to Boyle, "[a] taxpayer seeking a refund must therefore prove that his failure to file on time was the result neither of carelessness, reckless indifference, nor intentional failure."

The Court determined that Mrs. Specht was aware that the estate's federal tax return needed to be filed and paid nine months after decedent's death, was aware of the approximate amount of the tax that would be due, and was aware that the estate would need to sell certain stock to cover the tax liability. The Court also determined that Mrs. Specht understood that the deadline was important, and that missing the deadline would result in consequences. In the months prior to the estate tax deadline, Mrs. Specht received numerous notices from the probate court informing her that the estate was missing deadlines. After the deadline, Mrs. Specht received additional notices from the court warning that the attorney had failed to file an accounting, numerous calls informing her the attorney was incompetent, letters from the Ohio Department of Taxation informing her the state tax return was delinquent, and a warning from another lawyer (whom Mrs. Specht eventually hired) informing her that she needed to hire another attorney.

Although the Court noted that serving as the executor is not an easy task and noted the difficulty in holding that Mrs. Specht was responsible for her attorney’s malpractice, binding precedent required it to do so. The Court noted that in light of the attorney's malpractice, the State of Ohio refunded the late filing and payment penalties for Ohio estate taxes without the estate filing a refund suit, and that it was unfortunate that the United States did not follow the State of Ohio's lead.

IV. Thomas H. Smoot III, Executor v. Dianne M. Smoot, 2015 TNT 69-13, No. 2:13-cv00040 (U.S.D.C. S.D. Ga.) (March 31, 2015)

Thomas H. Smoot, II, an insurance broker, died on February 16, 2009. The beneficiaries of Mr. Smoot’s estate included Mr. Smoot’s son, Thomas H. Smoot, III, and Mr. Smoot’s ex-wife, Dianne Smoot.

Thomas H. Smoot, III, as the executor of his father's estate asked the court to require that the decedent's ex-wife, who was named as the beneficiary of various life insurance policies and retirement plans contribute a proportionate share of the estate taxes due with respect to such assets, as well as a portion of the attorney’s fees and costs.

Dianne Smoot received approximately $5.5 million as a result of Mr. Smoot’s death. Thomas III received approximately $2.2 million, and another beneficiary received approximately $100,000. Thomas III requested that Dianne pay federal estate taxes (and interest thereon) in an amount proportionate to the share of the assets she received. The total amount due was approximately $1.4 million.

Mr. Smoot’s will required that all estate taxes, except for GST taxes, be paid by the recipient of the property. The Court found that Mr. Smoot had incidents of ownership in the insurance policies payable to his ex-wife and therefore that the proceeds of that insurance were includible in his estate. Further, the Court held that under IRC Section 2206, Mr. Smoot’s ex-wife was responsible for the share of estate taxes, plus interest, for the portion of the estate tax related to insurance policy proceeds that were includible in the estate but not payable to the estate.

However, the Court ruled that Mr. Smoot’s ex-wife was not required to pay a pro-rata share of estate tax related to retirement plan assets, including IRA, 401(k), annuity and deferred compensation, because under Georgia law, the provisions of the will requiring apportionment of taxes as related to an ex-spouse were nullified upon divorce when the will was written without contemplation of divorce or annulment of the marriage. Retirement plans are not included within the scope of IRC Section 2206. Further, because Mr. Smoot’s ex-wife did not act in bad faith, she was not required to pay any attorney fees.

**V. Mikel v. Comm’r., T.C. Memo 2015-64, Docket Nos. 16538-13 and 16563-13** (**April 6, 2015)**

The Tax Court ruled, on summary judgment, that $1.44 million of property gifted through Crummey withdrawal rights (based on withdrawal rights of $24,000 each granted to each of 60 beneficiaries) qualified for the gift tax annual exclusion.

In 2007 the donors, husband and wife, created a $3.3 million gift trust granting 60 beneficiaries, many of whom were minors or spouses of immediate family members, annual rights of withdrawal. The trust provided that if a beneficiary exercised his or her withdrawal rights, the property must be distributed immediately. In 2011 the donors filed separate gift tax returns reporting these gifts and claiming an annual exclusion of $720,000 based on the present interest gifts to each of the beneficiaries. The IRS denied that the gifts qualified as present interest gifts because they did not have a legal remedy to enforce its terms.

Under the terms of the trust, the beneficiaries were required to make a claim on their share of the funds within sixty days of receipt of the Crummey notice. The trust also provided for discretionary distributions to the beneficiaries for wedding expenses, buying a home or entering a profession. Any dispute about the proper interpretation of the trust was to be submitted to arbitration of a three-person panel of Orthodox Jews called a “beth din.” The trust also contained an in terrorem provision which stated that any beneficiary who challenged the discretionary acts of the trustees “in any court, arbitration panel or any other manner,” would lose all beneficial rights in the trust.

The IRS claimed that the beneficiaries lacked a present interest in the trust because they had no practical legal remedy to enforce its terms. If a trustee refused to disburse funds and the beth din upheld that decision, the in terrorem clause would act to discourage the beneficiary from seeking recourse in the state courts.

However, the Tax Court ruled that the IRS did not properly interpret the terms of the trust. It stated that the beneficiaries had a present interest in the trust property because they had an unconditional right to withdraw property from the trust and the trustees would not “legally resist” their demands for withdrawal. Thus the in terrorem clause had no effect on the beneficiaries’ exercise of their withdrawal rights.

**VI.** **Estate of William Davidson, Tax Court Docket No. 13748-13, petition filed June 14, 2013)**

William M. Davidson, in addition to being the owner of the Detroit Pistons, was the president, chairman, and chief executive officer of Guardian Industries Corp., which is one of the world’s largest manufacturers of glass, automotive and building products. Prior to December 2008, Mr. Davidson owned 78% of the common stock of Guardian.

In December 2008 and January 2009, when Mr. Davidson was 86, he engaged in various gift, substitution, and sale transactions. The sale transactions involved the sale of portions of Mr. Davidson’s stock in exchange for self-canceling installment notes (SCINs). The SCINS provided for annual interest payments and balloon payments of principal in five years. Although the mortality tables under section 7520 provided that Mr. Davidson’s life expectancy at the time of the sale was 5.8 years, he died on March 13, 2009, before receiving any payments in connection with the SCINs.

Two SCINs involved stock worth hundreds of millions of dollars. One of the SCINs imposed interest at the applicable federal rate under 7520 with an 88% principal premium, and the other used the 7520 rate with a 13.43% interest rate premium. Addressing Mr. Davidson’s sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS argued the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson’s health. Even though four medical consultants, two chosen by the executors and two chosen by the IRS, all agreed on the basis of Mr. Davidson’s medical records that he had had at least a 50 percent probability of living at least a year in January 2009, the IRS saw the notes as significantly overvalued because of his health, and claimed that the difference in value was a gift. The IRS claimed that the combined gift, estate, and GST tax deficiencies were well over $2.6 billion (although the IRS acknowledged that it did not calculate certain deductions and credits to which the estate may have been entitled).

This case settled on July 6, 2015. In the settlement, gift taxes for prior years were increased by approximately $186.6 million, the GST tax for lifetime transfers was increased by approximately $48.6 million, and the total estate tax was increased by approximately $152.5 million. However, the GST tax owed on the estate tax return was reduced by $450,000.