ESTATE PLANNING COUNCIL
OF CLEVELAND

Tax Update

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COURT CASES

Hurford Investments No. 2, Ltd. v. Commissioner, Order on Motion for Summary Judgment, U.S. Tax Court Docket No. 23017-11 (4/17/2017). This current Tax Court action is an outgrowth of the estate tax case *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (12/11/2008), where the Tax Court had held that certain phantom stock in Hunt Oil Company, which had been contributed to a family limited partnership, was includable in a surviving spouse's taxable estate after she had inherited it from her pre-deceased husband. This ongoing case deals with the aftermath of that estate tax inclusion case, i.e. after Hunt Oil redeemed the phantom stock and distributed cash to the partnership, what were the income tax consequences of that distribution.

Gary Hurford was a long time employee of Hunt Oil, and was awarded a deferred compensation benefit termed "phantom stock", in that the value of the award was tied to the stock value of the company. The phantom stock was included on the estate tax return for Gary after his death. His death triggered a five year countdown period where the phantom stock would adjust with the company value, and a mandatory redemption of the phantom stock account would occur after five years. Upon his death, Thelma Hurford inherited it. She later transferred the phantom stock to the family partnership. Hunt Oil adjusted its books and records to reflect Hurford Investments No. 2 as the owner of the rights.

For reasons not fully explained to the court, the partnership reported a short term capital gain upon its receipt of the phantom stock from Thelma. At the transfer in 2000, the phantom stock was worth $6.4 million, and upon Thelma's death in 2001 it was worth $9.6 million. After the end of the five year countdown, Hunt Oil redeemed the phantom stock, and in 2006 distributed about $13 million to the family partnership. The partnership included $6.5 million of ordinary income on its 2006 partnership tax return (the proceeds less basis equal to what the partnership recognized as capital gain at the transfer).

The IRS and the taxpayer are before the Tax Court with differing positions on the effect of the 2006 redemption for income tax purposes. The IRS has changed its position during the examination, and argued that the estate tax case in Tax Court showed that the FLP was not a valid partnership, so Thelma really owned the phantom stock at death, and the phantom stock is deferred compensation, not a capital asset, so it can only produce ordinary income. The partnership argues that in its hands the phantom stock became a capital asset, and also that since the phantom stock was included in Thelma's taxable estate by virtue of the estate tax litigation, basis in the asset should adjust up to date of death value. The Tax Court agreed with the partnership that under Code Section 1221 the phantom stock became a capital asset after it was transferred by Thelma, the redemption by Hunt Oil was a sale or exchange of that capital asset, and the inclusion of it in Thelma's taxable estate caused a basis step up.

In the Matter of Estate of Vose, 2017 OK 3, 390 P.3d 238 (2/21/2017). The Oklahoma Supreme Court concluded that an executor can be required to elect portability by filing a federal estate tax return to make the election. This determination was in spite of the fact that the decedent and the surviving spouse had a prenuptial agreement with provisions that they each waived all rights to each other's estate.

Anne Vose died in 2016, survived by C.A. Vose and her two children from a prior marriage. Along with waiving rights to each other's estate in the prenuptial agreement, they also waived the right to serve as each other's executor. The agreement was signed in 2016 and did not include any mention of portability, which of course was not law at the time.

Anne's son was appointed administrator of the estate. C.A. Vose eventually filed a motion in state district court to force the son to file a timely estate tax return for purposes of portability and to obtain Mrs. Vose's unused exemption (the DSUE). The local court granted the motion and the administrator appealed to the state Supreme Court. The Supreme Court agreed with the local court ruling, and found that (i) the court had jurisdiction over the federal estate tax issue as it related to the fiduciary duties of an estate administrator to estate beneficiaries, (ii) the spouse's interest in the DSUE was not barred by the prenuptial agreement, since it could not have been waived when the law did not exist at the time, (iii) the DSUE is not an estate asset the rights to which can be waived in a marital agreement, (iv) the administrator's fiduciary duties to all estate beneficiaries compelled taking action to preserve the DSUE, since the surviving spouse was the only person who could benefit from it.

IRS RULINGS AND ANNOUNCEMENTS

Trust Division, PLR 201709020 (3/3/2017). The letter ruling involved a desired division of an irrevocable trust holding S corporation stock, among other assets. The taxpayer sought favorable rulings on estate, gift, GST and income tax consequences on the change.

When the trust was funded, GST exemption was applied to achieve an inclusion ratio of zero. The trustee has full discretion to distribute income and principal among the grantor's living descendants (currently seven children as well as grandchildren) and a Family Trust. Upon the grantor's death, separate trusts would be created for the descendants, and each separate trust would be further divided into a subtrust holding the S corporation stock allocated to that descendant, and another holding all other assets allocate to that descendant. The S corporation trust share would be a QSST with all income distributed to the beneficiary. The other trust provides for discretionary distributions of income.

The trust and the beneficiaries filed a petition with the local court to be allowed to alter the trust instrument and split the non-S corporation share of the current trust into eight separate trusts now before the grantor's death, one for the benefit of each child and one for the benefit of the Family Trust. The grantor's spouse is the initial trustee of each separate trust. Each trust would receive a pro rata share of each asset (except the S corporation stock). The requested rulings, each of which the IRS granted, were:

1. The eight trusts would not be includable in the grantor's or the spouse's taxable estate. They represented that the spouse would not transfer any assets to the trust, and the trust would not acquire insurance on the spouse's life.
2. The transfers into each of the new separate trusts would not cause a taxable gift. The beneficiaries have substantially the same beneficiary interest, rights and expectations after the trust division.
3. The GST inclusion ratio of zero will not be altered as a result of the current trust being divided into eight separate trusts. Here, as provided in Regulation Section 26.2601-1(b)(4), the reformation of the trust would not change the inclusion ratio since the modification is not shifting the beneficial interest of any beneficiary skip person, and did not extend the time for vesting beyond the original trust.
4. The pro rata transfer of each asset will not cause an income realization event under Code Sections 61 or 1001, and each asset will have carryover basis.