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Tax Court case shows dangers of last-minute estate planning

In *W. E. DeMuth, Jr. Est.*,[1] a decedent's estate was forced to include the value of several checks that might otherwise have been excluded as completed gifts. In 2007, William DeMuth executed a power of attorney granting his son, Donald, authority to make gifts to the father's issue in amounts not to exceed the annual gift tax exclusion amount. From 2007 through 2014, Donald made annual gifts to various family members.

By 2015, William DeMuth was seriously ill, and in early September, his condition worsened to the point of near death. On Sept. 6, Donald wrote 11 gift checks. Ten were in amounts matching the exclusion amount applicable for 2015 ($14,000 per donee or $28,000 for joint gifts). The other check was for $240,000. All were written from an investment account at Mighty Oak Strong America Investment Company.

On Sept. 11, 2015, William DeMuth died.

The following sequence illustrates what happened with payment of the 11 checks:

- Sept. 9, 2015: The first check (in the amount of $28,000) was paid by Mighty Oak.
- Sept. 14, 2015: Three checks (the first two for $28,000 and the third for $14,000) were paid.
- Sept. 15-30, 2015: Seven checks totaling $352,000 were paid.

On the decedent's federal estate tax return, the decedent's son, acting as executor, excluded the value of the 11 checks ($464,000) from the decedent's gross estate. The IRS did not agree with this characterization and issued a notice of deficiency based on its reasoning that $436,000 — representing the 10 checks that were not paid by Mighty Oak until after the decedent's death — was improperly excluded from the gross estate.

Deciphering the Code

In general, Code Sec. 2031(a) says "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

> "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

In addition, Code Sec. 2033 states "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

More specifically, with respect to the issues in DeMuth, the applicable regulations under Code Sec. 2031[2] clarify the treatment of cash in a decedent's estate:

"The amount of cash belonging to the decedent at the date of his death, whether in his possession or in the possession of another, or deposited with a bank, is included in the decedent's gross estate. If bank checks outstanding at the time of the decedent's death and given in discharge of bona fide legal obligations of the decedent incurred for an adequate and full consideration in money or money's worth are subsequently honored by the bank and charged to the decedent's account, the balance remaining in the account may be returned, but only if the obligations are not claimed as deductions from the gross estate."

Accordingly, the Tax Court observed, checks issued by a decedent before death that constitute completed gifts during their lifetime would not be includible in their gross estate. In turn, the question becomes what constitutes a completed gift? For the answer, it is necessary to look to the Code and regulations governing taxable gifts. In that regard, Reg. §25.2511-2(b) provides, in part, that a gift is complete "… as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another …"

Pennsylvania law controls

The Tax Court went on to note that, although federal law governs the taxation of an interest, the legal status of that interest is controlled by state law. At the time of the gifts and his subsequent death, the donor was domiciled in the Commonwealth of Pennsylvania. Consequently, Pennsylvania law determined when a check becomes a completed gift. In its analysis, the Tax Court noted the language in the Pennsylvania Commercial Code governing the stop-payment of a check.[3] Following that language, if the drawer of a check is still able to make a stop-payment order, the delivery of that check is revocable.

The Pennsylvania Commercial Code also addresses the point at which a drawer can no longer make a stop-payment order and the check becomes irrevocable. The earliest time this could occur, and a gift check could be complete, is when the drawee bank accepts, certifies or makes a final payment of the check. Consequently, the Tax Court concluded that "Mighty Oak did not accept, certify or make final payment on any of the 10 checks at issue until after the decedent's death." The inquiry could have stopped there, with all 10 of the checks paid after the decedent's death includible in the donor's gross estate. However, a misunderstanding among the parties and a concession in the IRS brief submitted in the case led to a different result.

A misunderstanding makes a difference

The Tax Court went on to analyze a misunderstanding between the IRS and the estate concerning the terms "drawee bank" and "depository bank." In the Pennsylvania Commercial Code, the drawee bank is the one ordered in a draft to make payment.[4] Alternatively, a depository bank is where a payee deposits a check.[5] The Court further noted that the depository bank is not always the same entity as the drawee bank and must somehow present the check to the drawee bank for payment.[6] The terms are not interchangeable.

The mistaken reference to the payee's depository banks as drawee banks first occurred in the parties' joint stipulation of facts. In that stipulation, it was agreed that on Sept. 11, 2015, three of the Mighty Oak checks were deposited and credited to the accounts of the named payees by their respective drawee banks. Instead, the Tax Court noted, those payees deposited their checks and had their accounts credited by their respective depository banks, not the drawee bank. The mistaken use

of "drawee bank" was repeated in both parties' simultaneous opening briefs, and neither party later recognized the error nor attempted to correct it.

This distinction resulted in an unforced error on the part of the IRS, in that the IRS conceded in its simultaneous opening brief that the three checks at issue were not includible in the decedent's gross estate, presumably because of the mistaken belief that the checks had been "credited by drawee banks" before his death. As noted above, those checks were not credited by Mighty Oak before DeMuth's death.

Finally, the Tax Court considered whether to hold the IRS to its concession concerning the three checks. Although it noted that this case was distinguishable from earlier decisions involving the attempted withdrawal of a concession by the IRS,[7] because the case had been submitted for decision without trial under Tax Court Rule 122, the principle remained the same. The estate relied on the concession and to reverse it now would be prejudicial to the estate. As a result, only the seven remaining checks, which were cashed Sept. 15-30, 2015, were includible in the donor's gross estate. ◆

[1] 124 TCM 22, CCH Dec. 62,080(M), TC Memo. 2022-72.
[2] Reg. §20-2031-5.
[3] 3 Pa. Cons. Stat. §4403(a) (2015).
[4] 13 Pa. Cons. Stat. §3103(a) (2015) and 13 Pa. Cons. Stat. §4105 (2015).
[5] 13 Pa. Cons. Stat. §4105.
[6] 13 Pa. Cons. Stat. §4204 (2015).
[7] *G. Glass*, 56 TCM 764, CCH Dec. 45,196(M), TC Memo. 1988-550 and *P. Cogan*, 40 TCM 1032, CCH Dec. 37,170(M), TC Memo. 1980-328.

Expired and expiring provisions that may affect 2022 tax returns

Several important changes may affect federal income tax returns for 2022 and future years without further legislation:

- Research and expenditures must be amortized under section 174, rather than expensed, beginning in 2022.
- Depreciation, amortization and depletion are not added back to the calculation of adjusted taxable income beginning in 2022 for the section 163(j) business interest limit.
- 100% bonus depreciation begins to phase out in 2023.

Several other temporary tax breaks for businesses and individuals expired at the end of 2021 that Congress typically extends on a regular basis.

Section 174 amortization of research expenditures

One of the most dramatic potential changes for the 2022 tax year is the deduction of research and experimentation (R&E) expenses. Before 2022, a taxpayer could expense and immediately deduct R&E expenses when paid or incurred, or amortize them over five years (10 years for the alternative minimum tax). Software development costs also could be treated like R&E expenses and either deducted immediately or amortized over five years (or three years from date placed in service).

For tax years beginning 2022, R&E expenditures must be amortized over five years (15 years for foreign expenditures). Amortization must continue even if the underlying property is disposed, retired or abandoned during the period. This includes software development costs without the option to expense.

Business interest limit under Section 163(j)

Another change in tax law involves the calculation of the business interest deduction limit under section 163(j). The deduction is generally limited to 30% of the taxpayer's adjusted taxable income (ATI). The limit was temporarily increased to 50% for 2019 and 2020 for all taxpayers except partnerships (50% for partnerships for 2020 only).

> "Research and expenditures must be amortized under section 174, rather than expensed, beginning in 2022."

ATI is calculated by taking the taxable income for the tax year as if section 163(j) does not apply, then adding and subtracting certain amounts. Amounts added back include deductions for interest, net operating losses and (for tax years beginning before 2022) depreciation, amortization and depletion.

For tax years beginning after 2021, the depreciation, amortization and depletion deductions are no longer added back to taxable income to determine ATI. Thus, ATI is similar to earnings before interest and taxes (EBIT) beginning in the 2022 tax year. As a result, some businesses may find their business interest deduction reduced compared to previous tax years unless legislation extends or removes the change in ATI calculation.

Phase-out of 100% bonus depreciation

One valuable tax benefit available to businesses is a bonus depreciation deduction allowed for a percentage of the cost of qualified property placed in service during the tax year. Qualified property is tangible personal property depreciable under the Modern Accelerated Cost Recovery System (MACRS) with a recovery period of 20 years or less. The cost of the property is its adjusted basis after considering any section 179 expense election. Any remaining cost after the section 179 expense election and bonus depreciation is deducted using regular MACRS depreciation.

The Tax Cuts and Jobs Act expanded the deduction to allow a 100% bonus depreciation deduction for qualified property placed in service through 2022. However, the bonus rate is scheduled to phase out 20% per year beginning in 2023. Thus, the bonus rate for qualifying property (other than long production property and certain noncommercial aircraft) is:

Property placed in service	Bonus rate
Sept. 27, 2017, through 2022	100%
2023	80%
2024	60%
2025	40%
2026	20%

Other expired tax benefits

Other tax provisions expired at the end of 2021 and may not be claimed for 2022 unless Congress extends them. For businesses, these extenders include:

- Three-year recovery period for racehorses under MACRS
- Accelerated depreciation for business property on Indian reservations
- Indian coal production credit
- Indian employment credit
- Mine rescue training credit
- Temporary increase in limit on cover-over of rum excise taxes
- American Samoa economic development credit

For individuals, extenders include:

- Expanded child tax credit
- Expanded child and dependent care credit
- Increased exclusion for employer-provided dependent care assistance
- Special earned income tax credit rules for individuals without qualifying children
- Treatment of mortgage insurance premiums as deductible mortgage interest
- Charitable contributions for non-itemizers
- Increased percentage limits for charitable contributions of cash. ◆

2023 COLAs for retirement plan limits

The IRS has released the 2023 cost-of-living adjustments (COLAs) to retirement plan limits. All pension plan limitations that are affected by COLAs have increased because the increase in the index met the statutory thresholds to trigger their adjustment.

“All pension plan limitations that are affected by COLAs have increased because the increase in the index met the statutory thresholds to trigger their adjustment.“

Employee benefit plans are subject to annually adjusted dollar limitations on benefits, contributions, compensation and other items. Annual benefit limits are generally calculated based on inflation data from the third fiscal quarter of each year. Adjustments are rounded down and may not take effect until certain minimum dollar amounts are reached.

Increased 2023 plan limits

Highlights of the 2023 maximum dollar limitations that changed from 2022 include:

Property placed in service	2022	2023
Elective deferrals	$20,500	$22,500
Catch-up contributions (non-SIMPLE)	$6,500	$7,500
Annual defined benefit limit	$245,000	$265,000
Annual defined contribution limit	$61,000	$66,000
Annual compensation limit	$305,000	$330,000
Limit for key employees in a top-heavy plan	$200,000	$215,000
Grandfathered compensation rule for government plans	$450,000	$490,000
Deferrals for government plans	$20,500	$22,500
Highly compensated employee limit	$135,000	$150,000
Annual contribution for IRAs	$6,000	$6,500
SIMPLE plan employee deferrals	$14,000	$15,500
SIMPLE catch-up contributions for employees age 50 and over	$3,000	$3,500
401(k) catch-up contributions for employees age 50 and over	$6,500	$7,500
SEP coverage	$650	$750
SEP compensation amount	$305,000	$330,000
Tax credit ESOP maximum balance	$1,230,000	$1,330,000
Amount for lengthening of five-year ESOP period	$245,000	$265,000

IRAs

The IRA contribution income phase-out range for single taxpayers covered by a workplace retirement plan in 2023 is $73,000 to $83,000 for singles, up from $68,000 to $78,000 in 2022. For married couples filing jointly in 2023, where the spouse making IRA contributions is covered by a workplace retirement plan, the range is $116,000 to $136,000, up from $109,000 to $129,000 in 2022. For an IRA contributor who is not covered by a workplace retirement plan but whose spouse is covered, the range is $218,000 to $228,000, up from $204,000 to $214,000 in 2022. The range for a married individual covered by a workplace retirement plan and filing a separate return remains $0 to $10,000 for 2023.

The income phase-out range for taxpayers making contributions to a Roth IRA in 2022 is $138,000 to $153,000 for singles and heads of household, up from $129,000 to $144,000 in 2022. For married couples filing jointly, the range in 2023 is $218,000 to $228,000, up from $204,000 to $214,000 in 2022. The range for a married individual who makes contributions to a Roth IRA and files a separate return remains $0 to $10,000 for 2023. ◆

Charitable contribution deduction and conservation easement

The Tax Court determined the charitable contribution deduction amount and valued the conservation easement at the time of donation in a case remanded from the Court of Appeals for the Eleventh Circuit for further consideration consistent with its opinion in *Champions II*, 2020-1 USTC ¶50,134, 959 F.3d 1033, vacating its decision in *Champions I*, T.C. Memo. 2018-146. The taxpayer developed and operated a golf club and claimed a charitable deduction for donating a conservation easement over property that included a private golf course and undeveloped land.

Valuation principles

The Tax Court used a valuation methodology keeping the fair market value of the donated easement equal to the difference between the fair market value of the property encumbered before and after the granting of the restriction, because there was no established market for similar conservation easements and no record of easement sales. The Tax Court concluded the highest and best use of the property before the easement grant was a partial residential development with an 18-hole golf course.

"These three opinions were evaluated on the value of the property with and without the easement."

Expert opinion

The IRS and taxpayer offered expert opinions to assist the Tax Court. These three opinions were evaluated on the value of the property with and without the easement. The first expert determined the highest and best use of the property before the easement grant was as a residential subdivision with an 18-hole golf course. The second expert agreed with this opinion. The third concluded the highest and best use before the easement grant was operation of a 27-hole golf course. All agreed that, because of use restrictions imposed by the easement document, the highest and best use after the easement grant was the continuing operation of a 27-hole golf course. However, the Tax Court found the taxpayer's argument valid that the highest and best use was a residential subdivision with an 18-hole golf course.

Fair market value

The Tax Court held that the first expert's valuation of the easement was too high and rejected the third expert's conclusion that the value was *de minimis* because its grant had no adverse effect on the property's fair market value. Not only did the easement document prohibit further subdivision of the property, it also restricted future construction of additional buildings and structures on the property. Thus, even assuming there was no demand for a subdivision, the Tax Court did not believe a prospective purchaser would not have considered easement restrictions material in determining the purchase price. *See Champions Retreat Golf Founders, LLC,* TC Memo. 2022-106, Dec. 62,118(M). ◆

Partnership properly distributed client-based intangible assets

An accounting firm recognized as a partnership distributed client-based intangible assets to two partners when they withdrew from the partnership. The assets distributed were properly valued under the terms of the partnership agreement. See *Clark Raymond & Company PLLC,* TC Memo. 2022-105, Dec. 62,117(M).

The partnership, subjected to Tax Equity and Fiscal Responsibility Act provisions, had three single-member entities (P1, P2 and P3) as partners. P1 and P2 negotiated a buyout of P3 in anticipation of the retirement of P3's principal owner. The buyout was memorialized in a restated partnership agreement. Shortly after executing the restated partnership agreement, P1 and P2 withdrew from the partnership.

Special allocations lacked substantial economic effect

The partnership's special allocations of income to P1 and P2 lacked substantial economic effect. It was therefore required to reallocate in accordance with the partners' interests under Code Sec. 704(b) and Treas. Reg. §1.704- 1(b)(3). The partnership failed to maintain capital accounts under Treas. Reg. §1.704-1(b)(2)(iv).

Partners held negative capital accounts

P1 and P2 had negative capital accounts for the tax year at issue. The partnership agreement included a qualified income offset (QIO). The ordinary income needed to be allocated first to P1 and P2 to bring each partner's capital account up to zero.

IRS' determinations on distributions and allocations dismissed

The IRS' determinations disregarding the partnership's client distributions and redetermining allocations of ordinary income were dismissed. The partners agreed to income allocations in their partnership agreement, including a QIO. This agreement was indicative of how they agreed to share the economic benefits and burdens of the partnership, particularly considering the unanticipated distribution of client-based intangibles. ◆

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