

# ***AALU's Washington Report***

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AALU Bulletin No: 04-99

July 27, 2004

Subject: **General Estate and Gift Tax Developments: May 2004**

1. **“Duty of Consistency” Requires That Discounted Estate Tax Value of Art Be Used To Calculate Gallery’s Cost-of-Goods-Sold**

Major References: [\*Janis v. Commissioner, T.C. Memo. 2004-117\*](#)

Prior AALU Washington Reports: 04-54; 98-15

2. **Child’s Disclaimer in Favor of Foundation Will Entitle Estate to Federal Estate Tax Charitable Deduction**

Major References: [\*PLR 200420007\*](#)

3. **Sharing Of Office Resources Does Not Create Excess Benefit Transaction**

Major References: [\*PLR 200421010\*](#)

Prior AALU Washington Reports: 02-36; 98-83

MDRT Information Retrieval Index Nos.: 2500.00; 7400.021; 7400.022; 7400.024

This *Washington Report* summarizes a few of the more important rulings in the estate and gift tax areas which were decided or reported by the Internal Revenue Service in May of 2004, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

## Cases

### 1. *Janis v. Commissioner*, T.C. Memo. 2004-117

***The U.S. Tax Court has ruled that taxpayers, a brother and sister who inherited an art gallery, cannot, for Federal income tax purposes, calculate the gallery's cost of goods sold using the undiscounted value of the gallery's collection of artwork, rather than the discounted value as determined for Federal estate tax purposes***

The “duty of consistency,” also sometimes referred to as “quasi-estoppel,” prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year, which cannot be corrected because the time to assess tax for the earlier year has expired. The duty of consistency applies if: (1) the taxpayer made a representation of fact or reported an item for tax purposes in one year; (2) the Service acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later year after the earlier year has been closed by the statute of limitations. The duty of consistency may be applied to bind one person to a representation made by another where the two are deemed to be in privity, that is, where there is sufficient identity of interests between them. Such an identity of interests may exist between an estate and its beneficiaries. *See, e.g., Estate of Letts v. Commissioner*, 109 T.C. 290 (1997), discussed in our Bulletin No. 98-15, and *TAM 200407018*, discussed in our Bulletin No. 04-54.

The recent Tax Court memorandum case of *Janis v. Commissioner* provides another illustration of this principle. In that case, the government found deficiencies in Conrad Janis and Maria G. Janis's (“Taxpayers”) Federal income taxes for 1995, 1996, and 1997 and also assessed accuracy-related penalties for those years. The government based its claims on its assertion that the Taxpayers, who, in 1989, inherited an art gallery from their father, Sidney Janis, could not calculate the gallery's cost of goods sold using the undiscounted value of the gallery's collection of artwork rather than the discounted value as determined for estate tax purposes.

Sidney Janis's estate filed a Federal estate tax return on February 28, 1991, reporting the value of the gallery to be \$19,533,750. This amount included a discounted value of \$12,403,207 for the 464 works of art (the collection) that the gallery owned on the date of Sidney's death. Based on an appraisal by Sotheby's that was commissioned by the estate, the undiscounted value of the collection was \$25,876,630. Per Sotheby's recommendation, the estate discounted this amount by \$4,059,540 to account for the large number of works in the collection by certain artists. Next, a \$350,000 discount was applied to account for the gallery's partial interest in three works of art in the collection, and a \$2,862,279 discount was then applied to account for the portion of the collection that would likely be sold in the dealer market (as opposed to the retail market). Finally, a \$6,201,604 discount was applied to account for (1) the inability to sell the gallery in the retail market for individual works of art, (2) the gallery buyer's not paying the full resale price of the underlying assets acquired in the bulk sale, and (3) the gallery buyer's taking into account the cost of maintaining the business for a reasonable period.

On audit, the IRS Art Advisory Panel (Panel) examined 227 of the 464 works of art in the collection (which represented 95 percent of the collection's undiscounted value as determined by Sotheby's) and determined that the undiscounted value of the collection was \$36,636,630 rather than the \$25,876,630 undiscounted value that had been determined by Sotheby's. The Panel determined that the discounted value of the collection was \$22,955,077, principally by taking into account a “blockage” discount. As explained by the Panel, “a blockage discount is applied to property in an estate in an attempt to reflect the market's response to a large number of items.”

Based upon the Panel's consideration of the blockage discount and other factors, it determined that an overall weighted discount of 37 percent was appropriate. The value of the collection was subsequently further discounted to \$14,500,000 (i. e., a total discount off approximately 60.42 percent). Accordingly, the IRS determined that the value of the gallery was \$21,630,543, or approximated \$2 million more than had been reported on the return. This amount was agreed to by Taxpayers, as executors of their father's estate. The period of limitations for assessment against the estate expired on February 28, 1994, 3 years after the estate tax was filed.

After their father's death, Taxpayers continued to operate the gallery, eventually forming a partnership. Beginning in 1990, on the advice of their accountant, the gallery used the discounted value of the collection as originally reported on Sidney's estate tax return, \$12,403,207, as the value of the gallery's inventory at the beginning of that year. Similar returns were filed for 1991 and 1992.

However, on or about February 19, 1994, Taxpayers' accountant prepared amended fiduciary income tax returns for the trust for 1990, 1991, and 1992 "per Art Advisory Panel" to reflect a beginning value for the gallery's inventory of \$36,636,630; *i. e.*, the collection's undiscounted value. The gallery's returns for 1993, 1994, 1995, 1996 and 1997 (including the partnership's K-1s) also reflected its use of the collection's undiscounted value as the value for its inventory, generating net operating losses and net operating loss carryovers in each of those years. Taxpayers, on their accountant's advice, reasoned that the blockage discount applied in determining the estate tax value of the paintings was inappropriate for income tax purposes because the paintings were not being sold in bulk, but as individual units.

The government determined, and the Court agreed, that the gallery's basis in the collection in 1995, 1996, and 1997 should have been reported in accordance with the discounted value that had been determined by the Panel and agreed to by Taxpayers for estate tax purposes, rather than the undiscounted value.

Section 1014 of the Internal Revenue Code provides that the presumptive basis of property acquired from a decedent is equal to the value placed upon such property for purposes of the Federal estate tax, *i.e.*, its fair market value on the date of the decedent's death or on the alternative valuation date. While it may be possible (based on existing case law) to challenge, in a later income tax proceeding, the application of a blockage discount (or other evidence of value) on a Federal estate tax return as being incorrectly determined, such a challenge may not be maintained where there is evidence supporting the discount. Moreover, in this case, Taxpayers did not contest the appropriateness of the blockage discount in the initial estate tax audit. They only later maintained that it did not apply in determining the value of each work of art that sold separately.

The Court further found that the "duty of consistency," noted above, should bind the Taxpayers in this case to the discounted value of the artwork reported on the estate tax return. Therefore, Taxpayers were bound to use the collection's discounted value as their basis for purposes of calculating the gallery's COGS for 1990 through 1997.

However, because they relied on the advice of their accountant, a tax professional, in preparing their returns, they are not liable for the considerable accuracy related penalties assessed for the years in question.

### **Private Letter Rulings**

#### **2. *PLR 200420007***

*The Revenue Service has ruled, in PLR 200420007, that a child's disclaimer of a fractional percentage of a decedent's residuary bequest that results in the disclaimed amount passing under the decedent's Will to a private foundation will be valid, provided*

***that certain changes are made to the foundation's governing documents. As a result, the disclaimed amount will qualify for the Federal estate tax charitable deduction.***

Under the facts of PLR 200420007, "Child," "Child's Spouse," and "Grandchild" formed a private foundation of which they are the current directors, officers and members. Foundation's Bylaws provide for two classes of members: regular members who are the directors with voting powers; and associate members and other classes, all of which are non-voting. The bylaws also permit the appointment, from time to time, of any temporary or special committees of the board of directors that it may deem necessary and advisable.

Sometime after the establishment of the Foundation, "Decedent," Child's father, executed a revocable trust. The trust indenture provided that, upon Decedent's death, a portion of the trust estate equal to Decedent's unused GST exemption would be set aside and held for 20 years in a charitable lead trust (with the remainder payable to Child's issue), and the balance would be distributed to Child. In the event that Child disclaimed all or part of his bequest, the disclaimed property would pass to the Foundation.

Decedent died survived by Child, Child's Spouse, and Grandchild. Child is the personal representative of Decedent's estate and the sole trustee of his revocable trust.

Child proposes to disclaim, within 9 months of Decedent's death, a fractional share of his residuary distribution. Prior to making the disclaimer, Child will not accept any benefit from, or receive any distribution from, the residuary disposition. Under the State law applicable to Decedent's trust, disclaimed property shall descend, be distributed, or otherwise be disposed of in the same manner as if the disclaimant (Child) had predeceased Decedent.

In connection with Child's proposed disclaimer, the members and board of directors of Foundation will amend the Articles of Incorporation and Bylaws of the Foundation to provide that: no person will have any wholly discretionary power to direct the distribution of any funds of the Foundation that were received by the Foundation by reason of a disclaimer of property made by that person. Disclaimed property received by the Foundation will be segregated in a "Special Fund" to be administered by a "Special fund Committee" on which the disclaimant may not serve. A disclaimant also will have no power to appoint or remove any member of the Special Fund Committee.

On these facts, the Revenue Service ruled that Child's proposed disclaimer will be a "qualified disclaimer" within the meaning of Section 2518 of the Internal Revenue Code, If a disclaimer is "qualified," the disclaimed property is treated, for federal gift, estate, and generation-skipping transfer tax purposes, as passing directly from the transferor (Decedent), and not from the disclaimant (Child), to the person entitled to receive the property as a result of the disclaimer (Foundation). Thus, the disclaimant is not treated as making a gift, and, in this case, Decedent's estate will be entitled to the Federal estate tax charitable deduction for the value of the disclaimed property.

One of the requirements of a "qualified" disclaimer under Section 2518 is that the disclaimed property must pass, ***without any direction on the part of the person making the disclaimer***, either to the spouse of the decedent, or to a person other than the person making the disclaimer. Thus, under applicable Treasury regulations, if a beneficiary who disclaims an interest in property is also a fiduciary (such as a trustee or a foundation director), the disclaimant cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest.

However, in this case, the power to make distributions of income and/or principal from the Special Fund and to select the recipients of such distributions will be held exclusively by the Special Fund Committee on which Child is precluded from serving. Therefore, the ruling concludes, Child's disclaimer will be qualified.

PLR 200420007 provides a textbook example of how a beneficiary of an estate may execute a valid disclaimer of a bequest in favor of a private foundation of which he is a director.

### 3. *PLR 200421010*

***The IRS has ruled that the sharing of office space, common employee services and office equipment and supplies between two private foundations exempt from Federal income tax under §501(c)(3), and certain disqualified persons and supporting organizations will not result in an “excess benefit transaction” under the “intermediate sanctions” rules.***

Section 4958 of the Internal Revenue Code, referred to as the “intermediate sanctions” rules (*see* our Bulletins Nos. 02-36 and 98-83), imposes excise taxes on each “excess benefit transaction” between an “applicable tax-exempt organization” and a “disqualified person.” Generally, applicable tax-exempt organizations include organizations described in §501(c)(3) (charities) or (4) (social welfare organizations), but specifically do not include private foundations. A disqualified person is generally any individual who is in a position to exercise substantial authority over an organization’s affairs, regardless of the individual’s official title. The excise taxes are imposed against the disqualified persons and the organization managers who engage in the excess benefit transaction. A disqualified person who benefits from an excess benefit transaction is subject to a first-tier penalty equal to 25% of the excess benefit. A second-tier tax, equal to 200% of the amount of the excess benefit, can be imposed if the prohibited transactions continue uncorrected. Organization managers who knowingly participate in an excess benefit transaction are subject to an excise tax equal to 10% of the amount of the excess benefit, up to a maximum penalty of \$10,000.

An excess benefit is the amount by which the value of the economic benefit provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person exceeds the value of the consideration received for providing such benefit. For example, to the extent the price charged by such an organization for the office resources sharing is less than fair market value, the discount could be considered an excess benefit.

In PLR 200421010, a charitable trust and a non-profit charitable corporation (both tax-exempt private foundations), two of the non-profit corporation’s disqualified persons and two of its supporting organizations entered into a fair market value contractual arrangement providing for their allocated shared utilization of: (i) office space; (ii) employees, including a secretary, receptionist, accounting staff and an administrative assistant; (iii) common office equipment and supplies, such as photocopy machines, facsimile machines, refreshments, supplies, computers and a telephone system; and (iv) insurance premiums for policies covering the shared employees. One of the supporting organizations was the lessor of the rental office space but it appeared that the employees and the equipment and supplies may have been those of one of the private foundations. The supporting organization that leased the office space administered the arrangement and allocated each type of expense on fair market terms, based on “detailed allocation records as to each entity’s use of the various allocated expenses,” according to the parties’ representations.

The IRS held that the participation of the charitable trust, the non-profit charitable corporation and the disqualified persons in an arrangement where a supporting organization provided for allocated joint utilization of office space, common employee services, and common office equipment did not constitute an excess benefit transaction between either of the supporting organizations and the disqualified persons under the intermediate sanctions provisions.

The ruling is somewhat unusual in that it apparently involves the sharing of certain resources owned by private foundations, the provision of economic benefits by which are not treated as excess benefit transactions under the intermediate sanctions rules. However, the relevant rulings focus on the involvement

of one of the supporting organizations - the activities of which are covered by those rules - in the arrangement. Thus, the ruling sheds some light on how the IRS may analyze expense-sharing arrangements, and the level of record keeping that may be expected to ensure that such arrangements do not give rise to excess benefit transactions.

Although the issue was not specifically raised in the ruling, the facts of the case raise a question as to the applicability of the intermediate sanctions rules where a private foundation, an applicable tax-exempt organization and a disqualified person enter into an arrangement to share employees, facilities, and equipment of the foundation, which overall receives fair market value consideration, but the applicable tax-exempt organization pays more than, and the disqualified person pays less than, fair market value. In that situation, it is conceivable that the applicable tax-exempt organization could be viewed as conferring an economic benefit on the disqualified person.

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