

The Great Estate Tax Mismatch

"You don't pay taxes; they take taxes."

—Chris Rock on Comedy Central

Here are two multiple choice questions, which assume no changes to current law. Answers are after the second question. *Don't peek!*

1. Decedent A dies in 2021 with a sizeable estate, including a single member LLC worth $25 million. In order to reduce federal estate taxes, her Will leaves the entire LLC to charity, split 75% to her family foundation and 25% to her local church. How much federal estate tax does the estate owe on account of the LLC?

   A. Zero, because the unlimited charitable deduction shelters the bequests to charity.

   B. About $1,000,000.

2. Decedent B dies in 2026, when the federal estate tax exemption will be $6 million.[1] His only asset is his business, worth $12 million. He leaves 50% of the business to his son, and the residue of his estate to his surviving wife. How much estate tax will his estate owe?

   A. Zero, because the exemption covers the bequest to his son, and the unlimited marital deduction shelters the residue to his wife.

   B. At least $600,000.

Answer: B in both cases. What's going on here? A fundamental principle of the estate tax is that it is not a direct tax on property, but rather a tax on the right to transfer property. Thus, it is only the value of the precise interest being transferred that



matters. Put another away, the decedent's gross estate includes the entire value of all property interests of the decedent, but any charitable or marital deduction is based solely upon the value of what the charity or surviving spouse actually receives, which may be valued quite differently,[2] creating a valuation mismatch.

Failure to plan for the mismatch problem can cause an estate tax surprise.

Question (1) is based on the recent case of *Estate of Warne*,[3] which follows a line of cases concerning the charitable deduction.[4] The court in *Warne* stated: "In short, when valuing charitable contributions, we do not value what an estate contributed; we value what the charitable organizations received."[5] In *Warne*, the whole LLC was worth $25,600,000, but the value of the 75% LLC interest passing to the family foundation required a discount of 4%, and the value of the 25% LLC interest passing to the church required a discount of 27.385%. After applying the discounts, the LLC interests were worth a combined total of only $23,079,360 in the hands of the two charities. This reduced the charitable deduction by a total of $2,520,640, which at a 40% estate tax rate caused $1,008,256

of additional estate taxes.

Question (2) is a hypothetical, but it too follows a line of cases establishing the same valuation principle, except with the marital deduction.[6] If we assume that the 50% interest passing to the surviving wife must be discounted by 25% by virtue of no longer being a controlling interest,[7] the value of wife's 50% interest is reduced from $6 million to $4,500,000. That in turn reduces the marital deduction by $1,500,000, which at a 40% estate tax rate causes $600,000 of additional estate taxes.[8]

What if a decedent leaves his entire estate to some combination of surviving spouse and charity? Although the estate would seem entirely covered by marital and charitable deductions, the valuation mismatch could generate estate tax liability if the numbers were large enough.

PLANNING

The good news is that the mismatch problem can usually be avoided with thoughtful planning and in fact can be used affirmatively to save estate taxes.

In Question (1) involving the bequest to two charities, the decedent could instead have left the entire 100% to the family foundation, and then later the foundation could have granted 25% to the church.

In Question (2) involving the marital deduction, the decedent could instead have left a 49% interest in the LLC to the son and a 51% interest to the surviving wife, in which case the marital share might well have been valued with a "premium" for control, rather than a discount for lack of control, eliminating any estate tax.[9]

Beyond avoiding the mismatch surprise at death, this type of discounting has been one of the primary drivers for wealthy clients to make gifts during life rather than at death. For example, a client owning 100% of a company can give (or sell) up to 49% to his children (or to trusts for the family) during his life at discounted values, using less of the client's gift and estate tax exemption, without losing control. Alternatively, that same client could simply give his wife 50% of the company during his life, tax-free, preventing either spouse from having unilateral control, in which case the total combined value of their two estates is significantly reduced.[10]

The valuation mismatch, then, rather than being a potential problem, should be seen instead, with good planning, as the "Achilles heel" of the whole gift and estate tax system.

NOTES

1. In 2026, the exemption (technically the applicable exclusion amount) will be $5 million, indexed for inflation from 2011. The indexed exemption will probably exceed $6 million by then, but here it is rounded to $6 million for simplicity.

2. While the value of assets like cash or stock is easily determinable, the value of assets such as a business depends on a variety of factors, because they are unique and have no regularly traded, easily established market value. In such case, the IRS requires the value of such interests for gift and estate tax purposes to be determined by appraisals, analyzing all facts and circumstances. The standard for appraisal is what a willing buyer would pay a willing seller for that particular interest, both parties having appropriate knowledge of the facts, and neither being under any compulsion to buy or sell. If an interest being transferred does not contain the full bundle of rights of ownership, then an appraisal of the true value must reflect the value of the partial bundle of rights, including any lack of control or lack of marketability. In other words, when the transferee receives something less than the whole, the true fair market value of that partial interest must be valued for gift and estate tax purposes in isolation. Any reduction in the fair market value on account of being only part of the whole is often referred to as a "discount" in value, but in reality such diminution in value merely reflects the economic reality and substance, *i.e.*, the bundle of economic rights and liabilities, of the specific interest being transferred.

3. *Estate of Warne v. Commissioner*, T.C. Memo 2021-17, issued Feb. 18, 2021. *Warne* involved California residents and is appealable to the Ninth Circuit Court of Appeals, if it is appealed.

4. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). *Estate of Schwan v. Commissioner,* T.C. Memo 2001-174. Technical Advice Memorandum 2006-48-028.

5. *Warne*, op. cit., at 53.

6. *Estate of Chenoweth v. Commissioner,* 88 T.C. 1577 (1987). Technical Advice Memorandum 90-50-004. Technical Advice Memorandum 94-03-005. Action on Decision CC-1999-006, describing acquiescence in *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999). *Estate of Disanto v. Commissioner,* 112 T.C. Memo 1999-421.

7. One might ask why the wife's 50% interest should be discounted for lack of control if the wife and son together own 100%. In Revenue Ruling 93-12, 1993-1 C.B. 202, the IRS conceded that family members, even spouses, cannot automatically be presumed to agree, and therefore each family member's interest must be valued "without regard to the family relationship of the parties."

8. In both Questions, the amount of estate tax owed also depends upon who must pay the tax. In Question (2), if the son's share pays the tax, then the tax is only $600,000. But if any part of the tax comes out of the wife's residuary share, which is likely, then the tax reduces what the wife receives, which reduces the marital deduction, which increases the tax, which further reduces the marital deduction, etc., in what is known as an interrelated calculation. If the Will requires that all the tax be paid from the marital residue, then the total tax owed would be $1 million. Such amount can be calculated by hand (ask any senior estate planner) or by a simple Excel spreadsheet or estate tax software. In Question (1), the *Warne* case did not state which beneficiary bore the burden of paying the additional estate tax, but if any part were charged to the charities' shares, which is unlikely, then the total tax would have been greater than the estimated $1,008,256.

9. The court in *Chenoweth* cited in footnote 6 found just such a premium.

10. Of course, the first spouse to die must be careful not to leave his or her interest in the company directly to the surviving spouse, which would then eliminate the discount in the hands of the surviving spouse. It must be left instead to a marital trust, family members, or some other entity or persons.

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