Estate of Jack Brown Owen, Deceased, Mary Ann Heyen, Executrix, Petitioner v. Commissioner of Internal Revenue, Respondent, 104 T. C. 498 (1995)

The valuation understatement penalty under IRC § 6660 applies to underreported values of bank accounts in an estate, but can be waived if there is a reasonable basis for the valuation and it was made in good faith.

Summary

Jack Brown Owen's estate underreported the value of two bank accounts on its federal estate tax return by excluding checks found in Owen's car after his death. The Tax Court held that underreporting bank account values can trigger the IRC § 6660 valuation understatement penalty. However, the penalty was waived for the undervaluation of one account because the estate had a reasonable basis and acted in good faith. The court also ruled that gifts made within three years of death were not includable in the gross estate under IRC § 2035(d)(1), thus no credit was allowed for state death taxes paid on those gifts.

Facts

Jack Brown Owen died on October 2, 1986. Prior to his death, Owen made several gifts in 1984 and 1986. After his death, checks written by Owen in the two weeks before his death were found in his car. The estate's federal tax return underreported the value of two bank accounts by the amount of these checks. The estate paid Kansas state inheritance tax on most of Owen's gifts. The Commissioner assessed deficiencies and penalties against the estate for undervaluing the bank accounts and failing to include the gifts in the gross estate.

Procedural History

The estate filed a timely federal estate tax return on July 6, 1987. The Commissioner issued a notice of deficiency on May 1, 1990, asserting deficiencies and additions to tax for negligence, fraud, and valuation understatement. The estate petitioned the U. S. Tax Court for redetermination. The Commissioner conceded the fraud penalties but maintained the other penalties. The Tax Court issued its opinion on April 20, 1995.

Issue(s)

1. Whether the estate is liable for additions to tax under IRC § 6660 for undervaluing bank accounts?
2. Whether the estate is entitled to a credit under IRC § 2011(a) for state death taxes paid on account of Owen's 1984 and 1986 gifts?
3. Whether Owen's 1984 and 1986 gifts should be considered in computing the maximum permissible state death tax credit under IRC § 2011(b)?

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Holding

1. Yes, because the underreported values of the bank accounts constituted valuation understatements within the meaning of IRC § 6660.
2. No, because the gifts were not includable in the gross estate under IRC § 2035(d)(1), and thus no credit was available under IRC § 2011(a).
3. No, because the gifts were not includable in the taxable estate, and thus not considered in computing the maximum state death tax credit under IRC § 2011(b).

Court's Reasoning

The court applied IRC § 6660 to the underreported bank account values, finding that bank accounts are property subject to valuation for estate tax purposes. The court distinguished between the two accounts: the penalty was upheld for the St. John Bank account because the estate failed to show a reasonable basis for excluding gift checks, while the penalty was waived for the First National Bank account due to the estate's reasonable basis and good faith in treating a check as payment for a legal obligation. For the state death tax credit issues, the court relied on the clear statutory language of IRC § 2035(d)(1), which excludes gifts made within three years of death from the gross estate for decedents dying after 1981. The court acknowledged the potential for double taxation but adhered to the statutory scheme.

Practical Implications

This decision clarifies that even straightforward assets like bank accounts are subject to valuation understatement penalties if misreported on an estate tax return. Estates should carefully document the basis for any exclusions from account balances and consider claiming deductions rather than reducing asset values when in doubt. The ruling also reinforces that gifts made within three years of death are not includable in the gross estate, impacting estate planning strategies. Practitioners must advise clients on the potential for state death tax credit limitations in such cases. Subsequent cases have followed this precedent in applying IRC § 6660 to various assets and upholding the exclusion of recent gifts from the gross estate.

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