Steinberg v. Commissioner, 145 T. C. 184 (2015) (United States Tax Court)

In Steinberg v. Commissioner, the U. S. Tax Court ruled that when calculating gift tax, the value of gifts can be reduced by the donees' assumption of potential estate tax liabilities under I. R. C. sec. 2035(b). Jean Steinberg's daughters agreed to pay any such taxes if she died within three years of the gifts. The court determined this promise constituted a detriment to the daughters and a benefit to Steinberg, impacting the gift's fair market value. The ruling clarifies how contingent liabilities should be considered in gift tax valuation, affecting estate planning strategies involving net gifts.

Parties

Jean Steinberg, the Petitioner, was the donor in the case. The Respondent was the Commissioner of Internal Revenue. The daughters of Jean Steinberg, Susan Green, Bonnie Englebardt, Carol Weisman, and Lois Zaro, were involved as donees but were not formally parties to the litigation.

Facts

Jean Steinberg, after the death of her husband Meyer Steinberg, inherited a marital trust valued at $122,850,623. In 2007, at the age of 89, she entered into a binding net gift agreement with her four daughters. Under this agreement, Steinberg transferred assets valued at $109,449,307 to her daughters. In exchange, the daughters agreed to assume and pay any resulting Federal gift tax and any Federal or State estate tax liability under I. R. C. sec. 2035(b) should Steinberg die within three years of the gifts. The daughters set aside $40 million in escrow, with $32,437,261 used to pay the gift tax and the remainder held for potential estate tax liabilities. Steinberg reported a net gift value of $71,598,056 on her gift tax return after accounting for the daughters' assumptions of tax liabilities.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to Steinberg, increasing her reported gift tax liability by $1,804,908 for tax year 2007. The Commissioner disallowed Steinberg's discount for her daughters' assumption of the potential I. R. C. sec. 2035(b) estate tax liability. Steinberg petitioned the United States Tax Court for review. The court had previously addressed a similar issue in Steinberg v. Commissioner, 141 T. C. 258 (2013) (Steinberg I), denying the Commissioner's motion for summary judgment and holding that the daughters' assumption of estate tax liability could be quantifiable and considered in determining the gift's value. The current case proceeded to trial to establish the relevant facts and calculate the value of the gift.

Issue(s)

Whether a donee's promise to pay any Federal or State estate tax liability that may

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arise under I. R. C. sec. 2035(b) if the donor dies within three years of the gift should be considered in determining the fair market value of the gift?

If so, what is the amount, if any, that the promise to pay reduces the fair market value of the gift?

Rule(s) of Law

The fair market value of a gift for gift tax purposes is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. I. R. C. sec. 2512(a); Treas. Reg. sec. 25. 2512-1. The gift tax is imposed on the transfer of property by gift and is measured by the value of the property passing from the donor, not the value of enrichment to the donee. I. R. C. sec. 2501(a); Treas. Reg. sec. 25. 2511-2(a). If a donor makes a gift subject to the condition that the donee pay the resulting gift tax, the amount of the gift is reduced by the amount of the gift tax, creating a "net gift". I. R. C. sec. 2512(b); Treas. Reg. sec. 25. 2512-8.

Holding

The U. S. Tax Court held that the daughters' assumption of potential I. R. C. sec. 2035(b) estate tax liability should be considered in determining the fair market value of the gift. The court further held that the value of the daughters' assumption of the estate tax liability reduced the value of Steinberg's gift to her daughters by $5,838,540.

Reasoning

The court's reasoning focused on the "willing buyer/willing seller" test for determining fair market value. It reasoned that a hypothetical willing buyer would consider the daughters' assumption of both gift tax and potential I. R. C. sec. 2035(b) estate tax liabilities as a detriment to the donees and a benefit to Steinberg, justifying a reduction in the gift's value. The court rejected the Commissioner's argument that the daughters' assumption of estate tax liability did not constitute consideration in money or money's worth under I. R. C. sec. 2512(b), citing the estate depletion theory. This theory posits that a donor receives consideration to the extent that their estate is replenished by the donee's assumption of liabilities. The court also found that the net gift agreement did not duplicate New York law's apportionment of estate taxes, as it provided a guaranteed mechanism for the daughters to assume the estate tax liability, which was not certain under state law. The court accepted the valuation methodology provided by Steinberg's expert, William Frazier, who used the Commissioner's mortality tables and I. R. C. sec. 7520 interest rates to calculate the present value of the daughters' contingent liability. The Commissioner's arguments against this methodology were deemed unpersuasive, leading to the court's conclusion that the valuation was proper.

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Disposition

The court entered a decision for the petitioner, Jean Steinberg, affirming the reduction of the gift's value by $5,838,540 due to the daughters' assumption of the I. R. C. sec. 2035(b) estate tax liability.

Significance/Impact

The Steinberg case is significant for clarifying the treatment of contingent liabilities in the valuation of gifts for gift tax purposes. It establishes that a donee's assumption of potential estate tax liabilities under I. R. C. sec. 2035(b) can be considered as consideration in money or money's worth, reducing the taxable value of the gift. This ruling impacts estate planning strategies involving net gifts, particularly in scenarios where donors seek to minimize their gift tax liability by conditioning gifts on the donees' assumption of tax liabilities. The case also underscores the importance of the "willing buyer/willing seller" test in determining fair market value and the use of actuarial tables and statutory interest rates in calculating the value of contingent liabilities. Subsequent cases and practitioners have referenced Steinberg in addressing similar issues, influencing how net gifts are structured and valued.

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