TAX COURT CASE UPDATE

Citation:

Estate of Bernard Kessel, et al. v. Commissioner, T.C. Memo 2014-97, May 21, 2014.

Overview:

The Tax Court has denied summary judgment to the IRS in an estate tax deficiency case that involved an estate of a decedent who had a pension plan with assets invested in an account at the firm of Bernard Madoff ("Madoff").

The Facts:

Bernard Kessel ("the decedent") died on July 16, 2006. He had a pension plan that invested with Bernard L. Madoff Investment Securities, LLC ("Madoff Investments"). The decedent's Madoff Investments' account ("Madoff account") ostensibly held assets appraised at more than $4.8 million. The decedent's estate filed a federal estate tax return in 2007 and reported the Madoff account as a $4.8 million asset of the estate. The estate paid the full amount of tax due on that value but subsequently filed a supplemental federal estate tax return claiming a refund on the ground that the Madoff account had a zero value. The IRS determined a $339,143 deficiency in the estate's Federal estate tax and denied its request for a $1.9 million refund.

The decedent owned Bernard Kessel, Inc. ("BKI"), a New York corporation. In 1982, BKI created the Bernard Kessel Inc. Pension Plan ("Plan"), a qualified defined benefit plan. The decedent was the sole participant in the Plan. In 1992, the Plan became a customer of Madoff Investments when the decedent opened and deposited $610,000 of the Plan's assets into the Madoff account. The customer agreement between the Plan and Madoff Investments allowed the Plan to assign its interest in the Madoff account with Madoff Investments' prior written consent.

The decedent designated his fiancee, Iris Steel ("Steel"), and his son, Richard Kessel ("the son"), as primary beneficiaries of the death benefits payable under the Plan. Steel was to get 70 percent and the son was to receive the remainder.

Steel was the decedent's executrix. After he died, she contacted Madoff Investments to determine the value of the assets held in the Plan's accounts. Madoff Investments sent a letter to her detailing the number and price of each publicly traded security, money market fund and option the Madoff account purportedly held. She forwarded this correspondence to an appraisal service, which determined that these assets were worth slightly over $4.8 million.

Steel timely filed a Form 4768, together with two checks totaling nearly $1.6 million. She then filed Form 706 within the six-month extension period and reported that the estate owed just under $1.9 million in federal estate tax. The Madoff account became payable to Steel and the son by reason of the decedent's death. Steel and the son made seven post-death withdrawals from the Madoff account totaling more than $2.8 million.

Madoff was arrested in late 2008. The Securities and Exchange Commission immediately issued a press release stating that it had charged him with securities fraud for a multi-billion-dollar Ponzi scheme. The SEC announced it was seeking emergency relief for investors, including an asset freeze and the appointment of a receiver for Madoff Investments.

The U.S. Attorney for the Southern District of New York ("U.S. Attorney") commenced a criminal proceeding against Madoff alleging fraud, money laundering, making false statements, perjury and theft. The U.S. Attorney alleged that Madoff effected his Ponzi scheme by failing to purchase securities and invest the investors' funds as he had represented. Madoff admitted that he perpetrated his Ponzi scheme through Madoff Investments and was sentenced to 150 years in prison.

The Securities Investor Protection Corporation ("SIPC") filed an application for a protective decree, seeking liquidation of Madoff Investments. Irving Picard was appointed the trustee ("Madoff trustee") for Madoff Investments' investors and the creditors of the Madoff Investments' general estate.

The Plan tried to recover $3.2 million in securities positions reportedly held in the Madoff account that were shown on the Madoff account statement for the month immediately before Madoff's arrest. The Madoff trustee denied the Plan's claim because Madoff Investments had not actually purchased securities for the Madoff account, and the account had a positive net equity of $2.7 million.

After the Madoff trustee denied the claim, the estate submitted a Form 843, Claim for Refund and Request for Abatement, requesting a $1.9 million refund. The estate also submitted a supplemental Form 706, which reported the date of death value of the investment account as zero.

The IRS denied the estate's request for refund and determined that the value of the decedent's taxable estate was greater than the estate had reported. The estate timely filed a Tax Court petition alleging that the fair market value of the Madoff account was zero rather than $4.8 million, as the estate had reported when the decedent died.

The IRS sought partial summary judgment. Specifically, it first asked the court to identify the Madoff account, as opposed to its purported holdings, as the property subject to federal estate tax. Next, it asked the Court to hold that a hypothetical willing buyer and willing seller of the Madoff account would not reasonably know or foresee that Madoff was operating a Ponzi scheme at the time the decedent died.

Conclusion:

Based on a decision of New York's highest court, the Tax Court agreed with the part of the IRS's argument with respect to the first issue - that the Madoff account existed on the date that the decedent died. It disagreed, however, with the next part of the IRS's first argument - that the Madoff account must be the property valued for federal estate tax purposes.

The Court noted that the federal estate tax is imposed on the transfer of property rather than on the receipt of property. Therefore, the value of the property to be taxed must be determined as of the time the property is transferred. Value in this context is defined as fair market value. Personal property under New York law includes everything that may be owned, except real property. The court said that the owner of the Madoff account had what appeared to be property-like rights in his agreement with Madoff Investments concerning the Madoff account; e.g., he had the restricted right to transfer the account. However, the court could not say on the record before it whether that agreement constituted a property interest includible in the decedent's gross estate separate from, or exclusive of, any interest the decedent had in what purported to be the assets held in the Madoff account. The court said this question is best answered after the parties have had the opportunity to develop the relevant facts at trial. It therefore denied IRS's motion on this point.

Then the Court examined the IRS's second argument - that a hypothetical willing buyer and willing seller of the Madoff account would not reasonably know or foresee that Mr. Madoff was operating a Ponzi scheme at the time the decedent died. The IRS argued that Madoff's Ponzi scheme was knowable or foreseeable only at the point when it collapsed. The Court disagreed, noting that some people had suspected years before Madoff's arrest that Madoff Investments' record of consistently high returns was simply too good to be true. Whether a hypothetical willing buyer and willing seller would have access to this information and to what degree this information would affect the fair market value of the Madoff account or the assets purportedly held in the Madoff account on the date the decedent died are disputed material facts. Thus, it denied the IRS's motion on this point as well.