MSCPA
FEDERAL TAX COMMITTEE
ESTATES, GIFTS AND TRUSTS

By Lorraine A. Travers

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Note: All above extracted from Thomson Reuters/RIA.

COURT APPLIES SECTION 2036 FAVORABLY TO FAMILY PARTNERSHIP

A family limited partnership need not operate an active business for the Section 2036 bona fide sale exception to prevent inclusion of the underlying partnership assets in the decedent's estate.

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Under Section 2036 , an individual's gross estate includes property he or she transferred during his or her life if the decedent retained for life the possession or enjoyment of the property, or the right to the income from the property. This requirement is met if there is an implied agreement among the parties to the transaction at the time of transfer that the transferor may retain the possession or enjoyment of, or the right to the income from, the transferred property. However, no inclusion is required if the transfer was a bona fide sale for adequate and full consideration in money or money's worth.

Two questions have arisen regarding the exception for a bona fide sale for adequate consideration:

> (1) Where a transferee partnership holds only marketable assets and does not operate an active legitimate business, can there under any factual circumstances ever be a transfer for consideration within the meaning of Section 2036(a) ?
> (2) What amounts to operating an active trade or business?

Both questions were addressed in a recent Tax Court decision, *Estate of Black*, which is appealable to the Third Circuit.

Circuit court conflict

The Fifth and Third Circuits have issued opinions that appear at odds concerning what is a legitimate business activity for the bona fide sale exception contained in Section 2036(a) . Much of the perceived conflict relates to the question of what percentage of the assets transferred to the family limited partnership (FLP) must rise to the level of a substantial legitimate business operation for the bona fide sale exception contained in Section 2036(a) to apply.

Kimbell.

The Fifth Circuit in *Kimbell*[2] held that a transfer of working oil and gas interests to a partnership along with marketable securities provided centralization of management and a substantial legitimate business purpose. At inception, only 11% of the assets of the partnership were oil and gas working interests. The Fifth Circuit decided a bona fide sale exception to Section 2036(a) applied.

Turner.

In contrast, the Third Circuit in *Turner*[3] (an appeal of the Tax Court decision of *Estate of Thompson*) held that, although the FLP did conduct some legitimate economic activity, the transactions did not rise to the level of substantial legitimate business operations. In that case, real estate used for ranching amounted to 21% of the partnership assets. The Third Circuit decided that a bona fide sale exception to Section 2036(a) did not apply. The Fifth Circuit in *Church* had previously applied the bona fide sale exception contained in Section 2036(a) to assets transferred to a limited partnership that consolidated undivided ownership interests and the administration of a family ranching business.

Strangi.

A subsequent decision from the Fifth Circuit, *Estate of Strangi*, has further complicated the issue. The *Strangi* estate asserted that working assets, including real property and interests in real estate partnerships, comprised an approximately equal proportion of the transfer of assets to the FLP as they did in *Kimbell.* Nevertheless, the court determined that a legitimate economic activity did not exist in *Strangi.*

Interestingly, the court did not focus on the percentage of partnership assets involved in the legitimate business and did not address the estate's assertion directly. Instead, the court distinguished the two cases on other grounds. It concentrated on the fact that the assertion of significant active business management was an unchallenged fact accepted in *Kimbell*, while in *Strangi* the issue of significant active business management had been the subject of a full trial and the decision of the trial court that could not be reversed without a finding of clear error. The Fifth Circuit later acknowledged somewhat ironically that, although predictability in the law governing estates and estate planning is important, it is not a preeminent concern—at least in the Fifth Circuit.

Planning considerations.

Unfortunately, the percentage of partnership assets that must rise to the level of a substantial legitimate business operation to satisfy the bona fide sale exception contained in Section 2036(a) was not addressed by the Fifth Circuit in *Strangi.* This issue remains a continuing concern.

Based on the procedural focus of the Fifth Circuit, assertions as to significant active business management must never go unchallenged or be accepted in the trial court. The existence of a nontax purpose triggering the bona fide sale exception is an objective factual determination for the trial court as the finder of fact and may not be reversed on appeal by an appellate court without a finding of clear error.

Tax Court approach

The Tax Court decided several cases in this area before its decision in *Black.*

Bongard.

The first trial decision from the Tax Court to attempt in some way to address, if not resolve, the inconsistencies at least within its particular factual situation was *Estate of Bongard*[6] in 2005. The decedent in that case was a skilled and experienced businessman

who, in 1980, established his own successful corporation for the design, development, manufacture, and marketing of plastic products used in the semiconductor and data storage industries. In 1984, the decedent remarried and in 1986 formed a **trust** primarily for the benefit of his children by his prior marriage and funded it with shares in his corporation. An LLC was established in 1986, capitalized with shares of the decedent and the **trust**. The decedent died unexpectedly in 1998, while on a hunting trip in Austria. The decedent was 58 years of age and in good health before his death.

The Tax Court held—after reviewing *Kimbell, Turner/Thompson,* and *Strangi*—that the transfer of the stock to the LLC satisfied the bona fide sale exception. The decedent was held to possess legitimate and significant nontax reasons for the transfer in that the transfer positioned the corporation for a liquidity event and pooled related-party interests. The Tax Court concluded that to come within the Section 2036 bona fide sale exception, a legitimate and significant nontax reason for creating the FLP is needed, and transferors must receive proportionate interests—but it does not require a business reason. [7]

Schutt.

Also in 2005, the Tax Court decided *Estate of Schutt,* [8] which was appealable to the Third Circuit and is factually very similar to the current case. It followed the conclusion in *Bongard.* In this case, all the formalities were followed. Under advice of an attorney, Mr. Schutt combined the assets of his revocable living **trust** and three **trusts** originally set up by Mr. Schutt's father-in-law and wife. The Wilmington **Trust** Company was the trustee of each of those three **trusts**. Those **trusts** were for the benefit of Mrs. Schutt's children and grandchildren.

Mr. Schutt was extremely concerned with perpetuating his buy and hold philosophy over family assets, as well as obtaining some tax discounts. Two Delaware business **trusts** were created by Mr. Schutt to hold significant blocks of two stocks (Dupont and Exxon). Mr. Schutt was the initial trustee of the Delaware business **trusts**. The **trusts** were classified for federal income tax purposes as partnerships.

Mr. Schutt had been the advisor to each of the contributing **trusts**, but required Wilmington **Trust** Company's consent to the creation of the Delaware business **trusts**, because the bank was concerned that having the business **trusts** would mean that the contributing irrevocable **trusts** would own illiquid assets with no control over investments or distributions at the termination of the respective **trusts**. Therefore, the negotiations between Mr. Schutt and the bank included requiring consents from all adult beneficiaries of the **trusts**. The Delaware business **trusts** provided that net cash flow less reserves established in the trustee's discretion, were to be distributed quarterly.

Capital accounts, units, and distributions were to be in proportion to the value of capital contributions. The **trusts** included restrictions on transfers and withdrawals.

None of Mr. Schutt's personal assets were commingled with those of the two **trusts**.

In this case, Mr. Schutt had a long-standing investment strategy of buying and holding stock long-term. As trustee, Mr. Schutt had investment control over the **trusts** and distribution standards. He was extremely concerned with perpetuating his "buy and hold" investment philosophy over family assets. At least through the time of his death, the **trusts** never sold any of the Dupont or Exxon stock used to fund the entities, nor had they acquired other assets.

The IRS determined that the discounts applied in valuing the interests in the **trusts** were excessive. Moreover, the IRS asserted that the full fair market value of the underlying assets contributed to the **trusts** should be included in his gross estate under Sections 2036(a) .

The Tax Court focused on the exception from Section 2036 for a bona fide sale for adequate and full consideration. The court held that the primary reason the **trusts** were created was to perpetuate the donor's investment strategy, which the court held was legitimate. The court held that, even though the portfolio was not traded, it was a pure investment philosophy that Mr. Schutt wanted.

The court seemed to focus on Mr. Schutt's long-standing concern about his descendants' ability to sell the principal and to diversify the portfolio. Also, Mr. Schutt was greatly concerned with outright distribution of assets to the beneficiaries of the various **trusts**. Because the investment strategy and the distribution would not be triggered by Mr. Schutt's death, the court felt it was inappropriate to call his underlying motive testamentary.

The attorneys' notes indicate that Mr. Schutt's concerns did not focus primarily on the valuation discounts available for these **trusts**. Also noted by the court is that Mr. Schutt was not financially dependent on distributions from the **trusts**, and retained sufficient assets to support his needs and lifestyle. Finally, the **trust** company was involved in the decisions regarding the **trusts**, some of which were accepted and some rejected. Thus, none of the assets in the Delaware **trusts** were included in his estate.

Jorgensen.

Early in 2009 the Tax Court decided *Estate of Jorgensen*,[9] a decision that might be interpreted as contrary to that of *Schutt. Jorgensen*, however, involved bad facts.

In this case the FLP assets were included in the estate, but the IRS allowed the estate to offset certain overpaid capital gains taxes against the estate tax deficiency, based on equitable recoupment.

In 1995, Mr. and Mrs. Jorgensen each contributed $450,000 of their $2 million portfolio of marketable securities to an FLP. Mr. Jorgensen, his son and daughter were the general partners, but Mr. Jorgensen made all decisions about the formation and operation of the FLP. Mrs. Jorgensen and the grandchildren were limited partners. Mr. Jorgensen died in late 1996. The FLP was valued with a 35% discount, and his credit shelter **trust** was funded with an interest in the FLP.

In late January 1997, an attorney recommended that Mrs. Jorgensen transfer her brokerage accounts to an FLP to qualify for valuation discount and to facilitate making annual gifts. He wrote to Mrs. Jorgensen to make the transfer to qualify her assets for the 35% discount, which would not be available to her "if the securities owned by you continue to be held by you."

A second FLP was formed in July 1997. The son, daughter, and the daughter's husband—but not Mrs. Jorgensen—were at a meeting to discuss the formation. The second FLP was to hold high-basis stock, and the first FLP was to hold low-basis stock. Mrs. Jorgensen contributed $2.1 million of her marketable securities and $500,000 of marketable securities from the estate of Mr. Jorgensen. The two children were the general partners,

and the children, grandchildren, and a son-in-law were limited partners but did not contribute anything.

In 1995, 1996, and 1998, Mrs. Jorgensen gave about 30.6% of the first FLP to her children and grandchildren. In 1997 and 1998, she gave about 6% of the second FLP to her children and grandchildren. In 1999-2002, Mrs. Jorgensen gave 34.75% of the second FLP to her children and grandchildren, with 50% and 42% discounts for some of the gifts.

In 1998, Mrs. Jorgensen consulted with another attorney who said that there was an audit risk for the gift of interests of the second FLP because it "held only passive investments." The attorney went on to cite a list of nontax reasons for the creation of the FLP. The court observed in a footnote "that taxpayers often disguise tax-avoidance motives with a rote recitation of nontax purposes."

Mrs. Jorgensen was not a general partner but had check-writing authority on partnership accounts. In October 1998, Mrs. Jorgensen wrote checks on the first FLP account for over $30,000, primarily for making cash gifts. In late January 1999, Mrs. Jorgensen wrote a $48,500 check to her daughter from the first FLP account to equalize gifts to her with a prior gift that had been made to the son. In April 1999, Mrs. Jorgensen deposited the $30,000 and $48,500 in the second FLP account to "repay for the gifts made" without explaining why the repayment was made to the second FLP and not the first FLP, from which the gifts were made.

In July 1999, the son borrowed $125,000 from the second FLP to buy a home. He made no payments on the loan for several years and then just made several interest payments.

Mrs. Jorgensen paid her 1998 estimated quarterly income tax payments from the first FLP. She paid Mr. Jorgensen's estate administration expenses from the second FLP, which she later repaid. Mrs. Jorgensen also paid Mr. Jorgensen's estate income tax and various administration expenses and expenses regarding her gift tax returns and some of her attorney's expenses from the second FLP. These were not repaid.

Mrs. Jorgensen died on 4/25/02. At the recommendation of the attorney, the son repaid his loan from the second FLP in January 2003. In January 2003, the second FLP paid $211,000 of Mrs. Jorgensen's federal and California estate taxes.

In 2003-2006, the FLPs sold assets contributed by Mrs. Jorgensen. The FLPs used a cost basis instead of a stepped-up basis and paid related income taxes. In 2008, the partners filed protective claims for income tax refund, but the refund claim for the 2003 income tax payments was not timely.

The Tax Court did not find any significant nontax reasons for forming the FLP. The FLP was not needed to manage assets as Mrs. Jorgensen had a revocable **trust** and power of attorney to provide such management, and there was little trading after the death of Mr. Jorgensen. Most importantly, there was insufficient evidence that pooling of assets was a motivating factor for Mrs. Jorgensen in setting up the FLP or that such pooling was not necessarily advantageous to children and grandchildren.

The Tax Court rejected the creditor protection argument as being a theoretical concern only and the argument about the son's spending habits because the son was a general partner and was allowed to borrow from the FLP anyway. Facilitating and simplifying gift-giving was not recognized as a significant and legitimate nontax reason, especially when

it was just as easy to make gifts of the underlying securities as it was to make gifts of FLP interests.

The Tax Court found no bona fide sale. It found it "especially significant that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities." The advice given at the time the FLPs were formed indicated tax savings as the reason for the planning. The lawyer's letter over a year later listing the nontax reasons was given little weight. Further, partnership formalities had been disregarded, as no books or records were maintained, no formal meetings were held, and the FLP paid personal expenses and commingled personal and FLP funds. There was a financial dependence on the FLP to make gifts.

The FLP made non-pro rata distributions on a regular basis contrary to the Tax Court decision in *Bongard.*

The Tax Court found that Section 2036(a)(1) and retained enjoyment applied. The Tax Court acknowledged that Mrs. Jorgensen had sufficient assets outside the partnership for her day-to-day living costs, but she wrote FLP checks for her personal expenses and the expenses of her husband's estate administration. Also, she needed FLP cash distributions to make cash gifts. Her attorney billed her and the FLP on the same statement. A significant portion of FLP assets were used to pay for her estate administration expenses. A substantial amount of FLP assets were used to pay pre-death and post-death obligations, thus making FLP distributions not pro rata, as required by the FLP agreements.

The son and daughter were general partners and also co-trustees of her revocable **trust.** As co-trustees they had a duty to administer the **trust** for her benefit only, so there was an implied agreement of retained enjoyment by her of the assets contributed to the FLPs.

Finally, the Tax Court relied on Section 6214(b) to apply the doctrine of equitable recoupment. The court allowed the recoupment of the overpayment of the 2003 income taxes attributable to the additional basis step-up allowed under Section 1014 because of the Section 2036 inclusion of partnership assets in the gross estate.

Interest deduction

On the separate issue of funding the payment of estate taxes by borrowing from third parties for interest payments, *Estate of Graegin,* is the seminal Tax Court decision. In that case, the estate borrowed funds to satisfy estate taxes attributable to the decedent's interest in a closely held corporation. The loan was from a wholly owned subsidiary of the corporation.

Pursuant to the terms of the promissory note, all principal and interest of the loan was to be paid in a single balloon payment at the end of the 15-year term. The interest was simple interest equal to prime. There was a prohibition against early repayment. The estate deducted the interest payment due at maturity (approximately $450,000) on the Form 706 as a cost of administration. The Tax Court held that the amount of the interest was capable of calculation, and the entire interest was deductible—not just its present value.

New case—*Estate of Black*

In the most recent case, *Black*, the Tax Court has held that stock transferred to an FLP did not have to be included in the transferor's gross estate under Section 2036 because

the transfer was a bona fide sale for an adequate and full consideration in money or money's worth. The case involved millions of dollars in asserted estate tax deficiencies, and the court relied on the above authorities in reaching its conclusion. Separately, the transferor's spouse died shortly after he did, and her estate involved interesting issues that were addressed in the case.

Facts of the case.

From 1927 until 1993, Mr. Black was an employee, officer, or director of Erie Indemnity Co. (Erie) an insurance company and was a major contributor to its success. Between 1988 and 1993, Mr. Black transferred Erie stock to his son and created **trusts** that held Erie stock for his grandsons. The stock split several times and substantially increased in value. Mr. Black became concerned that his grandsons—each of whom would be able to withdraw the **trust** principal, one-half at age 25 and the balance at age 30, at which point the grandson **trusts** would terminate—and his son would either need to or want to sell some or all of their Erie stock. His concern increased as the value of that stock increased.

Mr. Black's fear that his son might dispose of some or all of his Erie stock arose out of his concern:

> (1) That his son might default on a personal loan from PNC Bank, for which he had previously pledged 125,000 Erie shares as collateral, and that he might need to satisfy his obligation with that pledged stock.
> (2) Over the status of his son's marriage and how its ending in divorce (as it did in 2004), might result in the transfer of some of his son's Erie stock to his wife.
> (3) About the daughter-in-law's father's business and personal bankruptcies, which resulted in her parents' continuing need to obtain money from her and his son, a need that could conceivably require the sale of some of the Erie stock.

Mr. Black was also concerned about a brewing split between the two children of the founder of Erie, each of whom was a trustee of one of two **trusts** that, as of October 1993, controlled 76.2% of Erie's voting stock. The Black family stock, which, by 1993, represented 13% to 14% of the total voting and nonvoting Erie stock, might represent the swing vote in favor of one camp against the other camp. That was another reason he wanted to consolidate and retain the family's Erie stock.

In October 1993, Mr. Black, his son, and **trusts** for the two grandsons contributed their unencumbered Erie stock to Black LP (BLP), an FLP, in exchange for partnership interests proportionate to the fair market value of the Erie stock each contributed.

Mr. Black's advisors had explained the estate tax advantages of placing his Erie stock in BLP, but the transaction was initiated to implement Mr. Black's buy-and-hold philosophy with respect to the family's Erie stock. In 1993, the son and the two **trusts** owned approximately $12 million of the Black family's approximately $80 million worth of Erie stock.

At the time of the formation of BLP, Mr. Black, at age 91, was in good health. He was not suffering from any life-threatening illness, and he maintained an active lifestyle. He participated in the daily operations of Samuel P. Black & Associates, Inc., an insurance agency he formed upon his retirement from Erie, was an active member of the Erie board of directors, maintained a lively social schedule, remained an avid golfer, and traveled to Florida several times a year. Both before and after the formation of BLP, Mr. Black and his wife, Mrs. Black, received annual income from sources other than the Erie stock Mr.

Black transferred to BLP. This other income was more than sufficient to cover their personal living expenses.

Management of BLP was vested in the managing partner. Mr. Black was the managing partner from formation until 10/16/98, when he ceded to his son his 1% general partnership interest and his responsibilities as a managing partner. The partnership agreement:

(1) Generally prohibited a general or limited partner or the partner's spouse (including a divorced spouse) from transferring an interest in the partnership to persons or entities unrelated to any of the partners without "the written consent of the Partnership and all other Partners."
(2) Granted to the partnership or the partners a right of first refusal to purchase any partnership interest with respect to any lifetime disposition, including involuntary dispositions and dispositions incident to the divorce of a partner, and any testamentary disposition on the death of a partner or the spouse of a partner.
(3) Provided that no general or limited partner should have the right to withdraw from the partnership before it dissolved and liquidated.
(4) Provided that it "may be modified, terminated or waived only by a writing signed by the party to be charged with such modification, termination or waiver," which was the managing partner.

During 1995 and 1996, BLP purchased for $830,000 commercial condominium units in Erie, Pennsylvania, which it leased in part to Samuel P. Black & Associates, Inc., and in part to an independent insurance agency of which the son owned 65% and was president and treasurer. One or more of those condominium units was later leased to Erie after Samuel P. Black & Associates, Inc., moved out. In February, April, and October 2000, BLP paid $924,000 to purchase 4,400 shares or approximately 80% of the outstanding stock of Samuel P. Black & Associates, Inc.

In October 1995, Mr. Black, as both settlor and trustee, established the Samuel P. Black, Jr. Revocable **Trust**. It established a pecuniary marital **trust** for Mrs. Black and a $20 million bequest to a university endowment. The bequest to Mrs. Black provided for a legacy equal to the smallest amount, if any, needed to reduce the federal estate tax liability of Mr. Black's estate to zero or to the lowest possible figure. In calculating this amount, the trustee was first to take into account the amount of all other property, which, for federal estate tax purposes, was includable in Mr. Black's gross estate and which passes or had passed in any manner to Mrs. Black in a form that qualifies for the marital deduction.

The trustee was also to take into account all other deductions and all credits against the federal estate tax finally allowed to Mr. Black's estate for federal estate tax purposes. In making the computation necessary to determine this amount, the final determination in the federal estate tax proceeding of Mr. Black's estate was to control. This amount was to be satisfied only out of assets that qualified for the marital deduction or out of the proceeds of such assets. Assets distributed in kind in satisfaction of this amount were to be distributed at their market value on the date or dates of distribution. The remaining principal in the marital **trust** after the death of Mrs. Black was to be distributed to their son.

Mr. Black died in December 2001; Mrs. Black's death occurred five months later, in May 2002, before the marital **trust** was funded. Their son, as executor of both estates, had intended to fund this **trust** with a portion of Mr. Black's estate's interest in BLP. The son made an election to treat the property funding the marital **trust** as qualified terminable

interest property. In his capacity as executor of Mrs. Black's estate, the son deemed the marital **trust** to be funded on the date of her death and hence the size of the BLP interest included in Mrs. Black's estate under Section 2044 was determined by reference to the value of BLP on the date of Mrs. Blacks death not the date of Mr. Black's death. The parties stipulated that the fair market value of a 1% limited partnership interest in BLP was $2,146,603 on the date of Mr. Black's death and $2,469,728 on the date of Mrs. Black's death.

Mrs. Black's estate lacked sufficient liquid assets to discharge its tax and other liabilities. In an attempt to borrow money to pay both tax liabilities and administration expenses on behalf of Mrs. Black's estate, the son, as executor of the estate, first approached commercial lending institutions, including PNC Bank, National City Bank, Wachovia Bank, Credit Suisse, First Boston, Goldman Sachs, and several local banks. None of those institutions would accept the pledge of a partnership interest in BLP as security for a loan. Instead, each wanted BLP to pledge its Erie stock as security. In addition, they required "collaring," an agreement that the Erie shares would be sold if their value fell below a certain price. The son found those terms unacceptable. He was particularly concerned that the Erie shares would drop in price because of the discord among Erie's board of directors and that the "collaring" requirement might result in the forced sale of the thinly traded Erie shares, which would further depress their price.

The son next turned to Erie for a loan, but Erie was not interested in lending money to either the **trust** or the estate. Ultimately, the son—as BLP's managing partner—and Erie agreed to have BLP sell some of its Erie stock in a secondary offering. That sale raised $98 million, of which Erie lent to Mrs. Black's estate $71 million. The interest on the loan was payable in a lump sum on the purported due date, more than four years from the date of the loan, and was deducted in full on Mrs. Black's estate's tax return under Reg. 20.2053-1(b)(3) .

Mrs. Black's estate used the funds to discharge its federal and state tax liabilities, pay the $20 million bequest to the university endowment, reimburse Erie's costs, totaling $980,625, in connection with the secondary offering, and pay $1,155,000 each to her son, as executor fees, and to a law firm, as legal fees.

IRS position.

The IRS found that:

- The value of the Erie stock apportionable to Mr. Black's partnership interest in BLP at his death was includable in his gross estate under Section 2036(a) .
- The deemed funding date of the marital **trust** and, hence, the size of the BLP interest includable in Mrs. Black's estate under Section 2044 , was to be determined by reference to the value of BLP on the date of Mr. Black's death, not on the date of Mrs. Black's death when the value of BLP was higher and it would require a smaller interest in BLP to fund the **trust**.
- The interest payable on the BLP loan to Mrs. Black's estate was not a deductible administration expense.
- Mrs. Black's estate was not entitled to deduct the $980,625 reimbursement of Erie's secondary offering costs and was entitled to deduct only $500,000 of the executor fee and $500,000 of the legal fees.

Application of Section 2036 .

As to the Section 2036 issue, the Tax Court was asked to decide whether the Erie stock that Mr. Black contributed to BLP, rather than his partnership interest therein, was includable in his gross estate under Section 2036(a) because:

(1) His transfer of that stock to BLP was not a bona fide sale for adequate and full consideration.
(2) He retained an interest in the transferred stock within the meaning of Section 2036(a)(1) or (2) .

To avail itself of the parenthetical exception, the estate of Mr. Black needed to show that the transfer was both (1) a bona fide sale and (2) for adequate and full consideration.

The Tax Court first considered the earlier decision, *Turner,* that the transfer must be in good faith so as to provide the transferor some potential for benefit other than estate tax savings and that the transferor have a legitimate and significant nontax reason for creating the family limited partnership. Referring to *Bongard,* the court stated that a finding that the transferor sought to save estate taxes does not preclude a finding of a bona fide sale so long as saving estate taxes is not the predominate motive. The court cited the decision in *Schutt* as in accord.

The son, as petitioner, relied on the similarity of the facts in this case to the facts in *Schutt* in which the Tax Court found that the use of a family partnership to perpetuate the decedent's buy-and-hold investment strategy with respect to publicly traded Dupont and Exxon stock, in the "unique circumstances" of that case, was "a legitimate and significant non-tax purpose" for the formation of the partnership. The son also cited the opinion in *Kimbel,* for the proposition that consolidating family assets and providing for long-term centralized management of those assets are valid nontax purposes for forming a family limited partnership.

In response, the IRS cited the recent case of *Jorgensen,* in which the Tax Court rejected the taxpayer's argument that the decedent's "investment philosophy premised on buying and holding individual stocks with an eye toward long-term growth and capital preservation" was "a legitimate or significant nontax reason for transferring the bulk of one's assets to a partnership." In reaching that decision, the Tax Court distinguished *Schutt* on the ground that in that case "[t]he decedent's wife was the daughter of Eugene E. DuPont, and the decedent hoped to maintain ownership of the stock traditionally held by the family including stock held by certain **trusts** created for the benefit of his children and grandchildren in the event those **trusts** terminated."

The Tax Court acknowledged that *Turner* suggested that a mere holding of an untraded portfolio of marketable securities weighs negatively in the assessment of nontax benefits available as a result of a transfer to a family entity, particularly in cases where the securities are contributed almost exclusively by one person. Consistent with the focus of *Turner,* the Tax Court agreed that in the bona fide sale context where the transferee does not operate a legitimate business and the record demonstrates that the valuation discount provides the sole benefit for converting liquid marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of Section 2036 .

The Tax Court, however, refused to follow such a conclusion blindly when the facts otherwise supported a finding of a legitimate and significant nontax purpose. Although they did not conduct an active trade or business, *Bongard* and *Schutt,* were held to be

consistent with *Turner* with respect to their application of the parenthetical exception. A family limited partnership that does not conduct an active trade or business may nonetheless be formed for a legitimate and significant nontax reason. The Tax Court agreed with the specific conclusion in *Turner* that the decedent's transfers therein did not qualify for the Section 2036(a) exception because the FLPs involved therein did not either conduct a legitimate business operation or provide the decedent with any nontax benefit from the transfers.

Significant nontax purpose.

The Tax Court stated that, as in *Schutt,* this case presented a set of unique circumstances, which, on balance, required a finding that BLP was formed for a legitimate and significant nontax purpose—i.e., to perpetuate the holding of Erie stock by the Black family. It thus concluded that Mr. Black's transfer of Erie stock to BLP was a "bona fide sale" of that stock.

The Tax Court, relying on *Bongard*, held that the "adequate and full consideration" prong of the two-part test for finding a bona fide sale for adequate and full consideration was met as the transferors received partnership interests proportionate to the value of the property transferred. The Tax Court referred to the following four factors from *Bongard* as supporting a finding that the adequate and full consideration requirement had been satisfied:

> (1) The participants in the entity at issue received interests proportionate to the value of the property each contributed to the entity.
> (2) The contributed assets were properly credited to the transferors' capital accounts.
> (3) Distributions required negative adjustments to the distributee capital accounts.
> (4) There was a legitimate and significant nontax reason for forming the entity.

The IRS had conceded at trial that the first factor was present, and the Tax Court determined that the fourth factor was present. The BLP partnership returns filed for 1994 and subsequent years demonstrated that the second and third factors were present.

The Tax Court held that, because Mr. Black's transfer of Erie stock to BLP in exchange for a partnership interest therein was "a bona fide sale for an adequate and full consideration in money or money's worth" within the meaning of Section 2036(a) , the value of Mr. Black's gross estate did not have to include the value of the transferred Erie stock apportionable to his date-of-death interest in BLP.

The Tax Court also held that the deemed funding date of the marital **trust** was the date of Mrs. Black's death. This was based on the terms of the revocable **trust**, which provided that the amount of the pecuniary bequest was only ascertainable when the federal estate tax liability of Mr. Black was known. On the date of Mr. Black's death, BLP had yet to be appraised. Mr. Black's federal estate tax return was not filed until after Mrs. Black's death, however, as she survived Mr. Black and the marital **trust** was to terminate on Mrs. Black's death. Thus, her date of death was the last possible date on which the marital **trust** could have been funded.

Permitted deductions.

As to the interest deduction, the Tax Court relied on *Graegin* for the possible immediate deduction of the interest, although the interest was payable in a lump sum more than four years from the date of the loan. The Tax Court found, however, that the $71 million loan from BLP to Mrs. Black's estate was unnecessary in that BLP might have redeemed a part of the partnership interests of the estate by distributing Erie stock, which the estate might have sold to pay the debts. The Tax Court therefore held that the loan from BLP to Mrs. Black's estate was not "necessarily incurred" within the meaning of Reg. 20.2053-3(a) , so the interest on the loan was not a deductible administration expense.

Finally, the Tax Court held that Mrs. Black's estate could deduct $481,000 of its reimbursement of Erie's secondary offering costs, $577,500 for the executor fee, and $577,500 for legal fees because only those amounts corresponded to expenditures or efforts on behalf of Mrs. Black's estate. These amounts represented 49% of amounts involved. The Tax Court determined that the reimbursement of Erie's secondary offering costs might qualify as an expense related to a sale "necessary in order to pay the decedent's debts, expenses of administration, or taxes" within the meaning of Reg. 20.2053-3(d)(2) .

Of the $98 million realized from the secondary offering, however, only $71 million was made available to the estate. Furthermore, of that, $20 million was used to fulfill Mr. Black's charitable bequest, and after subtracting the $3.3 million in executor and legal fees, only approximately $48 million or 49% of the $98 million was used to pay debts. This percentage was used to determine the secondary offering costs, executor fee, and legal fees that might be deducted by Mrs. Black's estate.

Conclusion

The Tax Court is a national court and will generally follow its prior decisions across the country. Tax Court decisions are appealed to the circuit court for the taxpayer's place of work or residence. The decisions of the circuit courts are not always consistent as can be seen in this situation. Thus, when a taxpayer whose circuit has ruled on a given issue brings a case that includes that issue before the Tax Court, the Tax Court follows the holding of the pertinent circuit, even if the Tax Court disagrees with the holding or if another circuit has issued a contrary holding. This can lead to contradictory Tax Court rulings, based solely on the state of the taxpayer's residence unless the Tax Court can find consistency with the decision of the pertinent circuit. [1]

The recent Tax Court decision in *Black* is, like its prior decision in *Schutt* had been, appealable to the Third Circuit. Both decisions followed the Tax Court decision in *Bongard* that to come within the Section 2036 bona fide sale exception, a legitimate and significant nontax reason is needed for creating the FLP, and the transferors must receive proportionate interests. It is the position of the Tax Court that the exception does not specifically require an active trade or business or any business reason. The Tax Court in *Black,* as it did in *Schutt,* viewed the position of the Third Circuit in *Turner*—which has been interpreted as requiring a business purpose—as being consistent with the position of the Tax Court in *Bongard.* Obviously it is the position of the Tax Court that an active trade or business or any business purpose is one but not the only legitimate and significant nontax reason for creating a FLP that allows one to come within the Section 2036 bona fide sale exception. Although some judges in other courts might still want to see a business purpose, the Tax Court will not seek a business purpose unless it is required to by future pertinent circuit decisions.

Although the two questions initially posed might to some extent be resolved in the Tax Court, more litigation outside the Tax Court is necessary to answer them completely.

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USING A PERSONAL RESIDENCE DGT TO CAPITALIZE ON REDUCED PROPERTY VALUES

When real estate values are substantially depressed, using a sale to a defective grantor trust can result in more beneficial estate tax results than does a qualified personal residence trust.

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While the continued "repeal" of the estate tax for 2010 is uncertain, it is almost guaranteed that some form of estate tax will reappear in 2011 if not sooner. Whether the amount an individual can pass estate tax-free[1] returns in 2011 to $1 million as currently legislated, is set at the $3.5 million allowed previously in 2009, or is negotiated to another number, it is very clear that the estate tax is not going away anytime soon.[2] Therefore, taxpayers with estates over $5 million should expect some form of estate tax to apply to them.[3] For such taxpayers with large personal residences or vacation homes as part of their overall net worth, rare opportunities exist today to use some excellent planning tools to reduce or eliminate a good portion of such estate tax.

Although most homeowners see the substantial reduction in residential real estate value across all areas of the country[4] as only a detriment, these reduced values do provide a great estate planning opportunity. By transferring some or all of the real estate to an irrevocable trust, the taxpayer is able to "freeze" the value of the real estate at today's value and allow all future appreciation to pass tax-free out of the estate.

QPRT

One common strategy often employed for residential real estate is the qualified personal residence trust (QPRT). With that vehicle, the grantor transfers his or her residence to an irrevocable trust and retains the right to occupy the residence rent-free for a period of years.[5] By retaining the right of occupancy, the **gift** tax value of the transfer is reduced by the present value of the retained interest. To the extent the residence is transferred to multiple QPRTs or transferred separately by a husband and wife, the appraised value of the residence may be reduced by fractional interest discounts.[7]

For example, by retaining a 25-year term on a $2 million residence, the value of the transfer for **gift**-tax purposes is reduced by more than $1.4 million to $600,000. This assumes the interest rate used for valuing the income interest is 3.4% (the rate as of February 2010) and the taxpayer is 50 years old. If the undiscounted value of the residence was $2.4 million[8] and the residence appreciated at only 3% for 25 years, the entire residence worth $5 million would pass tax-free to the taxpayer's children.[9] As a result, by using $600,000 of the taxpayer's unified credit equivalent upfront, the estate tax savings on the $5 million transfer could be $2 million or more. This also assumes

only 3% growth on the residence; to the extent the value is depressed, the estate tax savings could be much higher.

While the QPRT can provide substantial benefits, there are four potential drawbacks with its use:

(1) The taxpayer must survive the retained term for the entire value of the residence to be excluded from his or her estate. Therefore, if the taxpayer is elderly or in poor health, the taxpayer should select a shorter term for the QPRT that the taxpayer is likely to outlive. However, the shorter the term of the QPRT, the greater the amount of the taxable **gift** of the remainder. For example, the taxable **gift** in the greater than 25-year term example doubles from $600,000 to almost $1.3 million with a ten-year term. Life insurance may be used in certain circumstances to minimize the risk of an early death to the extent the taxpayer is insurable.

(2) The trust is irrevocable and the residence must pass either outright or in trust to the taxpayer's children at the end of the term. To the extent the taxpayer would like to remain in the residence, he or she will need to rent back the residence from the children or the irrevocable trust. While the payment of rent effectively provides the taxpayer an opportunity to make additional tax-free **gifts** to his or her heirs, some taxpayers would prefer the option of recovering the residence at the end of the term—which is no longer permitted in a QPRT.

(3) Unlike many other estate planning strategies, the current low interest rate environment is a detriment to the QPRT as it reduces the value of the retained right to occupy the residence. For example, in the above scenario, if the interest rate used for valuation increased from 3.4% to 6% (as it was in early 2007), the taxable **gift** on the $2 million residence would be only $304,000 and save more than $295,000 of unified credit.

(4) Because the grantor retains an "interest" in the QPRT for the initial term, the generation-skipping transfer (GST) tax rules prevent the taxpayer from allocating his or her GST exemption to the initial **gift** to the QPRT. As a result, the QPRT does not give the taxpayer the ability to do GST planning with the residence and hold the property for the benefit of multiple generations tax-free.

DGT sale

These drawbacks can be overcome by using a common technique, a sale to a defective grantor trust (DGT sale), instead of a QPRT for the residence. Typically, a DGT sale is a technique whereby the grantor creates an irrevocable trust and funds it with a small taxable **gift**. Then, the grantor sells property to the trust in exchange for a promissory note. To the extent the property is income producing, some or all of the income is then used to repay the note over time. Once the note has been repaid, the value of the property is retained by the irrevocable trust and not subject to estate tax. Because the grantor retains a promissory note and not a retained interest in the trust, a premature death only causes the outstanding balance of the note to be included in the grantor's estate for estate tax purposes. [20] Therefore, unlike the QPRT, the estate tax benefit is not conditioned on the survival of the grantor.

A personal residence is not often considered a prime asset for a DGT sale since the asset is not typically income producing and the trust would not have sufficient assets to repay the promissory notes. However, assuming the grantor continues to reside in the residence after contribution to the DGT, the grantor can continue to reside in the property and pay fair market value rent to the irrevocable trust. The trust includes specific provisions that require all transactions between the grantor and the trust to be ignored for

income tax purposes. As a result, the original "sale" of the residence to the trust in exchange for the promissory note, all rental payments made by the grantor to the trust, and all interest and principal payments made by the trust to the grantor have no income tax effect. Essentially, the grantor will make rental payments to the trust and the trust can use some or all of those rent payments to make interest and principal payments back to the grantor in satisfaction of the note. Depending on the fair market rental rates for the residence, the notes can often be repaid in 12-20 years. At the minimum, the value of the residence will be "frozen" at the current value.

Using the same assumptions from the QPRT example above, the undivided residence worth $2.4 million was valued at $2 million for transfer tax purposes due to minority and marketability discounts associated with transfers of fractional interests. Assuming the grantor gives cash or property worth $200,000 to seed the trust, the balance due on the note would be $1.8 million and bear interest at 2.82%. Assuming the fair rental value of the residence is $10,000 per month and increases at the same 3% per year as the value of the residence, the balance of the note could be completely repaid in 16 years. Since rent can continue to be paid to the trust between years 16 and 25 (which was the final year of the QPRT term) and the rent and any reinvested accumulation grows income tax-free to the trust, Exhibit 1 illustrates that the net amount to the trust at the end of the 25 years can be more than $2.9 million. As a result, the residence DGT would produce a greater result than the QPRT with a lower initial **gift**.

One of the main reasons the result is better with the DGT sale is the ability to capitalize on the low interest rates. As an example, if the interest rates rose to 4% per year, the note would not be completely repaid for almost 18 years.

One of the other benefits of the DGT sale to the QPRT is the increased flexibility. Unlike the QPRT, the grantor retains the ability to exchange the residence with any property of equivalent value in the future. As an example, if the irrevocable trust repays the promissory note issued in year 15 and the residence is valued at $3.5 million, the grantor might choose to exchange cash or other property equal to $3.5 million to the trust for the residence so that he or she can continue to reside there rent-free until death. This also provides the grantor the potential opportunity to exchange cash or other high-basis assets with the residence prior to death and receive a full step-up in basis on the residence to fair market value upon death.

Lastly, if the grantor would like the property to remain in the family and pass from children eventually to grandchildren, the DGT sale is a better option. Because the grantor retains only a promissory note, in the above example, he or she may allocate $200,000 of his or her GST exemption to the initial **gift** and the residence can be held in trust for the benefit of children, grandchildren, and even great-grandchildren. This is not an option with the QPRT where the property must be subject to estate tax upon the death of the grantor's children.

As an added non-estate tax benefit of both the QPRT and the DGT sale, the transfer of the personal residence to the trusts may help protect the residence from seizure or sale by a future creditor of the grantor. [35] One of the easiest assets for a creditor to attach is real estate held in the grantor's personal name. With both the QPRT and DGT sale, however, the grantor no longer owns the home and instead retains the right to occupy the home or retains a promissory note. While a creditor has access to the grantor's right to occupy the home or can obtain the grantor's interest under the promissory note, the creditor may not be able to force a sale of the property. This potential benefit exists whether the grantor uses the QPRT or the DGT sale.

Conclusion

In sum, using both a standard QPRT and a DGT sale to "freeze" the value of one's personal residence can yield beneficial estate tax results. The QPRT, which is legislatively permitted under the Code, is often considered the primary estate planning technique for personal residences. However, in many circumstances, the sale of the personal residence to an irrevocable grantor trust provides better estate tax results. At the minimum, it provides additional flexibility to the grantor to reacquire the personal residence trust, permits the residence to be held in the family for multiple generations, and does not require the grantor to survive the entire term to be effective. Therefore, currently when real estate values are substantially depressed, using the DGT sale to capitalize on the low valuations for estate planning purposes is like turning lemons into lemonade.

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VALUATION OF LOTTERY PRIZE PAYMENTS FOR ESTATE TAX PURPOSES

Courts are split over whether IRS annuity tables should be used to value future lottery or structured settlement payments that are subject to limitations on transferability.

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A "Great Debate" has developed in the valuation of inalienable lottery prize payments for **estate** tax purposes. With the Sixth Circuit's recent decision in Negron, [1] the circuits are now evenly split two-to-two over the valuation of lottery payments with marketability restrictions. That is, the Fifth and Sixth Circuits are in concert, but the Ninth and Second Circuits are diametrically opposed. Moreover, the Treasury issued Reg. 20.7520-3(b) (effective on 12/14/95) to address the valuation issue. This regulation defines an ordinary annuity interest as the right to receive a fixed dollar amount at the end of each year or for some other defined period. Additionally, it provides that a restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction. A restricted beneficial interest is not required to be valued considering the IRS annuity tables. A question that arises is whether the nontransferable structured payments constitute a restricted beneficial interest, and hence, a departure from the annuity tables is warranted.

The split among the circuits centers on whether the annuity tables produce an "unrealistic and unreasonable" value when future lottery or structured settlement payments are subject to limitations on transferability. There is some common ground among the judiciary. Courts agree that these payments are annuities, and the annuity tables are appropriate for valuation unless their results are "unrealistic and unreasonable" and a more reasonable and realistic means of determining value is available. The party challenging applicability of the tables as established in the regulations has the burden of demonstrating that the tables produce an unreasonable result. Since the decisions of the Second and Ninth Circuits preceded the effective date of Reg. 20.7520-3(b) , these two circuits have not considered the "restricted beneficial interest" limitation for lottery payments. However, the courts that have considered the applicability of the "restricted beneficial interest" limitation have determined that these payments do not qualify.

Background

State lotteries are a fairly new form of gambling in America. In 1964, New Hampshire was the first state in the union to hold a lottery. Currently, there are state lotteries in 42 states. In 2005, the U.S. grossed over $52 billion, and in 2006, the U.S. grossed over $53 billion in revenue from state lottery sales. [2] Most states use their lottery revenues to augment funding for education (e.g., Georgia) and public works projects (e.g., Louisiana).

When a person wins the lottery, the state lottery commission tends to offer the winner a choice in taking the prize winnings as a lump-sum or as a series of inalienable installment payments, much like an annuity. Most state lotteries report that younger winners tend to opt for a lump-sum payment of their winnings, while elderly winners tend to opt for a series of inalienable installment payments. The lottery prize winnings are often

nontransferable, meaning that the winner of the lottery prize is not able to sell his or her right to the future payments. The death of a lottery winner receiving inalienable installment payments sometimes creates a liquidity issue when **estate** taxes cannot be paid when due. Valuing the remaining lottery payments in the winner's **estate** also can be a problem.

Illiquid estates.

Many people who buy lottery tickets are middle to low-income earners. Upon death, these taxpayers typically do not have enough assets in their **estate** to qualify for paying **estate** taxes. When a person from these income classes wins a sizeable lottery prize, the prize money alone will often put him or her over the **estate** tax threshold. Because lottery winners often opt to receive their prizes as nontransferable installment payments, many **estates** are not able to pay for the **estate** taxes until some of the remaining lottery payments are received. Without liquidity in the **estate**, they are not able to pay the **estate** taxes when they are due. The **estates** are then penalized in the form of interest on the **estate** taxes due and deficiencies until the **estate** tax has been paid.

Marketability.

The main issue in valuing future lottery payments for **estate** tax purpose has been the nontransferable nature that these payments tend to possess. Because of this restriction, a potential buyer of these types of payments is more likely to place a lower value on a nontransferable series of payments than on a series of payments that do not possess a transfer restriction. To account for this loss in value, a marketability discount is applied to reduce the fair market value of nontransferable lottery payments. The Service's preferred method of valuation for remaining lottery payments is through the annuity tables in Sections 2039 and 7520 . According to the IRS, these annuity tables already discount the future lottery payments to present value. **Estates** argue that the Section 7520 annuity tables do not take into account a marketability discount; therefore, they should be allowed to use another form of valuation that includes this discount when valuing the remaining lottery payments for their **estate** tax returns.

Statutory guidance

The Code does not specifically determine the valuation of lottery winnings, but it does account for the valuation of these payments in general. That is, an **estate** tax is imposed on the transfer of the taxable **estate** of every deceased U.S. citizen or resident. [3] The gross **estate** includes the value at the time of the decedent's death of all property, real or personal, tangible or intangible, wherever situated. [4] For **estate** tax purposes, the valuation date is the date of the decedent's death, unless the alternate valuation date is elected. [5] Pursuant to Section 2033 , the value of the gross **estate** includes the value of all property to the extent of the interest therein of the decedent at the time of his or her death. The general rule for valuation is that the value of every item of property includable in a decedent's gross **estate** is its fair market value. Fair market value 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 the relevant facts. [6]

When the value of the decedent's gross **estate** is substantial (in excess of $3.5 million for 2009), the **estate** is required to file Form 706 and pay federal **estate** taxes within nine months after the date of the decedent's death. [7] However, the executor of an **estate** can obtain a general extension of time for the payment of the **estate** tax for a period not

to exceed 12 months from the date fixed for payment of the **estate** tax.[8] The time for payment of **estate** taxes may be deferred for a period not in excess of ten years for "reasonable cause."[9] Grounds exist for an executor of an illiquid **estate** with inalienable lottery payments to apply for this discretionary extension of time.

The value of annuities is specifically included in the gross **estate** and that value is determined via tables prescribed by the Secretary.[10] As a result, the regulations assert that, except as otherwise provided, the fair market values of annuities and other interests are their present values as determined under the annuity tables.[11] The Service adopted the principles of well-established case law, including the "unreasonable and unrealistic" results exception, when it adopted these regulations.

In summary, the above statutes provide for either the use of the annuity table method or the fair market value method as relevant for the valuation of nontransferable lottery payments for **estate** tax purposes. Furthermore, the general fair market value regulation allows departure from the annuity tables only when the tables do not produce a value that reasonably approximates the fair market value of the annuity interest.

Administrative stance

The Service has promulgated specific regulations for the valuation of annuity payments and issued specific technical advice memoranda(TAMs) regarding the valuation of nontransferable lottery payments for **estate** tax purposes. The IRS issued TAM 9616004 , which concludes that the present value of lottery winnings payable in the form of an annuity for a specified period is determined based on the annuity tables. Additionally, the TAM requires the use of the interest rate in effect the month of the decedent's death. These requirements are specified even though the annuity payment may not be assigned without judicial approval. TAM 9909001 resolves that the present value of lottery winnings payable in the form of an annuity to a partnership should be determined under the annuity tables using the specified interest rate.

Judicial decisions

The judicial decisions on lottery valuations are presented in chronological order.

Shackleford

In 2001, the Ninth Circuit decided for the taxpayer in ***Estate** of Shackleford*,[12] upholding the district court's decision. Regarding this case, retired Air Force officer Thomas Shackleford hit the $10 million California Lotto in 1987. After receiving only three of 20 $508,000 annual payments, Thomas Shackleford died on 8/27/90, and an **estate** tax problem became abundantly clear to his heirs.

Upon death, the future payments were to be made to the deceased's **estate** according to the annuity terms, and the **estate** tax was to be calculated based on the present value of this income stream. At that time, California prohibited the receipt of a lump sum payment by the lottery winner or assignment of lottery payments to other parties without a court order. Considering the IRS annuity tables, the present value of the remaining payments was $4,023,903 and the **estate** owed $1,543,397 in federal **estate** taxes. The **estate** initially filed a return that reported the federal **estate** tax liability in accordance with the annuity tables and paid the total federal **estate** tax liability due. Subsequently, the **estate** filed both amended tax returns and a claim for refund, asserting that the value of

the future payments was improperly reported. The **estate** argued that use of the annuity tables to value the payments resulted in an "unrealistic and unreasonable" value because it did not reflect the fair market value of the asset. The IRS rejected the final refund claim, and the **estate** filed its claim for refund in district court.

The district court held that if the **estate** could prove that the true value of the interest was substantially below that attributed by the tables, departure would be warranted. The **estate** asserted that the trading prices of interests in lottery prizes around 1990 were substantially discounted to reflect questions surrounding the validity of those transactions. Also, it claimed that the proper discount rate to be used in determining the present value of a lottery prize could be derived by reference to the rate on tax-adjusted California bond obligations in August 1990, which was 10.4%.

The district court, after considering expert testimony on the issue, found that the use of the annuity tables produced a substantially "unrealistic and unreasonable" result, because the tables did not reflect the illiquidity of the prize. The court departed from the tables and valued the payments at $2,012,500, based on the taxpayer's expert witness and a positive adjustment for the risklessness of payments to be received from the state.

On appeal, the Ninth Circuit further reasoned that "the right to transfer is one of the most essential sticks in the bundle of property rights, and that the statutory restrictions on transfer reduced the fair market value of the right to receive future lottery payments." Therefore, the Ninth Circuit upheld the lower court's decision that sided with the taxpayer, also holding that the tables produced "unrealistic and unreasonable" results.

Gribauskas

In 2003, the Second Circuit decided for the taxpayer in ***Estate** of Gribauskas*,[13] reversing the Tax Court's decision, and held that the annuity tables produced "unrealistic and unreasonable" results. The decedent, Paul Gribauskas, and his wife won a $15,807,306.60 Connecticut Lotto prize in late 1992. This prize was to be paid in twenty annual installments of $790,365.34. The Connecticut Lotto prohibited acceleration of the annual installments; furthermore, winners were forbidden to transfer their rights to future installments to third parties. Following the first installment, the Gribauskas' divorced and each was entitled to receive annual installments of $395,182.67. Gribauskas died intestate on 6/4/94, with 18 installments remaining to be paid.

The decedent's **estate** timely filed the **estate** tax return on 9/11/95. The value of the remaining prize installments was discounted on the return to account for restrictions imposed on Lotto winnings by the State of Connecticut. The taxpayer identified a market that existed for such unassignable lottery winnings, albeit as a significant discount, at the time that the **estate** filed its return. This restriction and grey market discount was similar to those in *Shackleford.* The executor of the decedent's **estate**, after factoring in this risk-based market discount, valued the Lotto prize at $2,603,661.02 on the **estate's** return. The Service valued the lottery winnings at $3,538,058.22, in accordance with the annuity tables, and assessed an **estate** tax deficiency of $403,167.

On 2/18/98, the **estate** filed a petition with the Tax Court seeking redetermination of the deficiency. In support of its petition, the **estate** argued that the annuity tables should not govern valuation in this case because they yielded an "unrealistic and unreasonable" result because they did not accurately account for loss of value due to marketability restrictions. Notably, the taxpayer asserted that the prize's market value was diminished considerably due to transfer restrictions. The Tax Court held that the prize constituted an annuity and that marketability restrictions did not justify departure from the tables. In

particular, the court concluded that prior case law did not support deviating from the annuity tables on the basis of marketability restrictions alone. There was no clear risk that the **estate** would not receive future installments to justify departure from the tabular valuation. Furthermore, deviation from the annuity tables would undermine the policy favoring standardized valuation of annuities as per the intent of Congress.

The Second Circuit, however, agreed with the Ninth Circuit's reasoning that transfer restrictions reduced fair market value. The court explained that the **estate** met its substantial burden of showing that the tables produced an "unreasonable and unrealistic" result under these circumstances. This led the Second Circuit to reverse the Tax Court's decision.

Cook

On the other hand, also in 2003, the Fifth Circuit upheld the Tax Court's decision in *Cook* [14] to side with the IRS. In this case, Gladys Cook and her sister-in-law Myrtle Newby won a Texas lottery prize valued at $17 million on 7/8/95 payable in 20 annual installments. The initial payment of $858,648 was made 7/10/95, and the remaining payments of $853,000 each would be made on July 15th of the next 19 years. Texas law prohibited the assignment, other than by court order, of the right to receive the lottery payments, and lump sum collection was not available at the time.

On 7/12/95, Cook and Newby formed a limited partnership and each assigned her interest in the lottery winnings to that partnership. In exchange, each received a 48% limited partnership interest and a 2% general partnership interest. To address the apparent inconsistency of transferring the nonassignable lottery payments to the partnership, the **estate** explained that the partnership itself won the prize. According to the **estate**, the document titled "Assignment" in the partnership agreement was not a true assignment, but simply a formalization of the already existing partnership. The IRS accepted the partnership as owning the lottery prize for purposes of this litigation.

Cook died on 11/6/95, and the partnership's assets on that date were $391,717 in cash and the right to receive 19 annual lottery payments of $853,000 each. The parties asserted that no market for the right to lottery payments existed in Texas at the time of Cook's death. This fact was different than in the preceding *Shackleford* and *Gribauskas* cases, in which active grey markets existed to value the lottery prize.

Cook's executor hired a valuation expert who valued the partnership's right to the lottery payments at $4,575,000, using a discounted cash flow method and including a discount for nonmarketability. He valued the **estate's** interest in the partnership at $1,529,749, and the **estate** included this amount on its **estate** tax return. The IRS valued the partnership's right to the lottery payments using the annuity tables at $8,557,850. It then valued the **estate's** partnership interest at $3,222,919, allowing discounts for lack of control, restrictions in the partnership agreement, and lack of a ready market. Therefore, the Service's valuation yielded an $873,554 deficiency in the tax paid by the **estate**.

The **estate** petitioned the Tax Court for a redetermination of the deficiency, contending that the IRS erred in using the annuity tables to value the lottery prize held by the partnership. The **estate** and the Service agreed that the only remaining disputed issue was whether the lottery prize must be valued according to the annuity tables for purposes of valuing the partnership interest. Based on input from their respective experts, the parties also agreed to alternate values for the partnership interest if the

prize must be valued under the annuity tables. The value of the partnership interest was either to be $2,908,605 or $2,237,140.

The Fifth Circuit disagreed with the position of the Second and Ninth Circuits that marketability restrictions should be considered when valuing a lottery prize. The court reasoned that the annuity tables did not produce unreasonable results because nonmarketability of a private annuity is an assumption underlying the annuity tables. It also found it unreasonable to apply a nonmarketability discount when the asset to be valued is the right, independent of market forces, to receive a certain amount of money annually for a certain term. Furthermore, a marketability factor was not necessary to determine the value of a fixed income stream. The value was readily ascertainable by taking the present value of the remaining payments, using the annuity table discount rates. The Fifth Circuit sided with the IRS and upheld the Tax Court's decision that departure from the annuity tables was not warranted for valuation of the lottery prize in this case.

Donovan

In 2005, the Massachusetts federal district court decided for the government in ***Estate** of Donovan.* [15] This was the first case to address the valuation of lottery prize winnings for **estate** purposes after the effective date of Reg. 20.7520-3(b). The decedent, John Donovan, Jr. won the Massachusetts lottery on 1/4/99 and received his first and only payment of 20 annual $100,000 checks before his death on 7/23/99. Like the other cases, neither Donovan nor his **estate** was permitted to transfer the future payments to be received from Massachusetts to other parties. The **estate** tax return was filed on 4/9/00 and reported no **estate** tax due as an appraiser valued the remaining 19 payments at only $367,482, which included a discount for marketability restrictions. The Service audited the return and valued the asset at $1,091,553.28, using the annuity tables. The **estate** paid the resulting $173,610.99 tax liability, filed a claim for refund of this amount on 7/31/01, and, after the IRS denied the claim, brought suit on 3/26/04.

The premise of the taxpayer's suit contended that the lottery winnings were not an "ordinary annuity," but rather a "restricted beneficial interest," which justified departure from the annuity tables. However, the district court interpreted the "restricted beneficial interest" exception to mean payment streams that were in jeopardy of receipt, not merely to payment streams in which the right to transfer the interest was restricted. Hence, the court concluded that the "restriction" on the marketability of lottery earnings was not one that warranted characterizing the proceeds as "restricted beneficial interests" under the regulations. Additionally, according to the court, the taxpayer failed to demonstrate that the annuity tables produce a result that is "unrealistic and unreasonable." The taxpayer did not appeal this case to the First Circuit.

Davis

In 2006, the New Hampshire federal district court also sided with the IRS in *Davis,* [16] which also was not appealed to the First Circuit. In 1989, Kenneth Freeman won the Massachusetts lottery and received the first of 20 annual payments of $209,220 from the state. Freeman died in 1999 after receiving ten annual payments. Upon his death, the remaining annuity payments became payable to Freeman's **estate** and were being paid by the state. The executrix filed the federal **estate** tax return for the **estate** on 2/1/00 and reported a tax due of $520,012. Additionally, the **estate** tax return reported a prior payment of $530,624 and a $10,612 refund due for the difference. The **estate** disclosed the remaining ten annual payments due from the state as an asset of the **estate** valued at $1,584,690, based on the annuity tables. Subsequently, the IRS audited the **estate's**

return and determined that the ten remaining payments should have been valued at $1,607,164. The **estate** agreed that this amount was correct if the court decided that the value of the annuity payments must be determined by reference to the annuity tables.

However, the executrix determined that reference to the annuity tables was not appropriate because the tables fail to take into account the marketability restriction caused by the nontransferable nature of the payments. The **estate** filed a claim for a refund on 12/28/01, asserting that the correct value of the remaining annuity payments was only $800,000. On 11/21/02, the IRS denied the **estate's** claim for a tax refund. The taxpayer then filed suit seeking a tax refund in district court. The parties agreed to the following facts in the case. First, the ten future payments owed by the state to the decedent's **estate** on the date of his death constituted an "annuity," and the decedent's interest in those payments was an "ordinary annuity interest" rather than a "restricted beneficial interest." Second, at the time of the decedent's death, the remaining ten lottery payments were neither marketable nor assignable. Last, the fair market value of the **estate's** annuity if determined by reference to the annuity tables would be $1,607,164.

The taxpayer's expert, Eugene Sommer, submitted an annuity valuation computed pursuant to the IRS tables with a 50% discount to account for the annuity's lack of marketability. In his valuation, Sommer assumed that the hypothetical purchaser of the annuity would discount its value substantially, not simply because he or she would have difficulty selling it to another party, but also because "the income stream is at risk." This assumption was substantially different from that of the Service's experts. They reasoned that a hypothetical purchaser of a virtually riskless, but nontransferable, right to receive annual payments from Massachusetts would be willing to pay something very close to the present value of those payments.

Accordingly, the court resolved that the question at hand was how much a fully informed hypothetical buyer would pay for a legally enforceable, virtually riskless right to receive ten nontransferable annual payments of about $209,000. Based on the amounts submitted by the experts, the court determined that there was at most only a 5% difference between the "true" fair market value of the **estate's** annuity and the value yielded by the annuity tables. Therefore, the court concluded that the taxpayer failed to demonstrate that the value the tables ascribed to the annuity was "unrealistic and unreasonable." Thus, the proper value for the **estate's** annuity was $1,607,164.

Anthony

In 2008, the Fifth Circuit decided in favor of the IRS in *Anthony,*[12] affirming a district court's decision. The Fifth Circuit was the only circuit court to consider the decedent's right to receive nontransferable structured settlement payments in a manner similar to that of inalienable lottery payments. James Louis Bankston, Sr., sustained serious injuries in an automobile accident in 1990. He filed suit seeking damages and agreed to structured settlements of his claims and became the beneficiary of three annuities. The payments of two of the annuities could not be "anticipated, sold, assigned or encumbered," and the payments of the third annuity were simply nontransferable. Bankston died on 7/30/96 and was scheduled to receive ten annual payments from one annuity and monthly payments until July 2006 from the other two annuities.

The **estate** valued the guaranteed payments at $2,371,409, using the annuity tables and reported a tax liability of $468,078. An audit by the IRS resulted in an additional tax of $142,605 and the **estate** paid the total tax. In September 2001, the **estate** claimed that it had overvalued the annuities because of their nontransferability clauses and that it was

due a refund of **estate** taxes in the amount of $427,620. The Service denied the claim, and the **estate** filed suit in March 2002 in a Louisiana district court. The court determined that the results yielded by the tables were not unrealistic and unreasonable in this case.

The Fifth Circuit held that these annuities were not "restricted beneficial interests" under the regulations and that the annuity tables had to be used. The court determined that the "unrealistic and unreasonable" results exception to the use of the annuity tables was available, but that a basis for departure based solely on marketability restrictions was unwarranted. Like the Second and Ninth Circuits, the Fifth Circuit agreed that the basic economic tenet that an asset subject to marketability restrictions is worth less than an identical asset without marketability restrictions. However, the Fifth Circuit ruled that the unassignable nature of lottery winnings or litigation awards did not affect the relevant value of the property. The relevant value was the value of the property in the hands of the decedent, not the value to a hypothetical buyer holding a very different property interest with substantially greater risks.

Negron

In 2009, the Sixth Circuit sided with the government in *Negron*, [18] reversing the district court's decision in favor of the taxpayer. In this case, Mary Susteric and Mildred Lopatkovich, along with an unidentified third party, jointly won the Ohio Super Lotto jackpot on 1/19/91 and equally divided the winnings of $20 million. Each winner was to receive 26 payments of $256,410.26. Both Mary and Mildred died 2001, Mary on October 31 and Mildred on November 27, with 15 lottery payments remaining. As in the other cases, the payments were not assignable and could not be used as collateral.

Negron, a court appointed executrix of the **estate**, represented both **estates** and elected to receive a lump sum cash settlement of the remaining prize awards for each **estate** from the Ohio Lottery Commission. She reported the value as $2,275,867 on each **estate** return based on the amount that each **estate** actually received. The Commission calculated the lump sum payment to the **estates** using a discount rate of 9% in effect on the date that the lottery prize was won. The Service determined that the proper values of the remaining lottery payments were $2,668,118 for Mary and $2,775,209 for Mildred. It used discount rates of 5.6% and 5.0% for Mary and Mildred, respectively, based on their differing dates of death. Negron argued that the "unreasonable and unrealistic" results exception justified departure from the annuity tables in her motion for partial summary judgment, which the district court granted.

The district court held that "transferability of an annuity would affect its fair market value and the value ascribed by the annuity tables for both **estate** taxes was unrealistic and unreasonable." However, the Sixth Circuit reversed, reasoning that the appropriate discount rate for **estate** tax purpose was as of the time of the decedent's death and not the date of the prize winnings. Hence, the discount rate used by the Ohio Lottery Commission did not reflect the current fair market value. The court emphasized that it was the **estates**' choice to cash in the remaining payments with the state and accept the lump sum amounts. Furthermore, it said, "equity arguments are insufficient to invalidate properly enacted regulations, such as those requiring the use of the IRC annuity tables."

The Sixth Circuit agreed with the Fifth Circuit that the nonmarketability of annuities was an assumption underlying the IRS annuity tables. Additionally, a marketability factor was not necessary to determine the value of a guaranteed income stream. Furthermore, under the willing buyer/seller approach to estimating fair market value, the hypothetical buyer must hold the same property rights as the **estate**.

For a summary of the judicial positions on the valuation of alienable lottery payments with marketability restrictions, see Exhibit 1.

Exhibit 1. Summary of judicial decisions valuing inalienable annuities for estate tax purposes

Case	Date	Date of Death	Valuation Method Accepted by the Courts	Decision Outcome	Taxpayer	IRS	Deficiency Redetermined
Estate of Shackleford (88 AFTR2d 2001-5658)	2001	1990	Depart from table valuation of decedent's interest in future lottery payments.	U.S. Court of Appeals, 9th Circuit	X		
	1999			U.S. District Court, Eastern California	X		
Estate of Gribauskas (92 AFTR2d 2003-5914)	2003	1994	Depart from table valuation of decedent's interest in future lottery payments.	U.S. Court of Appeals, 2nd Circuit	X		
	2001			Tax Court		X	
Estate of Cook (92 AFTR 2d 2003-7027)	2003	1995	Use table valuation of decedent's interest in future lottery	U.S. Court of Appeals, 5th Circuit		X	
	2001			Tax Court		X	

		payments.			
***Estate** of Donovan (92 AFTR 2d 2005-2131)	1999 2005	Use table valuation of decedent's interest in future lottery payments.	Not appealed to 6th Circuit		
			U.S. District Court, Massachusetts		X
Davis (99 AFTR 2d 2007-3341)	1999 2006	Use table valuation of decedent's interest in future lottery payments.	Not appealed to 6th Circuit		
			U.S. District Court, New Hampshire		X
Anthony (101 AFTR 2d 2008 2008-983)	1999 2005	Use table valuation of decedent's interest in future lottery payments.	U.S. Court of Appeals, 5th Circuit		X
			U.S. District Court, Middle Louisiana		X
Negron (103 AFTR 2d 2009 2009-634)	2001 2007	Use table valuation of decedent's interest in future lottery payments.	U.S. Court of Appeals, 6th Circuit		X
			U.S. District Court, Northern Ohio	X	

* First case after the effective date of Reg. 20.7520-3(b), 12/14/95

Conclusion

The "Great Debate" over the valuation of nontransferable lottery payments for **estate** tax purposes involves several considerations. The statutes provide for either the use of the annuity tables or the fair market value method. Furthermore, under these circumstances, fair market value is allowed only when the annuity tables produce an "unrealistic and unreasonable" result and the party desiring to depart from the use of the annuity tables has the burden of proof. The judicial decisions have determined that the payments are annuities. As a result, the courts that have considered the "restricted beneficial interest" exception have concluded that these payments do not qualify. The determining factor will be the challenging party's ability to provide sufficient evidence that the annuity tables produce "unrealistic and unreasonable" results, and a more reasonable and realistic method is available to determine fair market value.

PLANNING TIP

Beyond providing evidence of a more reasonable value than that produced by the annuity tables, an individual taxpayer has some alternatives available to him or her. Specifically, retaining a professional tax planning advisor is crucial for minimizing **estate** taxes (e.g., by maximizing the marital deduction and annual gift tax exclusions). Life insurance, when cost effective, may resolve the **estate** tax liquidity problem. Also, an **estate** may obtain an extension of time for the payment of the **estate** tax under Section 6161 for a period not in excess of ten years.

ASSETS TRANSFERRED BY DECEDENT TO FLP WERE NOT INCLUDABLE IN GROSS ESTATE

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The Tax Court in ***Estate** of Shurtz*, TC Memo 2010-21 , RIA TC Memo ¶2010-021 , held that the value of assets transferred by a decedent six years before her death to her family limited partnership were not includable in her **estate** pursuant to Section 2036(a) .

The taxpayer's parents and their descendants owned and managed timberland in Mississippi. In 1993, the family established a limited partnership (Timberlands LP) to operate the family timber business. The decedent owned a 16% limited partnership interest in Timberlands LP. She was also one of three shareholders (with her two siblings) in Timberland LP's general partner, whose sole asset was a 2% general partnership interest in Timberlands LP.

The decedent wanted to give her children and grandchildren interests in timberland that she had acquired from her parents. On the basis of her experience with Timberlands LP, the decedent had concerns about creating a large number of undivided interests in her timberland. She and her husband also wanted to minimize **estate** taxes with respect to the value of her assets. To alleviate their concerns, she and her husband formed a limited partnership (Doulos LP).

Because the timberland was owned only by the decedent, to create a partnership, it was necessary for her to transfer an interest in the timberland to another person. Accordingly, in 1996, she transferred a 6.6% interest in the timberland to her husband. He then contributed the 6.6% interest to Doulos LP for a 1% general partnership interest. The decedent contributed her 93.4% interest in the timberland, as well as her 16% interest in Timberlands LP to Doulos LP for a 1% general partnership interest and a 98% limited partnership interest.

Between 1996 and 2000, the decedent made 26 gifts of 0.4% limited partnership interests in Doulos LP to her children and to trusts for her grandchildren. At the time the decedent died in 2002, the interests in Doulos LP were as follows:

- 1% general partnership interest held by the decedent.
- 1% general partnership interest held by her husband.
- 87.6% limited partnership interest held by the decedent.
- 10.4% limited partnership interests held by her children and her grandchildren's trusts.

When the **estate's** tax advisors calculated the **estate** tax, the decedent's 87.6% limited partnership interest was valued at $6,116,670, and her 1% general partnership interest was valued at $73,500. The other two major assets of her **estate** were her interest in Timberlands LP's general partner and one third of the residue of her mother's **estate**.

To achieve the decedent's **estate** plan's objective of minimizing or eliminating **estate** taxes, $345,800 went to a unified credit trust and the rest went to trusts qualifying for the marital deduction. After taking deductions for expenses and considering the remaining amount of the decedent's lifetime unified credit, her **estate** tax advisors believed that no federal **estate** tax was due, and no **estate** tax return was timely filed.

The IRS disagreed with the **estate's** calculations. It determined a federal **estate** tax deficiency of $4,737,934 and an addition to tax pursuant to Section 6651(a)(1) of $1,184,484 for failing to file a tax return. The Service contended that the values of the assets contributed to Doulos LP were includable in the value of the decedent's gross **estate** because she retained the control, use, and benefit of the transferred assets within the meaning Section 2036(a) . On the other hand, it asserted that for purposes of Section 2056(a) , the value of the decedent's interest in Doulos LP should be used to determine the amount of the marital deduction.

The **estate** argued that the decedent left no taxable **estate** because the entire **estate** was left first to a unified credit trust (formed to use the unified (exemption) credit) and then to various marital trusts. According to the **estate**, Section 2036(a) did not apply because the decedent's transfer of assets to Doulos LP constituted a "bona fide sale for adequate and full consideration" within the meaning of that section.

The Tax Court pointed out that Section 2036(a) is applicable when three conditions are met:

(1) The decedent made an inter vivos transfer of property.
(2) The decedent's transfer was not a bona fide sale for adequate and full consideration.
(3) The decedent retained an interest or right enumerated in Section 2036(a) in the transferred property.

Bona fide sale. The **estate** conceded that an inter vivos transaction occurred, and so the court moved on to the second condition. It

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pointed out that with respect to the contribution of property to a family limited partnership, it had stated in ***Estate** of Bongard*, 124 TC 95 (2005), that "the bona fide sale for adequate and full consideration exception is met where the record established the existence of a legitimate and significant nontax reason for creating the family limited partnership (FLP), and the transferors received partnership interests proportionate to the value of the property transferred." In that case, the court also stated that "the bona fide sale exception in section 2036(a) is applicable only where there was an arm's-length transaction." (See "LLC Units But Not Stock Included in **Estate**," 74 PTS 216 (May 2005).)

The *Shurtz* court pointed out that the decedent had several legitimate nontax reasons for establishing Doulos LP. According to the court, she was motivated by legitimate concern regarding the threat of Mississippi litigation. The establishment of FLPs was a customary response in Mississippi to this threat, the court said, and the Doulos LP partnership agreement was designed to limit the exposure of partnership ownership interests.

Additionally, the court said that establishing Doulos LP facilitated management of the timberland the decedent and her husband contributed to the partnership. Having multiple undivided ownership interests impeded the management of Timberland LP's property, and the same problem existed with timberland directly held by the decedent. Although only a portion of the property that was contributed to Doulos LP required active management, the court pointed out that courts have found this to be sufficient. For example, in *Kimbell*, 93 AFTR 2d 2004-2400 , 371 F3d 257 , 2004-1 USTC ¶60486 (CA-5, 2004), the subject property amounted to only 11% of the total assets contributed to the FLPs. In the present case, the value of the decedent's timberland (which required active

management) was 15.8% of the assets she contributed to Doulos LP. (See Walsh, "Fifth Circuit Decision Breathes Life Into FLPs," 73 PTS 41 (July 2004).)

Although the decedent did not manage the day-to-day operations of Doulos LP, no major decisions were made without her approval. Further, the decedent's husband, who was also consulted before major decisions, also received an ownership interest in the business. In *Kimbell*, the appeals court found that giving the decedent's son, who had managed the business for some time, an ownership interest was a factor in finding that a bona fide sale occurred.

Finally, the Tax Court said that business activities occurred with respect to the timberland. It pointed out that Doulos LP annually amortized business expenses, and in 1997 it realized a gain from cut timber. The court concluded by recognizing that although reducing **estate** taxes was a motivating factor in establishing Doulos LP, the decedent had valid and significant nontax reasons for establishing the partnership.

Full and adequate consideration. In ***Estate*** *of Bongard*, the court set out a list of factors by which it determined whether full and adequate consideration was received. It said all factors had been met in the present case:

(1) The contributors received interests in Doulos LP proportionate to the contributed ownership interest. The decedent and her husband engaged an accountant to calculate the value of a 1% general partnership interest in Doulos LP based on the total property contributed.
(2) The respective assets were properly credited to each partner's respective capital account.
(3) Distributions from Doulos LP required a negative adjustment in the distributee partner's capital account.
(4) Most importantly, there was a legitimate and significant nontax business reason for establishing Doulos LP.

Because the court concluded that a bona fide sale for adequate and full consideration in money or money's worth occurred, the fair market value of the property was not includable in the value of the decedent's gross **estate**. Consequently, the court did not have to address whether the decedent retained an interest or right enumerated in Section 2036(a) in the transferred property. Based on this, the court determined that the fair market value of the decedent's partnership interest in Doulos LP, rather than the fair market value of the contributed property, was includable in the value of her gross **estate**.

Because of that conclusion, the court decided that the marital deduction to which the **estate** was entitled under Section 2056 should be computed according to the value of the partnership interest that actually passed to the decedent's husband. Finally, because the assets transferred to Doulos LP were not includable in the decedent's gross **estate**, there was no **estate** tax deficiency and no tax due from the **estate**. Thus, the **estate** was not liable for an addition to tax pursuant to Section 6651(a)(1) .

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BENEFICIARIES WERE LIABLE AS TRANSFEREES FOR ESTATE TAX DEFICIENCIES

The Tax Court in *Upchurch*, TC Memo 2010-169 , RIA TC Memo ¶2010-169 , held that recipients of settlement payments from **estate** that were later disallowed by the IRS were liable for **estate** tax deficiencies as transferees of property from the **estate**.

At the time of their marriage, Tasker and Judith each had children from prior marriages. Bruce and Carl were Tasker's sons, and Judith had three children, Rodney, Ronald, and Robin. Tasker died in 1994, and Judith died in 2000. Among other bequests, her will directed that her interest in her house be divided among all five children.

After Judith executed her will in 1999, she subdivided the land on which her house was located. On 3/19/00, she conveyed part of the land to Ronald who built a house on it. On 8/8/00, she conveyed the rest of the land and her house to Robin. Twelve days later, she died. Judith's brother Larry was appointed executor of the will. The two parcels of land were not divided into equal interests and distributed to the children because neither was part of Judith's **estate** at the time of her death.

Bruce and Carl filed suit against the other children and Larry, as executor of the **estate**, seeking (1) to impose a constructive trust on the two parcels in favor of the **estate** and its devisees and legatees, including Bruce and Carl, or, in the alternative, (2) to obtain a declaratory judgment that both quitclaim deeds were invalid. They claimed that Judith, in poor health when the parcels were conveyed, used inaccurate, overlapping legal descriptions to convey the parcels and thus there were no valid deeds in the chain of title, which would have deprived the **estate** of the ownership of the parcels. They also alleged that Ronald and Robin had a fiduciary duty to Judith because of her poor health. According to them, the deeds were made in violation of the fiduciary relationship because the deeds operated to Judith's detriment by leaving her no interest in the parcels while she was alive and living in the original house on one of the parcels.

Subsequently, all the parties to the litigation signed a settlement agreement, which stated that Judith's **estate** would pay $53,000 each to Bruce and Carl. The agreement stated that Bruce and Carl would each file a claim for $53,000 in probate against the **estate**, which the **estate** would allow.

After the IRS audited the **estate**, the IRS disallowed the **estate's** claims to deduct as debt of the **estate** the settlement payments made to Bruce and Carl. The Service explained that it disallowed the settlement payments because they were not obligations of the **estate**, but only a family disagreement. The audit resulted in a $46,758 deficiency and interest of $7,162. The IRS did not collect the assessed liability from the **estate**, but sent notices of liability to Bruce and Carl who contested their liability in Tax Court.

Section 6901(a) does not independently impose tax liability on a transferee, but provides a procedure through which the IRS may collect unpaid taxes owed by the transferor of the assets from the transferee if an independent basis exists under applicable state law or equity principles for holding the transferee liable. In this case, the law and equity principles of Illinois governed Bruce's and Carl's transferee liability because Judith was an Illinois resident at the time of her death and her **estate** was administered under Illinois law.

Bruce and Carl acknowledged that Section 6901(h) provides that the term "transferee" includes "donee, heir, legatee, devisee, and distributee." They argued, however, that they were not transferees of property of a decedent under Section 6901(a)(1)(A)(ii) because they claimed the individual defendants in the **estate** litigation, Rodney, Ronald, and Robin, not Judith's **estate**, should be considered the transferors of

the property they received. They reasoned that if their lawsuit had resulted in a judgment, the individual defendants, not the **estate**, would have been liable for the damages.

The Tax Court found this reasoning "dubious." It pointed out that the executor of the **estate** was named as one of the defendants, which meant that the **estate** was at least potentially liable for any future judgment. Even if the court had accepted the premise that the individual defendants would have been solely liable for the judgment, it said the fact remained that a transfer had taken place from the **estate** to Bruce and Carl, which was compelled by the settlement agreement. Even if the transfer could be characterized as two transfers: (1) constructive payments from the **estate** to the individual defendants, and (2) payments from the individual defendants to Bruce and Carl, the court said such a characterization would not relieve them of liability for the **estate** tax because a transferee of a transferee is also liable. See Section 6901(c)(2) and *Bos Lines, Inc.*, 17 AFTR 2d 28 , 354 F2d 830 , 66-1 USTC ¶9149 (CA-8, 1965), *aff'g* TC Memo 1965-71 , PH TCM ¶65071 , 24 CCH TCM 370

Bruce and Carl also argued that they were not transferees of **estate** property within the meaning of Section 6901(a) because the settlement payment they received was an arm's-length exchange for the waiver of their right to sue to enforce the terms of the will. The court said that the settlement payment was a substitute for the real property that was devised to them in the will but was not available for distribution when the decedent died. According to the court, for tax purposes, it was appropriate to treat the settlement payments as a transfer from the **estate**.

The court ruled that Bruce and Carl were liable as transferees under Illinois equity principles. Bruce and Carl claimed they were not liable because under *Berliant*, 53 AFTR 2d 84-1619 , 729 F2d 496 , 84-1 USTC ¶13563 (CA-7, 1984), another **estate** tax transferee liability case, the IRS was required to file a petition in probate court requesting an order to return funds. The Tax Court said that although it was true that, under statutory law, the IRS was required to file a probate petition, the Seventh Circuit expressly noted that it was not necessary to prove liability under Illinois law because the Service could prove liability at equity.

Finally, Bruce and Carl argued that they should not be liable for the amount they paid their attorney because he received the entire settlement amount of $107,000 from the **estate**, transmitted $35,667 each to Bruce and Carl, retaining the balance of the proceeds as a one third contingency fee. The Tax Court held that Bruce and Carl should be liable for the entire amount ($53,500 each). It pointed to *Banks*, 95 AFTR 2d 2005-659 , 543 US 426 , 160 L Ed 2d 859 , 2005-1 USTC ¶50155 , 2005-1 CB 850 (2005), in which the Supreme Court held that the amount of damage payments includable in a plaintiff's gross income should not be reduced by the attorney's contingent fee. According to the Tax Court, Bruce and Carl ultimately controlled the entire litigation process and authorized payments to the attorney. Therefore, the property procured by the attorney was attributable to Bruce and Carl even though his fee did not pass directly through their hands.

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PARTNERSHIP'S TRANSFER RESTRICTIONS DISREGARDED FOR VALUATION PURPOSES

The Eighth Circuit in *Holman*, 105 AFTR 2d 2010-1802 , 2010-1 USTC ¶60592 (CA-8, 2010), affirmed the judgment of the Tax Court that the IRS correctly applied Section 2703 and disregarded a family limited partnership's transfer restriction for valuation purposes. It also agreed with the Tax Court that that lack-of-marketability discounts applied to the partnership shares should be less than claimed by the taxpayers.

The taxpayers amassed wealth primarily in the form of Dell stock during the husband's tenure as a Dell employee. As part of an overall **estate**-planning strategy seeking to achieve the goals of transferring their wealth to their children while preventing them from dissipating assets, the taxpayers developed an **estate** and gift plan that involved execution of wills, creation of a limited partnership, transferring Dell stock to the limited partnership, and transferring limited partnership shares to a trustee and conservator for the children.

The gifts of the partnership shares occurred in 1999, 2000, and 2001. In gift tax returns for those years, the donors claimed overall discounts of slightly more than 49% relative to the then-prevailing market prices for the underlying Dell stock. The discounts were based on appraisal recommendations that considered minority status and lack of marketability. The discounts also took into account the perceived impact that provisions of the partnership agreement had on the value of the limited partnership shares. These provisions provided that limited partners could not withdraw from the partnership or assign or encumber their limited partnership interests except as permitted in the agreement. The partnership had the option to purchase at an appraised value any partnership interest assigned in a manner prohibited by the agreement, but that was otherwise lawful. The taxpayers argued that these transfer restriction provisions would depress the value of the partnership shares relative to the value of the underlying assets.

In notices of deficiency, the IRS characterized the gifts as gifts of Dell stock rather than as gifts of limited partnership shares. It applied Section 2703 and disregarded the partnership agreement's transfer restrictions for valuation purposes. According to the Service, lack-of-marketability and minority interest discounts applied, but the discounts should be smaller (28%) than those claimed by the taxpayers. It based this lower discount on the view that partnership units should be valued without regard to restrictions on the right to sell or use the partnership interest within the meaning of Section 2703(a)(2) . Ultimately, when the case progressed to the Tax Court, *Holman*, 130 TC 170 (2008), the Service argued that even a smaller discount should apply.

The Tax Court held that the gifts were of limited partnership shares. (See "Stock Transfer to Family Partnership Was Not a Gift," 81 PTS 54 (July 2008).) However, it also held that the Service correctly applied Section 2703 and properly disregarded the partnership agreement's transfer restrictions. The Tax Court adopted the lower lack-of-marketability discount as asserted by the Service's expert based on historical studies of restricted stock sales. It noted that the partnership held only highly liquid, easily valued assets and that the agreement contained a consensual dissolution provision and granted broad managerial functions to the general partners (the taxpayers). According to the court, there was a natural cap on any lack-of-marketability discount because of the partnership provisions allowing the partnership to dissolve and be reconstituted or otherwise buy out a departing partner.

On appeal, the IRS did not challenge the determination that the gifts were gifts of partnership shares. The taxpayers challenged the Tax Court's application of Section 2703 , its determination of the discounts, and its overall valuation determination.

Section 2703 . According to the Eight Circuit, "[r]estrictions on the use of property generally tend to depress the value of the property. Sometimes, restrictions serve legitimate business purposes, impose actual and meaningful limitations on the use or transferability of property, and are accepted by parties dealing with another in arm's-length transactions." Section 2703 attempts to sort between permissible and impermissible use of restrictions. Section 2703(a) broadly prohibits consideration of restrictions for valuation purposes, but Section 2703(b) allows taxpayers to prove eligibility for an exception that permits valuation based on such restrictions.

To be eligible for the exception, a taxpayer must satisfy a three-prong test:

> (1) The restriction must be a "bona fide business arrangement."
> (2) It must not be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration."
> (3) Its terms must be "comparable to similar arrangements entered into by persons in an arms' length transaction."

The Eighth Circuit concluded that the Tax Court rightly held that the restrictions in this case were not a bona fide business arrangement, and so it addressed only the first part of the test. According to the appeals court, the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions; there was no business, active or otherwise. The taxpayers were not able to "distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, and interest-bearing checking account, government bonds, or cash." Along with other courts, the Eighth Circuit has held that maintenance of family ownership and control of a business may be a bona fide business purpose. However, in this case, the appeals court said there was no business.

The Eighth Circuit acknowledged that investment-related activity can satisfy the "bona fide business" test, but said that, when the restrictions at issue apply to a partnership that holds an insignificant fraction of stock in a highly liquid and easily valued company with no particular stated investment strategy, it is easy to determine that the test is not satisfied. The appeals court said that the strongest cases for the donors are a line of cases involving investment entities with restrictions to ensure perpetuation of an investment model or strategy. (See ***Estate*** *of Schutt*, TC Memo 2005-126 , RIA TC Memo ¶2005-126 , 89 CCH TCM 1353 , ***Estate*** *of Black*, 133 TC 15 (2009); and ***Estate*** *of Murphy*, 104 AFTR 2d 2009-7703 , 2009-2 USTC ¶60583 (DC Ark., 2009).) The taxpayers cited *Schutt* for the proposition that relatively inactive investment trusts and shells may nevertheless involve legitimate business purposes and gain favored tax treatment.

In *Schutt*, the Tax Court addressed a different Code section, but one of the underlying questions at issue was similar: whether the transfer of publicly traded stock into a business trust was a bona fide sale for full and adequate consideration. The Tax Court ultimately concluded that a buy-and-hold business strategy was, in that case, a legitimate business purpose. The holding was based on an express factual finding that the transferor's primary objective was to preserve his very specific investment strategy. The court, however, did note that "the mere holding of an untraded portfolio of marketable securities weighs negatively in the assessment of potential nontax benefits."

(See "Stock Transferred to Business Trusts Not Included in **Estate**," 75 PTS 38 (July 2005).)

In ***Estate*** *of Erickson*, TC Memo 2007-107 , RIA TC Memo ¶2007-107 , 93 CCH TCM 1175 , the Tax Court distinguished *Schutt*, illustrating an important difference between cases like *Schutt* and the present case. (See "Assets Transferred to Partnership Remained in Decedent's **Estate**," 78 PTS 355 (June 2007).) The court found a significant nontax purpose when the justification for the transaction was the decedent's personal views and concerns regarding the operation of an income-producing activity. There is no significant nontax purpose when a family limited partnership is "just a vehicle for changing the form of the investment of the assets, a mere asset container." The Eighth Circuit pointed out that, as in *Erickson*, the family limited partnership was a mere asset container. The taxpayers did not purport to hold any particular investment philosophy or any particular investing insight. The partnership agreement did not require the general partners to retain the Dell stock held by the partnership, and they intended to diversify their investments. The Eighth Circuit said there was "little doubt" that the restrictions included in the taxpayers'

limited partnership agreement were not a bona fide business arrangement, but instead were predominately for the purpose of **estate** planning, tax reduction, wealth transference, and protection against dissipation.

Valuation. On appeal, aside from the Section 2703 issue, the taxpayers challenged only the Tax Court's determination of a marketability discount. According to the Eighth Circuit, the taxpayers' expert (Ingham) and the Service's expert (Burns) employed methodologies that were similar in part. Both looked to studies comparing the private sales of restricted, unregistered stock in public companies with contemporaneous, unrestricted sales of registered stock in those same companies. The Tax Court agreed with Burns more detailed examination of restricted stock sales and rejected Ingham's conclusion as "speculative and unsupported."

The taxpayer's primary argument on appeal focused on the aspect of Burns's opinion that discussed what insiders likely would do in the face of potentially large discounts in partnership shares relative to Dell stock price. They claimed that this violated the hypothetical willing buyer/willing seller test by asking what the partnership or particular family members would do. Burns claimed that if outside buyers would demand too great a discount, economically rational insiders would have a clear incentive to purchase an exiting partner's shares at a lesser discount, which would put a cap on any potential discount.

The Eighth Circuit ruled that Burns's analysis comported with the general rule of casting a potential buyer as a rational economic actor. According to the court, it was not necessary "to look at the personal proclivities of any particular partner or the idiosyncratic tendencies that might drive a particular person's decisions....The Tax Court did not ascribe personal non-economic strategies or motivations to hypothetical buyers; it merely held that, presented with the opportunity, rational actors would not leave money on the table."

Dissent. Not all the judges on the appeals court agreed that the Tax Court had reached a correct decision. Judge Beam dissented from the majority's decision and would have reversed the Tax Court's application of Section 2703 's valuation rules and the willing buyer/willing seller test. He believed that the partnership restrictions satisfied all three

Section 2703(b) tests, which meant that the valuation of the limited partnership interests should have taken them into account. Additionally, because Judge Beam said that the willing buyer/willing seller test was violated, he argued that the case should have been remanded to the Tax Court for a new lack-of-marketability discount determination.

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2010 AND BEYOND—THE TRANSFER TAX ODYSSEY

Estate planning is made more complicated by the one-year estate tax repeal, archaic estate tax rules scheduled to return in 2011, possible retroactive legislation, and other likely changes.

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As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate and generation-skipping transfer (GST) taxes are not applicable to decedent's dying and GST transfers taking place during 2010. The gift tax is applicable during that time period, but at a reduced rate of 35%. On 1/1/11, the estate and GST taxes will be reinstated to how they were in 2001 (i.e., an estate tax exemption of $1 million and a top marginal rate of 55%). As a result of the vast differences in the law from 2009 to 2010 to 2011 and of the possibility of the estate and GST taxes being retroactively reinstated to be the same as they were in 2009, there is much uncertainty among practitioners and clients alike as to what, if anything, should be done and when it should be done.

Current law

The implications of the current estate tax environment differ somewhat for domestic and international taxpayers.

Implications for domestic clients.

Domestic clients need to evaluate considerations involving basis, informational returns, penalties, certain transfers in **trust**, and tax provisions scheduled to take effect in 2011.

Basis. Under prior law, Section 1014 generally provided that the basis of property acquired from a decedent or to whom property passed from a decedent was the fair market value of the property at the date of the decedent's death. [1] This was commonly referred to as a "stepped-up basis." Section 1014(f) was added by EGTRRA, making Section 1014 inapplicable to decedents dying during 2010. In place of Section 1014 , Section 1022 was added by EGTRRA. Section 1022 provides that the basis of the person acquiring the property from the decedent is the lesser of either of the following:

(1) The decedent's adjusted basis in the property at the date of his or her death.
(2) The fair market value of the property at the date of the decedent's death. [2]

This is commonly referred to as a (modified) "carryover basis," and was the basis historically in place for transfers only by lifetime gifts.

Although the persons acquiring property from a decedent in 2010 generally take a carryover basis, several provisions grant an increase to that carryover basis. Pursuant to Section 1022(b) , an aggregate basis increase of up to $1.3 million, indexed for inflation, is granted

for all assets that are "acquired from the decedent." Assets that are acquired from the decedent include:

- Assets acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent.
- Assets transferred by the decedent during his or her lifetime to a qualified revocable **trust** or to any **trust** with respect to which the decedent reserved certain powers to change the enjoyment of the **trust**.
- Assets passing from the decedent by reason of death if the assets passed without consideration.

The $1.3 million basis increase figure is increased by (1) the sum of any capital loss carryover under Section 1212(b), and any net operating loss carryover under Section 172, which would (but for the decedent's death) be carried from the decedent's last tax year to a later tax year of the decedent, plus (2) the sum of any losses that would have been allowable under Section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. [3] Any increase in basis cannot increase the basis above the fair market value of the asset on the date of death. [4]

Section 1022(c) also provides for an additional basis increase—the aggregate spousal property basis increase (the ASPBI) of up to $3 million, indexed for inflation. The ASPBI can be allocated to only "qualified spousal property." Qualified spousal property includes outright transfers of property to the surviving spouse and "qualified terminable interest property." Outright transfers of property to the surviving spouse generally include any outright transfer to the spouse unless the spouse's interest is a terminable interest (i.e., an interest that would terminate or fail in certain circumstances). [5]

Qualified terminable interest property is property that passes from the decedent in which the spouse has a qualifying income interest for life, i.e., the spouse is entitled to all income from the property, at least annually, and no person has a power to appoint the **trust** property to any person other than the surviving spouse. [6] Thus, in essence, the ASPBI can be allocated to outright transfers to spouses that are not subject to later contingencies and to transfers to **trusts** that are commonly known as qualified terminable interest property **trusts** or "QTIP **trusts**."

Certain special rules must be taken into account when applying the aggregate basis increase and the ASPBI. The decedent must have owned the property at the time of his or her death. [7] Further, special rules apply to jointly held property, revocable **trusts**, powers of appointment, community property, and property acquired by the decedent by gift within three years of death. [8]

Informational returns. Any applicable basis increase may be allocated in the discretion of the personal representative of the estate on an informational return as required by Section 6018. [9] Section 6018, which was amended by EGTRRA, requires that the personal representative of the estate file an informational return if the fair market value of the property (other than cash) acquired from the decedent exceeds $1.3 million or if the decedent acquired appreciated property by gift or inter vivos transfer for less than adequate and full consideration within three years of death and a gift tax return was required to be filed with respect to that property. The informational return is required to include the following:

(1) The name and taxpayer identification number of the recipient of the property.

(2) An accurate description of the property.
(3) The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death.
(4) The decedent's holding period for the property.
(5) Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income.
(6) The basis increase allocated to the property pursuant to the aggregate basis increase or the ASPBI.
(7) Such other information as the Secretary may prescribe by regulations. [10]

Within 30 days of the filing of the informational return, the personal representative is required to furnish a written statement to each person who acquires property from the decedent. The written statement is required to show the name, address, and phone number of the person required to make the informational return and the information shown on the return as it relates to the person acquiring the property. Presumably, the personal representative of the estate could furnish a copy of the informational return to each person who acquires property from the decedent to satisfy this requirement.

Penalties. Several penalties may apply for failure to satisfy the informational return requirements:

- A $10,000 penalty is imposed on any person who is required to file an informational return (other than a return with respect to appreciated property acquired by the decedent by gift within three years of death) pursuant to Section 6018 and does not do so. [12]
- A $500 penalty is imposed on any person who is required to file an informational return with respect to appreciated property acquired by the decedent within three years of death and does not do so. [13]
- A $50 per failure penalty is imposed on any person who is required to furnish a written statement in accordance with Section 6018(e) to the persons acquiring the decedent's property and does not do so within 30 days of the filing of the informational return and to any person who is required to file a gift tax return if that person fails to furnish a written statement to the persons whose names are required to be set forth in the return within 30 days of the filing of the return. [14]

An exception is granted for reasonable cause. If the failure to file the informational return or to furnish the required information to the beneficiaries is due to intentional disregard of the applicable filing requirements, the penalty is 5% of the fair market value of the property with respect to which the information is required. [16]

It is important to note that Section 1022 provides for the allocation of basis by the personal representative, as opposed to any other fiduciary, including the trustee of the decedent's revocable **trust**. [17] As such, the authors suggest adding a provision to each person's last will and testament that specifically authorizes the personal representative to allocate the basis increases and specifies the duties and responsibilities of the personal representative in doing so. Sample language is included below. The authors do not suggest giving this authority to the trustee of the decedent's revocable **trust** unless and until the IRS specifically authorizes the trustee to allocate the basis increases.

Depending on the family situation, the identity of the personal representative may now be more important than ever. If, for example, one child of the decedent serves as personal representative, that child could allocate all of the basis increase to assets passing to him or her and choose not to allocate any of the basis increase to assets passing to his siblings. This would obviously raise fiduciary issues and may ultimately

result in unnecessary litigation. Thus, careful consideration should be given to who will serve as the personal representative, and the decedent's intent for allocating basis should be specified clearly in the decedent's last will and testament.

Section 2511(c) —treatment of certain transfers in trust. EGTRRA also added Section 2511(c) . Section 2511(c) , which is applicable to gifts made after 2009, provides that, except as provided in regulations, a transfer in **trust** is treated as a transfer of property by gift, unless the **trust** is treated as a wholly owned grantor **trust** by the donor or the donor's spouse pursuant to the grantor **trust** rules. Section 2511(c) apparently prevents a donor from making an incomplete gift to a non-grantor **trust** to take advantage of the **trust's** lower income tax brackets. Section 2511(c) , as drafted, could have been interpreted to provide that a transfer of property by gift to a wholly owned grantor **trust** was not, in fact, a gift. In light of this possible interpretation, on 2/2/10, the IRS issued Notice 2010-19 to clarify that the gift tax provisions were not affected by the amendments made by EGTRRA and that those provisions continue to apply to transfers made in 2010.

Notice 2010-19 further clarifies that Section 2511(c) was adopted to broaden the types of transfers subject to the gift tax to include certain transfers to **trusts** that before 2010 would have been considered incomplete and, thus, not subject to the gift tax. Any transfer to a **trust** that is not wholly-owned by the donor or the donor's spouse pursuant to the grantor **trust** rules is now considered to be a transfer by gift of the entire interest in property. The IRS plans to issue regulations to further clarify Section 2511(c) .

2011 and beyond. Under current law, in 2011, the estate and GST taxes will return to how they were in 2001. The estate tax exemption will be $1 million, and the GST tax exemption will be $1 million, indexed for inflation. The top marginal rate will be 55%, plus a 5% surtax will apply for certain estates with a value in excess of $10 million. The gift tax exemption will also return to $1 million, with a top marginal rate of 55%. The carryover basis provisions of Section 1022 will no longer be applicable, and the stepped-up basis provisions of Section 1014 will once again apply.

Furthermore, the qualified severance rules for GST taxes would presumably no longer be applicable, as those rules became effective in 2007 and 2008. As such, it may be unclear whether the severance of a **trust** for GST tax purposes would result in the recognition of gain or loss.

Implications for international clients.

Under prior law, nonresidents of the U.S. who were not citizens of the U.S., commonly referred to as nonresident aliens (NRAs), had an estate tax exemption amount of $60,000 and were subject to a top marginal rate of 45%.

Basis. Under prior law, Section 1014 applied to NRAs in the same manner as it did to U.S. citizens and resident aliens. Section 1022 now similarly applies to NRAs in the same manner as it does to U.S. citizens and resident aliens, with some modifications. Specifically, the aggregate basis increase is $60,000, indexed for inflation, as opposed to $1.3 million, indexed for inflation, and the increase to the aggregate basis increase for unused built-in losses and loss carryovers is not applicable to NRAs. The personal representative of the estate of an NRA is required to file an informational return pursuant to Section 6018 if the fair market value of the property (other than cash) acquired from the decedent exceeds $60,000, indexed for inflation; however, the property at issue includes only U.S. situs tangible personal property and property acquired from the decedent by a U.S. person.

QDOTs. Under prior law, it was common for persons who held assets that were subject to U.S. estate tax that they wished to transfer to a surviving non-U.S. citizen spouse to create a qualified domestic **trust** (a QDOT) and to transfer those assets to the QDOT rather than to the noncitizen spouse directly. The assets passing to the QDOT then qualified for the unlimited federal estate tax marital deduction pursuant to Section 2056 , and the federal estate tax was effectively deferred until the surviving spouse's death or until such earlier time as a distribution of principal was made to the surviving spouse (other than a distribution on account of hardship).

Under current law, no estate tax will be imposed at the surviving spouse's death if the surviving spouse dies in 2010, and no estate tax will be imposed on any distribution of principal to the surviving spouse if the distribution is made after 2020. Thus, after the expiration of the ten-year period, distributions can be made from the QDOT to the surviving spouse irrespective of whether the surviving spouse is then a U.S. citizen.

State transfer tax laws

Many states impose a separate "state" estate or GST tax. Thus, when considering whether to update an estate plan, it is important to consider the possible state estate or GST tax implications. It may also be necessary to consider whether the state at issue permits a state-only QTIP election. If not, the plan may result in unanticipated state estate taxes.

Possibility of retroactive legislation

There is uncertainty as to whether Congress will act in 2010 to reinstate the estate and GST taxes. Even if Congress does act in 2010 to reinstate the taxes, it is not clear whether the taxes would be retroactively reinstated to 1/1/10 or would apply only prospectively. If the taxes were retroactively reinstated to 1/1/10, the retroactive reinstatement would highly likely be challenged on constitutional grounds. That litigation may take years to resolve and, thus, the tax consequences for the estates of decedent's dying between 1/1/10 and the date the retroactive legislation is enacted or becomes effective could be unknown for many years. This could leave fiduciaries in the precarious predicament of being able to make only partial distributions to the beneficiaries of those estates and **trusts** for many years to come.

At a minimum, any fiduciary of an estate or **trust** of a decedent who dies in 2010 with an estate in excess of $3.5 million should consider retaining the portion of the estate and **trust** funds that would be necessary to pay the estate tax liability that would be due assuming the 2009 rate system were in effect. This may displease the beneficiaries, but it seems to be the only prudent thing to do in these uncertain times.

If Congress does intend to make any legislation retroactive, the sooner Congress acts the better. Congress would appear to have until at least shortly before October 2010 to enact retroactive legislation, as that will be when the first estate tax returns are due for decedents dying in January 2010. Several fairly recent cases, *Carlton* and *NationsBank,* have upheld retroactive legislation in the estate tax context:

- In *Carlton*, the U.S. Supreme Court held that retroactive application of an amendment to prior Section 2057 (which granted an estate tax deduction for one-half of the proceeds of any sale of employer securities by the executor of an estate to an employee stock ownership plan) was "rationally related to a

legitimate legislative purpose" and, thus, did not violate the due process clause of the Fifth Amendment.

- In *NationsBank*, the court held that the retroactive increase of the estate tax rate from 50% to 55% did not violate equal protection principles under the equal protection clause of the Fourteenth Amendment because it was rationally related to the legitimate government purpose of raising revenue and fairly distributing the tax burden.

In *Carlton*, the retroactive period was 14 months; in *NationsBank,* it was eight months. Thus, presumably, any retroactive action taken by Congress within 2010 would likely be upheld based on the time frame. The question would become whether retroactive implementation of a tax, as opposed to the retroactive deletion of a deduction and retroactive raising of the highest estate tax rate, would survive a constitutional challenge. Based on the foregoing, the retroactive implementation of the estate and gift taxes to 2009 rates could be held unconstitutional. Despite that, one would expect, based on prior case law, that the IRS would assert that the retroactive implementation of the estate and gift taxes to 2009 rates would, in fact, withstand a constitutional challenge as the public is generally on notice that the taxes may be reinstated, the government has a legitimate purpose of raising revenue and distributing the tax burden, and the time frame would be within durations upheld in prior case law.

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TRANSFERS OF LLC INTERESTS DID NOT QUALIFY FOR GIFT TAX EXCLUSION

The District Court for the Southern District of Indiana in *Fisher*, 105 AFTR 2d 2010-1347 (DC Ind., 2010), has held that gifts made by the taxpayers to their children were not transfers of present interests in property and, therefore, they did not qualify for the gift tax exclusion under Section 2503(b)(1) .

In 2000, 2001, and 2002, the taxpayers, husband and wife, transferred a 4.762% membership interest in Good Harbor Partners, LLC to each of their seven children. Good Harbor's principal asset was a parcel of undeveloped land that bordered Lake Michigan. The taxpayers filed their gift tax returns and claimed the annual exclusion for each transfer. On audit, however, the IRS assessed a deficiency of $625,986 in additional gift tax. The taxpayers paid the deficiency and filed a claim for refund, claiming, in part, that the gifts of membership interests in Good Harbor were gifts of present interests.

Under Good Harbor's operating agreement, all powers of the company were to be exercised by or under the authority of a management committee. The timing and amount of all distributions would be determined by the general manager. The operating agreement also described how "capital proceeds" were to be distributed, and it provided the rules governing how the taxpayers' children could transfer their interests in Good Harbor. Specifically, the operating agreement had required the satisfaction of certain conditions of transfer, including giving Good Harbor a right of first refusal. This right of first refusal could be disregarded only if a transfer is made to family members or descendants by birth or adoption.

Section 2501(a) imposes a tax on gifts. Section 2503(b) , however, provides an annual exclusion for gifts of present interests in property; the maximum exclusion for gifts from a donor to a recipient was $10,000 for the year at issue (with cost-of-living adjustments, $13,000 in 2010). Gifts of future interests in property do not qualify for this exclusion.

A present interest in property is one in which there is an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property." In contrast, reversions, remainders, and other interests or **estates** that are "limited to commence in use, possession, or enjoyment at some future date or time" are future interests in property. The "sole statutory distinction" between present and future interests turns on whether there is "postponement of enjoyment of specific rights, powers or privileges which would be forthwith existent if the interest were present."

The taxpayers made three arguments in support of their assertion that the transfers of interest in Good Harbor to their children were gifts of present interests in property. The court rejected each argument.

First, the taxpayers argued that their children possessed the unrestricted right to receive distributions of Good Harbor's capital proceeds. The court rejected this argument, finding that under the operating agreement, any potential distribution of Good Harbor's capital proceeds to the taxpayers' children was subject to a number of contingencies, all within the exclusive discretion of the general manager. Specifically, the court found that the right of the children to receive distributions of Good Harbor's capital proceeds, when such distributions occur, was not a right to a "substantial present economic benefit."

Second, the taxpayers asserted that their children possessed the unrestricted right to possess, use, and enjoy Good Harbor's primary asset. Again, the court rejected the taxpayers' assertion, stating that there was

no indication from the operating agreement that this right was transferred to the taxpayers' children when they became members and interest holders. The court added that the right to possess, use, and enjoy property, without more, was not a right to a "substantial present economic benefit." Rather, it was a right to a non-pecuniary benefit.

Finally, the court dismissed the taxpayers' claim that their children possessed the unrestricted right to unilaterally transfer their interests in Good Harbor. The court noted that under the Operating Agreement, the taxpayers' children could unilaterally transfer their right to receive distributions from Good Harbor but only if certain conditions of transfer were satisfied. Among those conditions was Good Harbor's right of first refusal, which effectively prevented the children from transferring their interests in exchange for immediate value unless the transfer was to a descendant. Because conditions restricted their right to transfer their interests in Good Harbor, it was impossible for the taxpayers' children to presently realize a substantial economic benefit.

Based on the undisputed facts, the court held that the transfers of interests in Good Harbor from the taxpayers to their children were transfers of future interests in property and, therefore, were not subject to the gift tax exclusion under Section 2503(b)(1) .

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NEW SECTION 2511(c): A THORN IN THE SIDE, NOT A DAGGER TO THE HEART

Some estate planning and asset protection arrangements need to be adjusted in light of a new provision that treats transfers to incomplete gift trusts as completed, taxable gifts.

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A little noticed Code provision— Section 2511(c) —became effective with estate tax repeal on 1/1/10 and provides that transfers to nongrantor trusts must be treated as completed gifts. This rule likely forecloses certain asset protection trusts and may have some other surprising consequences of which estate planners should be aware.

History

Section 2511(c) provides:

Treatment of certain transfers in trust. Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.

This provision was included in the Economic Growth and Tax Relief Reconciliation Act of 2001, which repealed the federal estate tax effective 1/1/10. It was intended to address a perceived abuse that, in a world with no estate tax but a continuing gift tax, individuals could make incomplete gift transfers to trusts in order to shift income tax liability to beneficiaries in lower tax brackets. [1]

Example. In 2010, Theodore transfers property in trust to pay the income to Paula for life, remainder to such persons and in such portions as Theodore may decide. Under pre-2010 Reg. 25.2511-2(c) , the transfer of the remainder interest in the trust would not be treated as a completed gift. Under new Section 2511(c) , however, the entire value of the property is treated as being transferred by gift.

The perceived abuse here is a bit difficult to fathom. Individuals could make transfers to incomplete gift trusts for income tax planning prior to repeal, and, in fact, at least two recent letter rulings uphold such plans. [3] The "income splitting trust," however, was not a widely used tool, primarily because in order to achieve the benefit of lower income taxes, the trust income actually has to be distributed to the beneficiary or beneficiaries in lower tax brackets, and this can be problematic for several reasons:

(1) The grantor must have beneficiaries in lower tax brackets, which does not always occur.
(2) More importantly, for nontax reasons, many grantors would be uncomfortable mandating that trust income be distributed to these beneficiaries with no restrictions or controls (and if income is retained in the trust rather than distributed, it will quickly be taxed at the highest marginal rates).

(3) When trust income is distributed, a gift is completed. Since most grantors will not pay gift tax to save income tax, the technique is of limited utility and probably applies in only situations where the trust income would not exceed annual exclusion amounts. A grantor could just as easily make outright annual exclusion gifts.

Nonetheless, one can speculate that congressional tax law writers were concerned that, if there were no estate tax, the practice of creating income-splitting trusts would spread. Hence, Congress enacted Section 2511(c) , which creates strong disincentives to creation of an incomplete gift trust by treating the transfer of property to a nongrantor trust as an immediate completed, taxable gift.

The statute was amended by a technical corrections bill in 2002, which added the words "transfer of property by gift" to the statute and deleted the words "taxable gift under section 2503." The effect of the change was to clarify that the marital deduction, charitable deduction, and annual exclusion can apply to any transfer subject to this rule.

Application

What are the effects of the new Section 2511(c) ?

Delaware asset protection trusts affected.

Taken on its face, the statute effectively precludes incomplete gift transfers to nongrantor trusts because most grantors will not want to pay gift tax in order to set up such trusts. This is likely a significant blow to the asset protection planning field, where such trusts are most commonly used. Asset protection trusts are usually structured as nongrantor trusts to take advantage of favorable state income tax rules (e.g., in Delaware, income of a trust with no Delaware beneficiaries is not subject to state income tax) and perhaps for creditor protection purposes. Now, planners in the asset protection area may wish to consider creating asset protection trusts that are grantor trusts.

Existing incomplete gift trusts affected?

The statute also raises a serious question about incomplete gift trusts that were already in existence on 1/1/10, and whether the prior transfers to such trusts became completed gifts on 1/1/10, thereby triggering gift tax. The legislative history from the 2002 technical corrections bill raises this possibility but is unclear, stating:

Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511-2(c). [4]

The first sentence above could be read to mean that pre-2010 incomplete gift transfers to trusts became completed gifts on 1/1/10. The example in the second sentence, however, posits a 2010 transfer to a trust and makes no indication of how pre-2010 transfers

should be treated. Clients with pre-2010 incomplete gift trusts should be made aware of this uncertainty; a sudden gift tax liability for prior transfers could be a very unpleasant surprise.

This concern may be mitigated by Notice 2010-19, which states that, under Section 2511(c), each transfer made in 2010 to a nongrantor trust is considered to be a transfer by gift, and the gift tax rules in effect on 12/31/09 continue to apply (both before and during 2010) to all transfers made to any other trust to determine whether the transfer is subject to gift tax. The language implies that the new Section 2511(c) does *not* change the pre-2010 treatment of transfers to incomplete gift trusts.

Effect on grantor trusts.

The most serious question raised by new Section 2511(c) is whether the language of the statute can be read to include the negative implication that transfers to grantor trusts cannot be completed gifts. One possible interpretation of the statute is as follows: "Transfers in trust are completed gifts, unless the trust is a grantor trust. Therefore, transfers to grantor trusts are incomplete gifts." Some commentators have suggested this is a plausible interpretation.

If, however, the rule really means that transfers to grantor trusts cannot be completed gifts, the implications would be far-reaching. All techniques involving transfers to grantor trusts, such as insurance trusts, QPRTs, and GRATs—would be suspect. For example, annual exclusion gifts to insurance trusts would *not* be completed gifts. The transfer of a residence to a QPRT would *not* be a completed gift, even though such a transfer is expressly permitted under Section 2702. This author believes that such an interpretation leads to absurd results that conflict with long-established case law and other precedents, and if Congress intended such results, Congress would have written the rule differently.

Some commentators have suggested that a grantor could create a grantor trust, transfer a significant amount to it, and then take the positions that (1) the gift is incomplete under this reading of Section 2511(c), and (2) trust assets are not included in the grantor's estate. Is this the best of both worlds or too good to be true? This author finds it too good to be true, as it rests on a distorted reading of the statute.

The IRS recently clarified its position by issuing Notice 2010-19. The Notice states that some taxpayers may have inaccurately interpreted Section 2511(c) as excluding transfers to grantor trusts from the gift tax rules, but the IRS's position is that the gift tax rules continue to apply. Thus, a 2010 transfer to a grantor trust is considered to be a transfer by gift.

Assuming that Section 2511(c) applies to only nongrantor trusts, it will have no effect on the many estate planning techniques that involve grantor trusts, including sales to intentionally defective grantor trusts (IDGTs), where a gift component and a sale component should be treated consistently with the parties' intentions. The statute also should have no effect on transfers that are intended to produce completed gifts, such as lifetime QTIP trusts, charitable lead trusts, charitable remainder trusts, and GRATs.

Loans to nongrantor trusts.

From time to time, grantors and other parties make loans to nongrantor trusts. This raises the question of whether, under new Section 2511(c), such loans are respected as loans or instead are treated as completed gifts. The answer to this question hinges on the

language of the statute, which states that "a transfer in trust shall be treated as a taxable gift...." Although the IRS could argue that a loan should be treated as a completed gift, the better interpretation is that a loan is not a "transfer in trust" because the parties do not intend to treat it that way, and the loan should be respected as a loan. Documents that clearly reflect the parties' intentions will minimize the risk of the IRS succeeding with this argument.

Conclusion

It is unclear whether the potential abuse that Section 2511(c) was intended to prevent is truly abusive. It is clear, however, that the effect of the statute will be to limit the use of incomplete gift trusts, since transfers to them will now (for the time being, anyway) be treated as completed, taxable gifts. The statute thus affects asset protection planning and raises issues as to whether assets transferred to incomplete gift trusts prior to 2010 have now become completed gifts. On the other hand, the statute likely should not affect other common planning techniques involving grantor trusts, including sales to IDGTs and GRATs. Thus, the new Section 2511(c) is more a thorn in the side than a dagger to the heart. It is something to be cognizant of, but it does not reshape the entire estate planning landscape.

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FINAL REGS. ON THE EFFECT OF POST-DEATH EVENTS ON VALUING AN ESTATE

The IRS has issued final regulations (TD 9468 , 10/16/09), effective 10/20/09, that provide guidance under Section 2053 on the extent to which post-death events may be considered in determining the value of a taxable estate. (For a discussion of the proposed regulations, which were issued on 4/23/07, see "Post-Death Events Affect Deduction for Claims Against Estate," 78 PTS 354 (June 2007).)

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent, citizen, or resident of the U.S. Section 2031(a) provides that the value of the decedent's gross estate must include the value at the time of the decedent's death of all property, real or personal, tangible or intangible, wherever situated. Section 2051 provides that the value of the taxable estate is determined by deducting from the value of the gross estate the deductions provided for in Section 2051 through 2058 . Section 2053(a) states that the value of the taxable estate is determined by deducting from the value of the gross estate amounts for:

(1) Funeral expenses.
(2) Administration expenses.
(3) Claims against the estate.
(4) Unpaid mortgages on, or any debt connected with, property where the value of the decedent's interest in the property, undiminished by the mortgage or debt, is included in the value of the gross estate, as are allowable by the laws of the jurisdiction, whether within or without the U.S., under which the estate is being administered.

Section 2053(b) permits a deduction in determining the taxable estate for amounts incurred in administering property not subject to claims and that is included in the gross estate to the extent the amounts would be deductible under Section 2053(a) if the property was subject to claims. The amounts must, however, be paid before the Section 6501 limitations period for assessment has expired.

The Preamble to the final regulations acknowledges that "[t]he amount an estate may deduct for claims against the estate has been a highly litigious issue." The problem, the Preamble notes, is that unlike Section 2031 , Section 2053(a) does not contain a specific directive to value a deductible claim at its value at the time of the decedent's death. Rather, Section 2053 specifically contemplates expenses, i.e., funeral and administration expenses, that are determinable only after the decedent's death. The lack of a specific directive, coupled with a lack of consistency in the case law, resulted in different estate tax treatment of estates that were similarly situated. Consequently, this created a situation that called for guidance. The IRS said that it believes that similarly situated estates should be treated the same, regardless of jurisdiction.

To further the goal of effective and fair administration of the tax laws, the IRS published the proposed regulations. The proposed regulations proposed amending the Section 2053 regulations to clarify that events occurring after a decedent's death are to be considered when determining the amount deductible under all of Section 2053 's provisions. They also proposed that the deductions under Section 2053 be limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims. In addition, the proposed regulations proposed amendments to address issues involving:

- Final court decisions.

- Settlements.
- Protective claims.
- Reimbursed amounts.
- Claims that are potential, unmatured, or contested.
- Claims involving multiple defendants.
- Claims by a family member or beneficiary of a decedent's estate.
- Unenforceable claims.
- Recurring payments.
- The changes made to Section 2053(d) in 2001.

The IRS states that after careful consideration of written and oral comments on the proposed regulations, the proposed regulations were adopted as revised. A summary of written and oral comments received by the IRS and an explanation of the revisions made in response to those comments are included in the Preamble.

The new final Reg. 20.2053-1(b)(2)(i) specifies that amounts deductible under Sections 2053(a) and (b) must be for bona fide expenses and claims. A deduction is not permitted to the extent the expense or claim is based on a donative transfer (e.g., "a mere cloak for a **gift** or bequest")—except to the extent the deduction is for a claim that would be deductible under Section 2055 as a charitable bequest. Reg. 20.2053-1(b)(2)(ii) provides the following nonexclusive list of factors that are indicative of the bona fide nature of a claim or expense involving a decedent's family member or related entity:

> (1) The transaction underlying the claim or expense occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent.
> (2) The nature of the claim or expense is not related to an expectation or claim of inheritance.
> (3) The claim or expense originates in connection with an agreement between the decedent and the family member, related entity, or beneficiary, and the agreement is substantiated with contemporaneous evidence.
> (4) Performance by the claimant is pursuant to the terms of an agreement between the decedent and the family member, related entity, or beneficiary. In addition, the performance and the agreement can be substantiated.
> (5) All amounts paid in satisfaction or settlement of a claim or expense are reported by each party for federal income and employment tax purposes, in an appropriate manner.

Under Reg. 20.2053-1(b)(3) , if a court of competent jurisdiction over the administration of an estate reviews and approves expenditures for funeral expenses, administration expenses, claims against the estate, or unpaid mortgages, the final judicial decision in that matter may be relied on to establish the amount of a claim or expense that is otherwise deductible under Section 2053 and the regulations. The court, however, must actually pass on the facts on which deductibility depends. If the court does not pass on the merits of the claim, the decree may not be relied on to establish the claim or expense amount that is otherwise deductible under Section 2053 . A court is presumed to pass on the merits of a claim if an active and genuine contest occurred.

A local court's consent decree may also be relied on to establish the amount of a claim or expense in certain instances. To qualify, the consent must resolve a bona fide issue in a genuine contest. Consent given by all parties having interests adverse to that of the claimant is presumed to resolve a bona fide issue in a genuine contest.

Finally, a settlement may be relied on to establish the amount of a claim or expense (whether contingent or noncontingent) that is otherwise deductible under Section 2053 if

the settlement resolves a bona fide issue in a genuine contest and is the product of arm's-length negotiations by parties having adverse interests with respect to the claim or expense. A deduction is permitted for a settlement amount paid by an estate if the estate can show that the cost of defending or contesting the claim or expense, or the delay associated with litigating the claim or expense, would impose a higher burden on the estate than the payment of the amount paid to settle the claim or expense. Nevertheless, a deduction is not allowed for amounts paid in settlement of an unenforceable claim.

The IRS notes that it plans to issue additional guidance, including additional proposed regulations, to respond to certain comments and emerging issues that it believes merit further consideration.

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FORMULA CLAUSE CHANGES TAXABLE GIFT INTO CHARITABLE DONATION

A recent Tax Court decision upheld the validity of an adjustment clause that capped the taxable portion of a transfer and directed that the excess be allocated to charity.

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The Tax Court in *Estate of Petter* allowed a taxpayer to avoid substantial gift tax through a "charitable cap adjustment clause." When the taxpayer in *Petter* conceded to an IRS demand for a substantial increase in the value of property given as a gift, the taxpayer was able to avoid additional gift tax through an adjustment clause that allocated the entire increase to donor advised funds offered by public charities. In this manner, the taxpayer traded a taxable gift for a charitable deduction. Accordingly, *Petter* indicates that a gift tax liability can be capped by an adjustment clause allocating all subsequent increase in value to a public charity.

Background

Adjustment clauses are typically used with the transfer of property that is difficult to value, such as closely held business interests, to mitigate the risk of additional gift tax on a later increase in value. If the value of the property transferred is later increased by findings of an IRS audit, an adjustment clause adjusts the transfer to avoid an increase in gift tax.

Adjustment clauses impose a cap on the portion of the transfer intended to be gratuitous. To the extent the value of the property transferred is determined to exceed this "cap," an adjustment clause seeks to limit the donor's resulting gift tax liability through one of four approaches:

(1) By requiring the return of the excess to the donor (i.e., a "retransfer clause").
(2) By increasing the consideration paid by the donee for the property (i.e., a "price adjustment clause").
(3) By limiting the amount transferred to a dollar cap (i.e., a "defined value clause").
(4) By shifting the excess transfer to a deductible donee, such as a spouse or charity (i.e., a "deductible donee clause").

Examples of these varying approaches are set forth on Exhibit 1. It was the deductible donee clause that withstood scrutiny in *Petter.*

In *Petter*, Anne Y. Petter was able to avoid gift tax on an increase in the value of the property she transferred through an adjustment clause that allocated all such increase to charities. Thus, Anne "capped" the taxable portion of her transfers, with any adjustment to the value of the transferred property being allocated to recipients with respect to whom transfers were deductible for gift tax purposes.

The IRS challenged Anne's formula on public policy grounds, but the court denied the challenge. In doing so, the court observed that "public policy weigh[s] in favor of giving gifts to charities."

The genesis of the IRS's public policy challenge is the now infamous Fourth Circuit case of *Procter.*[3] *Procter* has become synonymous with the "public policy" challenge to "adjustment clauses." Thus, an analysis of *Petter* requires a brief description of *Procter.*

In *Procter*, the taxpayer tried to avoid gift tax through a "retransfer clause" (also referred to as a "savings clause") that negated any portion of the taxpayer's transfer later determined to be subject to gift tax. When it was later determined that the taxpayer's transfer included a taxable portion, however, the court did not allow the taxpayer to avoid gift tax through the retransfer clause. According to the court, the clause could not be given effect because it was contrary to public policy for the following three reasons:

[F]irst, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift; second, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax; and third, the condition is to the effect that the final judgement [sic] of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgement [sic] is rendered. In the words of the court, "It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained."[4]

Following *Procter*, these public policy concerns have been raised by the IRS to challenge a variety adjustment clauses. A summary of the more notable cases is provided in Exhibit 1. *Petter* is the most recent of these cases. Its holding reveals the Tax Court's reluctance to use public policy grounds to negate a charitable cap adjustment clause.

Facts of the case

Anne inherited millions of dollars worth of stock in United Parcel Service of America, Inc. (UPS). Anne was a schoolteacher and mother of three. Her receipt of the UPS stock did not change Anne very much; she continued to teach and to live in the same house. Anne's estate planning aims were to provide a comfortable living for her three children (Donna Petter Moreland, Terrence Petter, and David Petter) and her grandchildren, and to give money to charity.

To accomplish these desires, Anne formed a limited liability company under the name of Petter Family LLC (PFLLC) and contributed to it 423,136 shares of UPS stock worth $22,633,545. In exchange, Anne received all of the ownership interests in PFLLC. The ownership interests in PFLLC were divided into three classes of units, one intended for Anne, designated as Class A units, and two separate classes intend for two of Anne's children, Donna and Terrence, designated as Class D units and Class T units, respectively.

The holders of each class of units could elect, by a majority vote of units, a manager to represent their class. According to the operating agreement for PFLLC, a majority vote of the managers controlled the operations of PFLLC, except that the manager representing the Class A units could override the decisions of the other managers. This effectively gave Anne, as the manager of the Class A units, veto power over the operations of PFLLC. The operating agreement for PFLLC imposed restrictions on the transfer of units. Manager

approval was necessary to transfer units by gift or bequest to a nonfamily member, and transferees obtained only "Assignee Rights" unless they received manager approval for full membership in PFLLC.

Anne also created a separate irrevocable **trust** for each of Donna and Terrence. She provided for her third child, David, through separate estate planning. Both **trusts** were intentionally defective grantor **trusts** (IDGTs) the existence of which for income tax purposes (but not estate and gift purposes) is disregarded from the grantor of the **trusts**. The **trusts** were IDGTs because they permitted the trustees to purchase and pay premiums on a life insurance policy on the life of the grantor (Anne), in contravention of Section 677(a)(3) . The use of this power to create grantor **trust** status for a sale to an IDGT is unusual because commentators have theorized that this power may create grantor **trust** status only as to the income of the **trust** but not the principal which could cause capital gain recognition on sales between the grantor and the **trust**.

As IDGTs, Anne could enter into transactions with the **trusts**, such as sales and loans to the **trusts**, without income tax consequences, and Anne could pay the taxes arising from the income earned by the **trusts** from her assets without making a taxable gift to the **trusts** or the beneficiaries. Because of these benefits, IDGTs have become a premiere estate planning vehicle.

Anne then executed a plan in which she intended to transfer, without incurring gift tax, substantial ownership of PFLLC to the **trusts**. Most of this plan followed the now prescribed technique for an installment sale to an IDGT.

First, Anne funded each **trust** through a taxable gift of PFLLC units estimated to equal 10% of the total value of assets intended to be transferred to the **trust**. This initial contribution was intended to capitalize the **trusts** sufficiently so that the **trusts** "would be viewed by the IRS as a legitimate, arm's-length purchaser in the later sale." Commentators have warned that the sale of assets to an undercapitalized IDGT may be vulnerable to various IRS attacks, such as a sham transaction or debt versus equity argument. [6]

For the gift of PFLLC units to the **trusts**, Anne sought to avoid any gift tax liability through a pecuniary formula that limited the value of units given as gifts to the **trusts** to Anne's remaining applicable exclusion amount. The formula for each of the two **trusts** provided: "Transferor ... assigns to the **Trust** as a gift the number of Units ... that equals one-half of the [maximum] dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c) . Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910."

Second, Anne sold to the **trusts** PFLLC units estimated to equal 90% of the total value of assets intended to be transferred to the **trusts**. In exchange for the sale of PFLLC units, Anne received an installment note from each **trust** for the principal sum of $4,085,190, with quarterly payments of principal and interest, at the applicable federal rate, over a term of 20 years. The trustees executed pledge agreements securing the installment notes with a security interest in the PFLLC units sold to the **trusts**.

The charitable cap

To this prescribed technique, Anne incorporated a twist. She combined her desire to minimize gift tax with her charitable intentions by incorporating "charitable cap adjustment clauses" into her transfers to the **trusts**. Essentially, Anne used pecuniary

formulas to limit her gifts and sales of PFLLC units to the **trusts** to specific amounts (i.e., $453,910 and $4,085,190), with the balance of the units passing to two charities: the Seattle Foundation and Kitsap Community Foundations ("Foundations"). Both Foundations were public charities that offered donor advised funds. The court described donor advised funds in favorable terms as "owned and controlled by a charity, but kept separately identified" and allowing the donors at their "leisure [to] advise the charity where they want the money to go and how it should be invested."

The public charity status of the Foundations provided Anne with an opportunity to obtain a larger charitable deduction than if they had been private foundations (i.e., 50% of income for public charities versus 30% for private foundations [7]), and it minimized the risk of an excise tax from a self-dealing with a private foundation under Chapter 42 of the Code.

The pecuniary formula for Anne's gifts to the **trusts** provided: "The **Trust** agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed [$453,910], Trustee will, on behalf of the **Trust** and as a condition of the gift to it, transfer the excess Units to the [Foundations] as soon as practicable."

The Foundations in turn agreed to transfer to the **trusts** excess units "if the value of the units is 'finally determined for federal gift tax purposes' to be less than [$453,910]." (Interestingly, Judge Foley, in his dissent in *McCord*, [8] indicated that an agreement of a charitable organization to retransfer property, which the charity was otherwise entitled, to a noncharitable transferee could constitute "an impermissible private benefit" to the taxpayer's son negatively affecting the tax-exempt status of the charity or resulting in a excise tax.) Similarly, the sale documents allocated a total of 8,459 units of PFLLC between a sale to a **trust** and a gift to a Foundation through a pecuniary formula. This formula was set forth in the opinion as follows:

Transferor assigns and sells to the **Trust** the number of Units described in Recital C above [8,459] that equals a value of $4,085,190 as finally determined for federal gift tax purposes; and ... assigns to The [Foundation] as a gift ... the difference between the total number of Units described in Recital C [8,459] above and the number of Units assigned and sold to the **Trust**....
The **Trust** agrees that, if the value of the Units it receives is finally determined to exceed $4,085,190, Trustee will, on behalf of the **Trust** and as a condition of the sale to it, transfer the excess Units to The [Foundation] as soon as practicable. Likewise, the [Foundation] agrees to transfer shares to the **trust** if the value is found to be lower than $4,085,190.

The Foundations played an active role in Anne's transfers. They signed both the gift and sales documents, and they were admitted to PFLLC as substitute members. The Foundations, moreover, obtained legal advice to ensure that their receipt of the units would not jeopardize their tax-exempt status. Based on this legal advice, the Foundations insisted, among other things, that they be allowed "to monitor the investment mix of the PFLLC to ensure that [they] did not become exposed to unrelated business taxable income." Once the Foundations received the units, Anne directed many gifts through the Foundations.

The valuation

A professional appraisal firm was retained to prepare a qualified opinion as to the fair market value of a unit of PFLLC. The appraiser compared PFLLC to a closed-end mutual fund owning domestic stock and having little or no debt. The court noted that closed-end

mutual funds generally trade at a discount to net-asset value; in the case of PFLLC, the appraiser determined that PFLLC would trade at a 13.3% valuation discount from its net equity value. To this discounted value, the appraiser applied a second discount of 46% for nonmarketability to derive a per unit value of $536.20. Based on the per-unit value of $536.20, the units were allocated between the **trusts** and the Foundations in accordance with the gift and sales documents.

Anne timely filed a gift tax return, and she provided full disclosure of both her gifts and sales of units to the **trusts** and gifts of units to the Foundations. The IRS audited the return and challenged, among other things, the per unit value of PFLLC. According to the IRS, a unit of PFLLC was worth $794.39.

Anne petitioned for review by the Tax Court, and in the process Anne and the IRS agreed to a per unit value of $744.74. This represented a valuation discount of approximately 35% from the net asset value of PFLLC. With the agreement of the parties to a per unit value of PFLLC, the Tax Court was left with the issues of whether Anne should be allowed to avoid additional gift tax through the adjustment clauses in the gift and the sales documents, and whether Anne should be allowed a charitable contribution deduction for the resulting additional transfer of units to the Foundations.

Court gives clause effect

The court understood the adjustment clauses were nothing more than attempts to minimize or avoid gift taxation: "We have no doubt that behind these complex transactions lay Anne's simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community." Nevertheless, the court concluded that Anne's adjustment clauses needed to be honored and that Anne was entitled to an additional charitable deduction.

To reach this conclusion, the court relied on what it characterized as "two maxims of gift-tax law":

> (1) "A gift is valued as of the time it is completed, and later events are off limits."
> (2) "[G]ift tax is computed at the value of what the donor gives not what the donee receives."

Moreover, the court drew a distinction between Anne's charitable cap adjustment clause and the retransfer clause prohibited, on public policy grounds, in *Procter.*

According to the court, Anne's adjustment clause was consistent with the two maxims of gift tax law because it did not alter the units transferred by Anne, but only the ultimate recipient of the particular units. The allocation of units between the **trusts** and the Foundations was a "later event" that did not affect what Anne had personally given up.

The court analogized Anne's clause to those upheld in *Succession of McCord* [9] and *Estate of Christiansen* [10] and distinguished it from the clause disregarded in *Procter:* "The distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter.*" From this comparison, the court framed an estate planning rule of thumb: "A shorthand for this distinction is that savings clauses are void, but formula clauses are fine." The court described savings clauses as "adjustment clauses requiring that any gift subject to gift tax revert back to the donor."

The Tax Court, in *Christiansen,* also drew a distinction between a formula clause and a savings clause. It found valid a formula clause providing for 25% of the value of the property in excess of $6,350,000 to go to charity, while it found invalid a savings clause in a disclaimer in which the disclaimant promised to take "such actions to the extent necessary to make the disclaimer ... a qualified disclaimer." Such savings clauses are invalid, according to the Tax Court, because "they depend for their effectiveness on a *condition subsequent*" (i.e., the disclaimant taking additional action to ratify a previous disclaimer). Conversely, the formula clause required no further action by the transferor.

The court, in *Petter,* then examined the public policy considerations that have played such a key role in this area. As in *Proctor*, *King,*[11] *Ward,*[12] *McCord*, and *Christiansen,* the IRS argued that Anne's "formula clauses are void because they are contrary to public policy, which would create an increased gift tax liability for Anne." The IRS also expressed concern that if Anne's formula was honored it would result in "low-ball" estate appraisals backstopped by contingent charitable contributions. The court was not moved by these concerns. Instead, the court noted that "public policy weighed in favor of giving gifts to charities."

Essentially, the court found that the benefits of a charitable contribution trumped the public policy concerns for lost tax revenue: "We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits."

The court, moreover, characterized the IRS's fears of abuse of charities by "low-ball" appraisals as "exaggerated." The Foundations were not passive participants in an attempt to reduce Anne's tax bill. They actively negotiated in the transaction, retained their own counsel, and secured full membership in PFLLC. The court considered this participation important evidence of lack of abuse. According to the court, the fiduciary duties of the Foundations also hedged against abuse: "The directors of the [Foundations] owed fiduciary duties to their organizations to make sure the appraisal was acceptable before signing off on the gift—they also had a duty to bring a lawsuit if they later found that the appraisal was wrong."

The courts in *McCord* and *Christiansen* similarly observed that the participation of the charitable and fiduciary donees reduced the risk of abuse. In *McCord,* the Fifth Circuit noted: "[no] evidence of any agreement—not so much as an implicit, 'wink-wink' understanding between the Taxpayers and any of the donees to the effect that any exempt donee was expected to, or in fact would, accept a percentage interest ... with a value less than the full dollar amount...."

The Tax Court, in *Christiansen*, also commented: "But IRS estate-tax audits are far from the only policing mechanism in place. Executors and administrators of estates are fiduciaries, and owe a duty to settle and distribute an estate according to the terms of the will or law of intestacy. Directors of foundations ... are also fiduciaries." (Emphasis in original; internal citations omitted.) Based on this, the Eighth Circuit, in *Christiansen,* found "sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner...." Accordingly, active participation by a charity or an independent fiduciary can provide valuable substance to the transaction.

The court, in *Petter,* also discussed the inconsistency between the public policy arguments raised by the IRS to challenge Anne's adjustment clauses with the acceptance of the IRS of formula clauses in other income and transfer tax contexts. For instance:

- Reg. 1.664 -(a)(1)(iii), allowing formula provisions for charitable remainder **trusts**.
- Rev. Proc. 64-19 , [14] sanctioning the use of formula clauses in the marital deduction context.
- Reg. 26.2632-1(d)(1) , permitting formula allocations of generation-skipping tax exemption.

The IRS argued that the absence of a specific allowance of a gift tax adjustment clause in the context of Anne's transfer demonstrates an implicit intent of Congress and the Treasury to ban them. The court disagreed and found "the mere existence of these formula clauses, which would tend to discourage audit and affect litigation outcomes the same way as Anne's formula, belies the [IRS's] assertion that there is some well-established public policy against the formula transfer Anne used."

Finally, the court considered the issue of the availability and timing of a charitable contribution deduction for Anne's transfer. Based on its reading of both income and gift tax regulations (e.g., Regs. 1.70A-1(c) and 25.2511-2(a)), the court found that the date of Anne's transfers in 2002 was the appropriate date for the charitable deduction, even though the true value of the transfers to charity was not determined until much later. The court found "no reason a donor's tax treatment should change based on the later discovery of the true measure of enrichment by each of two named parties, one of whom is a charity." Accordingly, Anne was allowed to avoid additional gift tax despite a substantial increase in the value of PFLLC units transferred.

Income tax consideration.

The opinion, however, is ambiguous as to whether Anne was entitled to a charitable deduction for both gift tax and income tax. More than six years separated the year of Anne's transfer and the final determination of the value of the gift. Without an agreement with the IRS, Anne would be unable to amend her income tax return for 2002 to claim the resulting income tax deduction. The loss of an income tax charitable deduction due to the duration of a valuation dispute may further mitigate the concern for low-ball appraisals. A lengthy but unsuccessful defense of a large valuation discount could result in the loss of a valuable charitable income tax deduction. A more conservative valuation discount could minimize the risk of audit and ensure a maximum charitable deduction for both gift and income tax purposes.

Also absent from the opinion is any discussion of declaratory judgment provisions of Section 7477 which extended, for gifts made after 8/5/97, jurisdiction to the Tax Court to make declarations of the value of gifts. While Section 7477 is intended to give taxpayers a venue to dispute the valuation of gifts sheltered by the unified credit, it appears to conflict with the IRS's public policy argument against decisions by the court without resulting gift tax consequences.

Conclusion

Following in the wake of the opinions in *McCord* and *Christiansen*, the Tax Court's decision in *Petter* indicates further that a "charitable cap adjustment clause" can be used to minimize the risk of additional gift tax on the revaluation of hard-to-value property. The decision, moreover, sets forth a useful roadmap for the technique itself. It describes a manner in which a "donor advised fund" offered by a public charity can be incorporated into the prescribed steps of an installment sale to an intentionally defective grantor **trust**.

Based on *Petter,* the Tax Court appears to be unwilling to use public policy to increase gift tax at the expense of a charitable donee. Therefore, the proper use of a charitable cap adjustment clause should provide a valuable hedge against the risk of additional gift tax from the transfer of hard-to-value assets.

Adjustment clauses may also be of use in 2010 to counter the looming uncertainty as to whether the federal estate tax will be retroactively reenacted. For instance, a bequest to a generational **trust** for the benefit of a surviving spouse, children, and grandchildren could include an adjustment clause allocating any portion later made taxable by a retroactive reenactment to a **trust** for the surviving spouse that qualifies for the federal estate tax marital deduction. The reenactment of the tax would be the triggering event causing a reallocation of a portion of the transfer to a deductible donee, in this case the surviving spouse.

When there is no spouse, the deductible donee could be a charitable lead or remainder **trust**. Highly respected commentators have submitted that under the current uncertainty in the law, such formulas would not appear to be the "trifling with the judicial process" prohibited by *Procter.* [16] Such clauses would certainly be consistent with the reasoning of *Petter*.

Exhibit 1. Types of adjustment clauses

Retransfer clause

Authority: *Procter*, 32 AFTR 750 , 142 F2d 824 , 44-1 USTC ¶10110 , 44-1 USTC ¶10123 (CA-4, 1944), *cert. den.* 323 U.S. 756 (1944).

Wording of clause: "[I]n the event it should be determined ... that any part of the transfer in **trust** hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in **trust** hereunder and shall remain the sole property of [the transferor] free from the **trust** hereby created."

Holding: The clause was not given effect to avoid gift tax based on the following public policy grounds:

> (1) The clause "has [the] tendency to discourage the collection of tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift."
> (2) "[T]he effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case."
> (3) "[T]he condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered."

Retransfer clause

Authority: Situation 1, Rev. Rul. 86-41, 1986-1 CB 300 .

Wording of clause: "A transferred an interest in a tract of income producing real property to B. Under the deed of transfer, B received a one-half undivided interest in the tract. However, the deed further provided that if the one-half interest received by B were ever determined by the [IRS] to have a value for federal gift tax purposes in excess of $10,000, then B's fractional interest would be reduced so that its value equaled $10,000."

Holding: The IRS found the clause to be ineffective on public policy grounds; according to the IRS such clauses "tend to discourage the examination of returns and the collection[] of tax and therefore [are] ineffective for federal gift tax purposes."

Price adjustment clause

Authority: *In re King*, 39 AFTR 2d 77-353 , 545 F2d 700 , 76-2 USTC ¶9784 , 76-2 USTC ¶13165 , 76-2 USTC ¶16240 (CA-10, 1976).

Wording of clause: "[I]f the fair market value of the [stock] ... is ever determined by the [IRS] to be greater or less than the fair market value determined ... above, the purchase price shall be adjusted to the fair market value determined by the [IRS]."

Ruling: Based on the facts of the case, the court upheld the effectiveness of the price adjustment clause to prevent a taxable gift, finding "that the parties intended that the [purchasers] pay a full and adequate consideration for the stock and that the clause was a proper means of overcoming the uncertainty in ascertaining the fair market value of the stock." Key to its decision to respect the price adjustment clause was "[t]he trial court's finding that there was no donative intent and that the transaction was made in the ordinary course of business at arms [sic] length...."

Price adjustment clause

Authority: *Estate of McLendon*, TC Memo 1993-459 , RIA TC Memo ¶93459 , 66 CCH TCM 946 , *rev'd on other grounds* 77 AFTR 2d 96-666 , 77 F3d 477 , 96-1 USTC ¶60220 (CA-5, 1995).

Wording of clause: "[T]he parties agree that, to the extent any of the values ... are changed through a settlement process with the [IRS], or a final decision of the United States Tax Court, the purchase price hereunder shall be adjusted accordingly, with interest on said adjustment at the rate of ten percent (10%) from the date hereof until said final determination of value...."

Ruling: The court gave no effect to this adjustment clause because in the court's view: "it makes little sense to expend precious judicial resources to resolve the question of whether a gift resulted from the [] transaction only to render that issue moot." The court further noted that, because the buyers were not parties to the case, there was no assurance that they would pay the additional purchase price in accordance with the adjustment clause. The court also distinguished this case from *King* in that this transaction was "not an arm's-length deal," and more generally, it called into question the factual findings supporting the holding in *King*.

Price adjustment clause

Authority: Situation 2, Rev. Rul. 86-41, 1986-1 CB 300 .

Wording of clause: "The facts are the same as in situation 1, [described above] except that B was not required to reconvey any property to A. Rather, the transfer contained the condition that if the [IRS] determined that B received a gift in excess of $10,000, B would transfer to A consideration equal to the amount of the excess."

Ruling: The IRS relied on the public policy grounds of *Procter* to disregard the clause. The IRS considered the recharacterization of the transfer as a part-gift/part-sale to be irrelevant to the public policy considerations.

Defined value clause

Authority: *Ward*, 87 TC 78 (1986).

Wording of clause: "Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share ... exceeds or is less than $2,000.00 an adjustment will be made in the number of shares constituting each gift so that each Donor will give to each Donee the maximum number of full shares of [] stock ..., the total value of which will be $50,000.00 from each Donor to each Donee and a total of $150,000 from each Donor to all Donees."

Ruling: The court gave no effect to the clause finding "a condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of 'trifling with the judicial process' condemned in *Procter.*" The court found no relevant distinction between a clause requiring a return of the property transferred and a clause providing for a lapse of a previous transfer of property.

Defined value clause

Authority: TAM 200337012 .

Wording of clause: "Assignor desires to transfer as a gift to Assignee that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $a.... Pursuant to this assignment, [Assignee] received an e% interest in Partnership from [Assignor]."

Ruling: The IRS found this clause to be void as contrary to public policy under *Procter* and *Ward* because if it was "given effect and the value of the e% interest, as finally determined by the [IRS], is greater than $a, a certain percentage of the Partnership interest held by [Assignee] would be retransferred to [Assignor]." Essentially, the IRS found little distinction between this clause and a retransfer clause found invalid in *Procter.* Either way the property is essentially returned to the transferor.

Defined value clause with excess to deductible donee

Authority: *Succession of McCord,* 98 AFTR 2d 2006-6147 , 461 F3d 614 , 2006-2 USTC ¶60530 (CA-5, 2006), *rev'g* 120 TC 358 (2003) (reviewed decision).

Wording of clause: An assignment agreement which provided that "the children and the **trusts** were to receive portions of the gifted interest having an aggregate fair market value of $6,910,933, if the fair market value of the gifted interest exceeded $6,910,933, then [charity 1] was to receive a portion of the gifted interest having a fair market value equal to such excess, up to $134,000; and if any portion of the gifted interest remained after the allocations to the children, **trusts**, and [charity 1]; then [charity 2] was to receive that portion...." The assignment agreement left to the assignees the task of allocating the gifted interest among themselves, with dispute over the allocation to be resolved by arbitration. The assignees subsequently agreed to an allocation set forth in a "confirmation agreement." The Transferors were not parties to the confirmation agreement.

Ruling—Tax Court: The defined value clause could not be given effect because it did *not* provide each donee with "an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes...." Instead, the Tax Court found that the provisions of the assignment agreement were ratified by the confirmation agreement, so that any increase in value had to be allocated in accordance with the confirmation agreement. Thus, because of the confirmation agreement, no further interest could be allocated to the charities to avoid gift tax.

Ruling—Fifth Circuit: The Tax Court committed reversable error by improperly "relying on post-gift events ... the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts...." Instead, the Fifth Circuit gave effect to what it considered the "ascertainable value" set forth in the assignment agreement.

Defined value clause with excess to deductible donee

Authority: *Estate of Christiansen,* 130 TC 1 (2008) (reviewed decision), *aff'd* 104 AFTR 2d 2009-7352 , 586 F3d 1061 , 2009-2 USTC ¶60585 (CA-8, 2009).

Wording of clause: "Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift ..., less ... ($6,350,000.00) and the denominator of which is the fair market value of the Gift ... ("the Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift ..., shall be the price at which the Gift ... would have changed hands ... between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes."

Ruling: The Tax Court unanimously approved the operation of the formula clause and rejected the IRS's "condition subsequent" and "public policy" arguments:

No condition subsequent: "The transfer of property to the [charity] in this case is not contingent on any event that occurred after [the transfer]... —it remains 25 percent of

the total estate in excess of $6,350,000. That the estate and IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future."

Formula is not contrary to public policy: "The disclaimer in this case involves a fractional formula that increases the amount donated to charity should the value of the estate be increased. We are hard pressed to find any fundamental public policy against making gifts to charity—if anything the opposite is true. Public policy encourages gifts to charity...."

"This case is not *Procter.* The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among [beneficiaries].... That would not make us opine on a moot issue...."

The Fifth Circuit affirmed the Tax Court finding that the only uncertainty—"the valuation of the estate, and therefore, the value of the charitable donation" was not a disqualifying condition subsequent, and that public policy favors charitable donations: "Congress sought to encourage charitable donations by allowing deductions for such donations."

Defined value clause with excess to deductible donee

Authority: *Estate of Petter,* TC Memo 2009-280 , RIA TC Memo ¶2009-280 , 98 CCH TCM 534 .

Wording of clause: "Transferor ... assigns and sells to the **Trust** the number of Units described in Recital C above [8,459] that equals a value of $4,085,190 as finally determined for federal gift tax purposes; and ... assigns to the [charity] as a gift ... the difference between the total number of Units described in Recital C [8,459] above and the number of Units assigned and sold to the **Trust**....

The **Trust** agrees that, if the value of the Units it receives is finally determined to exceed $4,085,190, Trustee will, on behalf of the **Trust** and as a condition of the sale to it, transfer the excess Units to the [charity] as soon as practicable. Likewise, the [charity] agrees to transfer shares to the **trust** if the value is found to be lower than $4,085,190."

Holding: The court found the adjustment clause to be consistent with the gift tax laws because it did not affect the number of units transferred, but only the ultimate recipient of the particular units. The allocation of units between the recipients due to an adjustment in value was a "later event" that did not affect what the transferor had personally given up. The court analogized this clause to those upheld in *Succession of McCord* and *Estate of Christiansen* and distinguished it from the clause disregarded in *Procter:* "The distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter.*" From this comparison, the court framed an estate planning rule of thumb: "A shorthand for this distinction is that savings clauses are void, but formula clauses are fine."

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GIFT TAX PAID BY RECIPIENTS OF QTIP REMAINDER INCLUDED IN GROSS ESTATE

The Tax Court in *Morgens*, 133 TC 17 , held that gift tax paid by the recipients of deemed gifts of remainder interests in qualified terminable interest property (QTIP) was includable in the decedent's gross **estate** under Section 2035(b) .

In 1991, the decedent and her husband established a revocable inter vivos trust; the couple later executed several amendments of the trust. Under the amended trust agreement, the corpus of the trust was to be distributed into two separate trusts after the death of the first spouse (the survivor's trust and the residual trust). The amended agreement also provided that, after certain gifts, the residual trust balance would remain in trust for the benefit of the surviving spouse.

When the decedent's husband died, the trust was divided and the decedent and her two sons became the co-trustees of the residual trust. On 10/25/00, the husband's **estate** filed an **estate** tax return on which the executor made an election under Section 2056(b)(7) for the property passing to the residual trust, qualifying all of the property for the marital deduction. On 9/22/00, the decedent disclaimed her right to the principal invasion interest in the residual trust. In November 2000, the remainder beneficiaries of the residual trust entered into an indemnification agreement where, in consideration of any gifts of the decedent's income interest in the residual trust, they agreed to indemnify the decedent and her **estate** against gift or **estate** taxes. In December 2000, the co-trustees of the residual trust petitioned the court to sever the residual trust into two separate trusts (residual trusts A and B).

On 12/8/00, the decedent transferred her income interest in residual trust A as gifts to the remainder beneficiaries, triggering a transfer of the QTIP remainder under Section 2519 . The gift tax liability was paid by the residual trust A trustees. On 1/10/01, the decedent transferred her residual trust B income as gifts to the remainder beneficiaries, triggering a transfer of the QTIP remainder. The residual trust B trustees paid the gift tax on the 2001 deemed transfer.

On 11/24/03, the executor of the decedent's **estate** filed an **estate** tax return. The executor did not include the amounts of gift tax paid by the trustees on the 2000 and 2001 deemed transfers in the gross **estate** on the ground that those amounts were not gift tax paid by the decedent or her spouse within three years of her death. The IRS audited the **estate's** return and issued a notice of deficiency. The executor timely petitioned the Tax Court.

Under Section 2035(b) , an **estate** is increased by any gift tax paid by the decedent or the decedent's **estate** on any gift made by the decedent or his or her spouse during the three-year period preceding the decedent's death. The purpose of Section 2035(b) was to prevent individuals from reducing their **estate** tax liability by making inter vivos transfers before death.

The Tax Court stated that the issue before it arose at the junction of Section 2035(b) and Sections 2519 and 2207A(a) , which were added to the Code as part of the QTIP regime. Section 2056 provides a marital deduction for property passing from a decedent to his or her surviving spouse. The marital deduction does not eliminate the tax on the transfer of marital assets out of the marital unit; rather, it allows for the deferral of tax until the

death of or gift by the surviving spouse. Generally, a marital deduction is not allowed for terminable interest property (i.e., an interest passing from a decedent to his or her surviving spouse that ends on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur) passing from a decedent to his or her surviving spouse. Congress, however, provided an exception to the terminable interest rule for QTIP.

Section 2056(b)(7) provides that a decedent may pass to his or her surviving spouse an income interest in property for the spouse's lifetime. After the death of the surviving spouse, the property passes to the beneficiaries designated by the first spouse to die. When the surviving spouse dies, the value of his or her gross **estate** must include the value of the QTIP. Under Section 2207A(a) , the **estate** may recover from

the QTIP recipients the amount by which the surviving spouse's **estate** tax is increased by including the QTIP in the **estate**. Section 2519 governs dispositions of QTIP during the surviving spouse's lifetime and treats any disposition of all or part of a qualifying income interest for life as a transfer of all interests in the QTIP other than the qualifying income interest. If gift tax is due on the deemed transfer of the QTIP, Section 2207A(b) allows the surviving spouse to recover it from the QTIP recipients.

The IRS argued that the decedent was personally liable for the gift tax attributable to the 2000 and 2001 deemed transfers and that Section 2270A(b) did not shift her liability to the trustees. Instead, Section 2035(b) required that the gift tax paid on the transfers be included in the decedent's gross **estate** as gift tax paid within three years of death. The **estate** countered that applying Section 2035(b) to the gift tax paid by the trustees would result in an increased **estate** tax burden on the decedent's **estate** which was contrary to Section 2207A and the legislative intent of the QTIP regime. The **estate** added that the ultimate responsibility for paying the gift tax on the Section 2519 deemed transfers lay with the trustees of the trusts, and Section 2035(b) did not apply. The court disagreed with the **estate** and held that the gift tax paid on the deemed transfers of the QTIP was includable in the decedent's gross **estate**.

The court noted that because the executor of the decedent's husband's **estate** made a QTIP election under Section 2056(b)(7) , the decedent's transfers of her income interest in the residual trusts were treated as transfers of the QTIP (other than her qualifying income interest) under Section 2519 . The court added that although the decedent received no economic interest in the QTIP besides income for life, the QTIP regime employs a fiction that treats QTIP as passing entirely from the first spouse to die to the surviving spouse. That is, while only a life interest passes from the first spouse to die to the surviving spouse, the entire QTIP gets the deferral benefit of the marital deduction and escapes inclusion in the gross **estate** of the first spouse to die.

The quid pro quo for this favorable treatment is the inclusion of the property in the transfer tax base of the surviving spouse. In the case of QTIP, the inclusion occurs either at death of the surviving spouse or on the disposition of his or her qualifying interest. Simply put, Sections 2044 and 2519 treat the surviving spouse as if he or she owned the QTIP outright. The court noted that the legislative history showed that the QTIP regime employs a fiction of transfers to and from the surviving spouse. Because the Code treats surviving spouses as transferring QTIP, the court held that the decedent was the deemed donor of the QTIP.

As the deemed donor of QTIP, the surviving spouse bore the gift tax liability arising from the transfer of QTIP. The **estate** argued, however, that Section 2270A(b) showed that Congress intended that recipients of QTIP bear the ultimate gift tax liability, adding that the General Explanation of the Economic Recovery Tax Act of 1981 supported its argument because it stated "that Congress recognized that the burden of tax resulting from a deemed transfer under section 2519 should be 'borne by the persons receiving that property and not by the spouse or the spouse's heirs.'"

The court agreed that Congress intended that, as between QTIP recipients and the surviving spouse, the QTIP recipients should bear the ultimate financial burden for the transfer taxes, but it did not believe that by allocating the financial burden for the tax to the recipients that Congress shifted to them the liability for gift tax. The court stated that Section 2270A(b) does not provide that the donees of QTIP should be liable for the applicable gift tax. Rather, that section refers to the right to recover the gift tax.

The court found that the **estate's** argument effectively read Section 2207A(b) out of the gift tax regime, noting that Section 2502(c) provides that gift tax is the liability of the donor. Further, a donee is liable only if the gift tax is not paid by the donor when due. That is, the question of how private parties allocate the burden of the tax was different from the issue of who is liable for gift tax. Because the court believed that Section 2207A(b) did not shift the gift tax liability to QTIP recipients but rather that the liability remained with the donor, it held that the liability for the gift tax attributable to a Section 2519 deemed transfer remains with the surviving spouse.

The court next addressed Section 2035(b) , which requires that a decedent's gross **estate** must be increased by the gift tax on gifts made by the decedent or his or her spouse during the three-year period ending on the date of the decedent's death. Congress enacted Section 2053(b) to eliminate the Code's incentives for deathbed transfers; prior to Section 2053(b) , gift tax was not taken into account in either gift or **estate** tax basis.

The court then considered gift tax paid by a decedent on his or her **estate** in the context of net gifts. A "net gift" is a gift made by a donor when the gift is subject to the condition that the donees pay the gift tax. In those cases, to calculate the gift tax the donor reduces the gift by the amount of the gift tax. The court stated that the parties disagree whether a deemed transfer of a QTIP is a net gift or is merely reported as a net gift. The IRS asserted that a deemed transfer of a QTIP did not differ in any meaningful way from a

net gift, adding that Section 2053(b) applied to the gift tax paid on the deemed transfers under ***Estate** of Sachs*, 88 TC 769 , where the court held that the phrase "[gift tax] paid by the decedent or his **estate**" in Section 2035(c) included gift tax attributable to net gifts made by a decedent during the three-year period before his or her death, even though the donees were contractually obligated to pay the gift tax.

The **estate** opposed labeling Section 2519 deemed transfers as net gifts and pointed to a number of differences between net gifts and Section 2519 transfers, but the court rejected this argument. Instead, the court found that for purposes of Section 2035(b) the deemed transfer of QTIP here was similar to a net gift. The court also found that the **estate's** suggestion that the source of the funds used in paying the gift tax was pertinent in a Section 2035(b) analysis was misplaced. The court stated that although it agreed that the source of funds is pertinent in a Section 2035(b) analysis, the essential premise

of the QTIP regime is that the surviving spouse is deemed to pass the entire QTIP. That is, the **estate's** argument ignored the underlying assumption of the QTIP regime that the entire QTIP is deemed to pass to the surviving spouse, and the surviving spouse, in turn, is deemed to transfer the QTIP either at death or inter vivos.

The court stated that nothing in the code excepted the gift tax liability for the surviving spouse on transfers of QTIP from Section 2035(b) , and it rejected the **estate's** argument that Congress intended to "silently amend" Section 2035(b) when it enacted the QTIP regime. "Without a clear congressional mandate," said the court, "we shall not treat gift tax liability of the surviving spouse, for purposes of Section 2035(b) , any differently than any other gift tax liability for a decedent-donor that is paid by the donees with respect to gifts a decedent-donor makes within 3 years of death."

The court considered but ignored the remaining arguments made by the parties, concluding that the arguments were irrelevant, moot, or without merit.

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ENTIRE PROPERTY INTEREST ERRONEOUSLY INCLUDED IN DECEDENT'S ESTATE

The Second Circuit in *Estate of Stewart, 106*, AFTR2d 2010 (CA-2, 2010), vacated the Tax Court's decision that the terms of an implied agreement between the decedent and her son provided that the decedent would enjoy 100% of the economic benefit of the son's 49% undivided interest. It remanded the case to the Tax Court to make factual determinations necessary to determine the amount of net income from the son's interest. The Tax Court would then be able to calculate the corresponding proportion of the value of the entire property and include it in the decedent's gross estate under Section 2036(a)(1) .

The decedent and her son, Brandon, co-owned, as joint tenants with rights of survivorship, a house in East Hampton, New York. Each summer, they rented out the property, splitting the rental income evenly. The decedent and Brandon also owned a Manhattan brownstone, in which they lived on the first two floors. In 1999, the decedent leased the top three floors to an unrelated commercial tenant. The rent was $9,000 per month and the term ran through 7/31/02.

On 10/1/99, the decedent and Brandon met with an estate planning specialist who suggested that the decedent make a **gift** of part of the Manhattan property to her son. The decedent said that she wanted to give Brandon half the property along with half the rent. In December 1999, the decedent was diagnosed with pancreatic cancer and began chemotherapy soon after. On 5/9/00, the decedent and Brandon signed a deed that transferred a 49% interest in the Manhattan property to Brandon. The deed provided that the decedent and Brandon would be tenants-in-common.

The financial relationship between the decedent and Brandon underwent significant changes during the period after the **gift** and before the decedent's death in November 2000. While the decedent continued to receive the Manhattan property rent payments, Brandon received the rent payments from the East Hampton property. In contrast to their previous practice, Brandon did not write checks to the decedent for her share of the East Hampton rent. The decedent, who previously paid for all of the Manhattan property expenses, now paid for most of them; Brandon started paying a small, but not insignificant fraction

Following the decedent's death, her estate filed an estate tax return, which reported the contents of the estate as including 100% of the East Hampton property, but only a 51% interest in the Manhattan property. The IRS issued a notice of deficiency, asserting that the decedent had retained possession or enjoyment of the transferred 49% interest and, therefore, under Section 2036 , the entire Manhattan property was part of her estate for federal tax purposes.

The estate filed suit challenging the Service's determination of a deficiency. It argued that the decedent had not retained the enjoyment or income of the entire Manhattan property, but rather, as a 51% owner, had forgone much of the income from the top three floors by using a setoff to pay Brandon, and had shared the value of the bottom two by living with Brandon. According to the estate, instead of splitting up the rental income and expenses each month in proportion to their interests in the properties (which would have required the decedent and Brandon to write separate checks for every expense and receive separate checks from both tenants), the taxpayer and Brandon kept track of each person's net income from both properties and intended to reconcile the differences at the end of 2000.

The Tax Court in *Estate of Stewart*, TC Memo 2006-225 , RIA TC Memo ¶2006-225 , 92 CCH TCM 357 , denied the estate's petition. (See "Transferred Real Property Interest Was Includable in Decedent's Estate, 77 PTS 370 (December 2006).) It found that the taxpayer continued to receive the Manhattan property's monthly rent payments and enjoy the economic benefits of the property. There was no written agreement between the decedent and Brandon stating that they would reconcile the income and expenses of the two properties, and the court held that there was no oral agreement, rejecting Brandon's testimony that such an agreement existed. Instead, the court said the decedent and Brandon had an implied agreement that the decedent would retain the economic benefits of the Manhattan property. Because of this, the court found that the full value of the Manhattan property was includable in the estate under Section 2036 .

The Second Circuit pointed out that some taxpayers use various planning techniques designed to take property out of the gross estate or decrease its value. Section 2036(a)(1) is one of the statutory tools the IRS uses in fighting these techniques. The purpose of Section 2036 is to prevent individuals from using a **gift** transfer of property with reservation of a life estate (or a similar device) to avoid paying estate tax. One method used to accomplish this is an agreement (even an implied or unenforceable agreement) between the decedent and a lifetime transferee that the decedent will continue to enjoy the benefits of the property for life. Courts and the IRS have ruled that if there is this kind of agreement, the decedent is understood to have retained possession or enjoyment of the property, which must be included in the estate.

The appellate court said that dividing real estate into separate interests usually lowers the property's fair market value, and thereby the taxes due on it. According to the court, the fair market value of separate interests is typically discounted by about 10-20% for lack of control and marketability. In the present case, however, the parties stipulated to a much higher discount of 42.5% if the property had in fact been divided. The IRS and the Tax Court decided that the decedent owned all the property at her death, which meant no discount and higher taxes.

The Second Circuit said the Tax Court was justified in finding that the decedent would enjoy for her life the substantial economic benefit of some part of the rental portion of the Manhattan property. Because the estate failed to provide a credible explanation of why all the rent payments went to the decedent, they supported the Tax Court's finding of an implied agreement. The appellate court, however, held that the decedent's residential use of part of the Manhattan property did not indicate an implied agreement that she would retain the economic benefits of the residential portion of Brandon's 49% interest. According to the court, the decedent did not have exclusive possession of, nor did she exclude Brandon from, his 49% interest in the property.

Accordigly, the appellate court ruled that although the Tax Court was justified in finding an implied agreement, it was not justified in finding that the terms of the agreement were such that the decedent would enjoy the substantial economic benefit of 100% of Brandon's 49% interest in the property. Brandon enjoyed, and the decedent did not, the benefits of the residential portion of the 49%. Additionally, the appellate court said that even as to the commercial portion it seemed likely that the decedent retained the benefits of less than the total 49%.

The Second Circuit said that, because the Tax Court treated Section 2036(a)(1) as an all-or-nothing matter, it did not consider whether the decedent retained or reserved an interest or right with respect to only a part of the transferred property. According to the appellate court, the Tax Court needed to determine how much of the economic benefit generated by the 49% interest was attributable to the residential portion of the interest and how much was attributable to the commercial portion. Therefore, it remanded the

case back to the Tax Court to make the following findings to determine what part of the 49% interest should be included in the estate:

- The Tax Court had determined that the decedent had paid most of the Manhattan property expenses. The appellate court said that the Tax Court had to take these into account these expenses when apportioning the 49% interest to determine who received what portion of the net (rather than gross) income from the interest.
- The Tax Court did not consider the distribution of income and expenses from the East Hampton property. The appellate court said that although the Tax Court was under no obligation to credit Brandon's testimony that he and the decedent intended to use the East Hampton property to set off the Manhattan income and then reconcile their accounts at year's end, it should at least consider where the net income from the East Hampton property went. The Second Circuit rejected the Service's argument that the reference to property in Section 2036(a)(1) does not provide for consideration of the decedent's relationship to other property, regardless of its association with the property at issue. In some instances, according to the court, consideration of property might be useful to an accurate determination of who enjoyed the economic benefit of a property.

Dissent. Judge Livingston strongly disagreed with the majority decision, which she said turned "the proper—and longstanding—construction of Section 2036 on its head." She said it also opened up a "loophole that will vitiate to a considerable degree the efficacy of this section." According to the judge, the majority erred in two respects. First she said the majority treated co-occupancy post-transfer as sufficient evidence to *prove the absence* of an implied agreement, at least with respect to the residential portion of the property. She said that before this case, it had been merely insufficient evidence to *confirm the existence* of an implied agreement. Next, she said the majority incorrectly focused on what Brandon supposedly received after the transfer rather than what the decedent retained. This, the judge argued, contravened the plain language of Section 2036 . "The majority's reasoning," said Judge Livingston, "by focusing solely on Brandon Stewart's residence at the townhouse as a tenant in common as dispositive, not only departs from prior case law and contravenes the text of section 2036, but also thoroughly undermines the statute, inviting inevitable disparities among those subject to the estate and **gift** taxes due to easy dodges by future tax avoiders."

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