Estate Planning Current Developments and Hot Topics

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Introduction

This summary of recent developments includes observations from various recent developments including some observations from the 46th Annual Philip E. Heckerling Institute on Estate Planning.

1. Legislative Uncertainty and Predictions

a. *Possibilities; Estate Tax Returns Anticipated For 2011 Decedents with $5 Million Exemption; Possible Legislative Actions.* The Tax Policy Center has published a summary of estimates of estate tax returns that will be filed for 2011 decedents. It anticipates 8,600 returns being filed, but only 3,270 taxable returns that will result in estate taxes of $10.6 billion. There are interesting estimates about the very small number of returns that will involve farms or businesses that comprise at least 50% of the gross estate.

All returns where farms and businesses comprise at least 50% of the gross estate: 430 returns, but only 120 taxable returns, reflecting $660 million of estate tax.

Returns where farms and businesses comprise at least 50% of the gross estate *and* the farm or business is less than $5 million: 210 returns, but only 40 taxable returns, reflecting a grand total of $7 million of estate tax.

Various planners have reported rumors of hearing high level officials saying that a "deal" is already done in Congress to retain the current exemption level of $5 million (inflation indexed — which apparently would be $5,250,000 in 2013) next year with portability regardless of who wins the Presidential election. (The rumors have not been clear as to whether that applies to the gift exemption as well as the estate and GST exemption.)

Possible Congressional actions include:

- Doing nothing, and on January 1, 2013 there will be a $1 million exemption and 55%-60% tax rate. (Many planners think this is likely to occur, in which event there would likely be legislation sometime in 2013.)
- Repeal the estate tax. This cannot be ruled out, though it is unlikely. Governor Romney's official position was to repeal the estate tax (but keep in mind that was the official position of Presidents Reagan and George W. Bush as well.) (A problem with repeal is that the all estates would receive a step up in basis of death, with no offsetting revenues.)
- The Obama Administration's proposal is to use a $3.5 million estate exemption, a $1.0 million gift exemption, and a 45% maximum rate. (However, some do not believe that the 2012-2013 budget proposal's reference to the "2009 parameters" really means that the administration favors a $1 million gift exemption).
- The initial version of the Middle Class Tax Cut Act as introduced on July 17, 2012 by Senate Majority Leader Reid (initially introduced as S. 3393) would have applied a unified estate, gift and GST exemption of $3.5 million with a 45% top rate for one year. The transfer tax provision was pulled from the bill before the Senate voted on it due to disagreements within the Democratic caucus over the provision.
- Some other lower exemption. The "Sensible Estate Tax Act of 2011" (discussed immediately below) proposes a $1 million exemption, indexed from 2000). (Jonathan Blattmachr predicts "I think there is a very good chance the $5 million gift exemption will go away.")
- Retain $5 million/35% system. (Jeff Pennell thinks the exemption will not be reduced lower than $5 million; he puts it-"the toothpaste is out of the tube".) It is conceivable

that the rate could end up at something a little lower than 35%, to appease those favoring estate tax repeal.

- Canadian type capital gains and death system, though that is very unlikely.
- Adopt the 2010 approach, with the alternative to elect into carryover basis; this is also very unlikely.

In considering the cost of legislative proposals, projections should factor in not only the income tax effect of stepped up basis but also the income tax effect of additional income tax deductions for administrative expenses that would have been taken on estate tax returns if the estate tax applied to more estates.

b. "*Sensible Estate Tax Act of 2011.*" A bill that was introduced November 17, 2011, which has no chance of passing, has interesting draft language that we may see as forming the basis for transfer tax legislation. The legislation is sponsored by Rep. Jim McDermott (D-WA), who has sponsored similar legislation in prior years that has gone nowhere. H.R. 3467, The Sensible Estate Tax Act of 2011, has several features:

- the estate tax exemption is reduced to $1 million (indexed for inflation since 2000);
- rates are increased above 35% and the brackets are broadened; a 55% rate would apply for taxable estates over $10 million;
- the brackets are also indexed;
- the reduction in the exemption amount presents the potential for "clawback" for a donor who make gifts of $5 million in 2011-2012, but the legislation would eliminate clawback by providing that the applicable exclusion amount used to calculate the hypothetical gift tax to subtract under §2001(b)(2) may never exceed the estate applicable exclusion amount used to compute the "tentative [estate] tax;" in effect, the hypothetical gift tax would be determined using not only the rate table in effect at the decedent's death but also the applicable credit amount in effect at the date of death;
- the state death tax credit is re-instituted and the deduction for state death taxes is removed;
- valuation discounts are limited on nonbusiness assets (this is not the amendment to §2704 that has been in the President's Budget Proposal the last three years; no legislation has ever been submitted for that proposal);
- consistency of basis for estate and gift tax purposes and income tax purposes would be required (§§ 1014(f)(1) and 1015(f)(1) would require that the basis value be no less than the value "as finally determined" for estate or gift tax purposes; §§ 1014(f)(2) and 1015(f)(2) would require that the basis value be no less than the value reported "if the final value … has not been determined;" new § 6035 would require that an executor or donor give a report to transferees regarding values of interest reported on estate or gift tax returns; and penalties would apply for failure to comply with these rules);
- the portability provisions are revised to implement the "Example 3" result from the Joint Committee on Taxation Report of TRA 2010 (to refer to the "applicable exclusion amount" rather than the "basic exclusion amount of the last deceased spouse in the DSUEA definition of § 2010(c)(4));
- GRATs would require a 10-year minimum term, a remainder value greater than zero, and a prohibition on declining GRAT payments;

- the generation-skipping transfer tax exemption term for a trust will be limited by resetting the inclusion ratio to one when the trust is 90 years old;
- the effective date of the bill would be January 1, 2012.

c. *Rumors of Reduced Exemption in Fall 2011 Unfounded*. There was a flurry of rumors in November 2011 about the possibility of the Supercommittee reducing the gift exemption below $5 million, effective as of November 23, 2011. However, there was never any credible source for these rumors, and indeed they proved to be totally groundless.

d. *When Will Congress Act?* Ron Aucutt has summarized the situation very concisely: "No one could have predicted what happened in 2010, and here we are again." The most popular prediction position of planners is that it is unlikely that Congress will act before 2013. Congress will have a variety of extremely important issues to address in the lame duck session following the elections (including "sequestration" [the automatic cuts in domestic and military spending], the "Bush income tax cuts," and extenders for various issues that expired at the end of 2011 [including the alternative minimum tax] and at the end of 2012). The estate tax is a relatively small matter. Still, compromise was reached in December 2010 (very surprisingly).

Some planners believe that there may be a stronger possibility of an agreement on taxes in a lame duck session than if Governor Romney had won the Presidential election.

e. *"Kick the Can" Approach?* Many have suggested a strong likelihood of an extension of 3-6 months in a lame-duck session to avoid the "fiscal cliff." If there is no tax legislation until 2013, it could be "permanent," but it would be easier to grant another temporary extension of a year or two on the theory that tax rates should not be increased currently because the economy still needs time to recover.

Permanent estate tax provisions are likely to come only in a larger tax bill. We will not see a stand-alone estate tax bill to provide permanent relief.

f. *Retroactive Law in 2013*. Most planners have thought that estate tax legislation in 2013 could be retroactive to January 1 without a challenge, because the law would be more favorable to taxpayers than a $1,000,000/55% system. However, Treasury officials have expressed concern that some disgruntled beneficiary might nevertheless challenge the validity of the retroactivity of the law (for example, the lower rates may cause a shift in who receives benefits under a formula clause, or a shift in amounts that a charity receives). A challenge would take 5 to 7 years to be resolved by the Supreme Court before there would be uncertainty for estates of decedents who died during the period of retroactivity.

g. *Specific Legislative Proposals.*

- Make portability permanent — likely.
- Basis consistency — somebody will include that and get credit for taking away an abuse that is not being used anyway.
- Valuation discount/§2704 proposal — Ron Aucutt thinks that we eventually will see §2704 legislation, and regulations will be issued within 18 months of the date of enactment; he has no predictions when that will happen.
- GRAT — the 10-year minimum term proposal (with no frontloading) has passed the House in several different bills (but without the maximum term provision).
- GST 90-year limit — this raises no revenue in 10 years, so is unlikely to get enacted.

- Grantor trusts — the proposal "does not mean what it says;" it is estimated to raise only $910 million over 10 years; there will likely be an effort at a more focused provision, perhaps focused on sales to grantor trusts; likelihood of passage of a provision dealing with grantor trusts is "hard to handicap."
- Extending estate tax lien for § 6166 deferral — this is a logical solution to the difficulty of administering the lien rules for §6166."

h. *Planning in Light of Legislative Uncertainty*. Emphasize to clients that 2012 is the time to act if the client is considering making gifts. Make sure the clients' files point out that clients have been advised to act so that children cannot complain later that the planner did not act appropriately. The $5 million (indexed) gift, estate and GST exemption ($5.12 million in 2012) will end December 31, 2012. This is a wonderful time to make gifts: values are low, interest rates are low, and discounting is more favorable than it may be in the future.

2. Administration's Fiscal Year 2013 Revenue Proposals

a. *Overview*. The Treasury on February 13, 2012 released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals.

Last year's Budget Proposal (for Fiscal Year 2012) included three repeated transfer tax related items from the prior two years and two new items dealing with estate and gift taxes. In addition, the proposal modified the "Pay-As-You-Go (PAYGO)" baseline to assume that the 2009 estate tax system will be made permanent after the expiration of the Tax Relief … Act of 2010 provisions (at an estimated revenue cost of $270.21 billion from 2012 to 2021). The Fiscal Year 2013 Budget Proposal includes all of those transfer tax provisions and some new items.

b. *Repeated Items From Years Prior to Fiscal Year 2012 Proposals.*

(1) *Require Consistency in Value for Transfer and Income Tax Purposes*. This continues the approach of requiring that the basis for income tax purposes be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does *not* adopt the approach suggested in a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit.) (Estimated ten-year revenue: $2.014 billion in 2013 Fiscal Year plan.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The bill provides that the basis shall not exceed the value "as finally determined for purposes of chapter 11" [or chapter 12 in the similar gift tax provision]. If there has been no final determination, the basis shall not exceed the amount reported on a basis information statement that will be required under § 6035 to be given to estate or gift recipients where estate or gift tax returns are required under § 6018.

(2) *Modify Rules on Valuation Discounts*. This continues the proposal to revise §2704 in ways that are detailed in the proposal. The IRS has had a §2704 regulation project on its Priority Guidance Plan since 2003. Proposed regulations purportedly have been drafted, but apparently the IRS believes that they would not be valid

without legislative changes to §2704. (Estimated 10-year revenue: $18.079 billion in 2013 Fiscal Year plan.)

(3) *Require Minimum Term for GRATs*. The proposal imposes three additional requirements on GRATs: (a) a ten-year minimum term would be required for GRATs, (b) the remainder interest must have a value greater than zero, and (c) the annuity amount could not decrease in any year during the annuity term. (Estimated ten-year revenue: $3.334 billion in 2013 Fiscal Year plan.) (As discussed below, the 2013 Fiscal Year budget proposal adds that GRATs would be subject to a maximum term of the grantor's life expectancy plus 10 years.)

A stir was created by S. 1286, "Trade Adjustment Assistance Extension Act of 2011" filed on June 28, 2011. It included this minimum GRAT term provision, (which has been included in a number of other bills), but this bill was unique in making the entire bill-including this revenue raising provision-effective retroactive to January 1, 2011. Apparently, no thought had been given to the inherent unfairness of applying this minimum GRAT term provision retroactively and planners generally continued to form GRATs in the second half of 2011 without the minimum term provisions.

Because of this proposal, some planners suggest currently creating "shelf GRATs." The concept is to create and fund a series of mid-term GRATs currently (say, 4, 6, 8, and 10 year terms), and fund them with fixed income assets. If short-term GRATs are subsequently outlawed, if the § 7520 rate rises dramatically for new GRATs, or if the settlor acquires an asset that has high appreciation potential, one of the series of GRATs could be pulled off the "shelf," and volatile assets (with high appreciation potential) could be swapped into the GRAT, in effect resulting in a short-term GRAT (based on the remaining term).

c. *New Items in 2012 Fiscal Year Budget Proposal.*

(1) *Make Portability Permanent*. This proposal would permanently extend the provisions in the Tax Relief … Act of 2010 regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion in 2012 Fiscal Year plan.)

(2) *Limit Duration of GST Exemption*. The proposal would limit the GST exemption to 90 years after a trust is created. This would be accomplished by increasing the inclusion ratio of any trust to one on the 90th anniversary of the creation of the trust. GST exemption would have to be reallocated after 90 years in order for the trust to remain GST exempt. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date. (Estimated ten-year revenue impact: Negligible.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The general rule under that bill provides as follows:

> "In the case of any generation-skipping transfer made from a trust after the date which is 90 years after the date on which such trust is created, the inclusion ratio with respect to any property transferred in such transfer shall be 1."

The bill provides special rules to deal with deemed separate trusts under the GST rules and the creation of pour-over trusts from another trust.

(3) *Elimination of "Stranger Owned Life Insurance."* There would be a limit on the ability to sell life insurance to a third-party.

(4) *Eliminate Minimum Distribution Rules for Small Qualified Plans or IRAs.* The 2012 Fiscal Year Plan proposes the elimination of required minimum distributions for an individual whose aggregate IRAs and qualified retirement plan amounts are $50,000 or less. (The 2013 Fiscal Year plan modifies that to apply to plans valued in the aggregate at $75,000 or less.)

d. *New Items in 2013 Fiscal Year Budget Proposal.*

(1) *Exemptions and Rates.* The proposal uses the 2012 system as the assumed "baseline," and proposes returning to a $3.5 million estate tax exemption and $1.0 million gift exemption, with a maximum 45% rate. (This is estimated to raise $119 billion over 10 years. Very interestingly, this item becomes a revenue raiser by assuming the 2012 system as the baseline, even though the proposal represents a substantial loss of revenue as compared to what will happen if there is no legislative action [i.e., grandfather of the EGTRRA provisions, thus returning to a $1.0 million exemption, 55% system]. The general baseline adjustment provision adopting the "2012 parameters" as the new baseline for transfer taxes has a revenue impact of negative $431 billion over 10 years.) The revenue impact over 10 years, as compared to reverting back to the 2001 system, is $119 – 431, or negative $212 billion. (The Joint Committee on Taxation estimate of restoring rates to 2009 levels and extending portability is a negative $255 billion over 10 years.

(2) *Portability Made Permanent.* The proposal repeats the 2012 Fiscal Year proposal that portability be made permanent. There is no separate line item in the 2013 Fiscal Year plan assigning a revenue estimate, but the portability provision is included in the general baseline adjustment provision adopting the "2012 parameters" as the new baseline for transfer taxes.

(3) *GRAT Maximum Term.* There would be a maximum term imposed on GRATs—the grantor's life expectancy plus 10 years. (This would remove the planning strategy suggested by some planners of using a very long term [say 100 years]. Under this strategy, at the grantor's death, the amount included in the estate would be based on the amount which if multiplied by the AFR *at the date of death* would equal the annual annuity amount. If AFRs increase significantly prior to the grantor's death, this could mean that a significant portion of the assets in the GRAT would not be included in the grantor's estate.)

(4) *The Bombshell: Grantor Trusts Would Be Included in Grantor's Gross Estate.* The 2013 Fiscal Year budget plan adds that if a trust is a grantor trust, the trust assets would be included in the grantor's estate for estate tax purposes, any distribution from the trust would be treated as a gift, and conversion to non-grantor trust status would also be treated as a gift. The same rules would apply to section 678 trusts if the deemed owner sells assets to the trust (as to the sale transaction assets, income and appreciation therefrom). The transfer taxes are payable out of the trust. The amount subject to the estate tax on death or the gift

tax on a distribution or conversion to non-grantor trust status would be reduced by the value of any taxable gift made to the trust by the deemed owner. However, any trusts includable in the grantor's gross estate under existing law (e.g., GRITs, GRATs, QPRTs, etc.) would not be impacted. Regulatory authority would be granted to provide "transition relief for certain types of automatic, periodic contributions to existing grantor trusts." (Query, is this referring to continuing premium payments to irrevocable life insurance trusts, meaning that after the transition period the ILIT would be subject to estate inclusion? Apparently the intent is that this would just provide transitional relief and not have the effect of "grandfathering" trusts that have automatic periodic contributions.)

The proposal applies to trusts created on or after the date of enactment and the portion of pre-enactment trusts attributable to contributions made on or after the date of enactment [but not the portion attributable to sales made after the date of enactment, thus permitting sales to "grandfathered" grantor trusts as a planning strategy]. This proposal is estimated to raise $910 million over 10 years (which is comparatively small; for example, the 10-year minimum GRAT term provision is expected to raise $3.3 billion over 10 years and the consistency of basis provision is expected to raise $2.0 billion over 10 years). (The Joint Committee on Taxation revenue estimate for the grantor trust provision is significantly higher than the Administration's estimate, $3.3 billion over 10 years. The Joint Committee on Taxation's estimate is only somewhat higher than the Administration's estimate for the GRAT provision, $3.6 billion, but is dramatically lower than the Administration's estimate for the consistency of basis provision, $1.2 billion.)

This grantor trust proposal is a dramatic change and would have far-reaching effects. For example, many irrevocable life insurance trusts are grantor trusts under §677(a)(3). Irrevocable trusts that become foreign trusts by the appointment of a foreign person as trustee would be grantor trusts and therefore included in the gross estate. Irrevocable trusts that become grantor trusts by the appointment of successor trustees such that more than half of the trustees are related or subordinate parties would be included in the gross estate, and that could not be cured by the appointment of non-related persons as trustees because that would trigger a gift tax on the conversion to non-grantor trust status. Irrevocable trusts with the grantor's spouse as a potential beneficiary [which are grantor trusts under §677(a)(1)-(2)] would be included in the grantor's gross estate.

(5) *Section 6166 Estate Tax Lien.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death.

3. Treasury-IRS Priority Guidance Plan

a. *2011-2012 Guidance Plan* The 2011-2012 Priority Guidance Plan was released on September 2, 2011 (considerably earlier than in some years). New items in the estate planning area include a contemplated Notice on decanting, carryover basis guidance, portability guidance, and an indication that the guidance included on the plan in prior years regarding the effect of a substitution power on §2042 will be in the form of a Revenue Ruling.

b. *Highest Priority*. IRS and Treasury officials have indicated informally that their number one priority regarding trust and estate related matters for 2012 has been giving guidance regarding portability, and temporary and proposed regulations were issued June 15, 2012.

c. *Published Items*. Guidance has been published on a variety of the items in the Plan, including: (1) Effect of substitution powers under §2042; (2) protective claims for refund guidance; (3) § 67(e) regulations regarding the 2% "haircut" rule exception for estates and trusts (new proposed regulations were issued September 7, 2011); and (4) effects of certain events within the first six months on the alternate valuation rules.

d. *Carryover Items*. Carryover items from prior years include, among other things: (1) §2053 – effect of guarantees and applying present value concepts; and (2) private trust companies guidance.

4. Carryover Basis Issues

a. *Ability to Amend Form 8939 Ended July 17, 2012*. There was very broad ability to amend the Form 8939 by July 17, 2012 for estates of 2010 decedents that elected for carryover basis to apply. That date has passed. Making any further changes is allowed only in limited circumstances and even in those limited circumstances, formal 9100 relief is required.

b. *Legislative Discussion.* So far, there have been no rumblings of the possibility of continuing carryover basis, even in the unlikely event that the estate tax should be repealed.

5. Gift Planning Issues for 2012

a. *Overview of Tax Effects of Gifts*. The following is a brief summary of the tax effects of gifts.

- A donor can make gifts of the full additional gift exemption amount without paying gift tax.
- Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
- Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
  - removal of appreciation/income of gift assets from the gross estate;
  - utilizing fractionalization discounts;
  - paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
  - if the donor lives three years, gift taxes paid are removed from the gross estate; and
  - the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well;
  - removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate); and
  - removing $1.5 million from the estate without transfer taxes if the exemption amount is later reduced to $3.5 million and if there is no "clawback" of estate tax on the "excess" gift amount.

(For many clients, this "removing $1.5 million from the tax base" factor seems to be a major motivating factor to making gifts in 2012, to take advantage of the $5 million exemption *in case* it is decreased in later years. Many planners think it is likely that the estate exemption will remain at the $5 million level (and the gift exemption may remain that high), and the client may prefer to just take advantage of the $5 million estate tax exemption at death without the complexity of gifting transactions that make the client very uncomfortable. Carefully consider the client's likely reaction if the exemption does not get reduced before entering into somewhat convoluted transactions in 2012, to take advantage of a large gift exemption that *may* disappear.)

- The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.
- **Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect** — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers. Planners have indicated that some clients who have been reluctant to implement transfer planning strategies in the past, because of fear of the possible assessment of a current gift tax, have completed transfer planning transactions after 2010 in light of the cushion effect of the $5 million exemption.
- Gifts can be disadvantageous from an overall tax cost perspective if (i) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or (ii) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

b. *Indexed Exemption Amount for 2012*. The exemption amount is indexed, and has increased to $5,120,000 for 2012. (Some have indicated that if the $5.0 million indexed exemption should be extended to 2013, the amount would be $5,250,000 in 2013, based on data that the is used in calculating the indexed amounts.)

c. *Clawback*. If a gift is made of $5 million in 2011 or 2012 and the estate tax exemption is later reduced below $5 million, will estate tax have to be paid on the difference? Most planners agree there is unlikely to be a "clawback" in that situation. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear. (Commentators generally believe that eventually there will likely *not* be a clawback problem if the exemption is reduced in the future.)

(1) *Generally No Worse Off Even If Clawback Applies*. Even if the "clawback" applies, the estate will not pay more estate taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death. In effect, the transfer tax is deferred interest-free from the date of the gift to the date of death. The issue would be an apportionment problem — who has to pay the estate tax on the "clawback" amount. (There are conflicting

cases regarding attempts to apportion estate taxes to lifetime gifts. *Compare Estate of Necaise*, 915 S.2d 449 (Miss. 2005)(will provision apportioning estate taxes to lifetime gifts not enforceable) *with Estate of Finke*, 508 N.E.2d 158 (Ohio 1987)(state apportionment statute does not apportion state of federal estate taxes to recipients of lifetime gifts). If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is an agreement of donees to reimburse the estate for added estate taxes that is respected, that obligation presumably is an estate asset that would be added to the value of the gross estate. If there were insufficient assets in the probate estate to pay the estate taxes, that obligation would be an estate asset that the IRS could pursue for payment.)

(2) *Could Be Worse Off If Assets Pass to Surviving Spouse or Charity*. However, if clawback applies it could skew marital/charitable deduction planning. If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost at the first spouse's death. For example, if there is a $5 million gift in 2011 and the donor dies in a year in which the estate tax exemption has been reduced to $3.5 million and the rate has been increased to 45%, if clawback applies, and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be $1,227,272.73 if the Line 7 gift offset is determined under the Form 706 instructions approach. (Check: [$1,500,000 + $1,227,272.73] x 45% = $1,227,272.73.)

Carlyn McCaffrey points out that an approach to avoid this estate tax at the first spouse's death if clawback applies is to include provisions in the trust agreement of the trust that receives the gift (i) that give an independent party the right to grant the settlor a testamentary limited power of appointment over the trust (which would cause estate inclusion under §2038), and (2) that cause any trust property included in the settlor's gross estate to pass to a QTIPable trust if there is a surviving spouse at the settlor's death.

(3) *The Technical Issue — More Detail Than You Wanted.* One speaker believes the current law is crystal clear even without clarification that clawback does not apply. (Other planners are not so sure.)

The estate tax calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the "Line 7 Worksheet" for years before 2011 clarify that the gift unified credit attributable to the applicable credit amount

available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year.)

- Step 3: Subtract the applicable credit amount.
- TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The 2011 Form 706 Instructions take the position that the 2011 rates are multiplied by the gift exemption amount that applied in the year the gift was made, but that result is not necessarily mandated by the statute.

If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet for years before 2011; for 2011, the 2011 Form 706 Instructions provide a table of unified credit amounts for each year, redetermined using the 2011 rates — but the gift "exemption" amount for the year of the gift is used.) If the decedent had made a gift in 2011 of $5 million, the credit amount for an applicable exclusion amount of $5 million is what is used to calculate the hypothetical gift tax "payable" on the $5 million adjusted taxable gift. (Similarly, Letter Ruling 9250004 says that "the unified credit that would have been allowed to the decedent *in the year of the gift* is taken into account as a reduction in arriving at the gift tax payable" for purposes of the estate tax calculation.) The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the approach in the Form 706 instructions and in Letter Ruling 9250004 would be applied by using the exclusion amount that was used in the year of the gift and determining a hypothetical gift credit amount using the date of death rate. That is precisely what the Instructions to the 2011 Form 706 do. That means that the gift unified credit amount (which is based on a $5 million gift exemption) would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously. (This same analysis would apply for gifts up to $5.12 million in 2012, and the gift unified credit amount would be based on a $5.12 million exemption.)

The panelist who says the current law is clear that clawback would not apply stated that there would be a credit allowed based on the amount of gift tax that would have been paid using the *date of death* exemption amount, and that panelist said the 2011 Form 706 Instructions "get this calculation right." However, the 2011 Form 706 Instructions provide a Table of Unified Credits as Recalculated Using 2011 Rates for each year from 1977-2011. They clearly say to use the gift

credit amount equal to the rate in effect in 2011 times *the gift exemption amount that applied in the year of the gift.*

Even though the Instructions seem to suggest that *clawback would apply* if the estate tax exemption amount is decreased in the future, that has not yet actually happened. It is not clear that the IRS would continue to take that position in that event. That has never happened previously and the Instructions presumably were not written with that contingency in mind.

(4) *Proposed Legislation Clarifies that Clawback Would Not Apply.* A legislative proposal makes clear that clawback would not apply. H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). That proposal is discussed in Item 1.b. above. That legislation has no chance of passing, but the legislative language is indicative of statutory language that may included in other transfer tax legislative proposals. The drafting approach to make this issue clear in H.R. 3467 is to revise §2001(g), which generally says to use the date of death rates in making the calculation of the gift tax (including the determination of both the gift tax rate and the gift tax unified credit) that would be imposed with respect to adjusted taxable gifts that is subtracted under §2001(b)(2) in calculating the amount of the estate tax. Section 2001(g) is reorganized and the following is added as a new subsection:

> "(2) APPLICABLE CREDIT AMOUNTS. – The amount determined under section 2505(a)(1) [i.e., the gift tax unified credit amount] for each calendar year shall not exceed the estate's applicable credit amount under section 2010(c) [i.e., the tax on the estate tax applicable exclusion amount]."

This would have the effect of not imposing an estate tax on the amount by which the gift exemption amount at the time of the gift exceeds the estate tax applicable exclusion amount at the donor's death.

An anti-clawback provision was also included in S. 3393 (the initial version of the Middle Class Tax Cut Act introduced by Senate Majority Leader Reid on July 17, 2012) that was much more complex (and quite confusing) in its operation. The transfer tax provisions of the Middle Class Tax Cut Act were deleted before the Senate voted on that proposed legislation.

d. *Reverse Clawback Problem.* Assume a donor makes a $2 million gift in a year in which the gift exemption amount is only $1 million, but the estate tax exemption amount later increases to $5 million. In making the estate tax calculation, if the hypothetical gift tax payable on the $1 million gift is based on the exemption amount in the year of death (which is NOT the position taken in the Form 706 instructions but one speaker says that is the law that applies currently), there would be no hypothetical gift tax on the $2 million gift, so there would be estate tax imposed on the full estate plus adjusted taxable gifts, without any credit for the gift tax *that was actually paid* on the $2 million gift. That possible phenomenon would not be a problem under the legislative "fix" in the Sensible Estate Tax Act of 2011, because it says to calculate the hypothetical gift tax payable on the adjusted taxable gift (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount would not be used in calculating the hypothetical gift tax payable.

e. *Basis Concerns*. The differential between the 35% estate tax rate and a 15% (or perhaps increasing to 20%-25%) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 35% estate tax savings on that appreciation to offset the loss of basis step up on the *full* value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue.

Example: a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 15% rate, this means the family will receive net value of $850,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $150,000. The asset would have to appreciate to $1,750,000 in order for the estate tax savings on the appreciation to offset the loss of basis step up (i.e., $750,000 x 0.35 = 1,750,000 x 0.15).

In making these calculations, consider both federal *and* state income and estate taxes.

There is an example of a collectible in Mahon, *The "TEA" Factor,* TRUSTS & ESTATES (Aug. 2011). If a zero basis collectible worth $5 million is given, there would have to be almost $20 million of appreciation before the estate tax savings exceed the loss of basis step up.

Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like kind exchanges, basis step up is not an important issue.

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step-up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. Blattmachr, Gans & Jacobson, 97 J.TAX'n 148 (Sept. 2002).

f. *Keep in Mind Downside of Depreciation.* If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

g. *Avoid December 2012 Crunch*. Keep in mind that the $5.12 million gift exemption ends at the end of 2012. Do gift planning with clients throughout the year in order to avoid a workflow crunch in December of 2012.

A possible approach is to prepare the trust terms and make transfers to the trust, but provide that the trust is revocable until 11:00 pm on December 31, at which time it becomes irrevocable unless the settlor acts before that time to amend the trust. The planning, drafting, and transfer mechanics can be completed, but still leave the client the flexibility to determine whether the gift will be completed in 2012. Section 2035 should not apply if the settlor does not amend the trust and it becomes irrevocable at 11:00 pm on December 31, because the client does not take any affirmative steps to relinquish a power that would otherwise be a "string" power causing estate inclusion.

h. *How Much Can The Client Afford to or Want to Give? Desire to Retain Possible Indirect Benefits?* Spouses collectively could give up to $10 million without having to pay gift

taxes. Clients may have a concern that gifts of $5 million ($10 million from a couple) are too much for their children (or trusts for their children) to receive. Howard Zaritsky (Rapidan, Virginia) gives the following standard cautionary advice to clients contemplating gifts to their children:

> "(1) The gifts are likely to save a substantial amount of taxes;
>
> (2) The child will not say 'thank you;'
>
> (3) The parent will not approve of what the child does with the gift; and
>
> (4) The child will not love the parent more for having made the gift."

Furthermore, few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "Will I have enough left to live on?" How do you define what are "discretionary" assets? That is not for the planner to define. "It's not the actual ability to make a gift that matters — it's the *perceived* ability to make a gift and maintain one's standard of living into the foreseeable future that matters." As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a "rainy day" financial reversal (strategies are discussed below). A key observation is that clients absolutely should not make gifts of assets that they can't live without. At most, just plan around true "rainy day" concerns.

i. *Strategies for Making Use of $5.12 Million Gift Exemption in 2012 Without Giving Up Rights to Assets or Income From Assets.*

Donative Promise. If a client wants to take advantage of the $5 million gift exemption in 2012 (in case the estate exemption is dramatically reduced in 2013) but does not have assets to relinquish, some planners have suggested that the client make an irrevocable enforceable promise to give $5 million. *See* Austin Bramwell, *Donative Promise Can Lock in 2012 Gift Tax Exemption*, 39 EST. PL. 3 (August 2012). One issue is whether there is sufficient consideration so that the promise is an enforceable contract. IF so (and that may be a big "IF"), Rev. Rul. 84-25 says that the irrevocable enforceable promise is a gift in the year the promise is made (not when it is later funded).

For estate tax purposes, while the debt is not deductible under §2053 (because it is not made for full consideration, §2053(c)(1)(A)), there may still be an estate tax advantage to making the gift if the estate exemption is later reduced below $5 million and if there is not "clawback." Rev. Rul. 84-25 says that the gift amount is not treated as an adjusted taxable gift for purposes of the estate tax calculation (because the client's assets are included in the gross estate directly, and adding the gift amount back as an adjusted taxable gift would result in double counting of the assets). While there is not a tentative tax calculated on the amount of the estate plus the $5 million gift amount, there apparently would be a subtraction under §2001(b)(2) of hypothetical gift taxes that would be payable on gifts made after 1976. If "clawback" does not apply, this calculation would apparently be the amount of gift tax payable on the $5 million gift using the *date of death* estate exemption amount. For example, if Congress reduces the estate exemption from $5 million (for simplicity the indexed amount is not ignored in this example) to $3.5 million, the effect is to subtract the gift tax payable on the excess $1.5 million from the estate tax calculation.

Therefore, if Congress later reduces the estate exemption amount and if there is not clawback, the client gets the advantage of removing from the tax base the amount by

which the estate exemption is reduced by a future Congress. (This also assumes that a possible legislative fix to the "clawback" concern is not designed in a way to take away this possible benefit.)

A transfer of assets to a trust in 2012 (which would be reported on a gift tax return), and a subsequent repurchase of those assets by the settlor for a note in a later year would have the same long-term effect as transferring a note to the trust in the first place. The settlor may want to "live with the trust" for some period of time to determine the settlor's comfort level with not owning the trust assets. If the settlor became uncomfortable, the settlor could repurchase the assets. Under this scenario, the settlor's debt obligation would conceivably be deductible under §2053 because it would have been given for full consideration. The step transaction doctrine may apply if this were a pre-arranged plan, which doctrine may treat the settlor as originally transferring the note to the trust.

Section 2036 Transfer. A transfer of assets with a retained life estate, that would be includible in the estate under §2036, may have the same result. Under §2001(b)(last sentence), the gift would not be includible as an adjusted taxable gift in the estate calculation (because the assets would be included in the estate under §2036). However, the hypothetical gift tax payable on the gift would be subtracted in the estate tax calculation.

Section 2701 Transfer. A similar result may occur for a transfer that does not satisfy the requirements of §2701. For example, if a client owns all of the non-cumulative preferred stock and common stock of a corporation, and if the client gives the common stock, the client will be treated as having made a gift equal to the full value of the corporation. At the client's death, Reg. §2701-5(a)(3) provides for an "adjustment to mitigate double taxation." The amount on which the estate tax is calculated is reduced by an amount equal to the amount by which the taxable gift was increased under §2701. The effect is that the client has kept the preferred stock, and may have enjoyed the distributions from that stock over the client's lifetime, but the client still gets to subtract from the estate tax base the substantial amount by which the gift was increased under §2701.

j. *"Rainy Day Fund" Considerations; Possibility of Donor Borrowing From Trust.* A very simple way of dealing with the desire to keep a "back-door" to cash flow from the trust in the event of a financial reversal is that the donor could request a loan from the trustee of the trust. The trustee will likely want to require appropriate interest and collateral for the loan. The donor may want a stronger method of a possible "back-door" to the assets, but if the loan alternative is sufficient, that is a clean and simple solution.

If the loan is bona fide indebtedness, the donor's estate may be entitled to an estate tax deduction for the outstanding liability if the loan has not been repaid prior to the decedent's death. *But see Estate of Holland v. Commissioner,* T.C. Memo 1997-302 (citing various factors mentioned in prior cases regarding loan vs. equity cases to conclude that the estate did not owe bona fide indebtedness that could be deducted under §2053).

k. *"Rainy Day Fund" Considerations*; *Lifetime Credit Shelter Trust for Donor's Spouse.* The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). The trust would likely be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Provide that no distributions could be made that would satisfy the donor's legal obligation of support (and if distributions are made to the donee-spouse, preferably the spouse should use those distributions for things other than basic support needs to remove any inference that the funds are actually being used for the settlor's benefit)
- Spouse could have a "5 or 5" annual withdrawal power
- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under § 2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several states (Arizona, Delaware, Florida, Michigan and Wyoming) have passed statutes addressing this situation for inter vivos QTIP trusts, providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be subject to the donor-spouse's creditors. The power of appointment should provide that it cannot be exercised in a manner that would grant the original donor a power of appointment over the assets. See below for further discussion.
- A "trust protector" or some independent party could be given the discretion to add the donor of the trust at some time in the future (perhaps after a number of years or after the donor is no longer married to the donor's spouse at the time the trust is created). There should be absolutely no understanding (or even implied agreement) with the protector as to how the power would be exercised.
- Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust.
- If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the donor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married to at the time without causing estate inclusion in the donor's estate. *See Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or

divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§ 2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse.

- If the donor gets to the point that the donor really needs to be a beneficiary of the trust and wants the spouse to exercise the power of appointment, estate taxes may be the least of the donor's concerns.

With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the grantor under § 677 (unless the consent of an adverse party were required for distributions to the spouse).

(1) *Application of §§2036-2038 If Donee Spouse Appoints Assets Into Trust for Benefit of Original Donor Spouse.* This issue is receiving increased attention by planners. The IRS might argue that §§2036 or 2038 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. *See Estate of Skifter v. Comm'r.*, 56 T.C. 1190, at 1200 n.5 (19172), *aff'd* 468 F.2d 699, 703 (2d Cir. 1972)(life insurance policy transferred to wife and bequeathed back to trust for husband with husband as trustee at wife's death not includible in husband's estate under §2042, reasoning that §§2036 and 2038 would not have applied if an asset other than a life insurance policy had been the subject of the transfer; Tax Court and circuit court both emphasized that if the transfer and bequest were part of a prearranged plan, estate inclusion would have resulted, noting that the bequest back to the husband was made "long after he had divested himself of all interest in the policies"); *Estate of Sinclaire v. Comm'r,* 13 T.C. 742 (1949)(predecessor to §2036 and 2038 applied where decedent gave assets to her father, who transferred the assets the following day to a trust providing decedent with a life interest and power to appoint the remainder interests); Rev. Rul. 84-179, 1984-2 C.B. 195 (§2036 did not apply because decedent's transfer to the donee and the bequest back to the decedent in trust were unrelated and not part of a prearranged plan); Gen. Couns. Mem. 38,751 (June 12, 1981) (indication that step transaction doctrine will be applied if the decedent's transfer and the donee's bequest for the benefit of the decedent were part of a prearranged plan, and in particular that cases where the donee's transfer occurs shortly after the decedent's initial transfer would invoke the doctrine); *see generally* Gans, Blattmachr & Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP., PROB. & TR. J. 413, 432-33 (2007). To the extent possible, structure the transfer to remove the inferences of such an implied agreement (by allowing the passage of time, not transferring all assets, having the donee-spouse actually exercise a power of appointment rather than just allowing assets to pass back into trust for donor under trust default provisions, etc.).

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse's estate under §2044.

Jeff Pennell's Observations on §§2036/2038. (1) *Section 2038*. The real issue is whether the appointment back would trigger under § 2038. The initial reaction might be to apply §2036, but §2036 requires *retention* of enjoyment or control. Here, nothing was retained at the outset, but it came back by the exercise of the power of appointment. Section 2038, on the other hand, can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, be careful not to give the donor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor could not have a testamentary power of appointment by reason of the exercise.

In addition, realize that if creditors can reach the assets in a trust to which assets have been appointed by the donee-spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if there was no implied agreement of how the donee-spouse would exercise the power of appointment at the time of the original transfer. While most of the cases that have held that assets in a trust that can be reached by the donor's creditors are in the donor's gross estate under §2036 [*e.g., Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986)], some cases have also suggested that inclusion may also result under §2038. *E.g., Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)).

(2) *Section 2036*. The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

(2) *Creditor Rights Issue.* A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."

> "If, upon her death Debbie exercises a special power to create a credit shelter… trust for Dennis (the original donor), the trust assets appointed to Dennis may be considered as if Dennis created his own trust rather than Debbie being treated as the creator of such trust. The creditor under the Relation Back Doctrine could argue: (i) the exercise of a special power of appointment constitutes a transfer 'from the donor of the power, not from the donee' [citing *In re Wylie,* 342 So.2d 996, 998 (Fla. 4th DCA 1977) (quoting RESTATEMENT (FIRST) OF PROPERTY §318 comment (b) (1940))]; and (ii) the power of appointment is 'conceived to be merely an authority to the power holder to do an act for the creator of the power.' [citing American Law Institute, *Donative Transfers* vol. 2 §§ 11.1-24.4, *in* RESTATEMENT (SECOND) OF PROPERTY 4 (1986)]."
>
> … **[N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ….**"
>
> Nelson, *Asset Protection & Estate Planning – Why Not Have Both?,* at 15-11 2012 HECKERLING INST. ON EST. PLANNING.

See Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk"). *See also Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

Five states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, and Wyoming. The Arizona statute addresses the issue for all inter vivos trusts initially created for the donor's spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. It provides:

> "E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:
>
> > (1) An irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse. *[i.e. inter vivos QTIP trusts]*
> >
> > …

(3) An irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse. *[i.e., lifetime credit shelter trusts where spouse is a beneficiary]*

(4) An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse. *[i.e., reciprocal trusts by the spouses]*

…

F. For the purposes of subsection E, a person is a beneficiary whether so named under the initial trust instrument or through the exercise by that person's spouse or by another person of a limited or general power of appointment. ARIZ. STAT. §14-10505(E)-(F) (parenthetical comments are not in the statute)."

(3) *Gift From One Spouse With Split Gift Treatment*. Some planners have suggested the following as an alternative for making $10 million of gifts from both spouses, but allowing one spouse to remain a potential discretionary beneficiary. The donor spouse could give the entire $10 million to a trust of which the donee spouse is a discretionary beneficiary, along with the children. The donee spouse would make the split gift election, which treats the donee spouse as the transferor for gift and GST tax purposes (meaning that the donee spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the done spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The challenge with this approach is that split gift treatment is not allowed if the consenting donee spouse is a beneficiary of the trust to which the gift is made if the standard of invasion is not an ascertainable standard. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner*, T.C. Memo 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007).

If the donee spouse is a beneficiary under an ascertainable standard (preferably a standard based upon maintaining an accustomed manner of living), gift splitting apparently is permitted if the resources otherwise available to the donee spouse are demonstrably sufficient to maintain the accustomed standard of living, such that the likelihood that distributions will be needed from the trust is so remote as to be negligible. *See Wang v. Commissioner*, T.C. Memo. 1972-143 (issue of whether interest of spouse as beneficiary is ascertainable and severable, so that gift splitting is available for gift to other beneficiaries, is determined under same principles as whether bequest to charity is so indefinite that its value cannot be ascertained for purposes of allowing a charitable deduction; held that spouse's interest was not ascertainable); *Robertson v. Commissioner,* 26 T.C. 246 (1956)(applying predecessor provision to gift splitting in 1939 Code; standard for distributions to spouse was as "necessary for her maintenance and support … with due regard to her other sources of funds;" standard was ascertainable and court summarized various facts to support its conclusion that "there is no likelihood of the exercise of this power;" gift splitting allowed for full amount transferred); Rev. Rul. 54-285,

1954-2 C.B. 302 (discussing the remoteness rule for charitable remainder trust purposes). Various private letter rulings have addressed the standards of "ascertainability" for purposes of whether gift splitting is allowed where the consenting spouse is a beneficiary, and the analysis appears to be the same as that for determining ascertainability under §§2514 and 2041. Ltr. Ruls. 200130030, 200345038, 200616022. Interestingly, Ltr. Rul. 200130030 allowed gift splitting for the full amount of the transfer without discussing the value [in particular, that it had no value] of the done spouse's severable interest). Under this analysis, gift splitting should be allowed in full if:

- Distributions of both income and principal to the spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and
- The resources that are, and are expected to be, available to the spouse for the remainder of this or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

l. *"Rainy Day Fund" Considerations*; *Lifetime Credit Shelter "Non-Reciprocal" Trusts*. If the "rainy day" concern can be accommodated by having only one spouse make a gift to a trust with the other spouse as a discretionary beneficiary, that is far preferable. The gift by the other spouse would be to a trust with only descendants as beneficiaries. That clearly avoids the reciprocal trust doctrine (although an issue could arise if the spouses serve as trustees of each other's trust). Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

> "Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated*, and that the arrangement, *to the extent of mutual value*, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries." (emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; IRS conceded that if the special lifetime power of appointment was valid under local New Jersey law the reciprocal trust doctrine could not apply; see detailed discussion of case based on conversations with counsel in the case by Mark Merric, *The Doctrine of Reciprocal*

Trusts, LISI Archive #1282, April 24, 2008); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries); *but see Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995)(Jones, J. dissenting)(identity of beneficiaries is not a prerequisite to application of reciprocal trust doctrine; retained mutual powers to control timing of distributions should be sufficient to invoke the doctrine).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies to the extent of mutual value)
- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One of the spouses would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event (for example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife's trust until three years after wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a "5 or 5" withdrawal power from husband's trust after their son's death)
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party (not exercisable as a fiduciary) the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy)*
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party)

Jonathan Blattmachr suggests that there can be an advantage to making the primary beneficiary the Settlors' grandchildren, and including each other only as secondary beneficiaries.

In any event the differences need to be "real." Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are *administered after they are created* may be the most critical factor. If there are no distributions to either spouse from either trust, the spouses pretty clearly seem to be in a different position than if they had retained outright ownership of their own assets, and the trusts really do appear intended for someone other than themselves. If there are

distributions, but the distribution patterns are noticeably different, then the spouses' respective interests do not appear to be identical. On the other hand, even if the standards of distribution are materially different, but the patterns of actual distributions are remarkably similar, there is a good chance the IRS would successfully argue that the trusts were not truly different. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982). (This issue is discussed further below.)

For a discussion of the reciprocal trust doctrine generally see M. Merric, *The Doctrine of Reciprocal Trusts,* LEIMBERG ASSET PROTECTION PLANNING NEWSLETTER (2008)(five-part article); P. Van Horn, *Revisting the Reciprocal Trust Doctrine*, 30 TAX MGMT. EST. GIFTS & TR. J. 224 (2005); G. Slade, *The Evolution of the Reciprocal Trust Doctrine Since* Grace *and Its Current Application in Estate Planning*, 17 TAX MGMT. EST. GIFTS & TR. J. 71 (1992). For an extended discussion of the reciprocal trust doctrine in the context of spouses creating lifetime QTIP trusts for each other, see M. Gans, J. Blattmachr & D. Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The *Grace* case involved reciprocal interests rather than powers. Subsequent cases have differed regarding whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under §§2036(a)(2) or 2038. *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to §§2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984); Ltr. Rul. 9451059 (where beneficiaries of two trusts can appoint property to each other, unrestricted by an ascertainable standard, the trusts would be uncrossed, and each beneficiary would be considered to have a general power of appointment over the trust of which he is a beneficiary, citing *Matter of Spear, Jr.,* 553 N.Y.S.2d 985 (Sur. Ct. 1990), in which the court adopted the reciprocal trust theory to find that trust beneficiaries had general power of appointments to qualify for the "Gallo exemption" that was available for GST purposes prior to 1990); Ltr. Rul. 9235025 (the settlors' two daughters had a power to appoint the trust property to any descendant of the settlor other than herself, including the other daughter; while noting the potential application of the reciprocal trust theory, the IRS concluded that the particular factual situation did not justify its application); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Comm'r*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm'r*, 140 F.2d 636 (8th Cir. 1944).

Creditors Rights Issue? A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with

respect to claims of creditors against the settlors. *Cf. Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950)(the court "uncrossed" the trusts for state law purposes; husband made assignment of assets from trust created by wife for husband despite existence of spendthrift clause that prohibited him from alienating property; trust was identical to trust that husband created for wife on the same day; trusts were treated as reciprocal trusts; each party indirectly created a trust for his own benefit, so husband was treated as creating the trust for his benefit and he was not prohibited from assigning assets by reason of a prohibition on alienation in a trust that he is deemed to have created).

Although this is a theoretical concern, few if any reported cases have allowed creditors access to reciprocal trusts under this theory. Perhaps the closest is *Security Trust Co. v. Sharp* (summarized in the parenthetical above). It did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors:

> "Being practically identical in both purpose and objective, the court — looking to substance — will say that each party, by indirection, created a trust for his own benefit. Moreover, it is not unlikely that the same approach would be taken by the courts when such trusts are attacked by creditors. See the dictum in Provident Trust Co. v. Banks, 24 Del. Ch. 254, 9 A.2d 260."

That was over 60 years ago, and it is difficult to locate any reported case in which creditors have attacked a reciprocal trust under this theory.

State legislatures may address this issue. An Arizona statute provides protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E). (The statute is quoted in Item5.j.(2) above.)

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted "self-settled spendthrift trust" provisions (as discussed in the following paragraph).

If the donors' creditors can reach the trust assets, that would cause inclusion in the donors' estates for estate tax purposes under §2036.

As to the creditors' rights issue, Jonathan Blattmachr advises that spouses should create mutual but non-reciprocal trusts for a primary reason of asset protection:

> "Many spouses should do trusts for each other. There is a huge bonus — you have taken the property out of the reach of your creditors. Even if you're as selfish as I am, you ought to do this with your spouse not only to get estate protection for your kids and GST protection for your grandkids, but you also eliminate the assets from being subject from claims of creditors — provided you do not walk into the reciprocal trust doctrine."

Jonathan points out that this should be entitled to protection under §548(e) of the U.S. Bankruptcy Act because it is not done to avoid creditors but to take advantage of the special $5 million gift exemption that exists in 2011-2012.

m. *"Rainy Day Fund" Considerations*; *Discretionary Trusts in Self-Settled Trust States.* Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the

unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

At least thirteen states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). *See* Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

A §2036 concern may arise if the settlor ever needs distributions from the trust and distributions are made to the settlor. That might give rise to at least an argument by the IRS of a pre-arrangement or implied agreement that distributions would be made when requested. Of course, if the settlor gets to the point of needing distributions from the trust, estate tax concerns may be the least of the settlor's worries.

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot re-vest beneficial title or change the beneficiaries. (Various cases have held that the settlor has not made a completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed §2036. The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." Although this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under §2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if an understanding or pre-existing arrangement existed between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. Many commentators view the analysis as applying even if the grantor does not reside in the state in which the trust is created. *See* Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; *Estate of German v. United States*, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift trust apparently because the law of the grantor's domicile did not permit such trusts.

The position that the self-settled trust will not be included in the gross estate of the grantor may be the strongest for self-settled trusts created in Alaska and Nevada. In all of the other self-settled trusts states, some creditors can reach the trust assets (for example, for certain family obligations such as for alimony or child support), and that may jeopardize the "no inclusion" argument. *See* Rothschild, Blattmachr, Gans & Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate*, 37 EST. PL. 3, 11-12 (Jan. 2010).

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. *Estate of Uhl v. Comm'r*, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); *Estate of Paxton v. Comm'r*, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); *Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); *Estate of German v. U.S.*, 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because grantor's creditors could not reach trust assets if trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

Caution Regarding Letter Ruling 200944002: Last year, a financial institution engaged counsel to attempt to obtain a Delaware private letter ruling comparable to PLR 200944002. In late 2011, IRS representatives told counsel that the Service is not willing to issue the ruling. According to counsel, the Service's unwillingness to rule is not attributable to Delaware's family exceptions, etc. Rather, the Service appears to be troubled by commentary about the *Mortensen* Alaska bankruptcy case. The folks at the Service said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

(*Battley v. Mortensen,* Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act.)

In addition, some planners have expressed concern that the IRS might take the position that the gift is an incomplete gift, because of the possibility (perhaps, however remote) that creditors might be able to reach the assets. *E.g., Outwin v. Comm'r*, 76 T.C. 153, 162-65 (1981)(gift to trust incomplete if creditors can reach trust assets); *Herzog v. Comm'r*, 116 F.2d 591 (2d Cir. 1941)(gift to trust is completed gift if state law provides that settlor-beneficiary's creditors could not reach the trust corpus or income).The Illinois Supreme Court recently held that a decedent's creditors could reach assets that had been transferred to a Cook Islands trust. *Rush University Medical Center v. Sessions*, 2012 Ill. 112906 (Ill. Sept. 20, 2012). That case involved an egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge. The court did not address which jurisdiction's law should apply under relevant conflict of laws principles, but held that the state's passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor. In *Rush University*, the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about having to enforce the judgment in the Cook Islands. That case has caused concern among some planners about whether transfers to domestic asset protection trusts might arguably be incomplete gifts if the settlor resides and has assets in another jurisdiction that does not have "self-settled trust" legislation.

n. "*Rainy Day Fund" Considerations; Sale for Note or Annuity*. A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that § 2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§ 25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

o. *"Rainy Day Fund" Considerations: Retained Income Gift Trust.* The "Retained Income Gift Trust" (RIGT) is an idea that has been suggested for making a completed gift, retaining the right to the income from the trust, and shifting future appreciation so that it is excluded from the grantor's gross estate. The income itself would be distributed back to the donor resulting in a "leaky" freeze, but if the assets are invested for capital appreciation the income might be relatively small.

Advantages. If the strategy works as intended, when the grantor dies, the grantor would not be treated as having used up any of his or her estate tax exemption amount and there would be a stepped up basis for the trust assets. Furthermore, any gift taxes paid more than three years before the grantor's death would also be removed from the estate. In addition, there would be no clawback risk if Congress were to reduce the estate exemption amount in the future. The plan has been suggested by Igor Potym (with VedderPrice P.C. in Chicago, Illinois). Igor describes the plan:

> "There is another type of irrevocable trust where the grantor is a beneficiary, a retained income gift trust (RIGT), that seems attractive now. Donor makes a gift and retains an income interest (but not a principal interest) for life. The trust is a completed gift and the retained income interest does not reduce the gift because it is not a qualified interest under section 2702. This looks a lot like a pre-chapter 14 GRIT, except it lasts for life and we now have section 2702.
>
> The trustee is given discretion to distribute principal to descendants at any time and typically will strip off appreciation, keeping the trust at its original gift value. When the grantor dies, the trust is included in his gross estate. Because it is included, the gift is not treated as an adjusted taxable gift and therefore no unified credit is wasted. The assets get a stepped-up basis.
>
> The principal that was distributed to descendants during the grantor's life is not included in the gross estate and is not an additional gift because the gift was complete on day one. In effect, this is a freeze with respect to appreciation in excess of the gift, whether the gift is $5,120,000 or greater. Also, if gift tax is paid, the tax is excluded from the gross estate unless the three-year rule applies, but in such case all the assets of the trust get a stepped-up basis.
>
> This trust can be used to deal with the claw back under section 2001(b), at least in part (upon death, it can qualify for the marital deduction).
>
> In the mid 1990s, I ran this by Dick Covey and, with our permission, he mentioned it briefly in Practical Drafting (April 1997, at 4788-4789) and talked about it in Miami. He was convinced it worked. In fact, it has withstood audit every time. No agent has ever seriously questioned it, perhaps because the agents think it was a drafting mistake. I believe the technique works, possibly better than ever.
>
> Think about the client who can't afford to make a $5,120,000 gift because he needs the income, but would love to shift future appreciation on this amount without incurring an estate tax at the death of the first spouse due to the claw back. Or, possibly even better, a client who makes a gift and pays gift tax. The gift tax is out of the estate, the grantor keeps the income from principal remaining in the trust, the trust gets a stepped-up basis, there is no adjusted taxable gift at death because the trust is included in the gross estate, the estate tax on the trust is reduced by the gift tax paid dollar for dollar (in other words, inclusion in the gross estate does not generate any additional estate tax) and stripped off appreciation avoids estate tax."

p. *Taking Advantage of $5 Million GST Exemption.* There are no assurances that the GST exemption will remain at $5 million (indexed). Making a $5 million gift and allocating the $5 million of GST exemption that is currently available is one way of assuring that the full $5 million GST exemption can be used. The safest way of utilizing the $5 million GST

exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) "had never been enacted," there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and $5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full $5 million of GST exemption could be considered.

q. *Forgiveness of Outstanding Loans to Children*. Many clients will be interested in forgiving existing loans to children as an easy way of utilizing the $5 million gift exemption. Clients often do not view intra-family notes as "real assets," and they are more willing to give notes than other types of assets. In addition, closing out notes from sales to grantor trusts avoids the income tax uncertainty that would exist if the note is still outstanding at the grantor's death. If the client does not wish simply to forgive the note (giving up the rights to any future payments), consider giving a note to a new trust (which might include the donor's spouse as a possible discretionary beneficiary), so the obligation remains.

A possible concern exists if parents have engaged in a repeated pattern of forgiving loan payments. If the IRS can establish intent from the outset that the entire loan would be forgiven eventually, the IRS may treat the gift as occurring all in the year of the initial advance. *E.g.,* Rev. Rul. *77-299, 1977-2 C.B. 343;* Letter Ruling 200603002; Field Service Advice 1999-837. Utilizing the newly granted increased gift exemption may help rebut the "original intent" implication. Typically, the forgiveness will not result in discharge of indebtedness income. Rev. Rul. 2004-37, 2004-1 C.B. 583 ("debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules").

r. *Gifts to Grantor Trusts*. Making transfers to grantor trusts, for which the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple $5 million (or $10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)' gross estates over time.

s. *Gifts to Grantor Trusts Leveraged With Loans*. A very simple additional strategy would be to make a $5 million (or $10 million for couples) gift to a grantor trust and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.

t. *Gifts and Sales to Grantor Trusts*. Sales to grantor trust transactions are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from "burning" the estate by making the

income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide "seed" equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

The sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). Similarly a sale to an "old and cold" grantor trust for a lifetime annuity may leave the donor in a more comfortable position than making a large gift. See the discussion in Item 5.m above.

u. *Equalizing Gifts to Children or Grandchildren*. A frequently recurring request is to make gifts to equalize gifts to all of the children or grandchildren. The extra $4 million of gift exclusion may permit some donors to equalize gifts when they have not had enough gift exclusion to do so in the past.

v. *Gifts to Save State Estate Taxes*. A few states have state gift taxes. At least one state, Maine, requires that gifts made within one year of death be added to the gross estate for state estate tax purposes. In other states, gifts within the $5 million gift exemption would be free of federal and state gift taxes. However, the gift assets would no longer be subject to state estate taxes (as long as there were no retained interests in or powers over the gift assets that would cause estate inclusion for state estate tax purposes). Even deathbed gifts could result in substantial state estate tax savings. A disadvantage is that the gift assets will not be eligible for a step-up in basis at the donor's death, but that would not be a disadvantage for a gift of high basis assets.

w. *GRATs*. GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption*. Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

Furthermore, for transferring hard-to-value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

The $5 million gift exemption opens up the possibility of another strategy that would minimize the valuation risks in making annuity payments. For example, a client might give some of the $5 million gift exemption amount to the grantor trust that will be the remainder beneficiary of a GRAT. When the annuity payment is due, the grantor trust might loan funds to the GRAT which it could use to make the annuity payment, without having to make an in-kind distribution. There would be no gift valuation risk with respect to annuity payments that could be funded with such loan proceeds.

Because of the legislative proposal to require that GRATs have a minimum 10-year term, some planners suggest currently creating "shelf GRATs." The concept is to create and fund a series of mid-term GRATs currently (say, 4, 6, 8, and 10 year terms), and fund them with fixed income assets. If short-term GRATs are subsequently outlawed, if the §

7520 rate rises dramatically for new GRATs, or if the settlor acquires an asset that has high appreciation potential, one of the series of GRATs could be pulled off the "shelf," and volatile assets (with high appreciation potential) could be swapped into the GRAT, in effect resulting in a short-term GRAT (based on the remaining term).

x. *Life Insurance Transfers*. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

Split dollar agreements were often used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used, large gifts (within the $5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Consider making a large gift to the trust currently (while the $5 million gift exclusion still exists), rather than just making increased gifts as premiums become due. Lock in the ability to make a $5 million transfer to pay future premiums without having to pay a current gift tax. There is always the possibility that the gift exclusion returns to $1 million after 2012.

For transfers of life insurance policies, there is an inherent valuation uncertainty. (An ABA committee tried to address life insurance policy valuation several years ago. The process became so complicated that it gave up.) Form 712s of the interpolated terminal reserve values of policies can yield very surprising values because of the reserve requirements of companies.

Some clients may be inclined to drop coverage, under the theory that they have no estate tax concerns with a $5 million ($10 million for a couple) exclusion from the estate tax. Those clients should understand that they may not qualify for insurance if they subsequently find they have a need for it. Furthermore, the estate tax system is in a state of flux, and anything could happen in 2013 (including the unlikely possibility of going back to a $1 million exemption/55% system).

y. *Lapsing General Power of Appointment Held by Person With Modest Assets to Utilize That Person's GST Exemption.* Consider providing that the client's parent would be a discretionary beneficiary (together with the client's issue) and have an inter vivos general power of appointment over the trust, which will lapse at some point in 2012 (when the gift exemption amount is still $5 million). The lapse of the general power of appointment is treated as a gift by the parent, but the parent's $5 million gift exemption would fully cover the gift and no estate tax concerns would arise at the parent's death if the parent's other assets, even when added to the gift amount, would not be sufficient to cause the estate tax to apply at the parent's death. (Of course, this depends on what the estate tax exemption amount is at the parent's subsequent death.) When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor of the trust for GST purposes (I.R.C. § 2652(a)(1)), and the parent could allocate his or her GST exemption to the trust. In that situation, the parent should not continue as a beneficiary of the trust after the lapse

of the general power of appointment if the trust is not created in a "self-settled trust state", or else the parent's creditors might be able to reach the trust assets which might cause inclusion in the parent's estate under §2036(a)(1) and cause an ETIP, which would preclude the parent from being able to allocate the parent's GST exemption until the end of the ETIP.

z. *Deemed §2519 Gifts from QTIP Trusts*. One way to make use of the $5 million gift exemption is triggering §2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the $5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under §2519. However, §2036(a)(1) may cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING ON EST. PLAN. ch. 12 ¶ 1202.3 (2010).

For example, if the spouse makes a gift of 0.1% of the income interest, retaining the other 99.9%, it is likely that 99.9% of the trust assets would be included in the spouse's estate under §2036(a)(1). A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid §2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the §2036(a)(1) issue was not requested or given. (A sale of the income interest may result in the spouse having a zero basis in the income interest under §1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a gift of some or all of the income interest.)

aa. *QPRTs*. One of the disadvantages of a qualified personal residence trust (QPRT) is the significant (though highly discounted) gift element. The $5 million ($10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created. (Of course, QPRTs are not as favorable in the current very low AFR environment as they are with a higher AFR.)

bb. *Same-Sex Couples*. Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased $5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.

cc. *Inter Vivos QTIP Trust*. A spouse could make a gift to a "QTIPable" trust for the other spouse. Advantages of this planning approach include the following:

The grantor can defer the decision of whether to treat the transfer as a taxable gift utilizing the grantor's lifetime gift exemption amount (or requiring the payment of current gift taxes) until the grantor's gift tax return is filed (possibly until October 15 of the following calendar year). If the grantor decides that it would be best not to make a taxable gift, the grantor would make a QTIP election so that the transfer qualifies for the gift tax marital deduction (in which event the trust assets will be included in the done spouse's estate for estate tax purposes). If the grantor decides

to treat the transfer as a taxable gift (using up gift exemption or requiring the payment of gift tax), the QTIP election would not be made. For example, if the assets decline in value substantially the grantor may decide not to treat the transfer as a taxable gift using up gift exemption based on the higher date of gift value.

- Though untested by cases but apparently allowed by regulations, a formula QTIP election may allow the grantor to limit gift tax exposure to a desired specified amount. In effect, this would have the same advantages of defined value clauses, and would be based on provisions in regulations allowing formula QTIP elections. *See* Treas. Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h) Exs. (7-8). For a discussion of the mechanics of making a formula election, see Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets ... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to least amount possible …").
- There is flexibility of being able to allocate the grantor's GST exemption(by making a "reverse QTIP" election), to allocate the spouse's GST exemption, or not to allocate any GST exemption to the trust. This decision can be deferred until when the gift tax return is due (possibly until October 15 of the following year).
- If the transfer is treated as a taxable gift that does not qualify for the marital deduction, it *may theoretically* be possible to provide that the portion of the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse that would not be in the spouse's estate for estate tax purposes. However, it is not clear that regulation applies for gift tax purposes to an inter vivos QTIP trust. Changing the terms to be more flexible seems to be permitted under the *Clayton* regulations, Treas. Reg. § 20.2056(b)-7(d)(3). However, that relaxing provision is only in the estate tax regulation — it is not also in the similar gift tax regulation, Reg. § 25.2523(f)-1(b). The gift tax regulation refers specifically to § 20.2056(b)-7(d)(**1**) of the regulations. However, the "Clayton regulation" is in § 20.2056(b)-7(d)(**3**). Furthermore, the gift tax regulation specifically restates (with very similar mirror provisions) what is in § 20.2056(b)-7(d)(**2**), (**4**), (**5**), and (**6**), thus suggesting that the omission of 7(d)(**3**) has particular significance, raising the question of whether an income interest that is contingent on whether a QTIP election is made would qualify for the *gift* tax marital deduction. Furthermore, if a Clayton provision added other beneficiaries if the QTIP election is not made, it would seem that the gift would not be complete in the year of the original transfer—because the donor retains the power to shift benefits among beneficiaries until the gift tax return filing date has passed. (Conceivably the gift would never become complete during the donor's lifetime because the return making the election would always be due the following year, thus extending the completion of the gift to the following year, extending the due date of the return to the year after that, etc.)

6. Portability

a. *Brief Background.* Section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Tax Act") allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies

after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount." (Commentators have generally referred to this as the "DSUEA," but the regulations use the term "DSUE amount.") The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." While the portability statutory provisions will sunset after 2012 without further Congressional action, the Administration's Fiscal Year 2013 Revenue Proposals proposed making the portability provisions permanent (and there does not appear to be any constituency objecting to the portability concept).

b. *Brief Summary of Statutory Provisions.*

Estate Tax Exclusion Amount Definition Change. The portability concept is accomplished by amending § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." § 2010(c)(2),

Deceased Spousal Unused Exclusion Amount (or "DSUE Amount"). The "deceased spousal unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section § 2001(b)(1)").

The first item limits the unused exclusion to the amount of the basic exclusion amount. Many planners interpreted this to mean that if the estate tax exclusion amount were to be decreased by the time of the surviving spouse's death, the lower basic exclusion amount would be the limit on the unused exclusion of the predeceased spouse that could be used by the surviving spouse. (However, the regulations interpreted this differently — to mean the basic exclusion amount that applied at the predeceasing spouse's death, as discussed below.)

The second item is the last deceased spouse's remaining unused exemption amount. Observe that it is strictly defined as the predeceased spouse's basic exclusion amount less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a privity requirement (discussed below), but again the regulations(discussed below) interpreted this provision differently so that there is no privity requirement.

Statute of Limitations on Review of Predeceased Spouse's Estate to Determine Unused Exclusion Amount. Notwithstanding the statute of limitations on assessing estate or gift taxes for the predeceased spouse, the IRS may examine the return of a predeceased spouse at any time for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. I.R.C. § 2010(c)(5)(B).

Must be Timely Filed Estate Tax Return and Election for Predeceased Spouse's Estate. The 2010 Tax Act continues the position of prior portability bills that the executor of the first spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to utilize the unused exemption. § 2010(c)(5)(A). (Therefore, even small estates of married persons must consider whether to file an estate tax return for

the first deceased spouse's estate.) The regulations (discussed below) do not change this result but simplify some of the information that must be included on the return.

Only Last Deceased Spouse's Unused Exclusion Amount Applies. Only the most recent deceased spouse's unused exemption may be used by the surviving spouse (this is different from prior portability legislative proposals). I.R.C. § 2010(c)(5)(B)(i). An explanation of the 2010 Tax Act by the Joint Committee on Taxation reiterates that this requirement applies even if the *last* deceased spouse has no unused exclusion and even if the *last* deceased spouse does not make a timely election. Joint Committee on Taxation Technical Explanation, at 52 n.57.

Privity Requirement. Planners thought that the statutory language literally provided that a spouse could not use his or her spouse's "deceased spousal unused exclusion amount." This is sometimes referred to as the "privity" requirement. For example, assume H1 dies and W has his deceased spousal unused exclusion amount, and assume W remarries H2. If W dies before H2 and if there is a privity requirement, H2 may then use the deceased spousal unused exclusion amount from W's unused basic exclusion amount, but may not utilize any of H1's unused exclusion amount. The definition of the "deceased spousal unused exclusion amount" seems to have no element at all that might include a deceased person's unused exclusion from a prior spouse in determining how much unused exclusion can be used by a surviving spouse. However, Example 3 in the Joint Committee on Taxation Technical Explanation appears inconsistent with this conclusion.

> "Example 3. [Husband 1 dies with $2 million of unused exclusion amount.] Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife." Joint Committee on Taxation Technical Explanation at 53.

The Joint Committee on Taxation on March 23, 2011 issued an ERRATA document with a footnote stating that "[a] technical correction may be necessary to replace the reference to the *basic* exclusion amount of the last deceased spouse of the surviving spouse with a reference to the *applicable* exclusion amount of such last deceased spouse, so that the statute reflects intent." The regulation, discussed below, interpreted the statute to include the words that the Joint Committee on Taxation ERRATA document suggested would be needed in technical correction legislation — so that there is no privity requirement under the regulations.

Applies for Gift Tax Purposes. Portability applies for the gift exemption as well as the estate exemption. The 2010 Tax Act amended § 2505(a)(1), which describes the "applicable credit amount" for gift tax purposes, by referring to the applicable credit amount under § 2010(c) "which would apply if the donor died as of the end of the calendar year…" (Under § 2505(a)(2), the credit amount is further reduced by the amounts of credit allowable in preceding years.) The applicable credit amount under §

2010(c) includes the deceased spousal unused exclusion amount, so that amount is also included in the gift exemption amount.

Reasons for Using Trusts Even With Portability. There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including, (a) there is no assurance that portability will apply after 2012, (b) the deceased spousal unused exclusion amount is not indexed, (c) there is no portability of state estate tax exemption amounts (one possible strategy is to leave the state exemption amount into a bypass trust and rely on portability for the balance of the first decedent spouse's estate; this would have the effect of deferring all state taxes until the second spouse's death), (d) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse, (e) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (f) there is no portability of the GST exemption, (g) there is no statute of limitations on values for purposes of determining the unused exclusion amount that begins to run from the time the first deceased spouse's estate tax return is filed whereas the statute of limitations does run on values if a bypass trust is funded at the first spouse's death, (h) allowing beneficiaries other than just the surviving spouse to use the assets that could be left to a bypass trust, (i) if the first decedent leaves all of the assets to a QTIP trust and relies on portability to make use of the decedent's exemption, there is the risk that the surviving spouse might make gifts to persons other than the first decedent's family that utilize all of the DSUE amount and his or her exemption amount, forcing the QTIP trust (for the benefit of the first decedent spouse's family) to pay large estate taxes without any benefit of the first decedent spouse's estate tax exemption, and (j) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death.

c. *Likely to be Made Permanent*. The President's Budget Plan proposes making portability permanent.

d. *IRS Guidance Prior to Issuance of Regulations*. Even though the portability rules apply to decedents who died on or after January 1, 2011, the IRS has given limited guidance, up until issuance of the regulations. Notice 2011-42 provided that, pending further guidance, a "timely filed and complete" estate tax return would be deemed to make the election and deemed to include a computation of the DSUE amount. Notice 2012-21 granted a six month extension for filing the estate tax return to elect portability for estates of decedents who die in the first half of 2011. Other than that, planners have anxiously been awaiting guidance.

e. *Helpful for Avoiding Qualified Retirement Benefits, Retitling Assets, Saving State Estate Taxes, Maximizing Gifts to Grantor Trusts, Excessive Consumption or Administrative Costs*. There are a variety of advantages to using credit shelter trusts at the first spouse's death, and planners will likely advise clients to utilize credit shelter trusts for many clients. However, there are some situations where planners may strategically decide that relying on portability is better than creating credit shelter trusts in the first decedent-spouse's will.

Qualified Retirement Plans. For the classic situation of a client whose major assets are a residence and retirement or IRA benefits, there is often no way to fully fund a bypass trust without using the retirement or IRA benefits. However, optimal income tax deferral

typically results from naming the surviving spouse as the beneficiary. A possible planning strategy is to leave the retirement and IRA benefits directly to the surviving spouse and rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

Retitling Assets. Traditionally, if one spouse owned most of the marital assets, in order to utilize the estate exemption amount of the less-propertied spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund a QTIP trust for that spouse, often unpopular with the moneyed spouse. The reluctance will be even bigger with a $5 million exemption — a very large amount might need to be transferred to the poorer spouse. That can be avoided if the spouses are willing to rely on portability to take advantage of the less wealthy spouse's exclusion amount if he or she should die first. Many clients will find portability very attractive.

Saving State Estate Taxes. Using a credit shelter trust at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability. The surviving spouse could make gifts that would not be subject to state estate taxes (and only one state, Connecticut, has a state gift tax).

Creating Grantor Trust as to Surviving Spouse. Leaving assets to the surviving spouse or QTIP and using portability allows the surviving spouse to makes gifts using both spouses' exemption amounts and that full amount can pass to a trust that is a grantor trust as to the surviving spouse. For this purpose, portability may be desirable even for very large estates.

Consumption Exceeding Growth, Administrative Costs. If the surviving spouse consumes assets at a rate higher than the growth rate during his or her remaining lifetime, so that there is a net decrease in the estate (which is more likely to happen in smaller estates), portability is preferable to using a bypass trust. (With portability, the surviving spouse has the full unused exemption amount available in addition to his or her own estate tax exemption amount. If a bypass trust had been used, no unused exclusion amount would exist, and the bypass trust assets would have declined in value.)

For smaller estates, the simplicity advantage of portability is certainly significant. In considering whether to make the portability election, consider not only the cost of filing the estate tax return but also the cost of maintaining a bypass trust for future years (e.g., fiduciary fees, filing Form 1041s, etc.)

f. *Variety of Unanswered Questions About Executor's Responsibility For Making or Not Making Elections, Who Pays Expenses, Etc.* Example issues:

- Does the executor have a duty to inform the family about filing to elect portability?
- Will the surviving spouse or someone else be permitted to file an estate tax return making the election if the executor chooses not to do so? (Unfortunately, the position of the regulations — discussed below — is "no.")
- Can the executor request the surviving spouse to pay the cost of the estate tax filing since the election will benefit the surviving spouse's estate recipients at his or her subsequent death? (Most of the speakers feel that it is appropriate for the personal representative to ask the surviving spouse for reimbursement of expenses of filing the estate tax return.) Is the executor obligated to do so?
- Does the executor have a duty to the surviving spouse (particularly if the surviving spouse is not a beneficiary of the estate)?

g. *Basis Issues*. The reduction in the difference between estate tax rates and income tax rates is a "game changer." Income tax savings become relatively more important with income tax rates being closer to estate tax rates. Relying on portability instead of using a bypass trust means that the assets would receive a step up in basis after surviving spouse's subsequent death — but the surviving spouse would still be able to make use of the first deceased spouse's exclusion amount through portability.

h. *Temporary and Proposed Regulations — Overview*. Temporary and proposed regulations were issued on June 15, 2012. There are a few new general regulations for §§2010 and 2505 (interestingly, regulations were never previously issued for those statutes), but the newly issued regulations primarily provide guidance regarding the portability provisions included the 2010 Tax Act). The portability provisions generally allow a surviving spouse to use any unused exclusion from his or her deceased spouse. The regulations provide guidance on a variety of issues including election requirements, details regarding computing the unused exclusion amount, and the surviving spouse's use of the unused exclusion amount (either by gifts or for estate tax purposes following the surviving spouse's death).

The regulations generally provide very taxpayer-friendly positions (surprisingly friendly as to several issues) regarding a variety of issues. The regulations adopt reasonable positions, avoiding what would seem to be nonsensical results that might occur with respect to various issues under a literal reading of the statutory provisions of §2010(c)(4) and §2505 (the sections describing the unified credit against estate tax and gift tax, respectively). Perhaps the specific authorization in §2010(c)(6) for the Secretary of the Treasury to prescribe regulations necessary or appropriate to carry out that subsection afforded comfort in interpreting the statutory language very broadly in order to reach reasonable results.

The regulations apply to estates of decedents who died on or after January 1, 2011. However, the regulations expire in three years (if the proposed regulations are not finalized before that date).

Highlights of some of the more important provisions of the regulations include:

- The portability election is made by the executor's filing a timely and complete Form 706, but in most cases there will be no need to list values of assets passing to a surviving spouse or charity if the estate was not otherwise required to file an estate tax return;
- The surviving spouse's "deceased spousal unused exclusion amount" (DSUE amount) is not subject to being reduced if Congress later reduces the basic exclusion amount (assuming the portability provisions themselves are extended by future legislation);
- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount;
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;

- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

The balance of the detailed discussion in this Item addresses the rules regarding portability in light of the provisions in the regulations.

i. *Making the Portability Election.*

(1) *Statutory Provisions.* Section 2010(c)(5)(a) states that the DSUE amount is available to the surviving spouse only if the decedent's "executor" timely files an estate tax return on which the DSUE is computed and makes an election on the return for portability to apply.

(2) *Timely Filed Estate Tax Return.* The last return filed by the due date (including extensions) controls. Before the due date, the executor can supersede the election made on a prior return. After the due date, the portability election (or non-election) is irrevocable. Temp. Reg. §20.2010-2T(a)(4).There is no discussion whether 9100 relief may be available. Presumably not because this is a statutory requirement; in any event, planners should not assume the availability of "9100 relief" to permit a late election.

(3) *Election on Return.* The election is made by merely filing a "complete and properly-prepared" estate tax return unless the executor states affirmatively on the return or an attachment to the return that the estate is not electing portability. (The manner for making this affirmative statement will be in the instructions that will be issued for Form 706.) Another way of not making the election is not to file a timely return. Temp. Reg. §20.2010-2T(a)(2)-(3).

Some comments asked the IRS to give guidance about protective portability elections. For example, if there is a will contest, the DSUE amount may depend on who wins the contest. Until the contest is resolved, there may be no way of knowing who is the executor or even who is in actual or constructive possession of property unless the court appoints a temporary executor. The regulations have no discussion of protective elections.

(4) *"Executor" Permitted to Make Election.* If there is a court appointed executor, that person may make the election. (The regulations do not address the situation of having multiple court-appointed co-executors. Temp. Reg. §20.2010-2T(a)(6)(i). Presumably the rules for filing estate tax returns would apply, which generally require that all co-executors join in signing the return.)

If there is no appointed executor (and presumably only if there is no appointed executor) any person in actual or constructive possession of property may file the estate tax return on behalf of the decedent and elect portability or elect not to have portability apply. Any portability election made by non-appointed executor cannot be superseded by a subsequent election to opt out of portability by any other non-appointed executor. Temp. Reg. §20.2010-2T(a)(6)(ii).

Observation Regarding Surviving Spouse. Some comments to the IRS suggested allowing a surviving spouse to file an estate tax return to make the portability

election in the event that an appointed executor does not file an estate tax return. However, the IRS felt constrained by the statute's requirement that the "executor" make the election, and did not adopt this approach. It is interesting that the IRS construed the statute extremely broadly (to the extent of changing words and adding words to the statute) to reach just and reasonable results with respect to other issues, but felt constrained as to this issue. For example, consider a procedure by which the surviving spouse could file an affidavit with a return stating that the spouse had given 60-day prior written notice to the executor of an intent to file a return on behalf of the executor making the election unless the executor objected and that the executor had not objected (or perhaps stating that the executor affirmatively notified the spouse that the executor did not object to the spouse filing a return for this purpose on behalf of the executor). Does the statute really absolutely constrain a conclusion that a return filed by the surviving spouse under these circumstances on behalf of the executor is deemed to be filed by the executor for purposes of the portability election? Is that construction any more of a stretch than construing "basic exclusion amount" to mean "applicable exclusion amount" in §2010(c)(4)(B)(i) or adding DSUE amounts used from prior deceased spouses in the definition of the DSUE amount in §2010(c)(4)? A construction allowing a surviving spouse to file a return and make the election, where the executor consents or fails to object, could be quite helpful. Many planners have questioned whether it is not more appropriate for the surviving spouse to pay the expense of filing a return for the decedent to make the portability election than for the estate to bear that expense, because the surviving spouse's recipients are the ones who will benefit from the portability election, not the deceased spouse's estate.

Observe that if there is no court appointed executor and if the spouse is in actual or constructive possession of property of the decedent, the spouse *would* be able to file a return making the portability election, and no other individual would be able to supersede that with a return opting out of the election.

(5) *Computation of DSUE Amount on Return.* Until the Form 706 is revised to include a section for computing the DSUE amount, a complete and properly-prepared estate tax return will be deemed to include the computation. Estates that file returns before the Form 706 has been revised will not be required to file a supplemental estate tax return including the computation using the revised form. Temp. Reg. §20.2010-2T(c).

(6) *Relaxed Requirements for "Complete and Properly-Prepared" Return.* A "complete and properly-prepared" return is generally one that is prepared in accordance with the estate tax return instructions. However, there are relaxed requirements for reporting values of certain assets if the estate is not otherwise required to file an estate tax return under §6018(a). For assets that qualify for a marital or charitable deduction, the return does not have to report the *values* of such assets, but only report the description, ownership, and/or beneficiary of the property together with information to establish the right to the deduction. However, the values of assets passing to a spouse or charity must be reported in certain circumstances (where the value relates to determining the amounts passing to other beneficiaries, if only a portion of the property passes to a spouse or charity, if there is a partial disclaimer or partial QTIP election, or if the value is

needed to determine the estate's eligibility for alternate valuation, for special use valuation, or for §6166 estate tax deferral. Temp. Reg. §20.2010-2T(a)(7)(ii)(A).

In any event, the executor must exercise "due diligence to estimate the fair market value of the gross estate" including the property passing to a spouse or charity. The executor must identify the range of values within which the "executor's best estimate" of the gross estate falls. Until the estate tax return is revised to include those ranges of value, the return must state the "executor's best estimate, rounded to the nearest $250,000." Temp. Reg. §20.2010-2T(a)(7)(ii)(B).

Observation: The regulations provide little further detail regarding what extent of "due diligence" is required. The Preamble to the regulations states that the inquiry required to determine the executor's best estimate "is the same an executor of any estate must make under current law to determine whether the estate has a filing obligation…" Apparently, the required due diligence means something less than obtaining full-blown formal appraisals. In most situations, the executor will need to obtain valuation information in any event to support the amount of basis step up under §1014 (or perhaps for state estate tax purposes if there is a state estate tax).

Various examples are provided in Temp. Reg. §20.2010-2T(a)(7)(ii)(C).

(7) *2012 Form 706 Draft*. The Form 706 draft for 2012 decedents (released August 16, 2012) incorporates comments in the temporary and proposed regulations about portability reporting requirements. (The draft Instructions have not been released.) Changes to the Form 706 related to portability include the following:

- Part 2, Lines 9a-9d: DSUE amount and determination of applicable credit amount, based on the DSUE amount plus the basic exclusion amount;
- Part 4, Line 3b: Reporting information about prior spouses;
- Part 5, Lines 10 and 23: Listing estimated value of assets of gross estate, if the estate tax return is filed only to elect portability and the executor is not otherwise required to file the return; apparently the Instructions will list ranges of values, and the return must specify "an amount corresponding to the particular range within which falls the executor's best estimate of the total gross estate," Temp. Reg. §20.2010-2T(a)(7)(ii)(B); the amounts listed on Lines 10 and 23 may just represent the estimated value of assets that qualify for the marital or charitable deduction because the values of other assets must be listed on the return and apparently would be reported on Part 5, Lines 1-9;
- Part 6, titled "Portability of Deceased Spousal Unused Exclusion (DSUE)":
    - Sch. A-Box to check if executor opts not to elect portability;
    - Sch. B-Box to check if any estate assets pass to a QDOT;
    - Sch. C-Computation of DSUE amount (adding back an amount equal to taxable gifts in excess of the applicable exclusion amount for gift tax purposes that applied in years that gifts were made); and
    - Sch. D-Listing of DSUE amount the decedent received from the last deceased spouse and any DSUE amounts the decedent had received from prior spouses before the last deceased spouse and that the decedent had used with lifetime gifts; the DSUE amount used to calculate the estate tax is the sum of all of those DSUE amounts; and

- Schedules A-I: Directions on each Schedule indicating that values should not be listed for assets reported on those respective schedules that pass to a spouse or charity and that qualify for the marital or charitable deduction.

j. *Computation of DSUE Amount.* As mentioned above, the regulations referred to the deceased spousal unused exclusion amount as the "DSUE amount" (rather than the more commonly used abbreviation, "DSUEA").

(1) *Statutory Provision.*

§2010(c)(2) APPLICABLE EXCLUSION AMOUNT. – For purpose of this subsection, the applicable exclusion amount is the sum of –

(A) the basic exclusion amount, and

(B) in the case of a surviving spouse, the deceased spousal unused exclusion amount.

§2010(c)(4) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT. — For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of —

(A) the basic exclusion amount, or

(B) the excess of —

(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. [The last amount is the amount of taxable estate plus adjusted taxable gifts of the predeceased spouse.]

(2) *Overview of Regulation.* As a prelude to the following discussion of changes made by the regulation, compare the statutory language of §2010(c)(4), quoted above, with the regulatory interpretation of that same language (the italicized words have been added or changed in the regulations as compared to the statute):

… The DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts —

(i) The basic exclusion amount *in effect in the year of the death of the decedent*;

or

(ii) The excess of —

(A) The decedent's *applicable exclusion amount*; over

(B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent [*reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s)*], which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).

Temp. Reg. §20.2010-2T(c)(1) (the bracketed language is added by §20.2010-2T(c)(2)).

In addition, the DSUE amount is increased by

[t]he DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse.

Temp. Reg. §§20.2010-3T(b), 25.2505-2T(c).

(3) *Basic Exclusion Amount Limitation in §2010(c)(4)(A) Refers to Basic Exclusion Amount at Predeceasing Spouse's Death.* The regulation *very surprisingly* interprets the term "basic exclusion amount" in §2010(c)(4)(A) to mean the basic exclusion amount at the death of the predeceasing spouse. Temp. Reg. §20.2010-2T(c)(1)(i). This is very taxpayer-friendly, and ultimately allows the regulation to adopt the "Example 3" approach (discussed in Item 2d below) by regulation (even though the Joint Committee Technical Explanation ERRATA Report suggested that a statutory change might be necessary to achieve that intended result). However, the Preamble to the regulations suggests a rather unusual statutory construction in order to achieve this very desirable result.

Background and Observation. The DSUE amount is the lesser of two elements, the first of which is the "basic exclusion amount." That limitation is designed primarily to prevent an individual from amassing a number of DSUE amounts from various predeceasing decedents, by limiting the aggregate DSUE amount to the basic exclusion amount. Therefore, the surviving spouse would have his or her own basic exclusion amount plus up to one additional basic exclusion amount. From the statutory terms, most planners have assumed this term refers to the basic exclusion amount at the time that the surviving spouse makes use of the DSUE amount, either by gift or at the surviving spouse's subsequent death. This is for two reasons.

First, the definition of the "applicable exclusion amount" in §2010(c)(2) refers to the "basic exclusion amount," which obviously refers to the basic exclusion amount at the time the applicable exclusion amount is being used, either by gift or estate transfer. Section 2010(c)(2) also refers to the "deceased spousal unused exclusion amount," and that term is defined in §2010(c)(4) as the lesser of (A) the "basic exclusion amount" or an amount described in clause (B). Because of the obvious interaction of §2010(c)(2) and 2010(c)(4), the use of exactly the same term presumably would have the same meaning — i.e., the basic exclusion amount at the time the applicable exclusion amount is being used by a gift or estate transfer and not at some prior time.

Second, §2010(c)(4) defines "deceased spousal unused exclusion amount" as the lesser of "(A) the *basic exclusion amount*, or (B) the excess of — (i) the *basic exclusion amount of the last such deceased spouse of such surviving spouse*, over" an amount described in clause(B)(ii). Clause (B)(i) very specifically refers to the basic exclusion amount of the last deceased spouse, so presumably the term "basic exclusion amount" in clause (A) must refer to something different than that or it would have used the same words.

The regulations take a different approach, interpreting the term "basic exclusion amount" in clause (A) also to mean "basic exclusion amount *of the last of such deceased spouse of such surviving spouse*" even though clause (A) does not include those *italicized* words that are in clause (B)(i). Observe the dichotomy that exists under this most unusual construction. Words in clause (A) are interpreted to mean different words that are in clause (B)(i), but those same exact words in clause (B)(i) are interpreted to mean something totally different despite the fact that they are literally very precise. This quite unusual construction is employed so that the regulations can then interpret the term "basic exclusion amount" in clause (B)(i) to mean something other than the basic exclusion amount of the last deceased spouse. (The regulations interpret that term to mean "applicable exclusion amount" as described in Item 2d below).

This all achieves a *very* desirable result, but with a rather unusual (and surprising to this author) statutory construction. The regulations adopt creative reasoning suggested by comments from ACTEC as a way to confirm the Example 3 approach by regulation.

Planning Implications. This construction of the first "lesser of" element means that there is no risk that the DSUE amount will be reduced by subsequent legislation reducing the basic exclusion amount after the first decedent's death. This removes the possibility of a "clawback" that might otherwise occur if an individual make gifts using the DSUE amount and if the basic exclusion amount were later reduced by Congressional action, requiring estate tax to be paid on the inclusion of adjusted taxable gifts in excess of the lower basic exclusion amount (which would limit the DSUE amount but for the construction in the regulation) that applied at the surviving spouse's subsequent death.

(4) *Reference to "Basic Exclusion Amount" in §2010(c)(4)(B)(i) Means "Applicable Exclusion Amount;" Adoption of "Example 3 Approach" by Regulation.* The term "basic exclusion amount of the last such deceased spouse of such surviving spouse" in §2010(c)(4)(B)(i) is interpreted to mean "the decedent's applicable exclusion amount." Temp. Reg. §20.2010-2T(c)(1). This difference is critical, because an individual's "applicable exclusion amount" includes his or her basic exclusion amount plus DSUE amount (in the case of a decedent who is a surviving spouse of a prior decedent who left him or her with a DSUE amount). This adopts the position taken in Example 3 on page 53 of the Joint Committee on Taxation Technical Explanation of the 2010 Act.

As an overly simplified example, assume that H1 dies, leaving in unused exclusion amount of $2 million. Assume that W remarries and predeceases H2. In calculating the DSUE amount that H2 receives from W, can the $2 million DSUE amount that W received from H1 be added to her unused exclusion amount? Example 3 of the Joint Committee on Taxation Technical Explanation of the 2010 Act says yes, but that does not appear to be the correct answer under the statutory language. Under the statutory language, the DSUE amount from W would be her basic exclusion amount less the amount of her taxable estate and adjusted taxable gifts. The DSUE amount that she had from H1 would not enter into the calculation under the statutory language at all. Indeed footnote 1582A added to the technical explanation by the "ERRATA — 'General Explanation of Tax Legislation Enacted

in the 111th Congress (ERRATA), JCX-20-11, at page 1, acknowledges that "[a] technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent." By interpreting basic exclusion amount to mean applicable exclusion amount, a computation of the DSUE amount from W would start with her basic exclusion amount plus DSUE amount from H1 (because "applicable exclusion amount" means basic exclusion amount plus DSUE amount), and the DSUE amount from H1 is included in the DSUE amount that H2 receives from W.

To reach this statutory construction, the Preamble reasons that the statute requires that the DSUE amount be computed and included on the decedent's estate tax return, but it could not be calculated at the time of the decedent's death if it depended upon the basic exclusion amount that applied at the time of a subsequent gift or estate transfer by the surviving spouse. (*Observation: A*nother way of interpreting the statutory language is that the DSUE amount would be computed and included on the decedent's estate tax return, and having that computation would allow an appropriate adjustment to the computation of the available DSUE amount when there was an actual gift or estate transfer at a later time by the surviving spouse. Indeed, other provisions of these same regulations contemplate an adjustment to the DSUE amount after the first decedent's death if assets pass to a QDOT, despite the requirement that the DSUE amount be computed on the decedent's estate tax return. Temp. Reg. §§20.2010-3T(c)(2), 25.2505-2T(d)(2) Furthermore, the regulations also contemplate the necessity of adjusting the DSUE amount in the case of a spouse who receives and makes gifts of DSUE amounts from multiple spouses. Temp. Reg. §20.2010-3T(b).)

In any event, the IRS's very generous interpretation of the statute is most welcome and manages to reach a result that was apparently intended, as reflected in Example 3. The result is reached by regulation rather than having to wait for a statutory technical correction.

(5) *Adjustment to Omit Adjusted Taxable Gifts on Which Gift Taxes Were Previously Paid.* If the decedent paid a gift tax on prior gifts, the regulations provide that those gifts are excluded from the computation of the DSUE amount. This reaches a fair result.

Under the statutory language, if an individual makes lifetime gifts in excess of the gift exclusion amount, the excess reduces the DSUE amount for that individual's surviving spouse, even though the individual had to pay gift tax on that excess gift amount.

The second "lesser of" element in computing the DSUE amount is

> the excess of-- (A) The decedent's applicable exclusion amount; over (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent…. Temp. Reg. §20.2010-2T(c)(1).

Under the statute, there is no distinction for adjusted taxable gifts that were subject to actual payment of gift tax.

The regulations add that solely for purposes of computing the DSUE amount, the amount of adjusted taxable gifts "is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s)." Temp. Reg. §20.2010-2T(c)(2). An example clarifies that this means "the amount of the gift in excess of the applicable exclusion amount for that year." Temp. Reg. §20.2010-2T(c)(5)Ex. 2.

This is a very desirable and just result, even if the construction requires that the regulation effectively read additional words into the statute.

(6) *Other Credits*. Some comments filed in response to Notice 2011-82 asked for clarification as to whether the DSUE amount is determined before or after the application of other available credits. This issue is still under consideration, and the regulation reserves a space to provide future guidance. Temp. Reg. §20.2010-2T(c)(3).

The Comments by ACTEC that were filed with the IRS clarify how this issue can arise:

The purpose of the DSUEA rules is to leave the surviving spouse the full benefit of the first deceased spouses unused basic exclusion amount, and we believe it would be both useful and appropriate for the regulations to state explicitly that the DSUEA is determined after first taking full advantage of all other available credits. The following example illustrates this rule.

> Example. H and W are married and are both U.S. citizens. H dies in Year One, leaving an estate at $10 million, of which $5 million is left to H's children and $5 million to W. H has made no lifetime taxable gifts. H's gross estate includes property with a value of $6 million that was previously taxed in the estate of A, a U.S. citizen who died one year earlier. H's estate is entitled to a $X credit for the tax on prior transfers with respect to the property received from A. The DSUEA available to W with respect to H's estate is determined by reducing H's estate tax liability by $X, before using any of H's basic exclusion amount to offset that liability.

k. *Last Deceased Spouse*. The regulations reiterate that the "last deceased spouse" means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse." Temp. Reg. §20.2010-1T(d)(5). The regulations confirm that if no DSUE amount is available from the *last* deceased spouse, the surviving spouse will have no DSUE amount even if the surviving spouse previously had a DSUE amount from a previous decedent. Temp. Reg. §§20.2010-3T(a)(2), 25.2505-2T(a)(2). (However, as discussed in Item 5e below, DSUE amounts from previous deceased spouses are included to the extent the surviving spouse made gifts using DSUE amounts from prior deceased spouses.) The surviving spouse's subsequent marriage has no impact unless the subsequent spouse predeceases, and therefore becomes the new "last deceased spouse." If there is a subsequent marriage that ends in divorce or annulment, the death of the ex-spouse will not change the identity of the last deceased spouse. Temp. Reg. §§20.2010-3T(a)(3), 25.2505-2T(a)(3).

l. *When DSUE Amount Can Be Used*. The surviving spouse can make use of the DSUE amount any time after the first decedent's death. The portability election applies as of the date of the decedent's death, and the DSUE amount is included in the surviving spouse's

applicable exclusion amount with respect to any transfers made by the surviving spouse after the decedent's death. Temp. Reg. §20.2010-3T(c)(1). There is no necessity of waiting until after an estate tax return has been filed electing portability. Presumably, the surviving spouse could make a gift the day after the last deceased spouse's death, and the DSUE amount would be applied to that gift.

The surviving spouse's applicable exclusion amount will not include the DSUE amount in certain circumstances, meaning that a prior transfer may end up not being covered by the expected DSUE amount when the surviving spouse files a gift or estate tax return reporting the transfer. For example, if the executor eventually does not make a portability election, the DSUE amount is not included in the surviving spouse's applicable exclusion amount with respect to those transfers. This is the case even if the transfer was made in reliance on the availability of a DSUE amount such as if the executor had filed an estate tax return before the transfer was made, but subsequently superseded the portability election by filing a subsequent estate tax return before the filing due date opting out of the portability election. Similarly, the DSUE amount would be reduced to the extent that it is subsequently reduced by a valuation adjustment or correction of an error or to the extent the surviving spouse cannot substantiate the DSUE amount claimed on the surviving spouse's gift or estate tax return. Temp. Reg. §20.2010-3T(c)(1).

m. *Gifts by Surviving Spouse.*

(1) *Gift Tax Statutory Provisions.*

§2505(a) GENERAL RULE. — In the case of a citizen or resident of the United States, there shall be allowed as a credit against the tax imposed by section 2501 of each calendar year an amount equal to —

(1) The applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by

(2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.

(2) *Generally — DSUE Amount Included in Surviving Spouse's Applicable Exclusion Amount for Gift Tax Purposes.* If the surviving spouse makes gifts any time after the last deceased spouse's death, his or her applicable exclusion amount that is used to determine the gift tax unified credit will include the DSUE amount. Temp. Reg. §25.2505-2T(a)(1).

(3) *Last Deceased Spouse Determined At Time of Gift.* The "last deceased spouse" is determined at the time of the gift. The DSUE amount from that spouse is used to determine the applicable exclusion amount with respect to that gift, even if a subsequent spouse of the donor dies before the end of the year. Temp. Reg. §25.2505-2T(a)(1)(i). Without this rule, the DSUE amount from the subsequent spouse who died before the end of the year in which the gift was made would generally apply, because §2505(a)(1) (quoted above in Item 5a) says that the gift tax unified credit is based on the applicable exclusion amount that would apply "if the donor died as of the end of the calendar year."

Observation. Without this helpful special rule, surviving spouses would have been at risk in making gifts early in a calendar year utilizing their DSUE amount. The expected DSUE amount would not be available if a subsequent spouse died before the end of that calendar year. Because of a special rule discussed in Item 5e below,

if a surviving spouse wishes to make gifts to utilize the DSUE amount from a deceased spouse, the donor should make the gift as quickly as possible to assure that the DSUE amount from that particular last deceased spouse is utilized.

The rule also has a potentially detrimental effect from a taxpayer-point of view. A donor who is married to an individual who is expected to die in the near future cannot make a gift utilizing an anticipated DSUE amount from that individual, even if the individual dies before the end of the calendar year. If the donor's unified gift tax credit were determined based upon the donor's applicable exclusion amount determined as of the end of the calendar year without this special rule, and DSUE amount from the deceased spouse would be available to offset gifts made by the donor-spouse any time during that calendar year.

(4) *Ordering Rule.* The regulations include an ordering rule, providing that if a surviving spouse makes a gift with a DSUE amount from the last deceased spouse determined at the time of the gift, "such surviving spouse will be considered to apply such DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount." Temp. Reg. §25.2505-2T(b).

Observation. This ordering rule is important, as a result of other positions taken in the regulations. As long as the donor does not have a new last deceased spouse, the donor's applicable exclusion amount will include his or her basic exclusion amount plus the DSUE amount from the deceased spouse. However, if the donor does have a new last deceased spouse, there would be a risk that the donor would have used some of his or her own basic exclusion amount and would lose the benefit of the DSUE amount from the prior deceased spouse. (The special rule discussed in Item 5e immediately below, to add the DSUE amounts from prior last deceased spouses in calculating the DSUE amount, applies only to the extent that the DSUE amount from a prior deceased spouse was applied to taxable gifts of the surviving spouse. Without this ordering rule, the prior deceased spouse's DSUE amount may not have been applied to previous taxable gifts of the surviving spouse, and therefore might not be added to the DSUE amount of the surviving spouse.)

(5) *Gifts Utilizing DSUE Amounts From Multiple Deceased Spouses Is Permitted.* An incredibly taxpayer-favorable position in the regulations permits the use of DSUE amounts from multiple deceased spouses.

The regulations provide that, for both estate and gift tax purposes, if the surviving spouse has applied to gifts DSUE amounts from prior deceased spouses who are different than the last deceased spouse at the time of a particular gift or estate transfer,

> then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of [the surviving spouse's death][the current taxable gift] is the sum of —
>
> (i) The DSUE amount of the surviving spouse's last deceased spouse ...; and
>
> (ii) The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more [taxable gifts] [previous taxable gifts] of the surviving spouse.

Temp. Reg. §§20.2010-3T(b), 25.2505-2T(c) (the bracketed phrases are in the respective estate tax and gift tax regulations).

This special rule means that an individual can take advantage of DSUE amounts from multiple spouses, as long as the individual makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual is predeceased by a subsequent spouse. Without this special rule, the aggregate DSUE amount that could possibly be used would be limited to the highest single basic exclusion amount that applied at the deaths of any of the deceased spouses.

Example 1. Consider the straightforward example of H1 dying with $5 million of unused exemption, and W makes a gift of $10 million after H1 dies, all covered by her gift exemption amount (which includes her basic exclusion amount plus the DSUE amount from H1). Assume W remarries H2 (who is poor and in poor health) who predeceases Wife, leaving her his DSUE amount of $5 million (for this simple example, ignore indexing increases to the basic exclusion amount). Can W make another $5 million gift without paying gift tax? Before this quite favorable regulation, the answer was no. But for this special rule in the regulations, W's gift unified credit would be (1) the estate tax applicable credit amount she would have if she died at the end of the year [§ 2505(a)(1)], less (2) the amounts allowable as credit against the gift tax for preceding years [§ 2505(a)(2)]. Assuming for simplicity that the exemption amount does not grow due to indexing, under step (1) W has a gift credit amount based on $10 million of exemption (her $5 million basic exclusion amount and her $5 million DSUE amount from H2). Step (2) subtracts the prior gift credits used, which would be the gift credit amounts on the $10 million of gifts that W made after H1 died. Therefore, there would be no remaining gift credit amount that would cover additional current gifts.

Example 2. Consider the same example, but assume that W made only a $5 million gift before marrying H2, and that the ordering rule of the regulations applies to allocate H1's DSUE amount against that $5 million gift. After W remarries H2 and he dies leaving her an additional $5million of DSUE amount, can W make another $5 million gift without paying gift tax? Again the answer would be no, but for the special rule in the regulations. W's gift unified credit would be (1) a gift credit amount based on $10 million of exemption (her $5 million basic exclusion amount and her $5 million DSUE amount from H2), less (2) the prior gift credits used, which would be the gift credit amounts on the $5 million of gifts that W made after H1 died. W would have a gift exemption based on her own $5 million exclusion amount, but no more. The regulation changes that result.

Observation. Of all of the surprising very favorable positions in the regulations, this is probably the biggest surprise. The "black widow" situation that underlies limiting the DSUE amount to one additional basic exclusion amount, no matter how many deceased spouses a "black widow" has, still exists to the extent that an individual is able to make gifts following the deaths of each of the deceased spouses to take advantage of the unused exclusion from each decedent.

n. *Qualified Domestic Trusts*. If a decedent who is survived by non-resident spouse transfers property to a qualified domestic trust (QDOT), the estate is allowed a marital deduction. When distributions are made from the QDOT or when trust assets are distributed at the termination of the QDOT, an estate tax is imposed on the transfers as the *decedent's* estate tax liability. Accordingly, subsequent transfers from a QDOT would reduce the amount of the decedent's unused exclusion amount.

The regulations provide that when a QDOT is created for the surviving spouse, the executor of the decedent's estate who makes the portability election will compute a preliminary DSUE amount that may decrease as distributions constituting taxable events under §2056A are made. The surviving spouse will not be able to make any use of the DSUE amount from the decedent who created a QDOT until the date of the event that triggers the final estate tax liability of the decedent under §2056A with respect to the QDOT. That typically would not be until the surviving spouse's subsequent death, or until all of the assets of the QDOT have been distributed to the surviving spouse during his or her lifetime. Temp Reg. §§20.2010-3T(c)(2), 25.2505-2T(d)(2).

o. *Nonresidents Who Are Not Citizens.*

(1) *Decedent Nonresident*. If a decedent is a nonresident and not a citizen of the United States, that estate cannot make a portability election. No DSUE amount is available to surviving spouse of that nonresident decedent. Temp. Reg. §20.2010-2T(a)(5). The Preamble does not offer an explanation for this conclusion, but it is correct. The portability rules of §2010 are in Subchapter A of Chapter 11 of the Internal Revenue Code, which Subchapter is titled "Estates of Citizens or Residents." Subchapter B, titled "Estates of Nonresidents Not Citizens" contains no discussion of the portability concept.

(2) *Nonresident Surviving Spouse*. A surviving spouse of a decedent may not make any use of the DSUE amount for that person's last deceased spouse any time the surviving spouse is a nonresident/noncitizen for either estate or gift tax purposes, unless allowed under an applicable treaty. Temp Reg. §§20.2010-3T(e), 25.2505-2T(f). Apparently, if the surviving spouse subsequently becomes a resident or citizen, that individual then could utilize the DSUE amount for subsequent gifts or at the individual's death when the individual was a resident or citizen.

p. *Statute of Limitations For Considering Determination of DSUE Amount.* Section 2010(c)(5)(b) provides that the IRS "may examine a return of the deceased spouse" to make determinations in carrying out the portability provisions without regard to any period of limitations under §6501. The regulations confirm that the IRS may examine the returns of each previously deceased spouse whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount at the time of any transfer by the surviving spouse, regardless whether the period of limitations on assessment has expired on such returns. The IRS may adjust or eliminate the DSUE amount based on such examination, but it may not assess additional estate tax against a prior deceased spouse's return unless the applicable period of limitations on assessment of estate tax is still open. Temp. Reg. §§20.2001-2T(a), 20.2010-2T(d), 20.2010-3T(d), and 25.2505-2T(e).

q. *Gift Planning Considerations in Light of Regulations.* The DSUE amount applies for gift as well as estate tax purposes. Various gift planning uncertainties for gifts by surviving spouses who have DSUE amounts were clarified by the regulations.

(1) *Consider Early Gifts Utilizing DSUE Amount.* A surviving spouse may consider using the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if the new spouse predeceases. (Fortunately, the spouse no longer has to be concerned about the basic exclusion amount being reduced by Congress and thereby reducing the DSUE amount.)

(2) *No Uncertainty Regarding Gift Using DSUE Amount Before End of Calendar Year*. The gift exclusion is the estate tax applicable exclusion amount as if the donor died at the end of the calendar year. §2505(a). Prior to the regulations, at the time of a gift during a year, the donor with DSUE amount from a previously deceased spouse would not know for sure what the exclusion amount would be at the end of the year to cover the gifts made during the year. The regulations clarify that the DSUE amount from the last deceased spouse *at the time of the gift* controls. Without this special rule, there was a risk that if the donor's new spouse died during the year leaving a lesser DSUE amount than the donor had from a prior deceased spouse, the donor's DSUE amount and therefore the gift exclusion amount would be decreased as to all gifts made during that calenday year. Accordingly, donors wishing to make large gifts, utilizing the DSUE amount, no longer need to wait until near the end of the calendar year to do so.

(3) *Mechanical Timing Requirements of Estate Tax Return and Gift.* Before the regulations were issued, there was a concern that a surviving spouse might not be able to make a gift, using the DSUE amount, until after an estate tax return had been filed for the deceased spouse's estate making the portability election. However, the regulations clarify that the DSUE amount applies to all gifts during the year after the date of the decedent's death as long as an estate tax return is ultimately filed making the portability election, presumably even if the decedent's estate tax return is filed after the surviving spouse's gift tax return is filed. However, the DSUE amount could not be used to cover gifts made before the decedent's death (even if they occurred in the year of the decedent's death).

(4) *No Recapture/Clawback Issue*. There is no longer a recapture/clawback concern about the possibility of having to pay additional estate tax if the spouse makes a gift after the decedent's death and if the spouse later remarries and the subsequent spouse dies, with less unused exclusion. The DSUE amounts used by gifts from prior deceased spouses that are used to cover gifts by the surviving spouse (each time before the next spouse dies) are added to the DSUE amount that the surviving spouse would have at her subsequent death. Therefore, there would not be a problem of having adjusted taxable gifts that exceeded the surviving spouse's estate tax applicable exclusion amount, as long as all of the gifts had been covered by DSUE amounts.

(5) *Can Make Multiple Gifts of DSUEAs From Multiple Deceased Spouses.* The surviving spouse can make gifts from multiple spouses, using DSUE amounts from all of those prior deceased spouses, as long as the donor makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual is predeceased by a subsequent spouse. (This was a rather surprising provision in the regulations.)

7. Decanting

a. *General Description.* If a fiduciary can invade principal, the trustee may be able to "decant" (meaning "to pour from one container to another"), moving the assets from the existing trust to another trust for the beneficiary. *Phipps v. Palm Beach Tr. Co.,* 142 Fla. 782, 196 So. 299 (1940), decided as a matter of Florida common law that a trustee has the power to distribute to a trust rather than outright to a beneficiary. The first decanting statute in 1992 in New York said it was reflective of prior common law. Accordingly, there may be a common law power to decant even in states that do not have a decanting statute.

The following states have decanting statutes: Alaska, Arizona, Delaware, Florida, Indiana, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, South Dakota, and Tennessee. Legislation is pending in several other states.

The statutes vary. In some, it is not possible to eliminate an income interest, and in others it is. Some states require going to court and others don't. In some states (like New York previously), decanting was allowed only if there was an unlimited power to invade. Most states now allow it even if invasion is allowed pursuant to the standard (including New York now).

b. *Significance; Example Decanting Situations.* Highly respected attorneys in New York reportedly would average four or five decanting transactions a month. They are incredibly helpful, and may be used in a variety of situations, such as the following:

- To provide tax protection for trust purposes; for example, to eliminate the insured as a trustee to avoid estate inclusion under §2042;
- To give a beneficiary a power of appointment when a disposition different than the default beneficiary under the existing trust is desired; the trust could say that the beneficiary could exercise the power only with the consent of a non-adverse party to prevent a completed gift and to prevent an unwise exercise;
- To reduce administrative costs (for example, by merging trusts);
- To change fiduciaries or the manner in which fiduciaries are appointed; for example, beneficiaries could be given removal powers that comply with Rev. Rul. 95-58 by analogy;
- To extend the termination date of the trust (Jonathan Blattmachr says "The biggest mistake a lawyer makes is allowing a trust to terminate before the law requires it"); decant to allow the trust to last as long as local law permits;
- To convert a grantor trust to a non-grantor trust or vice-versa;
- To change the governing law of a trust;
- To divide a trust into separate trusts; for example splitting a sprinkling trust for multiple beneficiaries into separate equal trusts for the respective beneficiaries;
- To reduce potential liability; for example transferring environmentally tainted assets to a separate special trust with limited trustee liability;
- To convert a trust into a supplemental needs trust; three separate cases in New York have allowed that; this is done very commonly;
- To make a non-spendthrift trust a spendthrift trust, or vice versa;
- To make changes in light of changed family circumstances;
- To convert to a directed trust to permit desired investments; and

- To correct drafting errors without having to go to court

c. *No Ruling Position.* Rev. Proc. 2011-3, 2011-1 I.R.B. 111 is the annual "no ruling" revenue procedure. It adds "decanting" rulings to the list of topics under Section 5, dealing with areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise. The specific relevant sections of the Revenue Procedure include § 5.09 (whether decanting distributions qualify for a distributions deduction under § 661 or are included in income of the recipient under § 662), 5.16 (whether decanting is a gift under §2501), and 5.17 (whether a decanting distribution results in the loss of GST exempt status or constitutes a taxable termination or taxable distribution under §2612). The 2011-2012 Treasury-IRS Priority Guidance Plan describes a contemplated Notice on decanting.

d. *Notice 2011-101.* Notice 2011-101 requests comments on various issues regarding decanting. This provides insight as to the issues that the IRS is concerned about and that may be addressed in the anticipated guidance. The issues include tax consequences from any of the following events:

- a beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary;
- trust principal and/or income may be used to benefit new (additional) beneficiaries;
- a beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;
- the transfer takes place from a grantor trust to a non-grantor trust, or vice versa;
- the situs or governing law results in a termination date of the receiving trust that is longer than the termination date of the distributing trust;
- a court order approval and/or approval of the state attorney general is required for the transfer;
- the beneficiaries are or are not required to consent to the transfer;
- consent of the beneficiaries and/or a court order is not required but is obtained;
- the effect of state law or the silence of state law on any of the above scenarios;
- a change in the identity of a donor or transferor for gift and/or GST tax purposes;
- the distributing trust is exempt from GST tax; and
- none of the changes described above are made, but a future power to make any such changes is created.

Dennis Belcher: We've got to believe that when the IRS looks at issues like this, the answers are not likely to be favorable. So the question is when proposed regulations will come, what will they say, and what will be the effective date.

e. *Should Planners Continue Decanting Transactions?* In a private letter ruling pending since the summer of 2010, the IRS is saying that it will not rule because decanting is involved. The Service makes no distinctions whether the decanting is specifically authorized in the trust agreement or not. There is a decanting project on the Priority Guidance Plan, and we will likely see guidance in the future. Whether to proceed with a decanting transaction at this point depends upon the differences in the trust terms. If mere administrative provisions are being changed, that should not cause a problem, even though it is not possible to get a ruling. If the decanting transaction affects distributions or extends the

duration of the trust, various adverse tax consequences are possible, and planners should be wary.

f. *Strategy to Decant if Decanting is Not Allowed Under Local Law*. Jonathan Blattmachr says that the following strategy is being used if, for example, the trustee wishes to decant an Oklahoma trust but there is no decanting statute in Oklahoma. There is the possibility that Oklahoma common law recognizes decanting, but there have been no cases.

Strategy: Appoint an Alaska or New York co-trustee of the trust. If the co-trustees agree that Alaska or New York is the principal place of administration, the decanting powers of Alaska or New York would apply (under their decanting statutes). This is done very commonly. There is a common law rationale for this approach. *Scott on Trusts* says the powers of the trustee are not derived from the place where the trust was created, but from the place the trust is *administered*. This applies even if the instrument says the validity, construction, and effect of the trust will be determined by the law of a particular state. The place of administration is generally the place of domicile of the trustee.

That same strategy could be used in a state that allows decanting only if there is an unlimited invasion power over principal, but the particular trust has a HEMS standard.

g. *Gift Tax*. If the beneficiary acquiesces to the decanting, the IRS has raised the question in Notice 2011-101 whether that has gift tax consequences. However, the trustee is merely exercising a power that has applied to the trust from the outset or that applies under state law. How can the beneficiaries be deemed to have made a gift even if the time they receive assets has been extended?

A way to avoid gift implications for an acquiescing beneficiary is to give the beneficiary a testamentary limited power to appointment to appoint the assets among a class of beneficiaries. Reg. §25.2511-2. If the Settlors or trustees are concerned about how the beneficiary might exercise a power of appointment, they could provide in the decanted trust that the power can be exercised only with the consent of a non-adverse party (including the consent of the court.). That would still cause the gift to be incomplete.

Whenever there is a decanting, a beneficiary may be treated as having made a gift by not objecting to the decanting; the solution is to give the beneficiary a testamentary limited power of appointment. Jonathan does this every time he extends a trust.

An important Revenue Ruling also provides some relief. A beneficiary who is denied a right by the fiduciary through the exercise of a power does not make a gift as long as the beneficiary still has the power under local law to cause the trustee to reverse the decision. Revenue Ruling 84-105 involved a situation in which the trustee overfunded the credit shelter trust by valuing properties too low, and therefore underfunded the marital deduction trust. The Revenue Ruling says that as long as the surviving spouse has the power to reverse it there is no gift. If the beneficiary is also the trustee, that is a different situation. In that case, make sure that the beneficiary has a retained special power of appointment to make any gift an incomplete gift.

h. *Estate Tax*. If a beneficiary can participate in a decanting decision that may result in distributions to the beneficiary not limited by an ascertainable standard, there could be potential §2041 concerns. Many states have enacted legislation that would prohibit this result as a general matter. Furthermore, many of the decanting statutes include a statement that the power to decant is to be construed as a non-general power of appointment, and prohibit a beneficiary-trustee from participating in a decanting action. Some statutes

contain an exception to the prohibition on a beneficiary's participation in the power to decant if distributions are limited by an ascertainable standard.

i. *GST Impact on Decanting of Grandfathered Trusts.* The IRS was unhappy when the New York decanting statute referred to extending grandfathered GST trusts in the legislative history of the purpose of the decanting law. The IRS made changes to the final GST regulations governing grandfathered trusts (i.e., irrevocable trusts created before September 26, 1985 that are not subject to the GST tax). The regulations provide that a *beneficiary* can exercise a special power extending the trust as long as it does not violate the rule against perpetuities without destroying the grandfathering protection. However, if a trust is extended under a *trustee's* power to decant, the trust would remain grandfathered only if the decanting power was in the instrument at the time it was created or the power to decant was present in the governing law at the time the trust was first set up. Because there were no state decanting statutes in 1985 or before, that second leg would be present only if the common law of the state recognized decanting in 1985 or before. The only state where that clearly was the case was in Florida, with the *Phipps* case dating to back to 1940. Under the rationale of the *Phipps* case, a decanting power may have existed in all states, but there can be no certainty about that.

Strategy for Decanting a GST Grandfathered Trust. If the trust would terminate when the beneficiary reaches age 55, and there is a desire to decant to extend the trust for the beneficiary's lifetime, wait until the beneficiary is 54, 11 months and 29 days, then decant. That could be done by (1) getting a local court determination ahead of time that there is a common law power to decant, (2) decant the trust to a Florida trust with the same termination date, and (3) once it is a Florida trust, the trust could be decanted into an extended trust.

What if that strategy were to cause the loss of grandfathering? Perhaps nothing is lost because if the trust had not been extended through that strategy, the assets would have passed directly to the daughter in any event. To avoid a potential gift argument, as discussed above, give the beneficiary a testamentary limited power of appointment in the decanted trust.

j. *Income Tax Issues.*

(1) *Impact of Decanting on Trust DNI.* When a distribution is made from the trust to a new trust, it appears that DNI is swept out of the old trust to the new trust. If the entire trust is moved to a new trust, is there a new trust for tax purposes? Private Letter Ruling 200736002 says that a decanting of the entire trust into a separate trust will be treated as the same trust for income tax purposes (having the same tax ID number, etc.). The IRS will probably clarify that position in its decanting guidance.

(2) *Negative Basis Property.* Normally when there is a transfer of assets, any *Crane* gain (assets with liabilities in excess of basis) is recognized. However, §643(e) says that when a trustee makes a distribution there is no gain recognition unless the trustee elects to have gain recognized. There is tension between those two concepts and Jonathan advises not to take a risk on this issue. Leave the negative basis asset in the old trust unless you get a ruling from the IRS or unless it is being transferred from one grantor trust to another grantor trust.

(3) *Potential Gain by Beneficiary.* In *Cottage Savings,* the U.S. Supreme Court said that any change in what one owns by any means can result in a taxable disposition. For example, the IRS has taken the position that the conversion of a straight income interest to a unitrust interest will result in gain to the beneficiary under *Cottage Savings,* unless the change is pursuant to the highest court of the state or pursuant to a state statute. Reg. § 1.1001-1(h) says that the severance of a trust does not generate gain, including no gain recognition to the beneficiary under *Cottage Savings*.

8. Pre-Transaction Construction Actions Respected by IRS Despite *Bosch*

As an example of how pre-transaction constitution actions can be used, Jonathan was involved in a grandfathered trust case in which a trust said the beneficiary had a testamentary power of appointment "to her then living children." There was a desire to extend that to a trust that would last for the lives of her children and then to her grandchildren. The parties first obtained a court construction that the term "children" in that context really meant the Settlor's "descendants." The beneficiary then exercised a testamentary limited power of appointment to appoint the assets into a trust for her children's lives, then passing to her grandchildren.

This concept is based on a very important exception to the *Bosch* case (discussed immediately below) announced in Rev. Rul. 73-142. Jonathan says **"This will change your life. Aside from Revenue Ruling 85-13, this is the most important revenue ruling the IRS has ever given you. And it's like it's a secret."**

In *Bosch,* there was a question after Mr. Bosch died as to whether his surviving wife had a general power of appointment so that the trust for his wife qualified for the marital deduction. The local court construed the instrument and concluded that she did. The Bosch case said that the local court determination was not binding on the IRS, but it would be bound only by a determination by the highest court in the state.

In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73 – 142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

> "In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been.* Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch,* the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus,

while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power*. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter." Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. "You will use this Revenue Ruling numerous times over the balance of your career." Jonathan says he has used it repeatedly. For example, can you make a distribution to a person next year in order to shift DNI out to that beneficiary? If you get the court construction ahead of time, the "whole world is bound" by the court construction at the time of the distribution and the tax effects of the later distribution will be recognized.

9. Estate Planning For Large Estates Over $15 Million

An outstanding panel discussion at the 2012 Heckerling Institute by Ann Burns (Minneapolis, Minnesota), John Bergner (Dallas, Texas) and David Handler (Chicago, Illinois) addressed planning approaches and alternatives for hypothetical clients with $30 million and $100 million estates. The discussion addressed not only technical tax issues and best practices tips for various planning alternatives but an analysis of deciding which types of strategies are most appropriate for various different types of assets and family situations.

a. *Beginning the Process*. First explore the client's personal and financial situation. Next, focus on the client's goals — aside from taxes. That lays the groundwork for the overall planning recommendations, including tax effects of implementing the client's goals.

b. *Communicating With Client; Complexity*. It is imperative to be able to communicate the significance of planning issues that the client understands. "Providing a solution that is not implemented is not a solution."

- Point out to the client that the IRS is a 35% silent partner with the client as to all future appreciation.
- Also, point out to clients that we now have a $5.12 million gift, estate and GST exemption but there is no guarantee that will continue past 2012. That has motivated a number of clients to move forward now.
- Complexity is at the top of the list of things that keep clients from moving forward and pulling the trigger on advantageous tax planning strategies.

c. *Determine Client's Comfort Level With Transfers*. Explore with the client whether the client is comfortable giving away $5 million (or $10 million for a couple). Get a feel for the long term future cash flows needed for the client to maintain his or her lifestyle.

Carefully consider what amounts clients would want to pass to children. In the past, we have often focused on the estate tax exemption amount, but with the dramatic increase in the exemption amount over the last several years we should not assume the clients want the full exemption amount to pass to descendants.

Case Study 1: Client With $30 Million Estate. ("The Middle Class of the Super-Wealthy.") The couple's estate includes:

- Closely held business - $15 million
- Investment assets - $5 million

- Residence - $4 million
- IRA - $6 million
- Life Insurance - $200,000 cash value in $10 million policy, premiums of $50,000/year

d. *Straightforward Gifts Preferred If Client Comfortable With That*. If the client is comfortable with making $5 million gifts, straight gifts are the simplest and most efficient. All appreciation is out of the estate and can be GST exempt. Perhaps the transfer would be made to trusts (most preferably long-term grantor trusts). If the client prefers outright gifts to children but likes the other advantages of trusts, the beneficiary can be given a great deal of control over the trusts.

e. *Equalize Gifts Among Children or Grandchildren.* If unequal gifts have been made to children and/or grandchildren in the past, clients are typically very concerned about wanting to equalize them at some point. Equalizing trusts for all children and equalizing trusts for all grandchildren is one of the first places the clients will want to make use of their $5 million gift exemption amount.

f. *If Client Concerned About Possibly Needing Access to Transferred Funds*. If the client is concerned about possibly needing access to the transferred funds, consider making a $5 million gift to a trust for the donor's spouse. Possibly give the spouse a limited power of appointment that could be broad enough to appoint the assets back into a trust for the original donor spouse. There is some potential risk of having §2036 or §2038 apply at the original donor's subsequent death. But if the facts do not suggest an implied agreement that the assets would be appointed back to the donor spouse, §§2036 and 2038 should not apply. There is also a possible argument that after appointment of the assets back into a trust for the original donor, the trust might be considered a self-settled trust as to the original donor for state law purposes. Some states (e.g., Arizona) have legislation saying that it would not be considered a self-settled trust, and other states have legislation saying that creditors cannot access trust assets merely because the grantor is a permissible discretionary beneficiary of the trust. See Item 5.j above.

The next issue for consideration is whether both spouses should create trusts for each other. If that is done, various differences must be structured into the trusts to avoid the reciprocal trust doctrine. See Item 5.l above.

g. *Consider Liquidity.* This client has a $5 million investment portfolio and will probably be uncomfortable transferring the bulk of the liquidity in gifts. Look at what other assets are possible assets for transfer planning.

h. *Life Insurance.* The $10 million life insurance policy has a $200,000 cash value. The policy could be given to an irrevocable life insurance trust (ILIT) so that the $10 million of death proceeds would be excluded from the insured's gross estate.

(1) *Not Needed During Life*. A particular advantage of giving a life insurance policy is that it is an asset that is not used by the couple during lifetime.

(2) *Communicating Advantage of Using ILIT*. If clients balk at the expense of creating an ILIT to hold the policy, explain to the client that the IRS will otherwise receive 35% of the policy in estate taxes, so the client really only has a $6.5 million policy. So the client could reduce the policy to $6.5 million, place the $6.5 million policy into the ILIT, and the reduction in premiums the first year alone would more than pay for the cost of setting up the ILIT. "That helps clients move

forward. That is a way of communicating to a client solutions and empowering them to move forward with those solutions."

(3) *Obtain Independent Objective Financial Analysis of Policy*. Obtain an independent financial analysis of the policy. Get a comfort level that the premiums will not have to increase above $50,000 per year at some point in the future in order to maintain the policy.

(4) *Determining Value of Policy*. Knowing the value of the policy is important to know the amount of gift if the policy is given, or the appropriate purchase price if the policy is sold. The life insurance company will typically issue a Form 712 listing the value of the policy.

The value is generally the interpolated terminal reserve value. However there can be surprises. For whole life policies, the interpolated terminal reserve value is generally about the same as the cash surrender value. However, for a term policy this can be quite different. We generally think of the value of a term policy as being the amount of unexpired unearned premiums. However, the life insurance company may value the policy at many multiples of that. For example, in one case in which the annual premium for a $3 million policy was $3,000, with $30,000 having been paid in premiums over the first 10 years, the life insurance company valued the policy at $60,000. (Some companies take the view that the policy should be valued at the amount of reserves that the company must set aside to cover the particular policy.)

Even once we know how the life insurance company will value the policy, there is some uncertainty as to whether the IRS will respect that value.

(5) *Paying Premiums Going Forward*. In this case, the premiums are $50,000 per year which the couple can cover with $26,000 annual exclusion gifts to the ILIT, giving Crummey withdrawal rights to the three children.

If the non-insured spouse dies first, the surviving spouse's $13,000 annual exclusion gifts for three children will not be sufficient to cover the premiums. There must be a plan to be able to pay the premiums in that event. Possibilities include:

- Transfer the full $78,000 of annual exclusion gifts available each year for the three children to the trust and build up some excess to pay premiums.
- Have the policy owned by a trust with other assets as well that can be used to pay insurance premiums. For example, if the client makes a gift of some investment assets to a trust for children, the policy could be transferred to that same trust.
- Loans.
- Split dollar arrangements, including possibilities of a split dollar arrangement with the business or a private split dollar plan. (Split dollar arrangements need to have a plan for "rollout" to be able to repay the premium advances at some point. The $5 million gift exclusion is a way of providing funds for being able to rollout of existing split dollar plans.)
- This issue is more significant for second to die policies. After the first spouse dies, the second spouse must continue to be able to pay premiums.

(6) *Avoiding Three Year Rule*. If the insured transfers an existing policy, the proceeds will still be included in the insured's estate if death occurs within three years. Alternatives to avoid this include:

- Insured gives policy to spouse (covered by gift tax marital deduction) and the spouse then later gives the policy to an ILIT.
- Insured funds the trust, and the trust purchases the policy from the outset.
- Fund an ILIT that is a grantor trust, and the ILIT will purchase the existing policy from the insured. (If the sale approach is used, it is very important to know the value of the policy. If the purchase price is insufficient and there is a gift element, the three-year rule will still apply.)
- The trust should say that if any policy is included in the insured's estate, it should pass in a manner that would qualify for the estate tax marital deduction so that estate taxes are not accelerated at the first spouse's death.
- The three-year problem is more significant for a client in his 80s rather than in his 70s or younger.

(7) *Structuring ILIT as Grantor Trust.* There will be more flexibility if the ILIT is a grantor trust. For example, the grantor trust could purchase a policy from the insured without violating the "transfer for value rule." Rev. Rul. 2011-28 says that a substitution power will not cause inclusion of life insurance proceeds in the insured's estate under §2042. A substitution power is an easy and now safe way to cause the trust to be a grantor trust as to both income and principal.

i. *Residence*. This is not the first asset to focus on for transfer planning. It may not be the most highly appreciating asset. Children may not want the home and the obligation of paying upkeep expenses. However, if the residence is the only asset that the client is willing to consider giving, it can be a good use of the gift exemption.

- *Outright Gift.* The residence could be transferred outright to children or to a trust for children (preferably a grantor trust), but the client must understand that the client would have to rent the house if the client uses it. (If a grantor trust is used, the rent payments would not be taxable income to the trust.)
- *Gift to Trust for Spouse and Children.* With this arrangement, the client would not need to rent the house. The spouse is a beneficiary of the trust, and the donor can continue to live in the house with the spouse-beneficiary without triggering §2036.
- *QPRT*. For example, the client could be able to live in the house for a 10-year term of the QPRT, and the rental arrangement would not need to begin until after that time. However, this can be problematic for a 70-year-old, because the client would need to outlive the initial term or else the residence would be in the client's estate.
- *Due on Sale Clause*. If there is an outstanding mortgage on the resident, there is likely a due on sale clause that must be addressed with the lender before making any transfers.
- *Favorite Approach.* Of those alternatives, the outright gift to a grantor trust for children is the simplest and preferred approach if the client is not otherwise going to make use of the $5 million gift exemption amount.

j. *Closely-Held Business*. The first step is to determine the client's expectations for the business. Examples: Are children expected to work in the business? Is there an anticipated future liquidity event?

- *Favored Assets for Transfer Planning*. Closely held business interests are typically favored assets for transfer planning.
  - They may have the highest appreciation potential.
  - They may produce cash flow that can assist in making the payments if the business interests are sold rather than given.
  - Substantial valuation discounts may be available for closely held business interests that would not be available for other assets.
  - Pass-through entities may produce substantial cash flow that is merely used for paying income taxes. However, the cash flow can be "counted" for purposes of paying off loans to acquire the business interest (which the client-grantor would then use to pay the income taxes on the pass-through income attributable to the trust).
- *Outright Gifts*. Many clients with this size of estate will not feel comfortable giving away $5 million of value to children.
- *Trust Transfers*. However, they will feel comfortable transferring a significant portion of the business interest to a trust with the donor's spouse as a potential beneficiary. A valuation discount of about 40% would likely be available. All of the assets are still available for the spouses.

- *Single Trust With Multiple Duties*. The same trust will probably hold a life insurance policy as well. So cash flow from the business can be used to pay premiums.
- *Continued Cash Flow With Salaries*. Even after transferring the business interest, the client (and possibly the spouse) could continue drawing salaries for continued cash flow as long as they continue to work.
- *Cash Flow For Surviving Spouse*. After the client who is actively involved in the business dies, there may be no further cash flow if the spouse is not working in the business. Factor in where necessary cash flow will come from in that circumstance for the surviving spouse. A salary continuation plan could be adopted to provide continuing cash flow benefits even after the client retires or dies.
- *Buy-Sell Agreement*. Include appropriate transfer restrictions. For example: provide that the business interest cannot be transferred outside the family without consent; give a right of first refusal to the entity or owners to purchase business interests that someone wants to transfer; address whom the stock can be transferred to and under what conditions without getting consent; discuss whether the stock can pass to family members or trusts for their benefit or for their spouses. Do any family members have the right to buy back stock that is transferred? For example, if some children are involved in the business, can they purchase stock that is transferred to other family members? How will the stock be valued for any such transfer? After the client decides what restrictions are desired aside from tax considerations, the planner must then determine whether §2703 would apply to disregard those restrictions in valuing the stock for gift and estate tax purposes.
- *Ethical Issues*. It is very important for the planner to consider ethical issues if the planner is in the role of creating a plan for the closely held business for all family members. The planner will want to very carefully clarify who the planner is representing and who the planner is not representing.

k. *Education Issues.*

- *529 Plans.* The primary advantage of a 529 plan is that the assets grow tax-free and can be withdrawn for education purposes without paying income tax. The downside is that if the grandparents are still alive when the grandchildren reach college age, the grandparents could pay the college tuition directly. More value could be transferred free of gift or estate tax in that case if the annual exclusion gifts that were contributed to the 529 plans had instead been in a trust that the grandchildren would receive at some appropriate time.
- *Section 2642(c) Trusts.* A more favored approach is to make annual exclusion gifts to §2642(c) trusts for grandchildren that would be exempt from the gift and GST tax. (Section 2642(c) provides that special provisions must be included in order that annual exclusion gifts in trust for grandchildren qualify for the GST annual exclusion exemption — there must be "vested" separate trusts for each grandchild.) If the grandparent is not alive when the grandchildren go to college, education expenses could be paid from the trust funds. If the grandparents are alive, they could pay the tuition expenses directly, leaving the trust assets for the grandchildren.

l. *Assisting Children to Acquire Residences.*

- *Pay Off Prior Loans.* Clients may have previously loaned funds to the children to acquire houses. The $5 million gift exemption amount could be used to forgive those loans. Clients love the simplicity of this.
- *Loans to Acquire Houses.* The mid-term AFR in January 2012 is 1.17%. That is far lower than is available from any third party mortgage lender. Issues can arise with equalizing the benefits of these low-interest loans among children if one child wants a more expensive house than the other children, or if one child lives in a more expensive city than others.
- *Security Required.* For the children to be able to deduct the mortgage interest as qualified residence interest, the loan must be secured by the residence. Be sure to properly document the loan with a mortgage.

m. *IRA.* Gifts of IRAs are generally not available, because they will be treated as withdrawals requiring current income taxation on the retirement account. The client might consider using the IRA for living expenses during retirement to facilitate gifts of other assets. The planner will need to balance that approach against the advantages of "stretch-out" IRAs to delay as long as possible the time of withdrawal and payment of income taxes on the funds accumulated in the IRA.

n. *Favored Approaches.*

- Give $5 million from one spouse to a trust for other spouse, and allocate GST exemption to it.
- Ideally, that $5 million gift would be of an interest in the closely held business. There are valuation discounts, and it leaves the client with all the liquidity intact.
- If a closely held business interest is used, consider using a defined value clause in the transfer to the trust. See Item 20 below.
- Sell the insurance policy to that trust.

- Make annual exclusion gifts to §2642(c) trusts for the grandchildren.
- Make annual exclusion gifts outright to children if they need to consume the assets or to grantor trusts for children to provide creditor protection for them.
- Consider what alternatives are available for the other spouse (the donee-spouse) to make use of his or her $5.12 million gift exemption at some point. The donee-spouse could very safely make a gift to a trust for children (realizing that the spouse has access to the original $5.12 million of value transferred into the trust for the benefit of the donee-spouse). Another possibility would be to make a gift into a trust with the other spouse (the original donor-spouse) as a potential beneficiary, but the reciprocal trust doctrine creates a potential audit risk.
- Traditional basic planning. The testamentary planning will address how remaining assets will eventually pass to children and grandchildren or to charity. Take appropriate steps for disability planning. Coordinate IRA and life insurance beneficiary designations as appropriate. Make sure both spouses have enough assets in their names to make full use of the exemption amounts. By transferring one-half of the closely held business interest to the non-owning spouse and using QTIP trusts, lack of control discounts become available even without transfers to children. (Even better, transfer 1% to the children, so that each spouse ends up with 49.5%, yielding even greater discounts.)

Case Study 2: Client With $100 Million Estate. (The exact amount doesn't matter. The key is that the estate is large enough that the clients can afford to make transfers.) The couple's estate includes:

- Closely held business - $50 million
- Real estate used by business - $10 million
- Investment assets - $25 million
- Three homes (one owned jointly with a child) - $4 million
- IRA - $2 million
- Life Insurance – None
- Auto collection - $3 million

The clients have both previously used their $1 million gift exemptions. ($1 million was used in acquiring the house held jointly with the child. No GST exemption has been used.)

o. *Equalize Prior Gifts.* The client made a $1 million gift for one child in acquiring the home held jointly with that child. The client may want to consider equalizing the other two children.

p. *Closely Held Business.* With a $50 million business, this is clearly the preferred asset for transfer planning. Take into account the financial situation of the business, anticipated economics and cash flows, anticipated liquidity events, etc. That will have a considerable impact on the decision of whether to use direct gifts, gifts and installment sale, or a GRAT. All of those options must be explored with the client.

q. *Business Interest -- Gift and Sale to Grantor Trust.*

- A starting point is to create voting and non-voting units. One planner typically creates 999 non-voting shares for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business.
- Gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt.

- The installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.) Make the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year). John Porter suggests transferring an initial gift of cash to the trust—something other than the illiquid asset that will be sold to the trust—so that the cash is available to help fund note payments.
- The key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, the real estate could be transferred to the trust because it does have cash flow. (See the following subparagraph.)
- Cash flow from the business may be sufficient to assist making payments on the promissory note.
- Model anticipated cash flow from the business in structuring the note.
- For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This "tax distribution cash flow" may be enough to fund a substantial part of the note payments.
- The goal is to be able to pay off a note during lifetime.
- Lack of control and lack of marketability discounts would apply.
- Best practices for avoiding §2036, 2038 argument: Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments)(John Porter suggestion). Be as certain as possible that consideration paid in the sale transaction is "adequate and full consideration" so that the full consideration exception to §§2036 and 2038 applies.
- Use a defined value clause to protect against gift consequents of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value" typically a donor advised fund from a Communities Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)
- The interest rate is very low. For example, in January 2012 a nine-year note would have an interest rate of 1.17%. If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is 0.8%, so if the business has earnings/growth above that, there is a wealth shift each year.
- This approach takes advantage of opportunities available today that could be eliminated in the future – discounts, $5 million gift and GST exemptions, and extremely low interest rates.

r. *Real Estate Used In Business.*

- If the business does not produce excess cash flow, consider first transferring (by gift and sale if appropriate) the real estate to the trust. The lease of the real estate from the business will produce consistent cash flow. The trust can use some or all of the lease payments to pay down the note. After nine years when the note has been paid, the continued cash flow from the lease payments could be used to purchase some of the closely held business interests.
- Reverse planning strategy (depending on client's objectives): transfer the closely held business interest into the trust, and have the client retain the real estate. The client may want to retain the cash flow coming from the real estate.
- If the client is considering selling the business at some point, inquire whether the real estate would also likely be sold. If not, the real estate could provide continuing cash flow. (The third-party buyer of the business may or may not allow that.)
- When the ownership of the business and real estate are not the same, determining and structuring appropriate fair market rental rates becomes very important.
- Document the lease with commercially reasonable terms.

s. *Timing of Gift and Sale Transactions*. Do not make the gift and sale on the same day. The *Pierre* case aggregated assets that were given and sold on the same day for valuation purposes, to reduce the lack of control discount of the respective blocks that were given and sold. In addition, if the gift and sale is made the same day, that would open up a potential argument from the IRS that §2036 applies to the sale transaction, because the aggregate transfer is a transfer that does not come within the bona fide sale for full consideration exception in §2036 (i.e., it involves a gift element).

t. *GRATs*.

(1) *Target Client*. "I see GRATs as really fitting two types of clients-wealthy and very wealthy." The "wealthy" client who is not comfortable giving away $5 million can still freeze his or her estate with a GRAT. The GRAT is also helpful for the "very wealthy" client who has done lots of planning and is in the mode of "what else can we do"? For example, the GRAT can be used to freeze the investment portfolio.

(2) *Flexible With Caps and Floors on Remainder*. One of the unique and most intriguing aspects of the GRAT is the ability to customize the amount passing to children in relation to the amount that will be returned to the grantor at the end of the GRAT term. The GRAT can customize how much the client is willing for children to receive at the end of the GRAT term. If the remainder has grown to a value that is more than the client wants the children to receive, the GRAT can by formula when it is drafted specify how much will be returned to the client. (The calculation of the annuity amount in order to "zero out" the GRAT does not change. If the assets appreciate over the cap amount, the client could have left more to children without gift tax cost, but chooses not to do so.)

(3) *Increasing Annuity Payments*. The GRAT may be structured so that the annuity payments will increase as much as 20% each year over the prior year. If the client anticipates that the assets in the GRAT will appreciate substantially and the annuity payments will have to be funded in kind, or if there will be additional liquidity in the future, having increasing annuity payments is beneficial.

(4) *Decreasing Annuity Payments*. Using decreasing annuity payments may essentially turn the GRAT into a one-year GRAT. For example, the annuity payment due at the end of the first year may be about 90% of the value that was contributed to the

GRAT initially. At the end of the first year, if the assets have declined by 10% or more, all of the assets will be returned to the client, which can be contributed to a new GRAT so that all of the appreciation from that time forward could be shifted. (The Obama Administration proposes a prohibition on decreasing annuity payments, but that restriction does not apply currently.)

(5) *Multiple GRATs*. Use multiple GRATs so that the appreciation of assets in one GRAT is not offset by depreciation in another. Use different GRATs for each different category of investments. One speaker went through a gift tax audit of the client that had done dozens of GRATs with a clean bill of health.

This approach is "heads I win tails you lose" for the children. They receive the appreciation from the appreciating GRATs but do not have to bear any losses from the depreciating GRATs.

In order to assist clients with administering multiple GRATs, one firm uses a tickler system to keep track of all GRAT annuity payments that will be due each month. The firm sends out letters each month to every client with an annuity payment due that month, describing the due date and the amount of the payment.

Judge your client's willingness to stomach the complexity of multiple GRATs. One planner says that for some clients, he just does not even mention the possibility of multiple GRATs because he knows of their anxiety in dealing with just one GRAT.

(6) *Place to Hold Investment Portfolio For Mega-Wealthy Client*. For the mega-wealthy client, with hundreds or billions of dollars in investment assets, keeping the bulk of the investment assets in GRATs makes sense to shift all future appreciation out of the estate at no transfer tax cost.

(7) *Typically Do Not Use Short-Term GRATs With Illiquid Assets*. Short- term (2-year) GRATs are typically not used for illiquid hard-to-value assets. (The asset must be valued at the end of each year to determine how many units to distribute in satisfaction of the pecuniary annuity payments.) However, if a liquidity event is anticipated within the very near future, short-term GRATs could still make sense for illiquid assets.

(8) *Fund GRAT with Illiquid Business Interest and Cash to Make Annuity Payment in First Several Years*. If a client anticipates a liquidity event within 3-4 years, fund the GRAT (say a 4-year GRAT) with the business interest and a marketable securities portfolio that can be used to make the annuity payments in the first several years before the liquidity event is likely to occur. (The increasing annuity structure is also helpful in that scenario.)

(9) *Qualified Disclaimer*. The client may contribute stock to a general power of appointment marital trust for his spouse, and also create a GRAT at the same time. The marital trust provides that any assets disclaimed will pass to the GRAT. At the end of nine months, if the asset has appreciated substantially, the spouse will disclaim, and the disclaimer is effective as if the asset had passed into the GRAT when the trusts were originally created. If the asset has depreciated, the spouse will not disclaim, and it is a marital gift.

(10) *Use Stand Alone Separate Single Trust to Receive GRAT Remainders.*

- *Simplicity*. If "rolling" GRATs are used, with the client contributing the assets received in each year's annuity payment into a new GRAT, provide that the remainder in all of these various GRATs will pass to a single trust for

simplicity. The trust would be structured as a grantor trust, and the client might be the trustee of that trust. The trust receiving the remainders should be established under a separate trust agreement, and not under the same agreement creating a GRAT.

- *Fewer Boxes on Flowcharts*. One planner puts it well: "My clients like fewer boxes on their flowcharts."
- *Sale of Remainder Interest to Existing Trust.* Having a separate legal entity own the remainder interest of a GRAT affords the opportunity to enter into transactions regarding the remainder interest. For example, the trust that owns the remainder interest might sell the GRAT remainder interest to a GST exempt trust before the assets appreciate significantly, while the remainder interest still has a low value. (Determining that value may be somewhat difficult, because the value changes each day after the GRAT is created.) In order to leave open the flexibility of using this planning, ***there must not be a spendthrift provision*** in the GRAT instrument.

u. *Investment Portfolio.*

(1) *Family Limited Partnership*. FLPs are not appropriate for all situations.

- If the client is looking for discounts, ask the client whether he or she anticipates holding onto most of the limited partnership interest for life. If so, what is the likelihood that valuation discounts will be available at death? Also factor in the §2036 risk at death.
- If there is not a legitimate and significant nontax reason for the FLP, §2036 will apply at death, removing any discounts.
- If creditor concerns are one of the nontax issues, focus on whether existing liability insurance coverage is likely to cover that risk, and whether the FLP is reasonably needed for that purpose. (The client will recognize that the cost of umbrella liability coverage is very low – suggesting that the likelihood of liability concerns is also very low.)
  If creditor concerns justify using an FLP, organize the FLP or LLC in a jurisdiction with strong protective laws. Some state laws provide more protection than others, especially where a charging order is the sole remedy. The law of the client's residence may not be the best choice. Also, intentionally going out-of-state for more asset protection bolsters creditor protection as a genuine non-tax purpose.
- The planner gains credibility with the client and other advisors by not drafting partnership agreements that are not really useful.
- The client must factor in the administrative inconvenience of administering the FLP in future years.
- The FLP can set up many headaches for clients with administrative issues.
- For this client, $60 million of their net worth is tied up in the closely held business and real estate connected with it – in discountable entities. Don't get greedy and try to get everything into discount entities.

(2) *GRATs.* A GRAT might be a realistic possibility for the investment portfolio. See the preceding subparagraph. If the client does an installment sale with the business interest, that merely freezes the value, and indeed the estate continues to grow at

the 1% rate of the interest on the note. The planner needs to chisel away at the estate using other planning alternatives as well. This could include GRAT planning with the investment portfolio.

v. *Automobile Collection.* A collection of "collectibles" is not generally a desirable vehicle for transfer planning.

- Accumulating the collection is a hobby to the client, and the client often does not want to part with the collection.
- From a tax standpoint, it may be preferable for the client to retain the collection to receive a stepped-up basis at death. Collectibles are subject to a 28% income tax rate when sold.

w. *Remainder Purchase Marital Trust.* David Handler developed the concept of the Remainder Purchase Marital Trust (or "RPM Trust")as a type of freezing transaction. *See* Handler & Dunn, "GRATs and RPM Annuity Trusts: A Comparison," 20 TAX MNGMNT EST., GIFTS & TR. J. (July 8, 2004); Handler & Dunn, "RPM Trusts: Turning the Tables on Chapter 14," TR. & EST. 31 (July 2000).

(1) *Basic Description.* The RPM Trust involves a transfer of assets to a trust in which the donor's spouse has an income or annuity interest for a specified term or life of some individual. (It is important that the spouse is not a beneficiary under an ascertainable or discretionary standard, because that interest would be hard to value; straight income or annuity interests can be valued easily under the IRS's actuarial tables.) The transfer to the trust is gift-tax free because it qualifies for the gift tax marital deduction, even though it is not a general power of appointment trust or a QTIP trust. (See the discussion below about why this is not a "nondeductible terminable interest.") A grantor trust (perhaps a GST exempt trust) for descendants (referred to below as the "Descendants Trust") that was funded by someone other than the spouse pays the donor the actuarial value of the remainder interest when the RPM Trust is created in order to be named as the remainder beneficiary of the RPM Trust. The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there was no QTIP election) at their subsequent deaths.

(2) *Overall Result.* No gift or estate tax is paid with respect to the trust assets. The Descendants Trust pays an amount equal to the actuarial value of the remainder interest when the trust is created (i.e., the full value of property transferred to the trust less the actuarial value of the spouse's income or annuity interest). The value of the remainder interest may be relatively low compared to the value that the Descendants Trust will ultimately receive. (As with QPRTs, the discount is greater for an RPM Income Trust at higher § 7520 rates. However, as with GRATs, the discount is greater for an RPM Annuity Trust at lower § 7520 rates.) Thus, the Descendants Trust can acquire assets at significant discounts. The many restrictions that apply to GRATs or QPRTs would not be applicable.

(3) *Marital Deduction Terminable Interest Rule.* A transfer to a donor's spouse qualifies for the gift tax marital deduction unless it is a nondeductible terminable interest. Section 2523(b)(1) provides that no gift tax marital deduction is allowed if the spouse receives a life estate or other interest that will terminate at some time

and if the donor provides that the assets will then pass to someone else "for less than an adequate and full consideration in money or money's worth." As long as the amount passing to the third party is passing for full consideration, the marital deduction is allowed even though the spouse's interest terminates at some point.

(4) *Advantages of RPM Annuity Trust.* The RPM Annuity Trust functions much like a GRAT. The spouse receives set pecuniary annuity payments each year of the trust. The annuity payments are structured so that the spouse's present value of the annuity payments is equal to almost the full value transferred to the trust. The separate trust purchases the remainder interest from the client. Thus, almost all appreciation above the initial value will inure to the benefit of the remainder trust, analogous to a GRAT.

- In effect, this allows a GST exempt GRAT. (The issue is whether the distribution of RPM Trust assets to the Descendants Trust at the end of the RPM Trust term is a contribution to the Descendants Trust requiring that it change its inclusion ratio. Cf. Letter Rul. 200107015 (sale of remainder interest).)
- There is no mortality risk of inclusion in the donor's or the spouse's estate for estate tax purposes.
- Because there is no mortality risk, the trust can be structured for a longer term (so that the anticipated cash flow from a business interest contributed to the trust, for example, would be sufficient to fund the annuity payments).
- The trust does not necessarily need to be for a fixed term but could be for the shorter of a term of years or life (of the donor or donor's spouse).

Backloaded annuity payments are possible. Using backloaded annuity payments solves the problem of transferring business interests, real estate, or other assets that do not produce significant cash flow but have large appreciation potential. (For GRATs, the annuity is given value under § 2702 only to the extent that it has annual increases of no more than 20%.) In effect, this is a "shark-fin GRAT" substitute.

(5) *Disadvantages; Specific Requirements for RPM Trusts.*

- *Spouse Beneficiary.* The donor's spouse must be the beneficiary of the term interest (so that the transfer to the trust is covered by the gift tax marital deduction). (In the typical QPRT or GRAT, the donor retains the term interest rather than the donor's spouse. The client must be married and be willing to benefit his or her spouse in an RPM Trust transaction.)
- *No "Divorce Clause."* The spouse's term interest cannot terminate in the event of a divorce. Divorce would make the term interest very difficult to value, which would make the remainder interest very difficult to value.
- *Easy to Value or "Proportional" Assets.* Generally, cash or marketable securities that are easy to value should be contributed to the RPM Trust so that full consideration could be paid for the remainder interest. The RPM Trust at a later time could purchase other assets (such as business interests or real estate) in an independent purchase transaction. If hard-to-value assets are contributed to the RPM Trust, there is the possibility that the Descendants Trust will not pay full and adequate consideration for the remainder interest,

which would mean the disallowance of the gift tax marital deduction (whether this would cause disallowance of all or just part of the marital deduction is not clear).

- *Same Entity*. An alternative is for the donor and the Descendants Trust each to use interests in the same entity.

(6) *"Old and Cold" Descendants Trust*. The Descendants Trust should have been funded previously in a separate independent transaction. If the donor makes a gift to a new Descendants Trust and the Descendants Trust uses those funds the next day to purchase the remainder interest in an RPM Trust from the donor, can the IRS argue that there was not full consideration paid for the remainder interest but that it was, in effect, a gift from the donor? If so, the gift tax marital deduction may not be allowed for the contribution to the RPM Trust because the exception to the nondeductible terminable interest rule would not apply.

(7) *Not a "Garden Variety" Recognized Transaction*. There are no cases or rulings specifically addressing the RPM Trust transaction, and it is not a widely used strategy. However, the concepts underlying the use of the strategy seem sound. David Handler reports that he has created a number of these trusts. He has had at least one of these RPM Trusts go through an estate tax audit without question. The basic economics of the transaction are not abusive of the transfer tax system.

x. *Life Insurance*. The estate has $60 million of illiquid assets, and the estate tax will exceed the liquid assets of the estate. Address with the client whether the goal is to get $100 million of value to the family, or $100 million less estate taxes. The planning steps described above largely just freeze the value of the estate, and do not reduce the amount subject to estate tax. Therefore, it is appropriate to consider having the trust described above that is created to acquire business or other assets also acquire life insurance to assist in funding the estate tax.

y. *Testamentary CLATs*. Testamentary charitable lead annuity trusts (CLATs) involve paying a fixed amount to charity over a set period, with any remaining value passing to family members at the end of the trust term. The annuity payments payable to charity can be structured so that no estate tax is paid on the value of assets passing into the CLAT. With discounted assets, cash flow from the business may be sufficient to fund the annuity payments. Testamentary CLATs involve considerable complexity, but can be powerful for transferring business interests with minimal estate taxes.

10. Qualified Plan and IRA Minimum Required Distributions — Proposal in 2012 Transportation Bill Generally Requiring 5-Year Payout

Congress has been addressing a highway, transit and safety reauthorization bill (S. 1813). The Senate passed the bill on February 14, 2012.

A $9.8 billion financing proposal to be offered as an amendment to S. 1813 was approved by the Senate Finance Committee on February 7, 2012, led by Chairman Baucus (D-Mont.). The largest funding provision (estimated to raise $4.68 billion) in that proposal provided that in most cases, distributions of inherited qualified retirement plans and individual retirement accounts would have to be distributed *within five years* of the death of the account holder. There were various exceptions, including situations in which the beneficiary of the IRA is the surviving spouse of the participant, is disabled, is chronically ill, is an individual who is not more than 10 years younger

than the participant, or is a child who has not reached the age of majority. The provision is obviously a major change from prior law, which typically allows benefits to be paid out over the lifetime of the oldest beneficiary of the plan, and it would be a really rude surprise to persons who converted the IRAs to Roth IRAs last year (paying substantial up-front income taxes) thinking that the long-term tax-free earnings within the Roth IRA could continue over the lives of the IRA beneficiaries.

This funding provision met immediate widespread opposition and the inherited retirement plan funding measure was dropped the same day to reach bipartisan approval in moving forward with the full Senate. However, comments from Senate leaders the following day suggests that this is an issue under consideration and that it *may be considered again at some point*. In a report from BNA Pension & Benefits Daily, Senator Kyl (R-Az.) said the IRA offset—not previously discussed for the transportation reauthorization—*"is an issue that both parties recognize"* but it is perceived as being related to estate taxes and might be better suited to a discussion later in the year about the estate tax.

11. Gift Tax Audits

a. *Increased Gift Tax Audits; Special Audit Initiatives*. Historically, gift tax audit rates have been extremely low (significantly less than 1% of all gift tax returns). Two factors suggest an increase in the gift tax audit rate. (1) The increased exemptions will dramatically reduce estate tax audits, and (2) it is likely that there will be many more gift tax returns filed for 2011-2012 because of the $5 million gift exemption. There will be more IRS resources devoted to gift tax audits.

There were two IRS special gift tax initiatives last year: (1) applying the gift tax to §501(c)(4) lobbying organizations, and (2) searching real property records to identify undisclosed real property gifts.

b. *Section 501(c)(4) Initiative*. Five audits were opened in 2001 alleging that transfers to §501(c)(4) social welfare organizations that engage in lobbying (for example, the lobbying arm of AARP) are taxable gifts. Those organizations are tax-exempt entities, but transfers to them clearly do not qualify for income tax deductions. Several pre-1974 cases held that transfers to such organizations were not subject to gift tax (*Stern v. U.S.* and *Carson v. Commissioner*). While the IRS official position is that transfers to them are subject to gift tax, Rev. Rul. 82-216, 1982-2 C.B. 221, the IRS had not pursued gift tax audits of such transfers — until the 5 audits in 2011. There was uproar on Capitol Hill and in the press, claiming that this position was politically motivated. IRS Commissioner Shulman denied that in a letter dated May 31, 2011. {Very interestingly, the letter said this was "part of ongoing work that focuses broadly on gift tax noncompliance"-- *confirming that the IRS has an initiative to focus on gift tax noncompliance.]* After various letters from members of Congress to the IRS, a memorandum on July 7, 2011 from Deputy Commissioner Miller said that the IRS would not expend any further resources on this issue and that any future examination activity "would be prospective only after notice to the public."

Accordingly, transfers to §501(c)(4) organizations can now be made with certainty that they are not subject to the gift tax, until the IRS gives public notice that it has reconsidered its position.

c. *Review of Real Property Records.* The IRS has looked at property transfer records in 15 states, apparently for the years 2005-2010. (One of those states was California, which refused to turn over records of transactions where affidavits have been filed stating that the transfers were made to related parties, so that the real property taxes would not be reassessed. A District Court on December 15, 2011 granted the IRS's petition for a John Doe summons on California, so presumably California is now in the process of delivering that information to the IRS.)

A declaration filed by the IRS in the court proceeding to obtain a California summons stated that through October, 2011, this real property record review initiative has resulted in 658 completed exams, 190 open exams, and 364 cases under research. Twenty cases have resulted in gift tax where the transfer exceeded the remaining exemption of the transferor. Presumably many more resulted in donors having to utilize some of their lifetime gift exemption. Because only 1,500 to 2,000 gift tax returns are typically examined each year, this is a very significant number of audits generated by this initiative.

This initiative may cause many to wonder what should be done about unreported real property transfers or other gifts.

d. *Unreported Gifts.* Generally speaking, there is no obligation on a taxpayer to correct a tax return. However, because of the way gift and estate tax returns are structured, unreported prior gifts may cause future gift or estate tax returns to be false returns.

Under Circular 230, a lawyer who learns of a client's failure to comply with tax laws *must* advise the client promptly of the consequences of noncompliance, and *must* advise the client of the option of correcting the error. The burden on a CPA is even greater. CPAs are under a burden to consider withdrawing from the representation if the client decides not to correct the error.

e. *Voluntary Disclosure and Reporting Unreported Gifts.* Under the voluntary disclosure program, the IRS will generally forgo criminal prosecution if the taxpayer discloses before the IRS starts an examination or before the IRS possesses information that reveals the noncompliance, provided that the taxpayer files all relevant forms and either pays the tax and interest or makes a good-faith arrangement to pay, if the taxpayer is truthful and complete in the process and cooperates without any ensuing IRS inquiry. The voluntary disclosure process does not offer any protection against civil penalties, however. The key to qualify for this program is *timeliness*-- as long as the IRS has not begun an examination of that particular taxpayer.

If the unreported gift would be covered by the taxpayer's remaining gift exemption, the client should just file a late gift tax return reporting the gift. No penalties would apply.

If a tax would be due upon reporting the unreported gift, there is the possibility of either a "noisy" disclosure (first contacting the IRS to see if the disclosure would be acceptable under the voluntary disclosure program) or a "quiet" disclosure (simply filing a gift tax return reporting the unreported gift). If there is any possibility of a criminal investigation, consider a noisy disclosure. (This could include situations involving fraudulent appraisals, multiple unreported gifts over a series of years showing fraudulent intent, etc.) Another advantage of a noisy disclosure is that a closing agreement is received from the IRS whereas if a gift tax return is filed the taxpayer may have to wait three years to know the outcome. For that reason, fiduciaries may prefer a noisy disclosure approach to achieve

finality. It is also possible to get pre-clearance from the Criminal Division — to know the taxpayer is not already under investigation. Typically, the quiet disclosure approach is used for gift tax returns.

Reporting unreported gifts may require correcting all gift tax returns that have been filed subsequent to the time of the unreported gift.

Just pay tax and interest with the return. Do not voluntarily pay penalties.

f. *Penalties.* Failure to file and pay penalties are provided under §6651(a)(1)(failure to file timely, 5% per month, up to 25%), §6651(f) (increasing the penalty to 15% per month up to 75% for fraudulent failure to file), §6651(a)(2)(failure to pay, ½% per month up to 25%), §6651(c)(not apply failure to file and failure to pay penalty in the same month, so total combined penalty can be as much as 47.5%). Those penalties can be waived if the failure is "due to reasonable cause and not due to willful neglect."§6651(a).

In addition, a negligence penalty and substantial valuation understatement penalty can apply under §§6662(b)(1) and 6662(b)(5), respectively. These combined penalties can be 20%, but the substantial valuation understatement penalty is increased to 40% if the value listed on the return is 40% or less of the correct value. The §6662 penalties can also be waived for reasonable cause/good faith, §6664(c), but for charitable deduction property there is no reasonable cause/good faith exception with respect to the 40% gross overvaluation penalty unless there is a qualified appraisal and a good faith investigation of the value of the contributed property. §6664(c)(3).

Furthermore, there is a fraud penalty of 75% for any portion of an underpayment attributable to fraud. §6663.

12. Family Limited Partnership Planning Checklists

a. *Weakest Link*. Sound advice to clients is that the strength of a family limited partnership is determined by the weakest link in the structure and implementation of the partnership. Very often, planning and structuring of the partnership is excellent, but significant problems arise in the implementation, administration, and maintenance of the partnership over the years.

b. *Post Formation Audits.* Consider conducting post-formation audits of FLPs. When a tax controversy arises, the client who created and funded the FLP is probably not going to be available. It will be the advisors who will explain the purpose of the FLP and how it was operated. Some planners prefer to schedule partnership meetings and prepare minutes of the meetings describing activities of the partnership.

c. *Checklist of Ideas for FLP Maintenance.* Stephanie Loomis-Price (Houston, Texas) gives very insightful tips regarding FLP maintenance and transfers, summarized below.

- File required annual filings; memorialize all significant partnership decisions.
- Comply with the terms of the partnership agreement.
- Comply with loan terms, if loans are made.
- Make any distributions pro rata (and pursuant to terms of the partnership agreement).
- Refrain from the personal use of partnership assets (at least unless fair rental is paid) or using assets for the partners' personal obligations.
- Refrain from having the partners individually pay partnership obligations.

- Encourage partners to maintain current and accurate books and records.
- Avoid the following as recurring transactions between the partners and the partnership: loans, redemptions, non-regular distributions, non-pro rata distributions.
- Review the non-tax reasons for forming the partnership and follow them.
- Establish a protocol for administering the partnership in accordance with the requirements of the agreement.

d. *Checklist of Ideas Regarding Review of Transfers of FLP Interests.*

- Review books and records of the partnership prior to transfers.
- Amend the Certificate of Limited Partnership if necessary.
- Execute appropriate transfer documents concurrent with transfers to the FLP.
- Consider the effect of transfers if a §754 election is in effect.
- Wait until after the partnership is fully funded and operational to begin gift planning.
- Abide by transfer restrictions in the partnership agreement.
- Carefully consider tax consequences of transfers.
- Retain the services of an independent and qualified appraiser.
- Encourage open communication with appraisers; do not conceal information from the appraiser.
- Be specific about what interests need to be valued.
- Be aware of IRS settlement guidelines.
- Do not round down on appraisals and returns.

  Carefully review the appraisal report and request revisions if it is not easy to understand.

13. Section 2036 Inclusion for Assets in FLPs in Three 2011 Cases

Three cases in 2011 all involved pretty terrible fact situations holding that §2036 applied to interests transferred to family limited partnerships. Jeff Pennell observed that these three cases do not provide any learning as to how FLPs should be structured to avoid §2036. However, they do provide learning as to "what not to do."

a. *Estate of Jorgensen v. Commissioner*. In *Jorgensen*, 107 AFTR 2d 2011-2069 (9th Cir. May 4, 2011)(not published), *aff'g* T.C. Memo 2009-66, the Ninth Circuit Court of Appeals rejected the taxpayer's appeal of the Tax Court opinion, which held that §2036 applied to all assets in two family limited partnerships that were attributable to capital contributions by the decedent. T.C. Memo. 2009-66. The Ninth Circuit held that there was no clear error in the Tax Court's determination (1) that the decedent's transfer of assets to the partnerships was not a bona fide sale for adequate and full consideration, and (2) that "there was an implied agreement that the decedent could have accessed *any* amount of the purportedly transferred assets to the extent she desired them."

Tax Court Analysis.

The Tax Court determined that all assets in two partnerships attributable to the decedent's capital contributions were included in her estate under §2036. T.C. Memo. 2009-66.

Bad Facts. Some of the facts were not terrible — the decedent retained assets for her day-to-day living expenses. However, other facts were bad — (1) there was no evidence of why one FLP was created, but contemporaneous attorney correspondence referred only to estate tax savings as the reason for creating the second (and much larger) FLP, (2) the

decedent had control of the FLPs' checkbooks even though she was not the general partner, and (3) she in fact wrote checks out of the partnership accounts for personal purposes (including for making annual exclusion cash gifts).

Bona Fide Sale Exception. The Tax Court held that the bona fide sale exception did not apply, rejecting the following non-tax reasons offered by the estate: management succession, financial education of family and promoting family unity, perpetuating an investment philosophy and motivating participation by children, pooling of investment assets, creditor protection, and providing for children equally and facilitating gift-giving. The court reasoned that the following factors suggested that the primary purpose of the partnerships was to save taxes: contemporaneous advice referred to tax savings, disregard of partnership formalities, and the absence of arm's length transfers. The Tax Court concluded: "We find *especially significant* that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities." (emphasis added)

Retained Interest. There was an implied agreement of retained enjoyment of all assets contributed by the decedent to the partnerships. The court acknowledged that the decedent retained assets for day-to-day expenses, but pointed to (1) the use of partnership assets by the decedent to make cash gifts, and (2) the use of partnership assets ($211,000) to pay transfer taxes, legal fees and other estate obligations, and (3) the fact that significant non pro rata distributions were made. There were also significant pro rata distributions to all partners, but the court did not suggest that those pro rata distributions reflected an implied agreement of retained enjoyment of partnership assets.

Partnership Interests Given More Than Three Years Before Death. In dictum, the court observed that §2036 applied even as to assets attributable to partnership interests that the decedent gave to her children and grandchildren more than three years prior to her death, reasoning that the decedent "retained the use, benefit, and enjoyment of the assets she transferred to the partnerships."

Equitable Recoupment. Under the equitable recoupment doctrine, the Tax Court allowed an offset in the estate tax liability for the "overpayment" of income taxes, where a refund of the income tax was barred by limitations and where the prior income tax payments did not reflect the increased basis as a result of the increased value included in the decedent's estate under §2036. The IRS did not appeal this aspect of the Tax Court opinion.

Ninth Circuit

Bona Fide Sale Exception. The 9th Circuit's analysis was concise. Transfers to family limited partnerships are subject to heightened scrutiny and the estate did not demonstrate a legitimate and significant nontax reason for the transfers.

Retained Interest. The estate argued that §2036 could not be applied beyond the scope of the rights or interests retained by the decedent. It argued that any retained interests were *de minimis*, but in any event the application of §2036 "should be limited to the actual amount accessed by decedent." At oral argument, the estate in particular argued that *Stewart v. Commissioner*, 617 F.3d 148 (2d Cir. 2010) makes clear that §2036 should be applied only to the portion of transferred assets in which there is retained interest, and should apply only to the net benefit retained. The estate argued that checks had been written "innocently but erroneously" from the partnerships to the decedent reflecting only 2.84% of the partnerships' assets, and those *de minimis* errors were corrected,

demonstrating that there was no implied agreement that the decedent would have improper retained interests over the partnerships' assets. As to the post-death payments of estate taxes and other expenses from the partnerships, the estate argued at oral argument that while the partnerships' indeed wrote checks in partial payment of the some of the federal and state estate taxes, those amounts were recorded as payments in redemption of the decedent's stock (which interestingly, was not reflected in the facts as described in the Tax Court or Ninth Circuit opinions).

The Ninth Circuit disagreed. As to the repayment of the incorrectly written checks, the court acknowledged in footnote 1 that there had been an attempt to repay some of these funds (though to the wrong partnership), but

> "it was the failure to observe partnership formalities and the fact she had access to the accounts (including her name of the checks for JMA II) despite being only a limited partner that the tax court found significant in determining there was an implicit retention of economic benefits."

To support the retained interest finding, the court pointed both to the incorrectly written checks and the payment of estate taxes from the partnerships:

> "We do not find it *de minimis* that decedent personally wrote over $90,000 in checks on the accounts post-transfer, and the partnerships paid over $200,000 of her personal estate taxes from partnership funds [citing *Strangi* and *Bigelow* regarding post-death payment of expenses and debts from partnerships]."

The court concluded that the Tax Court did not clearly err in finding an implication that decedent could access any assets that she had transferred to the partnerships:

> "Nor did the tax court clearly err by concluding there was an implied agreement decedent could have accessed *any* amount of the purportedly transferred assets to the extent she desired them. The actual amount of checks written for decedent's benefit does not undermine the court's finding that she *could have* accessed more, it was only used to buttress the court's conclusion that decedent had such access to the funds if needed."

b. *Estate of Turner v. Commissioner*. In *Turner*, T.C. Memo 2011-209, the decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets, the income from which was sufficient to provide their living expenses. In late 2002 and early 2003, the decedent and his wife made gifts of 43.6% limited partnership interests to family members. The decedent and his wife paid themselves management fees of $2,000 per month although they provided few if any management services. After the gifts of partnership interests were made, no distributions were made to the family members prior to the decedent's death, but various payments were made to the decedent and his wife (although they were treated as repayment of advances made by the decedent and not as distributions). The decedent used partnership funds for personal uses (making gifts, making insurance premium payments, and paying estate planning legal fees).

The court (Judge Marvel) concluded that that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036. Judge Marvel issued a supplemental opinion on March 29, 2012 confirming the §2036 holding and addressing a marital

deduction issue. T.C. No. 14. The supplemental opinion (as well as the reasoning in the initial decision) is discussed below in Item 16.

c. *Estate of Liljestrand v. Commissioner*. In *Liljestrand,* T.C. Memo 2011-259, the decedent's revocable trust transferred 13 real estate properties (all of his income producing assets) to an FLP, leaving him with only his home and a few minor assets. The revocable trust initially received 98.98% of the partnership interests, but the trust subsequently gave 14.8% of the partnership interests to irrevocable trusts for his children (more than three years prior to his death). The partnership failed to follow basic partnership formalities. (These included that no bank account or capital accounts were created for two years and the partnership commingled funds during that period with the trust, and disproportionate distributions were made to the decedent to pay his debts and to pay a variety of his personal expenses.) The court (Judge Haines) concluded that all of the partnership assets were included in his gross estate under §2036(a)(1).

The bona fide sale for full consideration exception to §2036 did not apply. First, the court said the transfers were not bona fide sales. The court did not accept the purported nontax reasons for the FLP as legitimate and significant nontax reasons. (Those were to provide centralized management, assure the continued long-term employment of the decedent's son to manage the real estate, to prevent partition of the real estate, and to protect the real estate from potential creditor claims.) The court viewed as "especially significant" in determining the bona fide sale issue that the transactions were not at arm's length (there were no negotiations) and that the partnership "failed to follow the most basic of partnership formalities." Second, the transfers were not for full consideration because the interests credited to the partners were not proportionate to the assets contributed (the court did not believe that the decedent's son contributed $362 in return for his 0.02% initial partnership interest) and capital accounts were not properly maintained. (The court's analysis includes reasoning — that the discounted value of the partnership interests received was less than the value contributed to the FLP — that the full Tax Court rejected in *Bongard v. Commissioner,* 124 T.C. 95 (2005).)

The decedent by an implied agreement retained the enjoyment of assets contributed to the partnership. The court listed various reasons including not retaining assets for living expenses outside the FLP, the FLP's payment of estate taxes after the decedent's death, commingling of partnership and personal assets, disproportionate distributions, making distributions primarily to provide for the decedent's support, and because of the overall testamentary characteristics (including that there was no significant change of the decedent's relationship with the assets during his life and there was minimal practical effect of the FLP during the decedent's life).

Part of the court's reasoning as to the implied agreement of retained enjoyment was that receiving guaranteed payments that represented the estimated partnership income reflects such an implied agreement. This is the first case to reason that retaining a preferred partnership interest triggers the application of §2036(a)(1), at least where the preferred return equals the estimated income of the partnership.

14. No Section 2036 Inclusion For Real Property in FLP; Nontax Reason Was Desire to Have Property Held and Managed As Family Asset, *Estate of Stone*

Synopsis

In *Estate of Joanne Stone*, T.C. Memo 2012-48, the decedent and her husband owned woodland parcels near a lake developed by their family. They told their attorney that they wanted to give real estate to various family members and the attorney recommend using a limited partnership to simplify the gift-giving process (and to guard against partitions, though that factor was not addressed by the court). After creating the partnership and transferring the woodland parcels to the partnership, the Stones gave all of the limited partnerships to their children, their spouses, and their grandchildren over a four year period. The gifts of limited partnership interests were completed about five years prior to the decedent's death. No distributions were ever made from the partnership. There were a few situations in which appropriate formalities regarding the partnership were not followed (but those lapses in following formalities seemed rather benign). The IRS apparently contended that the portion of the property's value represented by the contribution from the decedent was included in the decedent's estate under §2036. The court (Judge Goeke) disagreed, finding that the bona fide sale exception to §2036 applied.

The estate contended that a nontax motive for transferring the properties to the partnership was to create a family asset that could be managed for subsequent development and sales of lakeside homes. Though agreeing with the IRS that making transfers to an FLP for the sole purpose of simplifying gift giving was not a sufficient nontax motive for purposes of the bona fide sale exception to §2036, the court concluded that simplifying gift giving was not the only purpose of creating this FLP. The court concluded that the "decedent's desire to have the woodland parcels held and managed as a family asset constituted a legitimate nontax motive for her transfer of the woodland parcels to [the partnership]."

The court's rejected the IRS's arguments that (1) the decedent "stood on both sides of the transaction" and (2) the full consideration requirement of the bona fide sale exception was not satisfied. The court reasoned that both of those arguments failed because there was a legitimate nontax purpose and the decedent received partnership interests proportional to her contributions to the partnership. That reasoning, in effect, made both of those arguments totally irrelevant because the existence of a legitimate nontax purposes was central to satisfying the bona fide exception in any event.

Planning Observations

1. *What Did the Taxpayers Do Wrong?* In many ways, the taxpayers did all of their planning correctly and conservatively, from an estate planning perspective. While there were some minor procedural poor documentation glitches, the taxpayers did most the major things that planners suggest doing in planning FLPs, including:

    - Retain plenty of assets for living expenses;
    - Being particularly conservative, retain assets to pay all estate taxes;
    - There was a nontax reason for the partnership (to provide joint management of the property for the family members until it could be developed);
    - Do not make non pro rata distributions to the parents (indeed this partnership made *no* distributions);
    - Do not make use of the partnership assets (the only use the IRS could argue was that the parents visited their son on his adjoining personally owned property and fished on

a lake that was adjacent to the son's property and the undeveloped property owned by the partnership);

- The parents gave away all of their limited partnership interests more than three years before their deaths (planners often note that there is no §2536 — i.e., §2036 does not apply to gifts — so make lifetime gifts of limited partnership interests to avoid the difficult §2036 issues that can arise at death);
- Giving away the limited partnership interests more than three years prior to their deaths seemingly would avoid §2035 issues with respect to relinquishing §2036 interests;
- The parents had the property appraised before they made gifts of limited partnership interests;
- The parents were ultra-conservative in not applying any discounts for purposes of valuing the limited partnership interest gifts — the estate received *no* discounting advantage in transferring the 98% interests to their family members, either during life or at death;
- The value to be derived from the undeveloped property owned by the partnership was the possibility of developing and selling lakefront home sites at some point, and the parents could not possibly share in the 98% interest attributable to the limited partnership interests owned by others;
- There were absolutely no facts suggesting that parents would make distributions to themselves of assets or profits attributable to the 98% limited partnership interests that they had given away more than three years prior to their deaths—they had not made any distributions to themselves of partnership assets attributable to others;
- There was no commingling of partnership and personal assets (however, the parents had continued to pay the $700 of annual property taxes directly, which should have been documented as a contribution to the partnership);
- All of the planning was done while the parents were in good health.

From an overall perspective, the IRS could see that the partnership yielded no discounting advantages whatsoever in moving the 98% interest from the parents to their family members. The entire planning scenario seems absolutely non-abusive. The overall context makes you wonder, as Paul Harvey would say — what is "the rest of the story?" Did the estate do something to anger the IRS agent and representatives from the Justice Department trying the case to cause the government representatives to take this case to litigation?

The major thing that the parents did "incorrectly," from a totally conservative planning perspective, was to remain as the general partners. However, they could have been removed at any time by 67% of the limited partners. The briefs and pleadings are not available on the Tax Court website. Perhaps the IRS's primary argument is that the decedent's retained managerial rights, as one of the two general partners, caused §2036(a)(2) to apply, thus bringing all of the partnership assets contributed by the decedent back into the estate. Even so, there seems to be no abuse going on here — why did the IRS agents pursue this so aggressively? Does this case reflect a policy decision by the IRS to aggressively pursue potential §2036(a)(2) claims, even in situations where the argument is not made just to avoid discounting transferred interests?

2. *Facilitating Gift-Giving as Purpose*. Judge Chiechi viewed creating a partnership to facilitate gift giving as a nontax purpose in *Mirowski* (T.C. Memo 2008-74). Footnote 45 in *Mirowski* directly addresses the "facilitating gifting" issue:

> "In Estate of Bongard, we did not conclude that an intention to facilitate lifetime giving may never be a significant nontax factor. Rather, we found on the record presented there that such an intention was not a significant nontax reason for forming the partnership involved in that case."

Other cases, however, have rejected that purpose as a legitimate nontax purpose because it seems related to testamentary purposes. The fact that the underlying goal of the Stones was to make gifts to family members may have been what encouraged the IRS to litigate this case. However, that is only relevant to the §2036 bona fide sale exception — that goal is not enough to establish that the elements of §2036 are present.

3. *Significance of Making Gifts Without Applying Discounts*. The Stones made gifts of limited partnership interests without applying any discounts for gift tax purposes, and the court gave that as one of the five reasons that it cited to outweigh the fact that partnership formalities were not followed in all circumstances. There is no indication how important that factor is. Of course, knowing the significance of this factor is important because discounts typically are applied in valuing gifts of limited partnership interests for gift tax purposes. This case should not be interpreted to suggest that gifts of limited partnership interests should generally be completed without applying any discounts for gift tax purposes. The case cites *Jorgensen* (T.C. Memo 2009-66, *aff'd* 431 F.3d 544) and *Hurford* (T.C. Memo 2008-278) for the proposition that one of the factors considered in deciding whether a nontax reason exists includes "discounting the value of the partnership interests relative to the value of the property contributed." Neither of those cases suggested that a nontax reason cannot exist merely because valuation discounts were applied. *Jorgensen* observed that the documentation of the purposes of the partnership when it was formed referred only to being able to "qualify for the 35% discount." *Hurford* concluded that the *only* purpose for creating the partnership was to be able to claim discounts.

4. *Marital Deduction Issue*. This case arose at the first spouse's death. In other cases, the IRS has argued that even if all of the partnership interest passes to the surviving spouse, the gross estate would include the full value of partnership assets under §2036 but the marital deduction would be allowed only for the discounted value of the limited partnership interest passing to the surviving spouse. *E.g. Black v. Commissioner,* 133 T.C. 340; *Shurtz v. Commissioner,* T.C. Memo 2010-21.

   However, that issue may not have been raised by the IRS in this case because the decedent had given away all of her limited partnership interests, so there is no question that no marital deduction is allowed with respect to the limited partnership interests (or the value of partnership assets attributable to those interests) in any event because they do not pass to the surviving spouse. However, that "marital deduction mismatch" argument could have been made with respect to the 1% general partnership interest if that interest passed to the surviving spouse.

   The marital deduction mismatch issue is discussed in more detail below in Item 16 regarding the *Turner II* case.

15. No §2036 Inclusion For Operating Quarries and Other Real Property and Other Assets Contributed to FLP; Nontax Reasons Were to Ensure Equal Distribution of Estate Thereby Avoiding Litigation, to Provide Effective Management, and to Protect Against Potential Liabilities; No §2036(a)(1) Inclusion For Gifts of Limited Partnership Interests Because There Was No Implied Agreement to Retain Income, Management Fees Paid to Corporate General Partner Were Reasonable, §2036 Held Inapplicable WITHOUT Relying on Bona Fide Sale Exception, *Estate of Kelly*

Synopsis

In *Estate of Kelly*, T.C. Memo 2012-73, the guardianship court entered an order allowing the decedent's guardianship estate to contribute operating quarries and other real estate and other assets to limited partnerships, with a corporation owned 100% by the decedent the sole general partner. The primary concern "was to ensure the equal distribution of the decedent's estate thereby avoiding litigation." In addition, the plan provided for effective management of these types of assets requiring active management that "would lead any prudent person to manage these assets in the form of an entity." Furthermore there were concerns about specific types of potential liabilities (e.g., a prior lawsuit against the decedent, dynamite blasting, etc.) The decedent retained $1.1 million out of the partnerships, and no distributions from the partnerships (or apparently. from the corporation) were used to pay any of the decedent's living expenses. The court (Judge Foley) held that those purposes were legitimate and significant nontax reasons, and the §2036 bona fide sale for full consideration exception applied so that the contributions to the partnerships were not treated as transfers causing inclusion in the gross estate under §2036.

The decedent made gifts of limited partnership interests in the several years prior to her death. The IRS argued that "the parties had an implied agreement that decedent would continue to enjoy the income from the family limited partnerships," and that the partnership assets attributable to those gifted interests were includable in the gross estate under §2036(a)(1). Their argument was bolstered by the fact that the petition to the court for authority to implement the plan on behalf of the ward specifically observed that the ward would own all of the outstanding stock of the corporate general partner and that the reasonable management charge "will ensure that the ward will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the ward's lifetime …."

The court disagreed, observing among other things that the parties respected the entities and entity formalities, the decedent retained assets for paying living expenses (and the management fee dollars paid to the corporation were not used to pay the decedent's living expenses), fiduciary duties prevented paying more than a reasonable management fee, and the management fee paid to the company was in fact reasonable. The comment in the guardianship petition about the management fees providing adequate income to cover living expenses was "merely an expression of financial benefits decedent could receive" and not a legally binding directive. Assets attributable to the gifted limited partnership interests were not included in the estate under §2036(a)(1). This is one of the few cases to hold that §2036 does not apply (even as to part of the case) without relying on the bona fide sale exception to §2036.

Analysis

1. *Section 2036 Bona Fide Sale for Full Consideration Exception Applied to Contributions to Limited Partnerships.* The decedent's primary concern was to ensure equal distribution of the estate thereby avoiding the litigation. In addition, the decedent was legitimately concerned about effective management, because the three children's management of the properties as co-guardians was cumbersome. The decedent was also concerned with potential liability relating to her assets. The court stated explicitly that her properties

required active management that "would lead any prudent person to manage these assets in the form of an entity."

While the petition to the court seeking authority for the guardians to implement the plan referred to estate tax savings, "there is no evidence that tax savings motivated decedent." The children had not considered tax ramifications before contacting the attorney for advice.

As to the "bona fide sale" requirement, the court began its analysis noting that the transfers met this requirement because the decedent had legitimate and significant nontax reasons for creating the limited partnerships. At the end of its analysis of this issue, the court summarized:

> "Decedent's primary motive was to ensure effective property management and equal distributions among the children--not minimization of tax liability. Decedent had valid nontax reasons to contribute property to the limited partnerships."

As to the "adequate and full consideration" element of the exception, the court summarized:

> "Furthermore, decedent received partnership interests equal in value to the assets she contributed to the limited partnerships. Estate of Bongard v. Commissioner, 124 T.C. at 118. As stipulated by respondent, decedent's contributions were properly credited to her capital account."

2. *Section 2036(a)(1) Does Not Cause Inclusion of Assets Attributable to Gifts of Limited Partnership Interests.* The bona fide sale for full consideration exception obviously does not apply to *gifts* of the limited partnership interests. The IRS argued that "the parties had an implied agreement that decedent would continue to enjoy the income from the family limited partnerships." Their argument was bolstered by the fact that the petition to the court for authority to implement the plan on behalf of the ward specifically observed that the ward would own all of the outstanding stock of the corporate general partner and that the reasonable management charge "will ensure that the ward will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the ward's lifetime …"

   The court disagreed, noting various reasons.

- The partnerships and corporate general partner were respected as separate and distinct legal entities.
- Partnership formalities were observed.
- The decedent retained sufficient assets for personal needs.
- Living expenses were paid from the guardianship account and the management fee was not used to pay these expenses.
- The general partner's fiduciary duty and contractual terms of the partnerships restricted decedent from requiring the partnerships to pay more than a reasonable fee to the general partner.
- The management fee was reasonable; indeed, the children selected fees that were lower than the industry standard.
- The decedent had a bona fide purpose for creating the corporation to manage the partnerships; her health prevented her from managing the property and using an entity to act as general partner was a natural choice.

As to the comment in the petition about the management fees providing adequate income to cover living expenses, the court reasoned that language was "merely an expression of financial benefits decedent could receive. It is not, however, a legally binding directive to provide her support and maintenance. To do so would be inconsistent with the partnership agreements and violated fiduciary duties imposed upon the general partner."

In summary, the court noted that the partnership agreements call for payment of income to the corporate general partner, not to the decedent.

> "In essence, respondent is requesting that the court disregard [the corporation's] existence, the general partner's fiduciary duty, and the partnership agreements. We will not do so. Decedent did not retain an interest in the transferred family limited partnership interests."

Planning Observations

1. *A Rarity.* This is one of few cases to hold that §2036 does not apply to assets in an FLP (even as to part of the case) without relying on the bona fide sale exception to §2036. The bona fide sale for full consideration exception did not apply to the second issue, regarding including partnership assets attributable to *gifted* limited partnership interests. The court determined that there was no implied agreement of retained enjoyment under §2036(a)(1).*That is a first.* No other reported case has determined that facts that might suggest an implied agreement of retained enjoyment were not sufficient to invoke §2036(a)(1). The other case holding that §2036 did not apply as to gifted limited partnership interests is *Estate of Mirowski v. Commissioner,* T.C. Memo. 2008-74.

2. *They Did it Right!!* The parties respected the various entities, observed formalities, and took reasonable steps each step of the way in doing so. The children obviously had excellent advice. The children carefully respected the management responsibility of the corporate general partner by providing their services as employees of the corporation and taking reasonable steps to determine an appropriate management fee to be paid to the corporation and to determine their respective salaries based on the services that they performed for the corporation.

   The one significant thing that could have been improved was not to make such explicit reference to the maintenance fee providing adequate income to cover living expenses of the ward. It would seem that the planners could have finessed a little more regarding the ability to provide for the ward's continuing needs out of the guardianship estate and still been able to obtain court approval of the plan to form the partnerships and corporation.

3. *Active Management Needed.* This case is a far cry from a partnership involving totally marketable securities with a concern for centralized management of the portfolio. Active management of the operation of the two quarries and other real estate properties (including a recreational property with a large waterfall, multiple rental homes and a post office) were clearly needed. The children collectively spent 60 to 80 hours a week managing the assets as employees of the corporate general partner. Indeed, the court concluded, quite appropriately, that the properties "required active management and would lead any prudent person to manage those assets in the form of an entity."

4. *Ensure Equal Distributions Purpose.* The court concluded that the decedent's primary concern (again, apparently through her guardians) "was to ensure the equal distribution of decedent's estate thereby avoiding litigation."

On the one hand, this sounds like a *testamentary purpose* that some courts have refused to recognize as a legitimate nontax reason for purposes of this bona fide sale exception. *E.g., Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007)("gift giving is considered a testamentary purpose and cannot be justified as a legitimate, nontax business justification"); *Estate of Thompson,* 382 F.3d 367 3d Cir. 2004) (purpose of §2036 is to include "transfers that are essentially testamentary in nature" [quoting *U.S. v. Grace* Supreme Court case]; loans from partnership to family members were "largely testamentary in practice;" concludes that any legitimizing effect of the partnership "is overwhelmed by the testamentary nature of the transfer and subsequent operation of the partnership"); *Estate of Rector*, T.C. Memo 2007-367 ("The estate's stated goal of gift-giving is a testamentary purpose and is not a significant nontax business").

A purpose of equalizing distributions is similar to a purposes of facilitating gift giving, and a number of cases have concluded that facilitating gift giving (to simplify the mechanical process of making gift transfers) is "considered a testamentary purpose and cannot be justified as a legitimate, nontax business justification." *Estate of Stone,* T.C. Memo 2012-48 (quoting *Estate of Bigelow*). While a number of courts have repeated that general viewpoint, some have suggested that facilitating gift giving *can* be a legitimate nontax purpose. *Estate of Mirowski,* T.C. Memo 2008-74, at n.45.

On the other hand, the creation of partnerships "to ensure the equal distribution of decedent's estate thereby avoiding litigation" is reminiscent of the facts of *Estate of Eugene Stone*, T.C. Memo 2003-309, in which the court concluded that the creation of partnerships to settle family hostilities constituted a legitimate nontax purpose.

In any event, it is significant that the court recognized the creation of the partnerships as a way to equalize distributions as constituting a legitimate nontax reason for purpose of the §2036 bona fide sale exception.

5. *Minimizing Potential Liabilities.* A number of cases have refused to recognize planning to avoid potential liabilities as a legitimate and significant nontax reason for creating the partnership. However, most of those have focused on the fact that there was no showing of a specific creditor concern on the particular facts of the case. *E.g., Estate of Bigelow,* 503 F.3d 955 (9th Cir. 2007); *Estate of Korby*, 471 F.3d 848, 854 (8th Cir. 2006)(creditor concern from liabilities associated with bridge-building and divorce liability; court rejected creditor concern as legitimate nontax purpose because of lack of showing that partnership would prevent a creditor of a partner from obtaining that partner's interest in an involuntary transfer); *Estate of Strangi*, 417 F.3d 468, 480 (5th Cir. 2005)(concern over possible personal injury claim rejected as a legitimate nontax purposes where maid had never threatened such action); *Estate of Liljestrand*, T.C. Memo 2011-259 (no single creditor or pattern of activity that could open partners to potential liability).

   In this case, there were very real and specific creditor concerns (such as actual lawsuits against the decedent from accidents at the quarries, dynamite blastings, and finding bullets in the fireplace at the waterfall property). Other courts have recognized creditor concerns as a legitimate purpose, where they existed under the particular facts of the case. *E.g., Estate of Kimbell,* 371 F.3d 257, 268 (5th Cir. 2004)(acknowledging legitimate risk of personal liability where decedent transferred working interest in oil and gas properties to partnership).

Interestingly, even in this case where the potential liability concerns seemed very real, the court did not mention the potential liability issue in its summary conclusion of why the decedent had valid nontax reasons.

6. *Receiving Management Fee as General Partner Not a Retained Income Interest Under §2036(a)(1).* Apparently there were no distributions from the limited partnerships during the decedent's lifetime, and the IRS's only argument under §2036(a)(1) was that the payment of management fees to the corporate general partner reflected an implied agreement of retained enjoyment of the income. The facts of this case contrast sharply with those in *Estate of Korby*, 471 F.3d 848, 853 (8th Cir. 2006), where the court viewed the estate as in effect recharacterizing distributions to the decedent from the partnership as management fees. In *Estate of Turner,* T.C. Memo 2011-209, the court similarly viewed the payment of a $2,000 per month management fee to the decedent and his wife as general partners as invoking §2036(a)(1), even though $24,000 per year seems very reasonable for managing a portfolio of over $9 million. However, in the court's view they performed few if any services.

   In this case, again, the parties "did it right." They took steps to determine appropriate management fees for a comparable situation in the local community, and they clearly documented the management fee arrangement. After one year, when they had more experience with the services that were being provided, they revisited the amount of the management fee. Furthermore, on the facts, it appears that the management fee was paid to the corporate general partner, and even though the decedent owned 100% of the stock of the corporation, none of those management fee dollars were actually used to pay any of the living expenses of the decedent.

7. *No §2036(a)(2) Argument.* The case does not discuss §2036(a)(2), and apparently the IRS made no argument for estate inclusion of assets attributable to the gifted limited partnership interests, despite the fact that the decedent was the 100% owner of the corporate general partner. Section 2036(a)(2) can apply if the decedent makes a transfer and retains the right to designate who can possess or enjoy the property or the income therefrom. The Service's approach toward applying §2036(a)(2) is curious at best. In some cases, like this one, where there seems to be at least a credible argument under §2036(a)(2), the issue is not raised at all. In other recent cases, however, the IRS has raised §2036(a)(2). *E.g. Estate of Turner*, T.C. Memo 2011-209 (§2036(a)(2) applied; decedent one of two co-general partners; not only broad authority to manage the partnership and decide when to make distributions, but general partner could amend the partnership agreement at any time without the consent of limited partners).

16. If §2036 Applies to Assets Contributed to FLP, Asset Value Attributable to Limited Partnership Interests That Had Been Given Away During Life to Children and Grandchildren Cannot Qualify for Estate Tax Marital Deduction; "Marital Deduction Mismatch" Issue Discussed But Not an Issue in Case, *Estate of Turner II*

Synopsis

This case supplements the Tax Court's opinion in *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209. (The court's supplemental opinion at 138 T.C. No. 14 is referred to as "*Turner II.*") The initial decision held that the bona fide sale exception to §2036 did not apply, and assets that the decedent contributed to the partnership were included in the gross estate under §2036. The

estate's motion for reconsideration asked the court to reconsider (i) the §2036 issue and (ii) a marital deduction issue.

After reviewing various stipulated facts that the estate said were inconsistent with the court's finding that there was no legitimate and significant nontax reason for forming the partnership, the court concluded in this supplemental opinion that there was no manifest error of fact, and left intact its finding applying §2036.

The *Turner* case was a situation in which there was a surviving spouse, but the initial case did not discuss how the marital deduction would apply. The taxpayer argued that the decedent's will contained a formula marital deduction clause and that the marital deduction should offset any value included in the gross estate under §2036. The marital deduction issue addressed in this supplemental opinion is whether a marital deduction is allowed for partnership assets attributable to 21.7446% limited partnership interests that the decedent had given to various family members (other than his spouse) during his lifetime. The court concluded that because the surviving spouse did not receive those 21.7446% limited partnership interests, no marital deduction is allowed for the value of assets attributable to those interests that are included in the gross estate under §2036. The court reasoned that the statutory and regulatory marital deduction provisions as well as the overall structure of the wealth transfer system support that result.

The IRS has made a "marital deduction mismatch" argument in several reported cases (*Estate of Black v. Commissioner* and *Estate of Shurtz v. Commissioner)*. In those cases, the IRS argued that while partnership or LLC assets may be included in the gross estate under §2036 (without a discount), all the estate owns to leave to the surviving spouse is the limited partnership or member interest (subject to discounts for lack of marketability and lack of control). There would be estate inclusion at a high level and a marital deduction at a lower discounted level, resulting in the possibility of having to pay substantial estate taxes at the first spouse's death. The Tax Court did not have to address this marital deduction mismatch issue in those two prior cases because the court held that §2036 did not apply. This classic marital deduction mismatch issue does not arise in *Turner II* because the IRS allowed a marital deduction for the full value of assets attributable to partnership interests that the decedent owned at his death, and that could pass to the surviving spouse under the formula marital deduction bequest in the decedent's will.

Perhaps the most significant aspect of this opinion, from a planning perspective, is the impact that it might have on the marital deduction mismatch issue when it is addressed by some court in the future. Some of the reasoning in the case about the overall structure of the wealth transfer tax system may support the government's argument that a marital deduction should not be allowed for the full value included in the estate under §2036. (However, there are also counterarguments, and at this point there is considerable uncertainty how the courts will eventually rule on the marital deduction mismatch issue.)

Basic Facts

The decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets outside the partnership, the income from which was sufficient to provide their living expenses. In late 2002 and early 2003, the decedent and his wife each made gifts of 21.7446% limited partnership interests to family members. The decedent and his wife paid themselves management fees of $2,000 per month although they provided few if any management services. After the gifts of partnership interests were made, no distributions were made to the family members prior to the decedent's death, but various payments were made to the decedent and his wife (although they were treated as repayment of

advances made by the decedent and not as distributions). The decedent used partnership funds for personal uses (making gifts, making insurance premium payments, and paying estate planning legal fees).

At the decedent's death, he owned a 0.5% general partnership interest and a 27.7554% limited partnership interest. These were reported in the estate tax return after applying lack of marketability and lack of control discounts at $1,608,984 (as opposed to a pro rata share value of the partnership's assets equal to $2,681,074, based on total asset value of $9,488,714 as used in the government's computation for entry of decision). The decedent's will contained a standard formula marital deduction bequest, and the estate tax return reported that an 18.8525% limited partnership interest was allocated to the surviving spouse and an 8.9020% limited partnership interest to a bypass trust. The estate claimed a marital deduction of $1,072,000 for the 18.8525% interest allocated to the spouse. (Therefore, the partnership interest allocated to the bypass trust would have been worth $506,241. The case does not reflect whether any other assets were allocated to the bypass trust, or whether the decedent only had $506,241 of estate tax "exemption" left at his death.)

Tax Court's Initial Opinion, T.C. Memo. 2011-209 (August 30, 2011)

The court (Judge Marvel) concluded that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036. (This initial decision is referred to as *Turner I.*) The bona fide sale exception to §2036 did not apply. The court rejected the purported nontax reasons urged by the estate: asset consolidation and centralized management, resolving family disputes, and asset protection for one grandchild.

After determining that the bona fide sale for full consideration exception to §2036 did not apply, the court held that there was an express and implied agreement for retained enjoyment of the transferred assets triggering inclusion under §2036(a)(1), even though the decedent and his wife had retained assets outside the partnership that were sufficient to pay their living expenses. Factors pointed out by the court include: (i) an unreasonably high management fee, (ii) the couple transferred most of their assets to the partnership, (iii) disproportionate distributions, (iv) taking distributions "at will," (v) use of partnership assets for personal uses, and (vi) the testamentary nature of the partnership's purpose. The court also stated that §2036(a)(2) would apply (in part relying on the "alone or in conjunction with any person" language in §2036(a)(2)). The court pointed to several powers of the decedent as general partner, without indicating how important each was in its conclusion that §2036(a)(2) applied: (i) the sole and absolute discretion to make distributions of partnership income, (ii) the ability to make distributions in kind, and (iii) the ability to amend the partnership without the consent of limited partners. The court's rationale for applying §§2036(a)(1) and (a)(2) are not at issue in *Turner II*.

The decedent's payment of insurance premiums on policies owned by an irrevocable life insurance trust were indirect gifts that qualified for the annual exclusion because the trust's Crummey withdrawal provision specifically applied to indirect gifts; therefore the gifts were not "adjusted taxable gifts" for purposes of calculating the estate tax. Whether the beneficiaries knew of the indirect gifts or of their withdrawal rights was irrelevant because they had the legal power to withdraw the indirect gift amount. This annual exclusion issue also is not involved in *Turner II* considering the estate's motion for reconsideration.

Government's Computation for Entry of Decision

Turner I held that one-half of the partnership assets (attributable to the decedent's one-half of contributions to the partnership) were included in the gross estate. The government's computation for entry of decision allowed an increased marital deduction for the portion of the assets attributable to the 28.2554% partnership interests held by decedent at his death. However, it did not allow a marital deduction for the portion of the assets attributable to the 21.7446% interests that had been given to children and grandchildren during the decedent's lifetime.

Taxpayer's Motion for Reconsideration (filed September 29, 2011)

Taxpayer's Motion for Reconsideration raised two issues: (1) "[T]he record contains stipulated facts which confirm that the Court's findings and opinion in connection with the application of section 2036 [and in particular the findings and opinion that the bona fide sale for full consideration exception do not apply] should be modified;" and (2) "the marital deduction should apply against the full value of assets included in the decedent's estate under section 2036 and therefore Mr. Turner's estate would have no additional tax liability."

The taxpayer succinctly summarized its marital deduction argument as follows:

> "(i) If section 2036 requires the Estate to use a certain value for purposes of valuing Clyde Sr.'s gross estate, the same value must also be used for purposes of calculating the marital deduction. *See Provident Nat'l Bank v. United States*, 581 F.2d 1081, 1091 (3d Cir. 1978).
>
> (ii) It is contrary to legislative intent to calculate the gross estate by attributing value to certain rights allegedly retained by Clyde Sr., but at the same time ignoring the value of those rights when calculating the marital deduction.
>
> (iii) The surviving spouse's right to the pecuniary marital bequest takes precedent over all other bequests provided in the Will and is enforceable under Georgia law, thus mandating that the surviving spouse receive assets equal in value to the amount necessary to reduce estate taxes to zero."

Central to the taxpayer's marital deduction argument was an alleged *procedural* defect in the government's handling of the marital deduction issue in the litigation. The taxpayer argued that the government

> "failed to address the marital deduction argument in either his pretrial memorandum or in his opening brief. Respondent addressed the marital deduction issue for the first time in his reply brief after trial, where his only statement in support of denying an increase to the marital deduction is the following: 'The value of the assets that Clyde Turner gifted to his children and grandchildren during his life is never eligible for the marital deduction.' . . . Respondent should be prohibited from raising any marital deduction argument for the first time in his reply brief nor should he be provided the opportunity to address the issue now. *See Coburn v. Commissioner,* 90 T.C. M. (CCH) 563 (where Respondent raised an argument in his reply brief but failed to raise such argument in his trial memorandum or opening brief, the Court found '[R]espondent is prohibited from raising such an issue for the first time on brief") (citing *Smalley v. Commissioner,* 116 T.C. 450, 456 (2001)). To date, Petitioner still has no understanding of Respondent's position on the critical marital deduction issue that would impact any Rule 155 computations."

Holdings

1. The bona fide sale exception to §2036 does not apply; the estate did not demonstrate any manifest error of fact in the original determination denying the availability of the bona fide sale exception to §2036.
2. Marital deduction is not allowed with respect to the portion of partnership assets included in the gross estate that is attributable to partnership interests that had been given to children and grandchildren during the decedent's lifetime (and that did not "pass" to the surviving spouse).

Analysis

1. *Bona Fide Sale Exception to §2036 Does Not Apply.* The taxpayer's motion for reconsideration argued primarily that various findings by the court in *Turner I* that supported its conclusion that there was not a legitimate and significant nontax reason for contributing assets to the partnership (and that the bona fide sale exception to §2036 therefore did not apply) were contrary to various stipulated facts. For example, the initial opinion noted one fact that it viewed as especially important as it weighed the overall credibility of the witnesses' testimony about the purported nontax reasons for the partnership. The motion for reconsideration viewed that this perception was based on a "clearly erroneous" finding:

   > "Petitioner's first ground for reconsideration is to correct the foundation upon which the Court found that Petitioner failed to show by a preponderance of the evidence that Mr. Turner had no legitimate and significant nontax reason for forming Turner & Co., LP. As this Court recalls, Respondent primarily challenged only the credibility of the witnesses who testified about the nontax reasons for formation of the partnership. . . . Ultimately, the Court found Petitioner was allegedly not forthright regarding any 'tax savings' discussion during the Turners' initial meeting with their lawyer and the 'implausibility' of such assertion tainted all of the testimony from witnesses regarding the nontax reasons for formation of Turner & Co.:
   >
   > > We are particularly struck by the implausibility of petitioner's assertion that tax savings resulting from the family limited partnership were never discussed during a meeting focusing in part on estate planning. We do not find testimony to that effect to be credible, and that lack of credibility infects all of the testimony petitioner offered about what Clyde Sr. allegedly said or intended about the purpose of the family limited partnership. Op. at 50-51.
   >
   > With all due respect, this finding is clearly erroneous and an unfair characterization of what Petitioner asserted, and such finding is contrary to stipulated facts by the parties. Petitioner addressed with Mr. Coyle, the Turners' lawyer, the 'tax savings' discussion from the first face-to-face meeting between the Turners and their lawyers *in the first hour of trial testimony. . . .*" (Emphasis in original.)

   Throughout its discussion of the impact of stipulated facts on various issues, the motion pointed out that the government did not object to the stipulation. The court responded that while it has "on occasion deemed the lack of objection to a proposed finding of fact to be a concession that it is correct except to the extent that it is clearly inconsistent with

the opposing party's brief, [citations omitted] we find facts on the basis of the record as a whole. . . ." The court addressed various such stipulations and issues. For example, as to the tax savings discussion that occurred at the first meeting of a strategy that "would have provided them greater tax benefits than they could achieve from a limited partnership," the court did not discuss its finding of "particular" concern about the witnesses' testimony because of an assertion of a lack of discussion about tax savings of family limited partnerships at any meeting. Instead, the court responded that "the rejection of another tax planning vehicle does not establish a nontax reason for the creation of" the FLP.

After addressing a number of such stipulations and issues, the court concluded that "[t]he estate has not demonstrated any manifest error of fact" and denied the motion for reconsideration regarding §2036.

2. *Marital Deduction Mismatch General Issue Not Addressed*. The general marital deduction mismatch issue arises when assets are included in the gross estate of the first-decedent spouse. The IRS has argued in several cases that while the full asset value is included in the gross estate, all the estate has to leave to the surviving spouse is a limited partnership interest (because it does not own the partnership assets directly), and that marital deduction should be allowed only for the discounted value of the limited partnership interest. That is all the estate owns to "pass" to the surviving spouse, as described in §2056. In effect, the IRS argues that the tax fiction that applies for purposes of the value to be included in the gross estate under §2036 should not also apply consistently for purposes of the marital deduction. The IRS has made this argument in *Estate of Black v. Commissioner*, 133 T.C. 340, 342 (2009) (issue is "whether the marital deduction to which Mr. Black's estate is entitled under section 2056 should be computed according to the value of the partnership interest that actually passed to Mrs. Black or according to the value of the underlying stock apportionable to that interest" which was included in the gross estate under §2036) and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21. The court did not have to address the marital deduction mismatch issue in either of those cases because the court held that §2036 did not apply in those cases. Footnote 5 of *Turner II* briefly discusses the marital deduction mismatch issue and the Tax Court's references to the issue in *Estate of Black* and *Estate of Shurtz*.

The court observes that the general marital deduction mismatch issue does not arise in this case, because the government's computation for entry of decision

> "allowed an increased marital deduction that he calculated on the basis of the value of assets transferred in exchange for the partnership interests that Clyde Sr. held at death, rather than on the basis of the discounted values of the general and limited partnership interests that Clyde Sr. owned at death, to the extent that they passed to Jewell. The estate recognizes that, and *we leave this mismatch problem for another day*." (Emphasis added.)

It is not clear whether the IRS inadvertently failed to raise the valuation mismatch issue in *Turner*. Perhaps it did not do so because the surviving wife was the sole general partner and the agreement may have permitted her unilaterally to decide to liquidate the partnership at any time.

[Observation: While the court does not address the classic marital deduction mismatch issue, some of the reasoning of the court regarding the next issue may have some relevance to the marital deduction mismatch issue when it is eventually decided by a court.]

For an excellent discussion of the marital deduction mismatch issue and *Turner II*, see Blattmachr, Gans & Zeydel, Turner II *and Family Partnerships: Avoiding Problems and Securing Opportunity,* 117 J. TAX'N 32 (July 2012).

3. *Marital Deduction Not Allowed For Partnership Assets Attributable to Limited Partnership Interests That Were Given to Children and Grandchildren (And That Did Not Pass to Surviving Spouse)*. The positions of the parties were summarized by the court. The taxpayer's argument, as summarized by the court:

> "In the estate's view, section 2036 applies a legal fiction for purposes of calculating the gross estate, and, for consistency, the marital deduction can also be increased to reflect that fiction. The estate argues that it would be inconsistent to conclude that Clyde Sr. retained a right to possess or enjoy assets he contributed to the partnership and at the same time ignore the values of those assets included in the gross estate under section 2036 in calculating the marital deduction."

The government's position was that

> "Clyde Sr. no longer owned the assets underlying the transferred partnership interest or the partnership interest itself and therefore he could not pass either to Jewell. Respondent contends that although section 2036 pulls the assets into the estate, the assets do not qualify for the marital deduction.

The issue, as framed by the court:

> "We must decide whether the estate may apply the marital deduction formula provision to increase the amount of the marital deduction for the assets that are part of the gross estate yet do not actually pass to the surviving spouse."

The court had little difficulty (but taking over seven pages of the opinion) in concluding that based on the statutory and regulatory provisions for the marital deduction and based on the overall structure of the wealth transfer system (which allows a marital deduction only as a *deferral* of tax until the death of or gift by the surviving spouse), a marital deduction is not allowed for the partnership assets included in the gross estate attributable to the gifted limited partnership interests:

> "Although the formula of Clyde Sr.'s will directs what assets should pass to the surviving spouse, the assets attributable to the transferred partnership interest or the partnership interest itself are not available to fund the marital bequest; their disposition to the donees occurred during Clyde Sr.'s lifetime but is deemed delayed until Clyde Sr.'s death by our holding that section 2036 applies. Because the property in question did not pass to Jewell as beneficial owner, we reject the estate's position and hold that the estate may not rely on the formula of Clyde Sr.'s will to increase the marital deduction."

The court's reasoning regarding the overall structure of the wealth transfer system may be relevant when the court eventually addresses the marital deduction mismatch issue in a case in which the decedent's limited partnership interests are available to pass to the surviving spouse at the decedent's death. The court reasoned that the structure of the estate tax allows a marital deduction under the assumption that the assets will be taxed when the spouse makes a gift or at the surviving spouse's subsequent death.

> "The policy behind the marital deduction rule is that property passes untaxed from the first spouse to die to his or her surviving spouse but then is included in the

> estate of the surviving spouse. [Citations omitted.] The marital deduction therefore does not eliminate or reduce the tax on the transfer of marital assets out of the marital unit but permits deferral until the death or gift by the surviving spouse.
>
> As follows from the foregoing, allowing a marital deduction with respect to an asset to the estate of the first spouse to die presupposes that the surviving spouse, if she does not consume the asset, would include it in the transfer tax base (subject to applicable exemptions), either when she makes a gift of the property during her lifetime or upon her death."

The court reasons that the surviving wife could not consume partnership assets attributable to the gifted interests or make a gift of those assets. As to whether the value would be included in the surviving spouse's gross estate at her subsequent death:

> "Lastly, Jewell would not include the partnership interest that Clyde Sr. had transferred as gifts during his lifetime or the assets attributable to it in her gross estate because none of the Code provisions would require her to do so. . . . Sections 2034 through 2045 require the inclusion of several narrowly defined classes of assets, none of which would apply to the assets we are considering. Allowing a marital deduction for the transferred partnership interest or the assets would allow them to leave the marital unit without a transfer tax either at the death of the first spouse or upon the transfer by gift or at the death of the second spouse."

[As discussed in the **Planning Observations** below, this reasoning might suggest that even if the estate owned the partnership interests to leave to the surviving spouse, the court might not allow a marital deduction for the full value included under §2036 because that full value would not be included in the surviving spouse's estate at her subsequent death. Section 2036 would not apply to the spouse because she did not originally transfer the assets to the partnership attributable to the partnership interest that she receives from the decedent.]

Planning Observations

1. *Section 2036*. This supplemental opinion offers no additional learning about planning to avoid §2036. The court considered the various factual details in the record, generally stipulated by the government, but was not persuaded that the overall record reflects the existence of a legitimate and significant nontax reason.

   The most important substantive discussion regarding §2036 in *Turner II* is about whether consolidated asset management can be a legitimate and significant nontax purpose. [Observation: This issue is significant for planning purposes because consolidated asset management is often cited as a nontax reason for placing assets in an entity with a management structure for the entity.] The estate requested the court to reconsider its statement in *Turner I* that consolidated asset management generally is not a significant nontax purpose for forming an FLP except for assets requiring active management or special protection. The supplemental opinion acknowledged that some cases have recognized asset management consolidation as a legitimate and significant purpose, but not where the FLP is "just a vehicle for changing the form of the investment in the assets, a mere asset container." (That obviously is a generic statement yielding no learning on what it takes to avoid being a proverbial "mere asset container.") The court then reasons in a rather circular manner about asset management as a nontax reason. The estate asked the

court to reconsider its statement that the Turners' concern about asset management "could have been readily addressed without transferring the assets to a family limited partnership," because taxpayers are free to choose among alternative structures without maximizing tax revenue. The court's response is that the taxpayer has the freedom of choice, but a judicial limitation in the context of the bona fide sale exception to §2036 is the existence of a legitimate and significant nontax reason. In effect, the court says asset management is not a legitimate and significant nontax reason because the taxpayer could have accomplished the same result with another structure, but it could not choose another structure (for purposes of applying the bona fide sale exception) unless there is a legitimate and significant nontax reason. That sounds like a classic "Catch 22," without guidance on when asset management can be a legitimate and significant nontax reason.

2. *Economic Impact of Denial of Marital Deduction for Value Attributable to Gifted Limited Partnership Interests.* The facts of the case are not totally clear, but apparently the government's calculations reduced the value allocated to the bypass trust to zero under the operation of the formula marital deduction bequest, but the additional value included in the gross estate far exceeded the estate's estate tax exemption, resulting in an estate tax deficiency. Stated differently, presumably the court allowed a marital deduction for the full value of all estate assets passing under the will (other than specific bequests, if any, to individuals other than the spouse) which would pass to the decedent's wife under the formula marital deduction bequest, or that passed by beneficiary designation to the surviving spouse; provided, however, the marital deduction would be reduced by any estate taxes payable out of the assets that would have otherwise passed to the surviving spouse. That last clause results in the big economic impact.

   The effect of having no marital deduction to offset the value included under §2036 attributable to the gifted partnership interests is exacerbated because the resulting estate tax itself would not qualify for the marital deduction. For example, under the facts of *Turner II*, the pro rata portion of the partnership assets includable under §2036 attributable to the gifted interests is $9,488,714 (the total value of partnership assets used in the government's computation for entry of decision) x 0.217446, or $2,063,283. Assume that $1,500,000 of that is absorbed by the 2004 applicable exclusion amount of $1,500,000. (Because §2036 applied to assets attributable to the limited partnership interest gifts, the IRS did not include the value of the gifts of limited partnership interests as adjusted taxable gifts. Assume that no other adjusted taxable gifts had been made so that all of the $1,500,000 applicable exclusion amount for 2004 was available.) That leaves about $563,000 that would generate estate tax. This would initially produce an added estate tax of $255,400. However, that $255,400 also does not qualify for the marital deduction, producing still more tax. A circular computation is required. Ultimately, the estate tax liability would be about $491,000 attributable to the additional $2,063,000 in the gross estate. (i.e., the combined $2,554,000 less the $1.5 million exemption, leaves $1,054,000 million; using a tax rate of 45% on the first $500,000 [i.e., the bracket from $1.5 million to $2.0 million] and a tax rate of 48% on the next $554,000 [the bracket above $2.0 million] yields a tax of $491,000).

   One strategy that may assist in minimizing the "circular calculation effect" if estate taxes are paid out of the marital share is that the decedent's will could have an apportionment clause that would not override §2207B, so that estate taxes attributable to the inclusion of assets in the gross estate under §2036 would be apportioned to the recipient of those assets. That would allocate estates taxes to the recipients of lifetime gifts of partnership

interests to which §2036 applied. However, that would not help with respect to limited partnership interests still owned by the decedent at his or her death. If the difference between the undiscounted value included under §2036 with respect to those assets exceeds the discounted value of those assets for which a marital deduction is allowed exceeds the decedent's remaining estate tax exemption amount, the excess will generate estate taxes that are necessarily payable out of the marital share and will trigger the circular calculation.

3. *Impact of Case on Future Consideration of Marital Deduction Mismatch Issue.* The most significant aspect of this case is its possible impact on a future court that considers the classic marital deduction mismatch issue. This situation arises when a spouse contributes assets to an FLP, retains most of the partnership interests until his death, dies with a formula marital deduction clause that leaves assets to the surviving spouse to minimize estate taxes, and the assets contributed to the partnership are included in the gross estate under §2036. In two reported cases (*Black* and *Shurtz)*, the IRS has made the argument while the partnership *assets* are included in the gross estate, the estate actually only owns a limited partnership or LLC *interest* and does not own the assets directly. All the estate can leave the spouse (i.e., all that can "pass" to the spouse for marital deduction purposes under §2056) is a discounted entity interest. Thus, there would be estate inclusion at a high level (without a discount) but the marital deduction would be allowed at a much lower level (taking into account discounts). That difference would first reduce the amount passing to the bypass trust, but if that difference were more than the remaining estate tax exemption amount available to the estate, there would be estate taxes due at the first spouse's death. *See generally* Angkatavanich, *Black Shirts (Black, Shurtz) and the Marital Deduction Mismatch*, TRUSTS & ESTATES 37 (June 2010).

   No court has yet faced the marital deduction mismatch issue. A tax fiction deems the assets that were transferred in the §2036 transaction to be in the gross estate, and the issue is whether that same tax fiction is applied for deduction purposes as well. On the one hand, the estate only owns the discounted limited partnership interest, so arguably that is all that can "pass" to the surviving spouse for purposes of the marital deduction's "passing" requirement. On the other hand, a sense of consistency and fairness arguably may suggest that the fiction should apply for marital deduction purposes as well as estate inclusion purposes. The concept of the marital deduction is that a couple can avoid estate taxes at the first spouse's death, deferring estate taxes until the second spouse's death, and it may not be possible to avoid having to pay large estate taxes at the first spouse's death if a full marital deduction is not allowed. Take the simple situation in which all of the estate is passing to the surviving spouse and the estate owns a 99% interest in the partnership that is left to the spouse. That is not a situation (like in *Turner II)* where the decedent had made gifts of most of the partnership interests to persons other than the spouse. The spouse is receiving all of the estate and all of the partnership interest related to the assets included under §2036, so arguably there should be marital deduction for all of that value. Or consider a situation in which the decedent made a lifetime gift of all of his partnership interests to the surviving spouse, but the court applies §2036. Again, the very asset that gives rise to §2036 also ends up in the hands of the surviving spouse and a sense of consistency may suggest that the marital deduction should match the inclusion amount.

   No analogous situations are obvious. Most §2036 situations involve the transfer of interests to others and the decedent retains certain rights or powers that trigger §2036. The transferred asset is not left to the surviving spouse, and (like in *Turner II*) it seems

rather obvious that a marital deduction should not be allowed for the asset included in the estate under §2036. Part of the reason for the lack of analogous §2036 situations is the very nature of applying §2036 to the contribution of assets to an entity owned by the decedent. That is a quite unusual application of §2036. (Indeed, before the courts started accepting the §2036 argument for transfers to FLPs, it was not at all clear that §2036 would apply. The IRS made various other arguments attacking FLP discounts, but about the only one that "stuck" was the §2036 argument.)

Some of the reasoning in *Turner II* may be relevant to the marital deduction mismatch issue. The court reasoned, in part, that the overall structure of the wealth transfer system allows a marital deduction as a deferral mechanism, under the assumption that the asset responsible for the deduction will be in the surviving spouse's transfer base if it is not consumed. If the assets that a decedent had contributed to an FLP are included in the gross estate under §2036, even if the related partnership interest passes to the surviving spouse, the partnership assets attributable to that interest (at their undiscounted value) would not be included in the spouse's gross estate under §2036. Section 2036 applies to assets that are *transferred* by a decedent in which the decedent retained certain interests or powers. Because she did not transfer the assets to the partnership, §2036 could not cause the partnership assets to be included in the spouse's estate at her subsequent death. A statement in the *Turner II* decision applying this concept, though not stated in the context of the classic marital deduction mismatch situation, seems to suggest that a marital deduction would not be allowed for the full undiscounted value of partnership assets included in the first decedent's estate under §2036:

> "Allowing a marital deduction for the transferred partnership interest *or the assets* would allow them to leave the marital unit without a transfer tax either at the death of the first spouse or upon the transfer by gift or at the death of the second spouse." (Emphasis added.)

Indeed, that is precisely the argument that the government made in *Estate of Black*. The government's brief in *Estate of Black* stated the argument as follows:

> "Petitioner overlooks the fact that §§2036 and 2035 include the value of property that has previously been transferred, while the marital deduction is limited to the value of the property actually passing to the surviving spouse. There is good reason for this limitation. On the death of the surviving spouse, only that property (here, the discounted value of the BILP interest) will be in includable in the spouse's gross estate under I.R.C. §2044."

4. *Possible Planning Strategies In Light of Marital Deduction Mismatch Issue.* If a married individual transfers assets to an FLP or LLC and retains most of the partnership interests, there is the possibility of large estate taxes being due at the first spouse's estate even if all of the estate passes to the surviving spouse if the government succeeds in arguing that §2036 applies and is eventually successful in its marital deduction mismatch argument. What can planners do to minimize the risk of having to pay large estate taxes at the first spouse's death if a client wants to create an entity but wants to do everything possible to avoid that risk?

To avoid this argument, some planners suggest leaving voting and non-voting stock of an LLC to the surviving spouse at the first spouse's death, so there is little or no discount for marital deduction purposes. After the first spouse's death, the surviving spouse could sell

the voting stock so that he or she is left with only non-voting stock (which should be discounted).

A possible planning strategy in the FLP context to avoid this risk, suggested by Kevin Matz, would be to include provisions in the partnership agreement so that the surviving spouse (or QTIP trust) would not have restrictions on liquidating the partnership:

> "Perhaps the best way to accomplish this would be to provide in the FLP's governing documents (which may need to be amended to allow this) that the holder of the FLP interests that would pass to or for the benefit of the surviving spouse (e.g., the trustee of the QTIP trust) would be able to liquidate the FLP without the consent of any other person.
>
> "For example, suppose that the partnership agreement permits liquidation to occur upon the affirmative vote of the general partner and limited partners holding more than two-thirds of the outstanding limited partnership interests. In this situation, the trustee of the QTIP trust — who pursuant to the decedent's estate plan would receive the general partnership interest and more than two-thirds of the limited partnership interests — would be able to liquidate the FLP without the consent of any other person. Consequently, there would not appear to be any viable basis for the IRS to argue that the value of the FLP interests passing to the surviving spouse should be discounted." Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 EST. PL. 16 (Jan. 2007).

If the individual contributes assets to an FLP or LLC and then makes gifts of a significant portion of the partnership or member interests, the client should be as careful as possible to do nothing suggesting that there is an implied agreement that the individual would continue to have any interest in or power over partnership assets attributable to the gifted interests. Once three years have passed (so that §2035 does not apply), even if the court applies §2036 to the contribution of assets to the partnership, it should not apply to assets attributable to the gifted interests, assuming the individual has not retained a §2036 interest in or power over that portion of the entity's assets at the individual's death. If §2036 applies to assets attributable to the gifted interests and the gifts of partnership interests were made to someone other than the individual's spouse, no marital deduction would be allowed for those assets, as the court held in *Turner II*.

Another planning strategy, as discussed above is that the decedent's will could have an apportionment clause that would not override §2207B, so that estate taxes attributable to the inclusion of assets in the gross estate under §2036 would be apportioned to the recipient of those assets. That would allocate estates taxes to the recipients of lifetime gifts of partnership interests to which §2036 applied.

5. *No Discussion of Alleged Technical Procedural Glitch by Government.* The taxpayer's central argument about the marital deduction issue may be an alleged *procedural* defect in the government's handling of the marital deduction issue in the litigation. The taxpayer argued that application of the marital deduction is central to the amount of any estate tax deficiency in an estate tax case at the first spouse's death, and that the IRS did not raise any argument about denying any marital deduction in its pretrial memorandum or opening brief, but only in its reply brief after trial. The taxpayer argued that other Tax Court cases have refused to consider arguments raised for the first time by the government in a post-trial reply brief. The taxpayer's central argument seemed to be this technical

procedural issue, but the court did not address it at all. The court's last sentence apparently covers this issue that was central to the taxpayer's marital deduction argument:

> "We have considered the remaining arguments of both parties for results contrary to those expressed herein and, to the extent not discussed above, find those arguments to be irrelevant, moot, or without merit."

Apparently, the taxpayer's procedural argument is "irrelevant, moot, or without merit." Perhaps the court's view is that some issues are so clear that they need not even be in a specific timely argument, such as whether the estate tax marital deduction is allowed for assets that do not pass to the surviving spouse. Perhaps the court's view is that substantive issues can be raised for the first time at any time by the government, even in a post-trial reply brief. Perhaps the court believed that the government could respond to the marital deduction issue in its post-trial reply brief because the estate apparently raised the issue that it should have no estate tax deficiency because of the marital deduction in its own post-trial brief. (*See* Footnote 2 of *Turner II*.) Perhaps the court believed that all of the marital deduction issues were merely a part of the Rule 155 computation process. We do not know why the court viewed the procedural argument, which seemed to be at the heart of the taxpayer's marital deduction argument, as irrelevant, moot, or without merit.

17. Summary of §2036 Implications of FLP Planning Issues Raised in Light of Recent Cases

The cases in 2011 (*Jorgensen, Turner* and *Liljestrand*) and 2012 (*Stone, Kelly* and *Turner II*) highlight some of the §2036 implications of FLPs.

a. *What Situations Can Satisfy the Bona Fide Sale Exception?* Courts now use the standard for the bona fide sale exception to §2036 for FLPs that was announced in *Bongard v. Commissioner* — there must be a legitimate and significant nontax reason for the partnership. If the planner wishes to avoid §2036 with respect to assets contributed to an FLP, see if one of the following special circumstances might apply to the specific facts of the family situation. These are the special situations that have been recognized by cases as meeting the "legitimate and significant nontax reasons" test.

- Large block of voting stock in closely held corporation, *Black v. Commissioner*
- Joint management and keeping a single pool of assets for investment opportunities, patent royalties and related investments, *Mirowski v. Commissioner*
- Closely held business; resolution of family litigation regarding active management of closely held business, *Stone v. Commissioner*
- Maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests, *Kimbell v. United States*
- Perpetuating buy-and-hold investment philosophy for du Pont stock, *Schutt v. Commissioner*.
- Preserve family ranching enterprise, consolidate undivided ranch interests, *Church v. United States*
- Placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts, *Bongard v. Commissioner*
- Continue investment philosophy and special stock charting methodology, *Miller v. Commissioner*

- Protect family assets from depletion in divorces, *Keller v. United States*
- Centralized management and prevent dissipation of family "legacy assets," *Murphy v. Commissioner*
- Asset protection and management of timberland following gifts of undivided interests, *Shurtz v. Commissioner*
- Managing woodland parcels as a family asset for later development and sales of lakeside homes, *Stone v. Commissioner*.
- Ensuring equal distribution of estate among children thereby avoiding litigation, effective management and minimizing potential liability for operation of quarries and other real estate properties requiring active management, *Kelly*.

b. *Post-Death Use of Partnership Assets to Pay Federal Estate Taxes*. Of the three recent cases in 2011, *Jorgensen* and *Liljestrand* pointed to the FLP's payment of federal and state estate taxes as one reasons for finding an implied agreement of retained enjoyment of assets contributed to the FLP. Post-death use of partnership assets has been discussed in various prior cases. In *Erickson*, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. Commentators argue that §2036 should not apply to post-death uses of partnership assets (John Porter points out that §2036 talks about retained interests by the "decedent," not the "decedent's estate"), but the clear trend of the cases is to consider post-death uses of partnership property for paying estate taxes for purposes of §2036. Seven cases have viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1). Those cases are *Rosen*, *Korby*, *Thompson*, *Erickson*, *Jorgensen*, *Miller* and *Liljestrand* (Tax Court cases) and the *Strangi* Fifth Circuit Court of Appeals case. *Miller* and *Erickson* are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In *Erickson*, T.C. Memo. 2007-107, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

Not all judges take the same view; Judge Chiechi was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in *Mirowsk*i. However, clearly many judges are now taking that position.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? Possibilities include the following.

- Borrowing from a third party is best, but a bank may be unwilling to make a loan using only the partnership interest as collateral. The bank may want a guarantee by the partnership. If so, the partnership should be paid a guarantee fee. There is a legitimate reason for the FLP giving a guarantee, because there will be an IRS lien against the partnership, and the partnership will not want the bank to foreclose on a partnership interest.
- Borrow from an insurance trust or a family entity, secured by the partnership interest.

- There are three options for utilizing partnership funds: redemption, distribution or loan. *Erickson* involved a purchase of assets and a redemption but the court held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distributions for taxes are made all the time from partnerships, but that is usually for income taxes. Borrowing from the partnership on a bona fide loan, using the partnership interest as collateral is preferred by some planners. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arms' length transaction). Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John Porter has used them successfully in a number of cases. (However, John Porter says that he has cases in which the IRS argues that Graegin loans from an FLP to the estate evidences a retained enjoyment under §2036.)
- Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses, so that the necessary cash never comes directly from the partnership.

c. *"Scorecard" of §2036 FLP Cases (13-21, With 2 on Both Sides)*. Of the various FLP/LLC cases that the IRS has chosen to litigate, thirteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — *Church* (preserve family ranching enterprise, consolidate undivided ranch interests); *Stone* ((this is the "other" *Stone* case [*Estate of Eugene E. Stone, III* T.C. Memo 2003-309];partnerships to settle family hostilities); *Kimbell* ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); *Bongard* (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); *Schutt* (maintaining buy and hold investment philosophy for family du Pont stock); *Mirowski* (joint management and keeping a single pool of assets for investment opportunities); *Miller* (continue investment philosophy and special stock charting methodology); *Keller* (protect family assets from depletion in divorces); *Murphy* (centralized management and prevent dissipation of family "legacy assets"); *Black* (maintaining buy and hold investment philosophy for closely held stock); *Shurtz* (asset protection and management of timberland following gifts of undivided interests); *Estate of Joanne Stone* (managing woodland parcels as a family asset for later development and sales of lakeside homes); and *Kelly* (ensure equal distribution of decedent's estate thereby avoiding litigation, provide effective management of quarries and other real estate requiring active management and minimize potential liability concerns). *All* of the FLP cases resulting in taxpayer successes against a §2036 attack, except *Kelly* and *Mirowski,* have relied on the bona fide sale exception to §2036. (*Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036, but reasoned that there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception]. *Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests.)

Interestingly, five of those eleven cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller* case and the recent *Stone* case and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both the other *Stone* case and *Mirowsk*i. Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, and Judge Foley decided *Kelly*. *Church* and *Kimbell* were federal district court opinions ultimately resolved by the 5th Circuit. *Keller* and *Murphy* were federal district court cases.

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 21 cases have applied §2036 to FLP or LLC situations: *Schauerhamer, Reichardt, Harper, Thompson, Strangi, Abraham, Hillgren, Bongard* (as to an LLC, but not as to a separate FLP), *Bigelow, Edna Korby, Austin Korby, Rosen, Erickson, Gore, Rector, Hurford, Jorgensen, Miller* (as to transfers made 13 days before death, but not as to prior transfers), *Malkin*, *Turner,* and *Liljestrand*. In addition, the district court applied §2036 in *Kimbell*, but the 5th Circuit reversed.

18. Indirect Gifts Qualify for Annual Exclusion Under Crummey Withdrawal Power Provision; Gifts of Partnership Interests Qualifying for Annual Exclusion, *Estate of Turner*

a. *Estate of Turner v. Commissioner*. *Turner,* T.C. Memo 2011-209, primarily involved the application of §2036 to assets in an FLP. As a side issue, the decedent's payment of insurance premiums on policies owned by an irrevocable life insurance trust were indirect gifts that qualified for the annual exclusion because the trust's Crummey withdrawal provision specifically applied to indirect gifts; therefore the gifts were not "adjusted taxable gifts" for purposes of calculating the estate tax. Whether the beneficiaries knew of the indirect gifts or of their withdrawal rights was irrelevant because they had the legal power to withdraw the indirect gift amount. (This opinion was supplemented by 138 T.C. No. 14, but the supplemental opinion did not discuss this issue.)

For three years (2000-2003), the decedent paid the life insurance premiums on policies owned by an irrevocable life insurance trust directly, without first contributing the money to the trust to allow the trust to pay the premium. The trust agreement provided that after each "direct or indirect transfer" to the trust, the beneficiaries had the absolute right to demand withdrawals from the trust. Because of the statement in the trust agreement that the "Crummey withdrawal right" applied to "indirect transfers" to the trust, the court concluded that the fact that the decedent did not transfer money directly to the trust is irrelevant.

The court held that notice of the withdrawal powers by the beneficiaries as to each indirect transfer was not important. Citing *Crummey v. Commissioner* and *Cristofani v. Commissioner*, the court concluded that "the fact that some or even all of the beneficiaries may not have known that they had the right to demand withdrawals from the trust does not affect their legal right to do so."

The IRS argued that even if the withdrawal powers applied to the gifts, the gifts of partnership interests in 2002 and 2003 used up the decedent's annual exclusions, so the life insurance payments could not be covered by the gift tax annual exclusions. The court responded that because the partnership assets were included in the decedent's gross estate under §2036, gifts of partnership interests "must be disregarded for purposes of calculating [the decedent's] adjusted taxable gifts" (apparently in light of the last phrase of §2001(b), "other than gifts which are includible in the gross estate of the decedent"). In

the court's view (to my knowledge, a case of first impression), disregarding gifts under §2001(b) that are brought back into the decedent's gross estate means disregarding any use of annual exclusions by those gifts, so that other gifts could be covered by annual exclusions that would otherwise constitute adjusted taxable gifts. Observation: The wording of §2001(b) certainly does not make clear that including as adjusted taxable gifts only taxable gifts after 1976 that are not otherwise included in the gross estate means that any use of annual exclusions by gifts that are included in the gross estate can be shifted to other taxable gifts to reduce the amount that must be included as adjusted taxable gifts in the estate tax calculation.

b. *Crummey Trust Drafting Implications*. The court's reasoned that indirect gifts to the irrevocable life insurance trust, by the decedent's payment of premium payments, were subject to the Crummey withdrawal power because the trust agreement explicitly stated that the *withdrawal power applies to both direct and indirect gifts* to the trust. Drafting the trust agreement in that manner may have "saved the day" for the annual exclusion qualification for those indirect gifts.

The court reasoned that the annual exclusion applied whether or not the beneficiaries were aware of the indirect gifts or their withdrawal powers. Cautious planners will not rely upon such a favorable ruling, and will continue to give notice to beneficiaries of each specific gift to the trust and of their withdrawal rights. However, there is absolutely *no authority* for the position that notice is required. (For example, notice was not required in the initial *Crummey* case.)

c. *Gift Tax Annual Exclusion For Gifts of Limited Partnership Interests*. Planners are concerned with how to structure family limited partnership so that gifts of limited partnership interest can qualify for the gift tax annual exclusion, in light of *Hackl v. Commissioner, Price v. Commissioner*, and *Fisher v. U.S.* **In this case, *the IRS* argued that gifts of limited partnership interests qualified for the annual exclusion.**

19. Background and Planning Suggestions Regarding Annual Exclusion Gifts of FLP or LLC Interests; Including *Estate of Wimmer*, Which Allowed Annual Exclusion Because Donees Received Income Distributions From Partnership

a. *Synopsis of Basic Facts and Court's Analysis in* Wimmer. Three prior cases have refused to allow an annual exclusion for gifts of limited partnership interests, for various reasons based on the facts in those cases. *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo. 2010-2; *Fischer v. Commissioner*, 105 AFTR2d 2010-1347 (S.D. Ind. 2010). *Estate of Wimmer* holds that gifts of limited partnership interests *did qualify* for the gift tax annual exclusion because the donees received income distributions from the partnership.

In *Estate of Wimmer v. Commissioner,* T.C. Memo 2012-157, the court (in a decision by Judge Elizabeth Paris) held that gifts of limited partnership interests to eleven donees (six of those eleven were beneficiaries who had Crummey withdrawal powers over gifts to a grandchildren's trust) in each of five years (1996-2000, potentially representing annual exclusion gifts up to $550,000) constituted gifts of "present interests" that qualified for the gift tax annual exclusion. Therefore the gifts were not adjusted taxable gifts that had to be considered in calculating the estate tax (and therefore did not "use up" any of the decedent's unified estate and gift tax credit amount).

The partnership assets consisted of publicly traded stocks that paid dividends. The partnership received dividends quarterly. For the first three years of the partnership (1996 -1998), the partnership made distributions to the partners of enough cash so that they could pay their income taxes on the "flow-through" income from the partnerships. (Apparently, this was not all of the partnership's income.) Beginning in 1999, the partnership distributed all dividends, net of partnership expenses, to the partners. Partners also had access to capital account withdrawals, and some partners actually made such withdrawals for, among other things, paying down their residential mortgages. (The opinion did not refer further to the partners' access to capital account withdrawals.)

The *Wimmer* court noted that a gift of "an outright transfer of an equity interest in a business or property, such as limited partnership interests, is not necessarily a present interest gift." The gift tax regulations describe a "present interest" as "an unrestricted right to immediate use, possession, or enjoyment of property or the income from property." Treas. Reg. §25.2503-3(b). The U.S. Supreme Court in *Fondren v. Commissioner,* 324 U.S. 18, 20-21 (1945) stated that there must be a "substantial present economic benefit" to qualify as a present interest for this purpose. In summary, *Wimmer* stated: "Therefore, to qualify as a present interest, a gift must confer on the donee a substantial present economic benefit by reason of use, possession, or enjoyment (1) of property or (2) income from the property."

The court held that the donees did not have immediate use, possession or enjoyment of the gift *property* (i.e., the gifted limited partnership interests) because of restrictions on the ability of the donees to transfer their limited partnership interests. As to this issue, the court concluded that "the donees did not have the unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the limited partnership interests themselves." The partnership agreement imposed significant transfer restrictions on transfers to anyone other than existing partners or related parties (as defined in the agreement). Limited partnership interests could be transferred only with the prior written consent of the general partners and 70% in interest of the limited partners. Furthermore, a transferee would not become a substitute limited partner until the transferee had been accepted as a substitute limited partner by "unanimous written consent of the general partners and the limited partners." (Apparently, the partnership agreement did not allow transfers subject to a right of first refusal by the partnership or the remaining partners.)

As to whether the donees had the use, possession, or enjoyment of *income from the property,* the court applied a three-part test (as announced in *Calder v. Commissioner*, 85 T.C. 713, 727-28 (1985)), under which the estate had to "prove, on the basis of the surrounding circumstances, that: (1) the partnership would generate income [the opinion later referred to this as a "partnership that expected to generate income"], (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained."

These requirements were satisfied. (1) The partnership assets consisted of publicly traded stocks that paid dividends quarterly. (2) The general partners owed fiduciary duties to the limited partners under the agreement and state law. One of the donee-partners was a trust for grandchildren that owned only the limited partnership interests and no other assets with which it could pay income taxes on the partnership's flow-through income. The court reasoned that "the necessity of partnership distributions in these circumstances comes within the purview of the fiduciary duties imposed on the general partners.

Therefore, the general partners were obligated to distribute a portion of partnership income each year to the trustee." Because the agreement required that distributions of net cash flow be made to all partners proportionately, distributions would be made to all partners of at least a portion of the partnership income. Therefore, "on the date of each gift some portion of partnership income was expected to flow steadily to the limited partners," and the partnership in fact made distributions pro rata from the dividends paid each year at issue. (3) The income could be readily ascertained because "the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership."

The gifts of the limited partnership interests qualified for the gift tax annual exclusion (even though the donees did not receive *all* of the partnership income in some years).

b. *Planning Observations in Light of* Wimmer *as Well As* Hackl*,* Price *and* Fisher.

(1) *Case Allows Annual Exclusion, Following Three Cases That Did Not.* The IRS often argues that gifts of limited partnership interests do not qualify for the gift tax annual exclusion, following the government's success in the *Hackl*, *Price,* and *Fisher* cases. (The *Hackl, Price*, and *Fisher* cases, as well as other relevant background cases and rulings, are discussed in detail below.) *Wimmer* reverses that trend of cases, and allows the annual exclusion.

(2) *Annual Exclusion Allowed Based on Expectations of Income Distributions*. In the context of gifts of FLP or LLC interests, the *Hackl, Price, Fisher,* and *Wimmer* cases suggest that the present interest determination can be based either on (1) the immediate right to sell the interest without substantial restrictions, or (2) having an immediate expectation of income distributions. *Wimmer* relies on the second approach.

Relying on a reasonable expectation of receiving income distributions may not be appropriate in all circumstances.

- The partnership may not own income producing assets (which was the case in *Hackl*, where the LLC owned freshly planted timberland).
- Even if the asset produces some income, if there are large fluctuations in the income that is produced, the third test (i.e., the portion of income that is distributed is ascertainable) may be hard to meet. *Wimmer* analyzed this requirement in terms of the regularity of dividends produced by the stock held by the partnership, as opposed to the regularity of distributions from the partnership.
- *Requiring* distributions of income may raise potential §2036(a)(1) arguments by the IRS if the donor retains any of the FLP or LLC interests.
- As illustrated in *Price,* if distributions are not made in *all* years, reliance on the "income for property" leg may be unsuccessful. (In *Price,* substantial distributions were made, but there were no distributions in 2 of the 6 years considered by the court.)

(3) *What If All Income is Not Distributed*? The *Calder* test requires that "(2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained." *Calder v. Commissioner*, 85 T.C. 713, 727-728 (1985).

What if a portion *but not all* of the income "flows steadily" to the donees? Is the annual exclusion allowed in full or for only some proportionate value of the gift property? The cases do not discuss the impact of the annual exclusion if the partnership distributes only a portion of the income. Interestingly, in *Wimmer*, only a portion of the partnership income was distributed to the partners in the first three years of the five years when gifts were made, and all of the income was distributed only in the last two years. However, the court allowed a full annual exclusion.

(4) *IRS Policy of Denying Annual Exclusion If Discounts Applied in Valuing Gift.* IRS agents have told some planners in gift tax audits that the IRS policy is to disallow any annual exclusion for gifts of FLP or LLC interests if a discount is taken in valuing the gifted interest. However, the legal tests for the annual exclusion and whether an interest should be valued with a discount as compared to pro rata asset value have nothing to do with each other. If the IRS policy is actually to deny the annual exclusion in gift tax audits automatically if discounts are taken, that policy is outrageous. If taxpayers took positions that unsupportable, the IRS would undoubtedly apply penalties. (For example, assume taxpayers were to take that same position, and argue that because a discount was not taken on the value of the gift of an interest in an FLP, it should necessarily qualify for the annual exclusion. If the gift were of an interest in a partnership with no income producing assets and that prohibited any transfers for a number of years, the IRS would be outraged if the taxpayer claimed that the gift qualified for the annual exclusion.)

(5) *Planning and Drafting Suggestions.* The following are planning and drafting suggestions in light of *Hackl, Price, Fisher,* and *Wimmer*. There are two alternate ways to cause the gift of partnership or LLC member interests to qualify for the annual exclusion as discussed in these cases: (1) the ability to transfer the interests for substantial present value, or (2) the expectation of regular distributions of the partnership income (or some portion of the income — with the uncertainty that raises as to whether the annual exclusion is allowed in full if only a portion of the income is distributed). Planners may want to try to qualify under both alternatives, although that is not required.

An alternative to avoid the issue of whether a gift of a partnership or LLC interest qualifies for the annual exclusion is to make cash gifts to donees (perhaps grantor trusts). The donees could exercise their own discretion to purchase limited partnership or LLC interests from the donor.

The following planning strategies are relevant primarily to the free transferability alternative.

- *Right of First Refusal Rather Than Prohibition on Transfers.* Do not include a prohibition on transfers but provide that any transfer will be subject to a right of first refusal, with reasonable time limits. If the right of first refusal is exercised, provide that the purchase price would be paid in cash or with negotiable instruments (do not allow payment with non-negotiable notes as was done in Fisher, because that means the donee would have no way immediately to obtain a "substantial present economic benefit" for his or her interest).

- *Do Not Just Give Assignee Interests*. Mere assignees have limited rights. *Hackl* and *Price* both suggested that gifts of assignee interests could not be present interest gifts because they "lack the ability 'presently to access any substantial economic or financial benefit that might be represented by the ownership units.'" Formally document that the existing partners consent to admit donees who receive limited partnership interests as substitute limited partners.
- *Put Right for Limited Period*. Give donee-partners a limited period of time to sell the interest to the donor (or perhaps the partnership) for its fair market value, determined without regard to the existence of the put right; this provision could be included in a conditional assignment that is subject to the transferee being allowed to require the donor or the partnership to substitute income producing property equal in value to the value of the donated partnership interest. Typically, the put option would require that the donor purchase the interest if the put option is exercised. If the partnership has the obligation to purchase the interest if the put option is exercised, the partnership would have to be a party to the assignment agreement if the put option is placed in the assignment. (The provision could also say that the partnership would have the first option to purchase the partnership interest but if it did not exercise the option, the donor would have to buy the interest.)

  A put option, which would *require* the donor to repurchase the interest if the donee wished to exercise the put option, is distinguished from a mere possibility that a donor may buy back a gift, which the Tax Court in *Price* said would not be sufficient:

  > "If the possibility of a donor's agreeing to buy back a gift sufficed to establish a present interest in the donee, little would remain of the present interest requirement and its statutory purpose would be subverted if not entirely defeated."

- *Withdrawal Power From Partnership*. Alternatively, give donees a Crummey withdrawal power with respect to gifts of limited partnership interests that would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift (this is obviously an unusual provision to be in a partnership agreement).

The following planning strategies are relevant primarily to the income alternative.

- *Agreement Should Not Favor Reinvestments Over Distributions*. Do not explicitly favor reinvestments over distributions in the partnership agreement (as was done in *Price*).
- *Regularize Distributions*. Make distributions every year and "regularize" distributions (although this may make an argument for §2036(a)(1) inclusion more likely if the parent retains interests in the partnership or LLC). The court in *Price* pointed out that the partnership did not make any distributions in 2001 for some reason (did the partnership not have any profits in 2001?), thus flunking the requirement that "some portion of the income … flow steadily to the donees." Making distributions every year does not assure present interest treatment based on the right to income because another requirement is that the

portion of income flowing to the donees can be readily ascertained. (The Tax Court emphasized this test in *Hack*l:

> "Furthermore, even if petitioners had shown that Treeco would generate income at or near the time of the gifts, the record fails to establish that any ascertainable portion of such income would flow out to the donees. Members would receive income from Treeco only in the event of a distribution. However, the Operating Agreement states that distributions were to be made in the manager's discretion. This makes the timing and amount of distributions a matter of pure speculation…")

Making "regular" distributions in some manner would help satisfy the "readily ascertainable" requirement. In any event, the failure to make distributions every year resulted in *Price* refusing to recognize that the gift in that case qualified for the annual exclusion on the basis of the expectation of income distributions, even though very large distributions had been made in other years.

Of course, all of this discussion must be considered in light of §2036. If regular distributions are made to the decedent (as well as to the donee-partners), the IRS may be more likely to argue the existence of an implied agreement to make regular distributions, triggering the application of §2036(a)(1) at the donor's death with respect to any partnership or LLC interests retained by the donor.

- *Consider Mandating Distributions of "Net Cash Flow."* Some attorneys favor requiring the distribution of net cash flow (defined to include the discretion to retain reserves needed to carry out the partnership's purposes), as a way of rebutting an allegation that §2036(a)(2) or §2038 would apply. That also has the advantage of bolstering an argument that the annual exclusions should be available. *However*, the IRS has argued in some cases that such a provision triggers §2036(a)(1), to create an express or implied agreement of retained enjoyment. For example, the IRS's brief in *Estate of Black v. Commissioner,* 133 T.C. 340 (2009) made that argument. Therefore, careful consideration must be given to including such a provision. The results of estate inclusion under §2036(a)(1) are much more draconian than the loss of gift tax annual exclusions.
- *Consider Whether to Require "Tax Distributions."* The court in *Price* noted that the partnership agreement gave the general partners discretion as to whether to make "tax distributions" so the partners could pay their income taxes on flow-through income from the partnership in response to the taxpayers' argument that the donee-partners expected to receive such distributions. Including a requirement to make "tax distributions" would provide a further argument for present interest status. However, be aware that the IRS has argued that the presence of mandatory tax distribution provisions triggers §2036(a)(1). In *Estate of Black v. Commissioner*, 133 T.C. 340 (2009), the IRS's brief argued: "Thus although there was no guarantee that Sam Black would receive the full amount of the dividends earned on the Erie stock he contributed, he nevertheless retained an express right to receive at least a significant portion of those dividends through the mandatory cash distribution

provision contained in the partnership agreement." (That was not addressed in the reported case because the court in *Black* determined that the bona fide sale exception to §2036 applied.) Again, because the results of §2036(a)(1) inclusion can result in huge additional estate taxes, give careful consideration as to whether to include a mandatory tax distribution provision even if it could help regarding the annual exclusion issue.

In addition, a requirement to make "tax distributions" could impact the valuation of the gifted units.

- *Fiduciary Duties.* Specify that the general partner/manager owes fiduciary duties to the other partners/members. This can assist in rebutting an argument for estate inclusion under §§2036(a)(2) and 2038 and may help to bolster the availability of the annual exclusion. The court in *Price* rejected that there was a "strict fiduciary duty" to make income distributions, or that such a duty (even if it existed) would establish a present interest. The court in *Wimmer* did not reason that a general partner necessarily had a fiduciary duty to make distributions, but reasoned that there was a fiduciary duty to make tax distributions to the trust-donee partner that had no other assets with which to make income tax payments (and other partners benefited from that duty because distributions had to be made proportionately).

  Some older IRS private rulings (predating both *Hackl* and *Price*) concluded that gifts of limited partnership interests may qualify as present interests if the general partner's discretion over distributions is subject to a fiduciary standard and if the donees have the right at any time to sell or assign the interests, subject to a right of first refusal. *See* Tech. Adv. Memo. 9131006 & Ltr. Rul. 9415007. Those rulings emphasized that the general partner has a fiduciary duty to limited partners and distinguished a general partner's powers from a trustee's discretionary power to distribute or withhold trust income or principal and also emphasized that the donees had the right at any time to sell or assign their interests, subject to a right of first refusal.

c. *Supreme Court Guidance.* The Supreme Court in *Fondren v. Commissioner*, 324 U.S. 18, 20 (1945) after reviewing the statutory language , regulations and legislative history, concluded that a present interest is created for purposes of the gift tax annual exclusion only if the donor confers on the donee "the right to a substantial present economic benefit." The Supreme Court expanded on this discussion in *Commissioner v. Disston,* 325 U.S. 442, 446 (1945) by concluding that a gift to a trust constitutes a future interest if the trust had income but limitations were placed on its disbursement:

> "In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the [beneficiary]would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest." *Id.* at 449.

d. *Calder — Announcing Three-Part Test Regarding Income From Property.* The Supreme Court's formulation in *Disston* of when a present interest exists based on the right to

income from property was the basis of the three-prong test announced in *Calder v. Commissioner,* 85 T.C. 713, 727-28 (1985):

> "*Disston* thus requires the taxpayer to prove three things: (1)That the trust will receive income, (2) that some portion of that income will flow steadily to the beneficiary, and (3) that the portion of income flowing out to the beneficiary can be ascertained." *Id.*

The Fourth Circuit had previously relied on the *Disston* analysis to conclude that "[t]he taxpayer must show that the trust will receive income, and, second, that some ascertainable portion of the income will flow steadily to the beneficiary." *Maryland National Bank v. United States,* 609 F.2d 1078 (4th Cir. 1979).

In *Calder,* the Tax Court observed that it had been reversed in *Rosen v. Commissioner* by the Fourth Circuit, which held that the annual exclusion was allowable for a gift of stock which had no dividend history, relying partially on the fact that the trustees had the power to sell non-income-producing assets and to reinvest the proceeds in income-producing property. 397 F.2d 245 (4th Cir. 1968), *rev'g* 48 T.C. 384 (1967). However, the Tax Court refused to follow *Rosen* in *Berzon v. Commissioner,* 63 T.C. 601 (1975), *aff'd,* 534 F.2d 528 (2d Cir. 1976), in finding that an income interest in a trust holding non-dividend paying closely held stock was not susceptible of valuation.

e. *Private Rulings.* IRS private rulings regarding FLPs have concluded that gifts of limited partnership interests may qualify as present interests if the general partner's discretion over distributions is subject to a fiduciary standard and if the donees have the right at any time to sell or assign their interests, subject to a right of first refusal. *See* Tech. Adv. Memo. 9131006 & Pvt. Ltr. Rul. 9415007 (rulings emphasized that the general partner has a fiduciary duty to limited partners and distinguished general partner's powers from a trustee's discretionary power to distribute or withhold trust income or principal and also emphasized that the donees had the right at any time to sell or assign their interests, subject to a right of first refusal).

Gifts of non-dividend paying stock qualify for the annual exclusion if there are no restrictions on transfers of the stock. Tech. Adv. Memo. 9346003.

Technical Advice Memorandum 9751003 held that gifts of limited partnership interests (to 35 different donees over three years) did not constitute present interest gifts, focusing on special provisions in the partnership agreement that deviated from the general partnership law. First, the agreement gave the general partner (a corporation owned by the donor) complete discretion in deciding what funds to distribute from the partnership, including the discretion to retain funds "for any reason whatsoever." The IRS concluded that provision is extraordinary and outside the scope of a business purpose restriction, and "effectively obviates the fiduciary duty ordinarily imposed upon a general partner, and clothes the general partner with the authority to withhold income for reasons unrelated to the conduct of the partnership." Second, the IRS interpreted the agreement as prohibiting the donee limited partners from assigning their interests. Because the donee limited partners could not assign their interests (even to assignees) and could not unilaterally liquidate the partnership, the IRS concluded that the gifted limited partnership interests "lacked the tangible and immediate economic benefit required...for a present interest in property."

f. *Hackl v. Commissioner*. In *Hackl v. Commissioner*, the Tax Court ruled that gifts of LLC interests to 41 donees over a number of years did not qualify for the annual exclusion, and the Seventh Circuit Court of Appeals affirmed that decision. 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

In *Hackl,* the donor-spouses formed an LLC and made annual exclusion gifts of member interests to 8 children, their 8 spouses and to 25 minor grandchildren (41 donees total). For both spouses, this represented annual exclusion gifts of $820,000 per year. Gifts made in 1996 generated a gift tax deficiency of over $600,000 because they did not qualify for the annual exclusion. (Annual exclusion gifts were also made in 1995 that were not questioned — presumably because the gift tax statute of limitations had run.)

The LLC invested in a tree farming business for long-term growth. The assets constituted land with little or no existing merchantable timber — to provide a greater long-term return on investment. The LLC would not produce any significant cash flow for many years.

Under the terms of the LLC Operating Agreement:

- Mr. Hackl was named as the initial manager with a lifetime term (until his resignation, removal, or incapacity). He had the power to name a successor manager during his lifetime or by his will.
- The manager "may direct that the Available Cash, if any, be distributed to the Members, pro rata in accordance with their respective Percentage Interests."
- No member had the right to withdraw except as approved by the Manager.
- A member desiring to withdraw could offer his units for sale to the company, and the Manager had exclusive authority to accept or reject the offer and to negotiate terms.
- The agreement waived the right to have any company property partitioned.
- Members could not sell their Interests except with the Manager's consent, which consent "may be given or withheld, conditioned or delayed as the Manager may determine in Manager's sole discretion."
- If the transfer is made in violation of the agreement, the transferee would have no opportunity to participate in the business affairs of the entity or to become a Member, but the transferee would only be entitled to receive the share of profits or distributions which otherwise would have inured to the transferor. (Observe, these are similar to the rights that an "assignee" would have in a partnership context.)
- The Members had no control over the date of dissolution.

The Tax Court held that the gifts of the member interests did not constitute present interest gifts and did not qualify for the annual exclusion.

Outright transfers of equity interests in a business or entity do not automatically qualify as a present interest. The court concluded that existing case law regarding indirect gifts (such as gifts in trust) would apply to gifts of interests in an entity. The court noted "the right to substantial present economic benefit" requirement described in *Fondren v. Commissioner*, 324 U.S. at 20-21. The court described a two-step alternative analysis — the donee must have "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom."

The donees did not have "use, possession, or enjoyment" of the property itself within the meaning of section 2503(b).

- The exception in the regulations for contractual rights in a bond, note or insurance policy is not applicable, because the regulations refer to assets "*immediately disposable by the obligee*."
- The rights granted in the Operating Agreement did not afford *substantial* economic benefits to the donees. The court was troubled by various restrictions in the Operating Agreement, including (1) the absence of the ability of the donees presently to access any substantial economic or financial benefit, (2) the restrictions on unilaterally withdrawing the capital account, (3) and member desiring to withdraw could only offer units to the Company and the Manager had the authority to accept or reject the offer, (4) no donee acting alone could effectuate a dissolution, (5) the agreement prevented a donee from selling his Interest to third parties without obtaining the consent of the Manager; the court concluded that "for all practical purposes, [the Agreement] bars alienation as a means for presently reaching economic value."

The donees did not have "use, possession, or enjoyment" of the income from the property within the meaning of section 2503(b). The three-part test described in *Calder v. Commissioner*, 85 T.C. 713, 727-728 (1985) was not satisfied because the parties anticipated that no income would be produced for about six years, and even if the partnership produced income, there was no ascertainable portion of the income that would be distributed to the donees because distributions were to be made in the manager's discretion.

The Seventh Circuit Court of Appeals affirmed, agreeing with the Tax Court's analysis that the transfer restrictions left the donees with no substantial present economic benefit:

> "In this case, Treeco's operating agreement clearly foreclosed the donees' ability to realize any substantial present economic benefit. Although the voting shares that the Hackls gave away had the same legal rights as those that they retained, Treeco's restrictions on the transferability of the shares meant that they were essentially without immediate value to the donees. Granted, Treeco's operating agreement did address the possibility that a shareholder might violate the agreement and sell his or her shares without the manager's approval. But, as the Tax Court found, the possibility that a shareholder might violate the operating agreement and sell his or her shares to a transferee who would then not have any membership or voting rights can hardly be called a substantial economic benefit. Thus, the Hackls' gifts — while outright — were not gifts of present interests." 335 F. 3d 664 (7th Cir. 2003).

Commentators disagreed with the *Hackl* analysis. For example, Professor Kasner concluded as follows:

> "Unfortunately, the Hackl opinion has obscured some of the issues. Is the lack of a defined income stream, taken alone, enough to deny the annual exclusion? The rulings indicate it is not unless the manager or general partner holds control over distributions in what amounts to a nonfiduciary capacity. There is certainly no requirement that the transferred property be income producing at all, *at least if the transferee has the right to transfer or assign it*. While it is clear that an absolute prohibition to an assignment of the interests in the entity will be a basis for

denying the annual exclusion, is there any requirement that the assignee be admitted as a partner or member? The court contains confusing language of this issue, which is unfortunate." Kasner, Tax Analysts (April 22, 2002) (emphasis added).

Based on the Tax Court's description of the factual nature of the transfer restrictions it seems that at least the value of an assignee interest should constitute a present interest. The Tax Court acknowledged that "if the transfer was made in violation of the Agreement, the transferee would be afforded no opportunity to participate in the business affairs of the entity or to become a member; rather, he or she would only be entitled to receive the share of profits or distributions which otherwise would have inured to the transferor." Therefore, there was no restriction against selling an "assignee" interest, so the gift arguably should have been a present interest to the extent tot the value of the assignee interest. The Seventh Circuit responded to this notion by merely concluding that the assignee interest, without any membership or voting rights, would not be a substantial present economic benefit. However, the Seventh Circuit did not address that the assignee interest itself may have had substantial current value. (Indeed, the IRS in various cases has argued that the value of a partnership assignee interest should not be significantly lower than the value of a full limited partner interest.)

g. *Price v. Commissioner*.Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts and therefore did not qualify for the gift tax annual exclusion. T.C. Memo. 2010-2. The following is a brief synopsis of the court's analysis (discussed in more detail below). There was no immediate enjoyment of the donated property itself, because the donees had no ability to withdraw their capital accounts and because partners could not sell their interests without the written consent of all other partners. Furthermore, there was no immediate enjoyment of income from the donated property (which can also, by itself, confer present interest status) because (1) there was no steady flow of income, and (2) distribution of profits was in the discretion of the general partner and the partnership agreement specifically stated that distributions are secondary to the partnership's primary purpose of generating a long-term reasonable rate of return. Interestingly, the IRS pursued this annual exclusion argument in litigation even though there were limited donees (three, unlike the *Hackl*, case where there were 41 donees) and even though there were over $500,000 of actual distributions to the children from the partnership's creation in 1997 to 2002.

Before selling his closely held company, Mr. Price contributed his stock and commercial property leased to the company to a family limited partnership in 1997. The FLP sold the stock in early 1998, and the proceeds were invested in marketable securities. The 1% general partner was a corporation owned by Father's and Mother's revocable trusts, with Father as president. The 99% limited partnership interests were initially held equally by Mr. and Mrs. Price's revocable trusts.

The terms of the FLP agreement include the following:

- *Prohibition Against Transfer*. Partners cannot sell partnership interests without written consent of all partners, but a limited partner may sell its interest to another partner.
- *Purchase Option*. If there is a voluntary or involuntary assignment of a partnership interest, the other partners have an option to purchase the interest for its fair market value, determined under a procedure requiring three appraisals. There is no time limit on exercising the purchase option in the event of voluntary transfers.

- *Distributions*. Profits are distributed proportionally to all partners "in the discretion of the general partner except as otherwise directed by a majority in interest of all the partners, both general and limited." There is no obligation to make distributions to enable partners to pay their income taxes on the partnership's profits. Furthermore, the partnership agreement stated that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments."

Mr. and Mrs. Price each made gifts of limited partnership interests to each of their three adult children in each of the years 1997-2002. In each year, the gifts by the two donors to each child exceeded $20,000 ($22,000 in 2002), and they intended that the gifts would qualify for the federal gift tax annual exclusion.

The partnership actually made distributions to the children as follows:

Year	Total Partnership Distributions to Children
1997	---
1998	$ 7,212
Year	Total Distributions to Children
1999	343,800
2000	100,500
2001	---
2002	76,824
Total	528,336

The gifts were large enough that the children collectively held a majority interest in the partnership in every year beginning in 1997. The children's cumulative interests in the partnership during the three years at issue (2000-2002) were 63%, 68.1%, and 99%, respectively.

(1) *No Right to Present Enjoyment of "Property."*

Mere Assignees. The donees were mere assignees, not substitute limited partners, because the children were not initial partners and §11.2 of the partnership agreement provided: "Any assignment made to anyone, *not already a partners*, shall be effective only to give the assignee the right to receive the share of profits to which his assignor would otherwise be entitled * * * and *shall not give the assignee the right to become a substituted limited partner*." (Emphasis supplied by court.) [Observe: It would be unusual for the partnership not to give the existing partners the ability to admit any transferee as a substitute limited partner if they so desired. Even if the partnership agreement allowed that, apparently there was no documentation that the original partners (Mr. and Mrs. Price's revocable trusts and the 1% corporate general partner) formally consented to their admission as substitute limited partners.] However, even if the children were substitute limited partners, the court said its decision would not have changed because of

contingences on the "receipt of economic value for the transferred partnership interests."

No Withdrawal Rights. Like most partnership agreements, this agreement did not give the partners the unilateral right to withdraw their capital accounts.

Transfer and Sale Restrictions. The primary reason the court gave for refusing to find that the donees had an immediate substantial right to enjoyment of the property was because of transfer and sale restrictions in the partnership agreement.

> "Pursuant to section 11.1 of the partnership agreement, unless all partners consented the donees could transfer their partnership interests only to another partner or to a partner's trust. In addition, any such purchase would be subject to the option-to-purchase provisions of section 11.4 of the partnership agreement, which gives the partnership itself or any of the other partners a right to purchase the property according to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer."

Even though the donees could sell their interests to the general partner (or Mr. or Mrs. Price's revocable trusts), that was not sufficient because the corporate general partners was owned by the donors and Mr. Price was the President. "If the possibility of a donor's agreeing to buy back a gift sufficed to establish a present interest in the donee, little would remain of the present interest requirement and its statutory purpose would be subverted if not entirely defeated."

Borrowing Ability Too Contingent. Donors argued that the donees' interests in the partnership enhanced their "financial borrowing ability." This is "at best highly contingent and speculative and does not, we believe, constitute a source of substantial economic benefit, particularly in the light of the restrictions on alienation (including on the ability of a partner to 'encumber' a partnership interest) contained in the partnership agreement."

(2) *No Right to Income From Transferred Property*. The court applied the three-part *Calder* test to show that the donees had the right to immediately use, possess or enjoy the income from the transferred property. The court agreed that the first test was satisfied — the partnership could be expected to generate income. However, it concluded that the last two tests were not met: income did not flow steadily and the portion of income flowing to the donees could be readily ascertained.

No Steady Flow of Income. In fact, no distributions were made in 1997 or 2001.

Partnership Agreement Restriction That Distributions Are Secondary to Achieving Return. Profits are distributed at the discretion of the general partner (except as directed otherwise by a majority of the limited partners). Furthermore, "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments."

Tax Distributions Not Required. The donors allege that the partnership is expected to make distributions to cover the partners' income tax liabilities for flow-through income from the partnership, but the partnership agreement clearly says that is discretionary with the general partner.

No "Strict Fiduciary Duty" to Distribute Income. The court disagreed with the donors' argument that the general partner has a "strict fiduciary duty" to make income distributions and that meant the donees had a present interest. There was no citation of authority that such a strict fiduciary duty existed. Even if it did, it would not establish a present interest "where the limited partner lacks withdrawal rights." Finally, the donees were mere assignees, so there is a significant question as to whether the general partners owed them "any duty other than loyalty and due care."

h. *Fisher v. U.S.* Parents gave membership interests in an LLC to each of their seven children over three years (resulting in 42 annual exclusion gifts). The principal asset of the LLC was undeveloped beachfront property. The IRS contested the availability of annual exclusions, and the court rejected the donors' three arguments. 105 AFTR 2d 2010-1347 (S.D. Ind. March 11, 2010).

First, the donors argued that the children had the unrestricted right to receive distributions. The court rejected this argument because distributions "were subject to a number of contingencies, all within the exclusive discretion of the General Manager."

Second, the donors argued that the children possessed the unrestricted right to use the beachfront property. The court responded that the Operating Agreement did not convey this right to members. Somewhat confusingly, the court added that "the right to possess, use, and enjoy property, without more, is not a right to a 'substantial present economic benefit.' *Hackl*, 335 F.3d at 667. It is a right to a non-pecuniary benefit."

Third, the donors argued that the children had the unrestricted right unilaterally to transfer their interests. Under the Operating Agreement, the children could transfer their "Interests" in the LLCs if certain conditions are satisfied. One of those conditions was that the LLC would have a right of first refusal over any such transfer. If the LLC exercises the right of first refusal it will pay "with non-negotiable promissory notes that are payable over a period of time not to exceed fifteen years" providing equal annual installments of principal and interest. The right of first refusal would not exist for transfers to the donors or to their descendants (but as noted below, the court said that other restrictions would apply, without explaining what those restrictions were). The Agreement defines "Interest" as a member's share of profits and losses and the right to receive distributions. The children could only transfer "Interests" rights as opposed to the rights of "Members" admitted by the LLC, which also include the right to inspect the Company's books and records and to "participate in the management of and vote on matters coming before the Company." (The rights that could be assigned seem analogous to "assignee" rights in the context of a partnership.) The court did not comment negatively on the fact that the children could merely transfer the right to share in profits, losses and distributions rather than a full membership right. However, the court reasoned that the right of first refusal "effectively prevents the Fisher Children from transferring their interests in exchange for immediate value." Even transfers to family members are "not without restrictions." "Therefore, due to the conditions restricting the Fisher Children's right to transfer their interests in Good Harbor, it is impossible for the Fisher Children to presently realize a substantial economic benefit."

The third argument is the one that most donors will use to support the availability of the annual exclusion for gifts of interests in partnerships or LLCs. If the donees had the immediate right to sell their interests for cash or other assets they could immediately enjoy,

it would seem that the gifts would constitute present interests. The court did not explain its reasons that the right of first refusal kept the children from being able to transfer their interests for "immediate value." However, the court was probably correct in reaching this result because the LLC could pay with *non-negotiable* notes. This means that if the LLC exercised its right of first refusal, the children had no ability to sell the LLC's note for cash or other "immediate value." While the court did not explain its specific reasons, limiting the right to transfer the interest for only a non-negotiable note does seem to be a substantial impediment to being able to receive "immediate value." As suggested by *Price*, partnership or LLC agreements should not prohibit transfers. *Fisher* casts some doubt on whether merely subjecting transfers to a right of first refusal precludes annual exclusion treatment, but it would seem that the practical planning pointer from *Fisher* is that the partnership or LLC should not be able to exercise the right of first refusal by giving *non-negotiable* long term promissory notes.

20. Defined Value Clause Updates, Including *Hendrix*, *Petter*, and *Wandry*

a. *Hendrix v. Commissioner*, *T.C. Memo. 2011-133 (June 15, 2011)*.

Parents transferred stock in a closely-held S corporation to trusts for their daughters and descendants and a charitable donor advised fund (the "Foundation") using a "McCord-type" defined value formula transfer. Parents transferred a block of stock to a trust and the Foundation, to be allocated between them under a formula. The formula provided that shares equal to a specified dollar value were allocated to the trust and the balance of the shares passed to the Foundation. The trust agreed to give a note for a lower specified dollar value and agreed to pay any gift tax attributable to the transfer. Under the formula, the values were determined under a hypothetical willing buyer/willing seller test. The transfer agreement provided that the transferees were to determine the allocation under the formula, not the parents. The trust obtained an appraisal of the shares and the Foundation hired independent counsel and an independent appraiser to review the original appraisal. The trust and Foundation agreed on the stock values and the number of units that passed to each. (This description is simplified; in reality, each of the parents entered into two separate transfer transactions involving a "GST trust" and an "issue trust" and the same Foundation using this formula approach.)

The case was first filed in 2003 (and delayed until the *McCord* result was determined). This case is appealable to the 5th Circuit, and the court held that *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006) controlled. The taxpayer filed a motion for summary judgment, in light of the ruling of the Fifth Circuit Court of Appeals in *McCord,* but the judge wanted to hear evidence as to whether there was any collusion between the taxpayers and the charity. The court addressed two distinctions from that case raised by the IRS — that the transfers were not at arm's length and were contrary to public policy.

As to the arm's length argument regarding the daughters' interests, the court observed that just because the daughters were close to the parents and benefitted did not necessarily negate an arm's length transfer and that having negotiations and adverse interests are not essential to the existence of an arm's length transaction. Furthermore, there was no evidence to persuade the court that there was no negotiation or that the trusts lacked adverse interests, because the trusts assumed economic and business risks under the transactions. As to the arm's length argument regarding the Foundation, the court listed several reasons for concluding that there was no collusion between the parents and the

Foundation: (1) the transaction was consistent with prior charitable transfers by the parents; (2) the Foundation accepted potential risks including the loss of tax-exempt status if it failed to exercise due diligence; (3) the Foundation negotiated some elements of the transaction, by insisting that the parents pay income taxes attributable to the S corporation income if the corporation did not distribute enough cash to pay those taxes; (4) the Foundation was represented by independent counsel; (5) the Foundation conducted an independent appraisal; and (6) the Foundation had a fiduciary obligation to ensure that it received the proper number of shares.

As to the public policy argument, the court determined that the formula clauses do not immediately and severely frustrate any national or State policy. The *Procter* case was distinguished because there is no condition subsequent that would defeat the transfer and the transfers further the public policy of encouraging gifts to charity. The court observed that there is no reason to distinguish the holding in *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) that similar formula disclaimers did not violate public policy.

b. *Commissioner v. Petter Ninth Circuit Appeal.*

Tax Court Synopsis (T.C. Memo 2009-280, December 7, 2009)

Petter involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. These formula amounts were to be based on values as finally determined for federal gift tax purposes. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue is whether the IRS is correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.

Ninth Circuit Court of Appeals Affirmation — Synopsis

The Ninth Circuit Court of Appeals has affirmed the Tax Court decision, 653 F.3d 1012 (9th Cir. 2011), but the IRS did not make the "stand alone" public policy argument under the *Procter* case. On appeal to the Ninth Circuit Court of Appeals, the IRS argued "that part of the gifts to the charitable foundations were subject to a condition precedent — an IRS audit — in violation of Treasury Regulations 25.25222(c)-3(b)(1)." (The regulation provides that no gift tax charitable deduction is allowed for a transfer to charity that is dependent on a future act or "a precedent event" for the transfer to be effective.) The IRS dropped the public policy argument under *Procter*. The appellate court rejected the IRS's condition precedent argument. (1) There was no condition precedent to the transfers; the transfers were effective immediately on the execution of the assignment documents and "the only possible open question was the value of the units transferred, not the transfers

themselves". (2) Section 2001(f)(2), which provides that a value as finally determined for gift tax purposes means the value reported on the return unless the IRS challenges the value, does not mean that the transfers were conditioned on an IRS audit, and the court gave various reasons for rejecting that argument. (3) The result is consistent with *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), which held that an almost identical estate tax regulation did not prohibit an estate tax deduction with respect to transfers to a charity under an analogous defined value disclaimer. (4) Public policy does not invalidate a charitable deduction pursuant to this regulation because the regulation clearly does not preclude a charitable deduction in this situation. The Ninth Circuit did not address the general public policy argument against defined value transfers because the IRS explicitly dropped that argument.

c. *Wandry v. Commissioner, T.C. Memo. 2012-88.*

Synopsis

In *Wandry v. Commissioner* T.C. Memo 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." This is a very important development in the structuring of defined value transfers. Indeed, this may be the "Blockbuster Case of the Year" in estate planning circles.

Defined value clauses have been analogized to asking for $10 worth of gasoline (back in the days when attendants pumped gasoline), rather than a certain number of gallons of gas. This case literally opens up the simplicity of giving "$13,000 worth of LLC units" to make sure the gift does not exceed a desired monetary amount, or giving "$5,000,000 worth of LLC units" to make sure the donor does not have to pay gift tax as a result of the transfer of a hard-to-value asset. For sure, the planner would use a little more verbiage than that, but the simplicity of that kind of transfer is what the court recognized in *Wandry*. This is a much simpler approach than the formula allocation approach involving charities that has been approved in four earlier cases. While this kind of transfer seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless. The court rejects those arguments in *Wandry*.

Parents made gift assignments of "a sufficient number of my Units as a Member of [an LLC], so that the fair market value of such Units for federal gift tax purposes shall be as follows: [stated dollar values were listed for various donees]." Following the list of dollar values was a general statement making clear that the donor intended to have a good-faith determination of such value by an independent third party professional, but if "the IRS challenges such valuation . . . , the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The court, in an opinion by Judge Haines, held that the parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC. The gift tax returns and the attached schedules reported gifts of those dollar amounts. Unfortunately, the descriptions of the gift assets on the return created some confusion by referencing specific percentage interests, rather than clearly describing the gifts as a particular dollar amount worth of units, but Judge Haines concluded that the parties

clearly intended to make dollar value gifts and the schedules of the gift tax returns indeed reported the gifts as gifts of specific dollar values. The court also rejected an argument by the IRS that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. To the contrary, the court determined that the underlying facts determine capital accounts, not the other way around. Book entries do not override more persuasive evidence that points to the contrary.

Finally, the court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old *Procter* case. Judge Haines concluded that the transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent, and they do not violate public policy.

As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by *Procter,* the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case to result in a reallocation of units between the donors and the donees. The court in particular noted that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

As discussed below, this case is not being appealed by the IRS, but the IRS has filed a nonacquiescence in the case.

Basic Facts

All of the facts were stipulated by agreement of the IRS and the donors. Parents made gifts of limited partnership interests beginning January 1, 2000, as advised by their tax attorney, of specific dollar amounts rather than a set number of units. (Apparently, the IRS did not raise any issues about the gifts of the limited partnership interests and they were not involved in this case.) The partnership assets were later contributed to an LLC, which also housed a family business. Parents continued their gift giving program of LLC units in a similar fashion. Because the number of membership units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation could be made of the LLC's assets, the attorney advised that "all gifts should be given as specific dollar amounts, rather than specific numbers of membership units."

On January 1, 2004, each of the Parents wished to give LLC units equal to their $1,000,000 gift exemption amounts equally among their four children and their $11,000 annual exclusion amounts to each of their four children and five grandchildren. Pursuant to their attorney's advice they made gifts of LLC units "*so that the fair market value of such Units for federal gift tax purposes*" equaled those desired dollar amounts.

The actual assignment documents that each of the Parents used is as follows [the actual full assignment document is quoted because it may serve as a helpful form for defined transfer assignments by planners in the future]:

"I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The donors and family members' understanding of the nature of the gifts is summarized by the court (and stipulated by all parties) as follows

"The only gifts with respect to Norseman membership units that petitioners ever intended to give were of dollar amounts equal to their Federal gift tax exclusions. At all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units. Petitioners' tax attorney advised them that if a subsequent determination revalued membership units granted, no membership units would be returned to them. Rather, accounting entries to Norseman's capital accounts would reallocate each member's membership units to conform to the actual gifts."

An independent appraiser valued the LLC assets as of January 1, 2004 in its report issued July 26, 2005, finding that a 1% Norseman interest was worth $109,000. Based on that

value, the CPA entered on an undated and handwritten ledger that adjustments were made to the capital accounts in 2004, decreasing the Parents' combined capital accounts by $3,603,311 attributable to the gifts, resulting in increases to capital accounts to each of the children and grandchildren of approximately $855,745 and $36,066, respectively.

The CPA prepared gift tax returns for the Parents. Consistent with the gift documents, each of the Parent's returns reported total gifts of $1,099,000 and attached schedules reporting net transfers of $261,000 to each of the four children and $11,000 to each of the five grandchildren. However, the schedules "describe the gifts to petitioner's children and grandchildren as 2.39% and .101% Norseman membership interests, respectively (gift descriptions). Petitioners' C.P.A. derived the gift descriptions from the dollar values of the gifts listed in the gift documents and the gift tax returns and the $109,000 value of a 1% Norseman membership interest as determined by the K&W report." [In retrospect, the gift descriptions should have been more detailed, reflecting them as dollar value gifts.]

The IRS audited the gift tax returns. The parties ultimately agreed upon $132,134 as the value of a 1% interest in the LLC, and the IRS took the position that the gifts were of the percentage amounts listed in the "gift descriptions" and that multiplying those percentage amounts times the stipulated value of a 1% interest resulted in a gift tax deficiency.

Holdings

(1) The Parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC.

(2) The transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses because they do not operate to "take property back" as a condition subsequent, and do not violate public policy. As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exception to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. The court in particular concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

Analysis

(1) *Assignments Transferred Gifts of Specific Dollar Value of Member Units Rather Than Fixed Percentages of Member Units.* Amounts reported on estate and gift tax returns are admissions and lower values cannot be substituted absent "cogent proof" that the reported values are erroneous. The IRS argues that the gift descriptions are binding admissions and that the Parents therefore transferred the fixed percentage interests listed in the gift descriptions. The IRS cited *Knight v. Commissioner,* 115 T.C. 506 (2000). In *Knight*, the assignment document assigned partnership interests with a value of $300,000, but the returns reported gifts of 22.3% interests in the partnership, rather than a dollar value. The court distinguished Knight, because in that case the taxpayers argued at trial that the gifts were actually worth less than $300,000. That "opened the door" to the court considering the IRS's argument that the gifts were actually worth more than $300,000. The court in *Knight* concluded that the "donor's gift tax returns showed their disregard for the transfer document and that they intended to give their children 22.3% interests in the partnership."

That was not the case in *Wandry.* At all times the Parents believed they had made dollar value gifts equal to the specified dollar amounts. The gift tax returns and the attached

schedules reported gifts of those dollar amounts. "Petitioners' C.P.A. merely derived the gift description from petitioners' net dollar value transfers and the K&W report. Therefore, petitioners' consistent intent and actions prove that dollar amounts of gifts were intended."

The IRS also argued that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. The court disagreed, concluding exactly the opposite: "The facts and circumstances determine Norseman's capital accounts, not the other way around. Book entries standing alone will not suffice to prove the existence of the facts recorded when other more persuasive evidence points to the contrary." The IRS claimed that "a determination that the gifts were inconsistent with the capital accounts would be contrary to fundamental principles of the Federal tax system because it would render Norseman's capital accounts 'tentative' until a final adjudication." The court pointed out that the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect prior years; thus it could be said that a capital account is always "tentative" until final adjudication or passing of the appropriate limitations period.

(2) *Assignments Are Not Void as Savings Clauses Because They Do Not Operate to "Take Property Back" Upon a Condition Subsequent; Discussion of Procter*. The IRS argued that the assignments were an improper use of a formula to transfer assets in violation of principles established in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the trust indenture making the gift included the following clause:

> "Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort 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 Frederic W. Procter free from the trust hereby created." (emphasis added)

[**Observation: The literal language of the transfer document in *Procter* contemplates that there is a present transfer that counsel believes is not subject to gift tax, and that any property "*hereby transferred*" that would be subject to gift tax is "*deemed*" not to be included in the conveyance. This is different from the clause in Wandry that only purported to transfer a specified dollar value of property and nothing else.**]

The court in *Wandry* summarized that the "Court of Appeals for the Fourth Circuit held that the clause at issue operated to reverse a completed transfer in excess of the gift tax . . . [and] was therefore invalid as a condition subsequent to the donor's gift." (The court also summarized *Proctor's* public policy analysis; that is discussed below.)

The court reviewed other cases that have rejected attempts to reverse completed gifts in excess of gift tax exclusions. (*Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner,* 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).) The court reviewed other cases that have recognized valid formulas to limit the value of a completed transfer. (*Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009)(defined value disclaimer so that assets in excess of a defined value passed to charities); *Estate of Petter v. Commissioner,* T.C. Memo. 2009-280, *aff'd* 653 F.3d 1012 (9th Cir. 2011); *McCord v. Commissioner,* 461

F.3d 614 (5th Cir. 2006), *rev'g,* 120 T.C. 358 (2003).) (Interestingly, the court did not cite *Hendrix v. Commissioner,* T.C. Memo. 2011-133 (June 15, 2011), which also upheld a defined value sale/gift transfer.) The court noted that *King v. United States*, 545 F.2d 700 (10th Cir. 1976) upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price, but the court viewed that as an adjustment to the consideration paid in the sale rather than an adjustment of the shares transferred, and therefore not controlling in this case.

To determine what types of clauses are valid and which ones are not, the court focused on the analysis in *Estate of Petter,* which drew a distinction between a "savings clause," which is not valid, and a "formula clause," which is valid.

> "A savings clause is void because it creates a donor that tries 'to take property back.' [citing *Petter*]. On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value.' [citing *Petter*]. The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*]."

The court applied various analytical steps (quoted below in italics) that the 9th Circuit isolated in its description of the operation of the formula in *Petter.*

- "Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula." In Wandry, the units that the donees were entitled to receive essentially were expressed as a mathematical formula. Each of the children was entitled to receive a percentage of units equal to $261,000/FMV of Norseman. Each of the grandchildren was entitled to receive a percentage of units equal to $11,000/FMV of Norseman.
- "This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant." Similarly in Wandry, the formula had one unknown, the value of Norseman. "But though unknown, that value was a constant." The parties stipulated that the value of Norseman was $13,213,389. "This value was a constant at all times."
- "Before and after the IRS audit, the foundations were entitled to receive the same number of units." Before and after the audit in Wandry, the children were each entitled to receive a 1.98% interest ($261,000/$13,213,389) and the grandchildren were each entitled to receive a 0.83% interest ($11,000/$13,213,389).
- "Absent the audit, the foundations may never have received all the units there were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive." On the facts of Wandry, the donees might never have received the proper percentage interests they were entitled to without an audit but that does not mean the transfers were dependent on an IRS audit. The audit just ensured they received the percentage interests they were always entitled to receive.

Summary of "Take Back"/Condition Subsequent Issue:

> "It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization

> because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to 'take property back'. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. The clauses at issue are valid formula clauses."

(3) *Formula Dollar Value Gift Assignments Do Not Violate Public Policy.* The court in *Wandry* summarized the *Procter* public policy argument as follows:

> "The Court of Appeals further held that the clause was contrary to public policy because: (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment."

The court observed the Supreme Court's warning against invoking public policy exceptions to the Internal Revenue Code too freely, holding that the frustration caused must be "severe and immediate." *Commissioner v. Tellier,* 383 U.S. 687, 694 (1966).

As to *Procter's* first public policy reason, the court replied that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. Also there are mechanisms outside of IRS audits to ensure accurate valuation reporting. (In this case, the parties all had competing interests and each member of the LLC has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.)

As to *Procter's* second and third policy reasons, a judgment in these gift tax cases will reallocate units among the donors and donees. Therefore, the court is not ruling on a moot case or issuing merely a declaratory judgment.

The court very specifically addressed the fact that a charity was not involved in this case, but charities had been involved in the prior defined value cases approved by the courts as not violating public policy:

> "In *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, ***but it was not determinative***. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern." (Emphasis added.)

Planning Observations

(1) *A First — and a Major Development.* This is the *first reported case* to hold that a "formula transfer clause" is valid and does not violate the *Procter* analysis. The case is also important in that it is the *first reported case* to recognize the validity of defined value clauses where a charity was not involved in the formula allocation, and the case points out that the public policy analysis does not hinge on charity involvement. Four cases have previously recognized defined value clauses but they all involved formula allocation-type clauses (where the donor transfers a fixed block of shares or units and the allocation of the transferred shares or units is allocated among multiple donees by formula) and all involved charities in the formula. (*McCord*, *Christiansen*, *Petter,* and *Hendrix*.)

This is a *major development* from a planner's perspective because the formula transfer approach is much simpler than the formula allocation approach that has been approved in prior cases. (These different approaches are described immediately below.) Also, some clients do not want to make substantial charitable transfers and do not want to involve charities in the formula gifts.

(2) *Formula Assignment in Wandry May Become Form Template.* The formula assignment that was used in this case (presumably that same form was used by this attorney going back to 2000 when the Wandrys started making these stated value dollar gifts) is very clearly stated and may become a form template that will be used by planners, in light of its specific approval in this case.

(3) *Gift Tax Return Should Properly Describe the Gift.* In retrospect, the C.P.A. in *Wandry* made a mistake in describing the gift on the gift tax return as a specific number of LLC units. Aside from the public policy argument, the IRS's best argument in this case was that the description of the gift on the gift tax return as a particular number of units of the LLC suggested that the gift was actually of a fixed number of units rather than a fixed dollar value. This is reminiscent of the *Knight* case where the parties not only listed the gift on the gift tax return as a gift of a stated number of shares, but also argued at trial that the gift was actually less than the dollar value stated in the formula. The facts in *Wandry* were much better than in *Knight* in making clear that the intent was actually to transfer just a stated dollar value worth of units.

The gift tax return properly listed the value of the gifts as the stated dollar values, but the gift description should also make clear that the gift is of units of the LLC having the specified value. The description could state that based on the attached appraisal, the number of units under the formula would be x%, but that ultimately the percentage is based on the value of the units for federal gift tax purposes.

(4) *More Contemporaneous Appraisal Should Be Made.* The formula assignments were made in this case on January 1, 2004 but the appraiser did not deliver its report until July 26, 2005 — about 19 months later! The appraisal should be prepared fairly contemporaneously with the stated dollar value gift. One wonders, in this case, how the parties allocated profits and losses for 2004. The assignments had been made of member units, but there was no way to determine even the initial allocation of those units for the remainder of 2004. Presumably, the appraisal came in time both to file the gift tax returns as well as the relevant income tax returns, under extension.

(5) *Fifth Case Recognizing Defined Value Clauses.* Five cases have now recognized the validity of defined value clauses (or analogous formula disclaimers), *McCord, Christiansen, Hendrix, Petter,* and *Wandry*. Three of those are courts of appeal cases, *McCord* (5th), *Christiansen* (8th), and *Petter* (9th). Four of these cases have involved "formula allocation" type clauses in which the excess amount over a defined value passes to charity.

Christiansen, the *Petter* Tax Court case, *Hendrix,* and *Wandry* all addressed the public policy issue. The 5th Circuit *McCord* Tax Court decision did not, although a majority of the Tax Court judges in the case seemed to have no problem with the public policy concerns in *McCord.* The *McCord* and *Petter* circuit level opinions did not address the public policy issue. However, the oral argument in *Petter* before the Ninth Circuit was filled almost totally with public policy arguments, and all three judges on the panel seemed to have fun in criticizing the government's position. (For a summary of the *Petter* oral argument before the Ninth Circuit, see

http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/06_2011_Petter%2520Oral%2520Argument%2520Summary.html.)

Presumably, at some point the IRS will risk the possible assessment of attorney's fees under §7430 for continuing to assert the same argument in the face of consistent contrary court decisions. *See Estate of Baird v. Commissioner*, 416 F.3d 442 (5th Cir. 2005), *rev'g*, T.C. Memo 2002-299 (award of administrative and litigation costs against government because IRS was not substantially justified in taking the position that the only discount allowable when valuing fractional undivided interests in timberland was the cost of partitioning the property).

(6) *General Description of Defined Value Clauses and "Formula Transfer" vs. "Formula Allocation" Approaches*. In making transfers of hard-to-value interests, such as limited partnership interests in an FLP, some planners have structured gifts or sales of a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless.

There are two general types of defined value clauses, "formula transfer clauses" and "formula allocation clauses."

(i) *Formula Transfer Clause*. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula). An example *very simple* fractional formula transfer clause, which the IRS approved back in 1986 in Technical Advice Memorandum 8611004 (but would no longer approve), is as follows:

"such interest in x partnership…as has a fair market value of $_________."

Another example, somewhat more complicated but still simple in concept (designed to produce a small gift if the IRS asserts higher values for gift tax purposes to help counter a *Procter* attack) is as follows:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 [i.e., the desired dollar value to be transferred by gift] plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the 'Gift Tax Value') over $100,000. The denominator of the fraction is the Gift Tax Value of the property."

McCaffrey, *Tax Tuning The Estate Plan By Formula*, 33rd ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶ 402.4 (1999).

(ii) *Formula Allocation Clause*. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to

values. For example, the *McCord* and *Hendrix* cases used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two other cases have both involved clauses that were based on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

The formula allocation clause is significantly more complicated and by its nature includes multiple parties other than just the donor and donees. In all of the reported cases so far, these types of cases have involved a charity to receive the "excess value" over the stated dollar amount passing to family members.

(7) *THE Issue for Planners Now — Should Formula Transfer Clauses Be Used Typically Instead of Formula Allocation Clauses?* THE issue for planners regarding defined value transfers is now whether to rely on *Wandry* in using the simplicity of formula transfer clauses, or whether to continue to using formula allocation clauses in light of the fact that there are four reported cases approving those types of clauses. The analysis in *Wandry* seems persuasive to many planners and not inconsistent with the prior reported cases within the last ten years. The one rationale in *Wandry* where the analysis seems weak is the statement that other enforcement mechanisms than just IRS audits exist to ensure accurate valuation reporting. Where third parties are involved (as in formula allocation transfers) there typically are competing interests. However, when the transaction just involves a donor and donee, both parties may wish to transfer as many units as possible, and there may not be incentives for enforcing accurate valuation. (That is a reason to use a professional appraiser to prepare the valuation, as discussed below, to avoid the appearance of using the clause as a tax-dodge as opposed to legitimately attempting to structure transactions, but doing so in a way to avoid gift tax costs.) Even if that argument does not fly, there is still the argument that the IRS's role is to enforce the tax laws and not just to maximize tax collections (also stated by the Eighth Circuit in *Petter* as well as by the *Wandry* court.). Also there is the argument that was made in *Petter* that there are various other types of formula transfers contemplated in the regulations, and there cannot be a broad public policy against formula transfers.

A theoretical concern with the formula transfer vs. formula allocation approach is that the condition subsequent transfer argument mentioned in *Procter* may be stronger against a formula transfer-type clause. Whatever is not transferred under the formula remains with the donor. The government may try to argue, despite the express terms of the formula assignment language, that assets were transferred and the formula clause operates to "take property back" upon a condition subsequent, in line with *Procter's* reasoning. That argument seems totally irrelevant with a transfer using the formula allocation approach, in which nothing either remains with or returns to the donor. All of a block of some asset is absolutely transferred to someone else, and the formula merely describes how the assets are allocated among multiple recipients. Despite this additional theoretical concern of using the formula transfer-type clause, the analyses of the 9th Circuit Court of Appeals in *Petter* and of Judge Haines in *Wandry* persuasively reason that the "taking property back upon a condition subsequent" argument should not apply to transfers under the formula transfer approach—all that is transferred from the outset is the described dollar value amount.

While *Procter* has been often cited over the last 60 years, it is not a U.S. Supreme Court case, and various changes have occurred in the intervening years regarding the use of formula clauses. It is not clear that the 4th Circuit would come to the same conclusion if

it were hearing the *Procter* case today. For example, formula clauses have been sanctioned in various regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts that automatically adjust the annuity amounts retained by the donor) . In addition, the 1966 *Tellier* U.S. Supreme Court case (383 U.S. 687) limited the application of public policy exceptions to the Internal Revenue Code, holding that the frustration must be "severe and immediate."

The IRS filed a Notice of Appeal on August 28, 2012, but the government subsequently filed a dismissal and dropped the appeal on October 16, 2012. The appeal would have been to the 10th Circuit Court of Appeals—which is the circuit that approved a formula price adjustment clause in *King v. United States*, 545 F.2d 700 (10th Cir. 1976) (formula adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price).

The IRS has filed a nonacquiescence in the case. I.R.B. 2012-46 ("nonacquiescence relating to the court's holding that taxpayers made a completed transfer of only a 1.98 percent membership interest in Norseman Capital, LLC").

All in all, Judge Haines' opinion does not seem out of line with the prior Tax Court opinions, and perhaps it will be upheld in future cases. If so, it is likely that there will be a big shift toward using this type of clause. When attorneys explain to their clients that this very simple type of clause can be used (though only one case so far has upheld it) or the much more complicated clause can be used (with a charitable component to be as conservative as possible), many clients will opt for the simpler approach, even if it entails somewhat more risk until there are additional similar cases.

Clearly, the more conservative approach at this point is to use the formula allocation clause, with the "excess" value passing to charity, which has been approved in four prior cases (*McCord, Christiansen, Petter* and *Hendrix*). If the client is unwilling to involve charity, consider using formula allocation clauses where the excess value passes to some entity that does not have gift consequences (such as the spouse, a QTIP trust, an incomplete gift trust, or a zeroed-out GRAT). If the client is unwilling to employ that degree of complexity either, the client could use the *Wandry*-type very simple formula transfer clause as a backstop argument against an assessment of gift taxes by the IRS.

Some practitioners using the formula transfer approach recommend that the trust agreement specify that any disclaimed assets will remain with the donor, and that the donee(s) immediately following the transfer execute a formula *disclaimer* of any portion of the gift in excess of the value that the donor intends to transfer. The rationale is that the regulations have always recognized formula disclaimers as being valid, so even if the formula transfer for some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. Until further case law develops approving formula transfer clauses, this is a strategy that may provide additional comfort when using formula transfer rather than formula allocation clauses.

If the disclaimer approach is used and the disclaimer provision is included in the trust agreement, consider adding a provision in the trust agreement expressing the trustor's wish that the trustee would disclaim by a formula in order to benefit the beneficiaries indirectly by minimizing the gift tax impact to the settlor's family, and perhaps make the transfer to

the trust as a net gift so that if there are gift tax consequences they would be borne by the trust. That may give the trustee comfort in being able to disclaim, even though doing so could decrease the amount of assets in the trust. In addition, the formula transfer to the trust in the first place may help give the trustee comfort in making the formula disclaimer despite potential fiduciary concerns; the formula disclaimer is given in order to effectuate the settlor's intent as much as possible in making the formula transfer to the trust.

(8) *Basic Advantages/ Disadvantages of Using Defined Value Clauses*. The basic advantage of using the defined value transfer clause is creating the ability to make lifetime transfers without the risk of having to pay current gift taxes. Disadvantages include: (1) whether the defined value clause is a red flag that triggers or intensifies a gift tax audit (for formula transfer or formula allocation-type clauses); (2) complexities of administering the defined value clause (but a "formula transfer" type of clause approved in *Wandry* is much easier to administer than a formula allocation among transferees); and (3) if the IRS does not respect the clause (resulting in having to pay gift taxes) , there may nevertheless be an adjustment of the amount of assets passing to the family trust (with more assets passing to a charity or other "pourover" party) even though no tax benefits result from the adjustment (for formula allocation-type clauses) or an adjustment of the number of units passing to the family trust vs. what is retained by the donor (for formula transfer clauses). One has to believe that with the IRS's consistent losses, using defined value clauses should no longer be perceived as a red flag of an abusive transaction. As a practical matter, defined value clauses are used when large gifts are being made (to minimize the risk of having to pay gift tax if the gift tax return is audited) and reporting large gifts of hard-to-value assets on a gift tax return raises the red flag in any event.

With a formula transfer clause (as was used in *Wandry*), if the IRS does not respect the clause and imposes a gift tax on the number of units that the donor thought was transferred, for state law purposes the formula would still seem to apply (although perhaps that would be grounds for a rescission) and some of the units may remain with the donor to be included in the donor's estate for estate tax purposes. If that happens, perhaps there would not be double inclusion because under §2001(b)(last sentence), the gift is not treated as an adjusted taxable gift to be added back into the estate tax calculation if the gift asset is included in the gross estate.

One situation in which a formula transfer clause could be disadvantageous is if the asset may explode in value in the near future. If that were to happen and if the IRS prevailed in asserting that the value is somewhat higher than reported on the gift tax return, the client might prefer to pay gift tax on the relatively small amount in excess of the gift exemption rather than having some of the units remain in the donor's estate, with the subsequent large appreciation on those units being added to the donor's gross estate.

(9) *Professor Pennell Predictions — Formula Transfer Clause Valid and IRS Will Issue Regulations*. At the Heckerling Institute on Estate Planning in January 2012, Prof. Jeff Pennell expressed his viewpoint that a formula transfer type of clause should work. Other panelists did not disagree but based on existing case law were unwilling to recommend that clients use the simple type of clause at this point, joking that if Jeff was wrong, it is likely that his students won't sue him. Jeff's viewpoint is now upheld in the first reported case to consider a formula transfer type of clause.

Prof. Pennell's other prediction is that the IRS will follow up on the invitation by the 9th Circuit in *Petter*: "We expressly invite the Treasury Department to 'amend its regulations'

if troubled by the consequences of the resolution of th[is] case [quoting the U.S. Supreme Court in *Mayo Foundation*, 131 S. Ct. 704, 713 (2011)]. (However, the 9th Circuit was specifically addressing the condition precedent charitable deduction regulation rather than the general public policy/*Procter* issue.) Prof. Pennell believes the government likely will issue regulations, but he thinks the regulation writers will struggle to find a viable distinction between those formula provisions that are legitimate and those that they will continue to regard as invalid. He does not believe the government will try to reverse the clear trend in the cases that have supported defined value transfers and seek to declare that all forms of inter vivos formula provisions are improper. The government understands that many forms of formula provisions are valid—even blessed by them (such as marital deduction formula bequests and formula disclaimers, among others). Prof. Pennell thinks the IRS and Treasury will need to find a way to validate "good" formula gifts while still challenging the ones they regard as an abuse; the challenge will be in describing the distinction in a regulation so that they do not open themselves to being abused.

(10) *"Like Taking Aspirin."* Dennis Belcher expressed the viewpoint at the 2012 Heckerling Institute on Estate Planning that considering using defined value clauses with transfers of hard-to-value assets should be "like taking aspirin." They should be viewed as a normal everyday alternative. Some are concerned that this creates a red flag for the IRS but Dennis does not believe so. "You're in the soup anyway." He thinks we should be using them for large transfers this year.

The defined value clause was not as simple as just popping an aspirin when a formula allocation type clause was used. Third parties were involved, and the prior reported cases all involved charities, with substantial amounts passing to charities under the clause. If the planner and client are comfortable moving forward with the much simpler formula transfer approach that was used in *Wandry*, using defined value transfers may truly become commonplace with almost every large transfer of hard-to-value assets.

(11) *Charity Involvement. Wandry* is very helpful is stating explicitly (in two different places in the opinion) that the fact that a charity was not involved does not impact the condition subsequent or the public policy analysis.

McCord, Christiansen, Petter and *Hendrix* all address formula allocation clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. *Hendrix* gives only two reasons for its public policy analysis, that there is no condition subsequent and that public policy encourages charitable gifts. *Christiansen* and *Petter* each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved (some of which arguments were repeated in *Wandry)*.

From *Christiansen*: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. The court in *Christiansen* reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." *Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009). In light of the other more robust

discussion of the public policy issue in *Christiansen*, it is perhaps significant that *Hendrix* cited *Christiansen* with approval even if it did not repeat all of its public policy reasoning.

From *Petter*: (1) There are other potential sources of enforcement (including references to fiduciary duties to assure that the parties were receiving the proper values); (2) the case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment; and (3) the existence of other formula clauses sanctioned in regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts) suggest there cannot be a general public policy against formula provisions.

(12) *Use Professional Appraiser*. In all five of the defined value cases (*McCord, Christiansen*, *Petter*, *Hendrix*, and *Wandry*), the taxpayer used a reputable professional appraiser; in the first four cases to prepare the appraisal for purposes of making the original allocation among donees and, in *Wandry*, for the purpose of determining the number of units actually transferred. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in *Petter*) "shady dealing" by a "tax-dodging donor."

(13) *Use Grantor Trusts as Donees.* The government, in making its argument that the capital accounts should control the transfer, rather than the stated dollar values, noted that "if petitioners prevail it will likely require the preparation and filing of numerous corrective returns." That is certainly correct where the donees are individuals, as in *Wandry.* A much preferable planning design is to make the gifts to grantor trusts. Even if the ownership percentages change as a result of a gift tax audit, all of the income and losses will have been reported on the grantor's income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity's owners).

(14) *For Many, Defined Value Clauses Are Not as Important With $5 Million Gift Exemption.* Many individuals may wish to make gifts this year in excess of the $1 million gift exemption allowed under prior law, but far less than the full $5 million allowed in 2011 and 2012. For those individuals, perhaps the most important effect of the $5 million gift exemption is that it provides a great deal of "cushion" before a gift tax audit would require the payment of current gift taxes. For example, an individual who wishes to make a $3 million gift will not be as concerned as in the past with having a way to structure the transaction in a manner that will transfer as much value as possible to an irrevocable trust for children without having to pay gift taxes. Even if the individual claims substantial valuation discounts on the gift tax return, the individual may feel comfortable that current gift taxes will not be due even if there is a gift tax audit. Clients making gifts of hard-to-value assets well under $5 million this year may choose not to use any type of defined value clause. However, the formula transfer type of clause approved in *Wandry* is so simple to administer that it may become commonplace in most significant transfers of hard-to-value assets.

21. Sale to Grantor Trusts; Ten Percent Equity "Rule of Thumb;" Section 2035-2038 Attacks

Petter v. Commissioner, T.C. Memo 2009-280, *aff'd,* 653 F.3d 1012 (2011), involved "classic" sale to grantor trust planning. Mother made gifts and sales to the grantor trusts, so that the gifts reflected about 10% of the trust assets. The Tax Court opinion and the Ninth Circuit opinion (in footnote 4) specifically noted that the attorney "believed there was a rule of thumb that a trust whose debts do not exceed 90% of the value of its assets (i.e., a trust with at least a 10% capital base) would be viewed by the IRS as a legitimate, arm's length purchaser in the later sale of LLC units."

There are no hard and fast rules as to how much equity a trust should have in order to support the legitimacy of a sale to the trust. One concern is that if the trust is undercapitalized, the note given by the trust in purchasing assets will not be worth face value, and the transaction may result in a larger gift amount than anticipated. It is interesting that in this gift tax audit, the IRS did not make the argument that the note was worth less than face value because of the structure of the sale transaction (or because of having an undercapitalized trust-purchaser). Observe, that argument could have resulted in additional gift tax being due, even if the formula allocation clause was recognized, because the clause merely allocated to the trust assets having a value equal to the face amount of the note. While the 10% equity rule of thumb is not addressed by the IRS or the court, the case does provide some comfort that the IRS did not attack the transaction on the basis of not having sufficient equity "seeding" in the trust prior to the sale transaction.

There have been informal reports of the IRS on occasion attacking sale to grantor trust transactions under §§2036 and 2038 and suggesting that there must be a significant and legitimate non-tax reason for the sale under the bona fide sale exception. To help guard against §2036-2038 attacks on sales to grantor trusts where distributions from the entity are being used to make the note payments, John Porter suggests the following:

- Provide an initial gift of cash to the trust — something other than the illiquid asset that will be sold to the trust — so that the cash is available to help fund note payments;
- Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments).
- Make the initial upfront gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days), or make a "seed" gift of cash or marketable securities and sell an interest in an entity.

22. Up-Front Estate Tax Deduction for All Interest Under Graegin Loans

a. *Estate of Duncan v. Commissioner*. In *Duncan*, T.C. Memo 2011-255, the decedent had transferred a substantial part of his estate, including oil and gas businesses, to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries.

Following decedent's death in January 2006, the revocable trust *borrowed about $6.5 million* from the irrevocable trust to cover the estate's shortfall in being able to pay federal and state estate taxes and various administration expenses and debts. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. (This type of loan for a fixed term that prohibits prepayment is often referred to as a "Graegin loan," by reference to *Graegin v. Commissioner*, which approved an up-front estate tax interest

deduction for that type of loan.) A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The 6.7% interest rate was the rate quoted by the banking department of the corporate co-trustee for a 15-year balloon loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.) In fact, the revocable trust ended up being able to generate over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

The estate claimed a *deduction under § 2053 of about $10.7 million* for interest that would be payable at the end of the 15-year term of the loan. The IRS denied any deduction for the interest (although at trial it was willing to allow a deduction for three years of interest).

The court (Judge Kroupa) determined that the interest was fully deductible. (1) The loan was bona fide debt. Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. (2) The loan was actually and reasonably necessary. The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." (3) The amount of the interest was ascertainable with reasonable certainty. The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other.

b. *Key: Reducing Payment to IRS 9 Months After Date of Death.* The same ultimate estate taxes would be paid whether the interest deduction is allowed at the outset, or as each interest payment is made. This phenomenon results because administrative expense deductions are not limited to the present value of payments made years after the date of death. However, for estates facing a liquidity crunch, obtaining an up-front deduction and dramatically reducing the dollars that the estate must come up with to pay the IRS nine months after date of death is critical.

c. *2009 Cases Allowing Interest Deduction.* In *Murphy* and *Keller*, the court allowed interest deductions for amounts borrowed from partnerships (both nine-year notes). Both cases concluded that the borrowing was necessary for the estate administration.

d. *Black Refused Interest Deduction.* An interest deduction for a Graegin loan from the FLP was denied in *Black*, 133 T.C. 340 (2009). The court held that the loan was not "necessary," primarily because it did not avoid having the company stock sold in any

event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). The court reasoned that the loan process was merely a recycling of value and that the partnership could have just made a distribution.

e. *Tension of §2036 vs. Interest Deduction*. A distribution from an FLP to allow the estate to pay estate taxes may be a factor suggesting the existence of a §2036 retained interest. On the other hand, a loan from the partnership raises the issue of whether the interest is deductible. A Graegin loan from an FLP runs the risk of the estate not being able to deduct the interest and also the risk of flagging that there is a §2036 issue.

f. *Business Judgment*. Courts generally have been lenient in not questioning the business judgment of executors as to whether borrowing by the estate is necessary. However, *Black* reasoned that the borrowing was unnecessary because there could have been a partial redemption of the estate's partnership interest. John Porter points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in *Black* substituted its business judgment for that of the executor.

g. *Interest Deduction Denied in Estate of Stick v. Commissioner, T.C. Memo. 2010-192*. In *Stick* the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan. (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)

h. *Interest Deduction Allowed in Estate of Kahanic, T.C. Memo. 2012-81.*

A deduction was allowed in *Estate of Kahanic*. T.C. Memo. 2012-81. This case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053.

The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short–term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial. The IRS's arguments and the court's responses are as follows.

Loan was bona fide debt. The IRS argued that the lender never intended to create a genuine debt because she never demanded repayment and because she benefited from the estate being able to pay its estate taxes (otherwise she would have been liable for some of

the estate taxes because of transferee liability). The court responded that she did not demand payment when the loan became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the IRS's estate tax determination. The court also agreed with the estate that the ex-wife's benefiting from the estate's payment of its taxes and did not mean that she did not intend to collect the loan.

Loan was actually and reasonably necessary. The IRS argued that the estate could have recovered from the ex-wife a portion of the estate tax liabilities to pay them on the due date. The court disagreed, stating that the estate did not have a right of contribution from her for estate taxes at the time they were due because the residuary estate value at that time was sufficient to pay the taxes. In addition, the IRS maintained that the estate could have sold its illiquid assets in time to pay the taxes. The court again disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount.

Interest will be paid by the estate. The IRS believed the estate had not shown that it could pay the interest, but the court accepted the estate's counter that based on other findings in the case, the estate taxes would be reduced to the point that it could pay the interest.

i. *Possibility of Income Tax Recognition With No Offsetting Deduction If Estate Tax Interest Deduction Is Denied For Some or All of Graegin Loan.* The IRS often tries to settle cases involving Graegin loans by allowing an estate tax interest deduction for some but not all of the years of the loan. This can create a potential income tax issue where the amount is borrowed from a family entity rather than borrowing it from a bank. For the remaining years, the interest payments to the lender will still be taxable income, and there may be no offsetting income tax deduction for the estate's payment of the interest. Some planners indicate that they have been able to negotiate the estate tax settlement to provide that there will be no income recognition of the interest income in years for which an estate tax interest deduction is not allowed.

j. *Regulation Project.* The IRS-Treasury Priority Guidance Plan includes a project that addresses the application of present value concepts to estate tax administrative expense deductions. *Graegin* loans are within the scope of that project.

23. New Proposed Regulations Under §67(e); Expenses of Trusts and Estates That Are Subject to the "2% Floor" on Deductions

a. *Synopsis*

Under §67(a), miscellaneous itemized deductions generally may be deducted only to the extent they exceed two percent of adjusted gross income. Section 67(e)(1) provides an exception for costs of estates or trusts that "would not have been incurred if the property were not held in such estate or trust." The Supreme Court in *Knight v. Commissioner* interpreted §67(e)(1) to apply to expenses that are not commonly or customarily incurred by individuals. The proposed regulations regarding the application of §67(e) that were published before *Knight* was decided have been withdrawn (as requested by many commentators) and new proposed regulations have been issued that reflect the Supreme Court's decision. Unfortunately, the proposed regulations offer little in the way of workable and easy-to-apply safe harbors. Highlights of the new proposed regulations include the following.

- The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior proposed regulations), but whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."
- In making the "commonly or customarily incurred" determination, the type of product or service actually rendered controls rather than the description of the cost.
- "Commonly or customarily" incurred expenses that are subject to the two-percent floor include costs in defense of a claim against the estate that are unrelated to the existence, validity, or administration of the estate or trust.
- "Ownership costs" that apply to any owner of a property (such as condominium fees, real estate taxes, insurance premiums, etc. [other examples are listed]) are subject to the two-percent floor.
- A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor. Costs of preparing all other returns are subject to the two-percent floor.
- Investment advisory fees for trusts or estates are generally subject to the two-percent floor except for additional fees (above what is normally charged to individuals) that are attributable to "an unusual investment objective" or "the need for a specialized balancing of the interests of various parties." However, if an investment advisor charges an extra fee to a trust or estate because of the need to balance the varying interests of current beneficiaries and remaindermen, those extra charges *are* subject to the two-percent floor.
- Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the two-percent floor and those that are not.
- A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the two-percent floor. All of the balance of the bundled fee is *not* subject to the two-percent floor (This exception may be overly broad as applied to attorneys' and accountants' fees.)
- If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the two-percent floor, that portion of the bundled fee will be subject to the 2% floor.
- Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requests comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS is particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggests that it will not use.

b. *Unbundling.* The proposed regulations state that "any reasonable method" may be used. The Preamble to the regulations requests comments for the types of methods for making a

reasonable allocation. The first set of proposed regulations had a list of safe harbors that were eliminated in the newly issued proposed regulations. Jeff Pennell recommends using the safe harbors in the first set of proposed regulations as the starting point to determine a "reasonable method" of unbundling. Interestingly, none of the cases that have addressed §67(e) have required unbundling, and indeed some have commented that trustees fees would not be subject to the 2% floor.

c. *Unbundling Effective Date*. The Preamble reiterates the timing under Notice 2011-37, that unbundling of fiduciary fees is not required for taxable years beginning before the date of the issuance of final regulations. Therefore, 2013 is the earliest that a trust would have to report unbundling.

d. *AMT Impact*. The often overlooked but quite significant impact of §67(e) is that all expenses subject to §67(e) are AMT preference items. Quite often, this is much more significant than the loss of the income tax deduction for miscellaneous itemized deductions up to the first 2% of taxable income.

e. *Final Regulations Likely to be Very Similar*. Jeff Pennell concludes that the IRS turned a deaf ear on the comments filed with respect to the first set of proposed regulations, and he anticipates that they will do so with respect to the second set as well and that the final regulations will be very similar to the recently issued proposed regulations.

24. Substitution Power Not a § 2042 Incident of Ownership, Rev. Rul. 2011-28

a. *Follow-up to Rev. Rul. 2008-22*. Revenue Ruling 2008-22, 2008-16 I.R.B. 796, provides that a grantor non-fiduciary substitution generally will not trigger estate inclusion under §§ 2036 or 2038 as long as several conditions are met (which are typically provided by state law). However, that ruling does not address whether a nonfiduciary substitution power (which is often used to cause a trust to be a grantor trust for income tax purposes), will result in the holder of the power having an incident of ownership under §2042 if the trust assets include a life insurance policy on the power holder's life. The §2042 issue under a nonfiduciary substitution power has been on the IRS "business plan" for several years.

b. *Rev. Rul. 2011-28*. Revenue Ruling 2011-28, 2011-49 I.R.B. 831, concludes generally that a nonfiduciary substitution power will not constitute a §2042 incident of ownership.

The precise holding (and limitations on the holding) is very similar to the precise holding in Rev. Rul. 2008-22. The IRS's approach toward this issue is intriguing because a 1979 Revenue Ruling, however, provides that the IRS position is that a power to purchase a policy *does* create an incident of ownership. Revenue Ruling 79-46, 1979-1 C.B. 303, takes the position that an employee has an incident of ownership if the insured's employment contract gives the insured the right the buy the policy at any time for its cash surrender value. The ruling reasons that the right to buy the policy amounted to a power to veto the policy's cancellation, and that constituted an incident of ownership. The IRS lost that argument in *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979), *acquiesced in result*, 1981-1 C.B. 2, but the acquiescence in result only disagrees with the Tax Court's reasoning of what constitutes an incident of ownership, and Rev. Rul. 79-46 has never been withdrawn. **Interestingly, Rev. Rul. 2011-28 does not retract the prior seemingly inconsistent ruling, and does not even mention the *Estate of Smith* case, which directly supports the conclusion of Rev. Rul. 2011-28.**

In any event, in light of Rev. Rul. 2011-28, the substitution power can now apply to a life insurance policy on the power holder's life without causing estate inclusion of the life insurance policy and without requiring any additional language in the trust instrument. Prior to the issuance of Rev. Rul. 2011-28, trust agreements often provided that the substitution power would not apply to such life insurance policies. That limitation can now safely be omitted from trust agreements.

c. *Exercise of Substitution Power; Difficulty of Valuing Life Insurance Policies.* Both Rev. Rul. 2011-28 and 2008-22 condition the conclusion that assets are not included in the estate under §§2036, 2038 or 2042 on the fiduciary "satisfying itself that the properties acquired and substituted by the grantor were, in fact, of equivalent value." Interestingly, under §675(4), in order for a nonfiduciary substitution power to cause a trust to be a grantor trust, the power must be exercisable "without the approval or consent of any person in a fiduciary capacity." Apparently, satisfying that the substituted property is of equivalent value is different than giving "approval or consent." There seems to be a positive disconnect between the estate tax ruling and the income tax requirements in §675(4). Consider using a third-party substitution power which was authorized in the 2007 revenue procedures containing a model CLAT forms.

This valuation issue could be particularly difficult for life insurance policies, which by their nature can be very difficult to value. However, as a practical matter, the substitution power over a life insurance policy typically would never be exercised. The important planning point is that the mere existence of the substitution power does not cause the trust to be a grantor trust, and that power can now safely be used for life insurance policies as well as other assets. Caution should be exercised if the power holder ever wishes to actually exercise the power.

d. *Voting Stock of "Controlled Corporation."* Similar to what has been done in the past for life insurance policies, some planners suggest providing that the nonfiduciary substitution power should not be exercised to acquire to any voting stock of a "controlled corporation" for purposes of §2036(b). A substitution power might be treated indirectly as the power to control the voting of the stock under § 2036(b). In any event, there should be no reason to exclude partnerships from having substitution powers (in light of the fact that §2036(b) only applies to corporations and not partnerships).

While there is now direct confirmation that a nonfiduciary substitution power does not constitute a §2042 incident of ownership, which lends strength to the argument that the mere power to acquire trust assets for full value does not result in a shifting of benefits and should not be treated as an indirect taxable power over the assets, still there is no direct confirmation from the IRS that a nonfiduciary substitution power will not be treated as an indirect power to control how the stock is voted. Some planners may continue to except stock of a controlled corporation under §2036(b() from the scope of the nonfiduciary substitution power.

25. Alternate Valuation Date — Proposed Regulations Regarding Effect of Distributions, Sales, Exchanges or Dispositions During Six-Month Valuation Period on Alternate Values

a. *Alternate Valuation Date Election.* An executor may elect to have the estate assets valued as of a date six months after the decedent's death. §2032(a). Distributions, sales, exchanges, or dispositions during the first six months after the date of death generally trigger valuation on the "transaction date" rather than on the six-month date.

b. *2008 Proposed Regulations*. Proposed regulations issued in 2008 provide that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events. "Market conditions" is defined as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued." The regulation goes on to provide that "[c]hanges in value due to mere lapse or time or to other post-death events other than market conditions will be ignored…under the alternate valuation method." Prop. Treas. Reg. §20.2032-1(f)(1). The 2008 proposed regulation was to be effective, when the regulation was finalized, for estate of decedents dying on or after April 25, 2008.

c. *2011 Proposed Regulations*. The IRS received comments to the 2008 proposed regulations raising enough concerns that the IRS withdrew those proposed regulations and issued new proposed regulations on November 17, 2011. The new proposed regulations take the approach of describing events that constitute an acceleration event, whereas the prior proposed regulations described events that would be ignored (such as a recapitalization).

Highlights of the new proposed regulations are briefly summarized.

- There is a general rule describing very broadly transactions that constitute distributions, sales, exchanges, or dispositions that trigger valuation on the "transaction date" rather than on the 6-month date). Prop. Reg. §20.2032-1(c)(1)(i). There is a nonexclusive long list of events including investing in other property, contributions to an entity (whether nor not gain is recognized on the contribution, an exchange of an interest in an entity for a different interest in that entity or in another entity (unless the fair market values of the exchanged interests are within 5% of each other, Prop. Reg. §20.2032-1(c)(1)(ii)).
- Also included in the general rule list of accelerating transactions is a change in the ownership structure or interest in or assets in an entity such that the interests after the change does not reasonably represent the property at the date of death, including the dilution of the decedent's ownership interest, the redemption of a different owner which increases the decedent's ownership interest, a reinvestment of the entity's assets, and a distribution or disbursement of property by the entity other than earnings or expenses paid in the ordinary course of business (but see the exception below that applies to distributions or disbursements) . Prop. Reg. §20.2032-1(c)(1)(i)(I).
- There is an exception for a distribution or disbursement from an entity or from other assets if the distribution/disbursement does not reduce the combined value of the payment plus the entity value after the distribution/disbursement. In that case the alternate value is the value of the payment on the payment date and the value of the remaining interest in the entity on the 6-month date. Prop. Reg. §20.2032-1(c)(1)(iii)(A).
- A special aggregation rule applies when *part* of an interest owned by the decedent is "distributed, sold, exchanged or otherwise dispose of" during the initial 6 months. The special aggregation rule *eliminates the application of fractionalization discounts* in determining the value of the interest or interests that are distributed and of any interest remaining in the estate at the end of the six-month period (if any). For example, if the estate distributes 70% of Blackacre to beneficiary A after one month and distributes

the remaining 30% to beneficiary B after two months, the value of each distribution is determined on the respective distribution date without any fractionalization discount. Prop. Reg. §20.2032-1(c)(1)(iv).

- Property that is distributed by beneficiary designation or by operation of law is not treated as a disposition. Prop. Reg. §20.2032-1(c)(2). Those various distributed interests are valued on the six-month date.
- There are a number of examples illustrating these rules. As examples, a contribution of assets to a limited partnership or the dilution of a decedent's interest in an entity to a noncontrolling interest is treated as an accelerating transaction. Also, multiple distributions or sales of interests during the six-month period are treated as proportionate distributions without applying a fractionalization discount attributable to the fractionalized interests thereby created.
- These provisions specifically apply to IRAs and retirement plans. For example, merely retitling the IRA account into the name of the beneficiary or dividing the account into separate accounts for various named beneficiaries is not treated as a disposition for alternate valuation date purposes. Prop. Reg. §20.2032-1(c)(5)Ex.12. The rules apply to retirement accounts on an asset-by-asset basis. For example, sales of specific assets or withdrawals from the account are treated as dispositions and the alternate valuation date for those particular sold or distributed assets from the IRA or retirement account is the date of such sale or withdrawal. Prop. Reg. §20.2032-1(c)(5)Exs.10-11.
- The new proposed regulation will be effective for estates of decedents dying on or after the date the regulations are finalized (rather than on the date the proposed regulations were issued, which was the approach taken with the 2008 proposed regulations).

26. Protective Claim for Refund Procedures, Rev. Proc. 2011-48

a. *Section 2053 Regulation*. The IRS issued final regulations on October 20, 2009, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amounts for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Treas. Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved, even if that is after the general period of limitations on refunds has expired. Treas. Reg. §20.2053-1(d)(5).

The §2053 regulation briefly addressed protective claims for refund regarding §2053 deductions. It identified issues involving timing of filing protective claims (before the statute of limitations runs on refunds), identification of claims (requiring a description of the reasons and contingencies delaying actual payment of the claim but not requiring listing of actual amounts), and consideration of the claim after the contingency is resolved (requiring notification to the IRS "within a reasonable period that the contingency has been resolved").

The regulations also provides that the possibility of a contingent claim against an estate will not reduce the amount of a marital or charitable deduction available on the estate tax return, even if the contingency is payable out of a marital or charitable share. However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

The preamble to the final regulations indicates that the IRS will issue further guidance regarding the process of using protective claims for refund. Two years later, we have received that guidance.

Guidance is available from three different resources in making protective claims for refund: Rev. Proc. 2011-48, Notice 2009-84, and CCA 200848045.

b. *Overview of Rev. Proc. 2011-48.* Rev. Proc. 2011-48, 2011-42 IRB 527 describes procedures for filing §2053 protective claims for refund (in §4) and procedures for notifying the IRS that a §2053 protective claim for refund is ready for consideration (§ 5).

The procedures described in §4 for filing and processing the protective claim include the timing of filing the protective claim, who can file the protective claim (and documenting the authority of such person), two alternative methods for filing the protective claim (a separate filing is required for each separate claim), the required manner of specifically identifying of the particular claim or expense, the processing of a protective claim by the IRS (filing a protective claim does not delay the estate tax audit or issuance of a closing letter), the advisability of contacting the IRS if the filer does not receive acknowledgement from the IRS that it has received the protective claim within a specified period of time, and the opportunity to cure an inadequately identified claim or expense.

Procedures in §5 for giving "notification of consideration" of the claim after it has been paid or after contingencies have been resolved include procedures and time period for notifying the IRS, alternatives for "perfecting" the claim when multiple or recurring payments are part of the protective claim, who can perfect the claim if there is no longer an executor or personal representative for the estate, limits on reviewing other aspects of the estate tax return in considering the claim, and necessary adjustments to the marital and charitable deduction if the claim was paid from a charity or surviving spouse's share of the estate.

c. *Exception.* The new rules do not apply if the claim is less than $500,000. A qualified appraisal is required, but for small claims (say $30,000) it is unlikely that the IRS will be particularly strict on the appraisal requirement.

d. *Issues Addressed.* Rev. Proc. 2011-48 addresses a wide variety of issues, including the following:

- Limited scope of review when the protective refund claim is considered—as long as the procedures in Rev. Proc. 2011-48 are satisfied;
- Time period for filing protective claim;
- Alternative methods of filing protective claim for refund;
- Processing of protective claim after it is filed;
- Separate filling required for each separate claim or expense;
- Identification of the claim or expense and ancillary expenses;
- Opportunity to cure inadequately identified claims;
- Audit not delayed by filing protective claim for refund;
- Perfecting protective claim by notifying IRS of payment or resolution of contingency; (the Revenue Procedure does not explicitly say so, but apparently the claim for refund is *forever barred* after the expiration of the general period of limitations *if the taxpayer does not meet a 90-day deadline* or establish reasonable cause for the delay);
- Coordination with marital or charitable deduction; and

- Effective date (protective claims for refund under §2053 for decedents dying on or after October 20, 2009.

27. Tax Patents Invalidated Under Patent Reform Legislation; Validity of SOGRAT Patent Under Review

a. *America Invents Act Bans Tax Strategy Patents*. Congress passed the "America Invents Act" on September 8, 2011. Section 14 of that Act provides that tax strategies are not patentable because they are "deemed insufficient to differentiate a claimed invention from the prior art." The issue of tax strategy patents has been under study for several years, and the approach of this legislation was suggested by the Patent and Trademark Office staff in conjunction with the Senate Finance Committee and Senate Judiciary Committee staff as a way to deal with tax strategy patents that would not set a blanket exemption precedent that might apply to other types of patents. There are exceptions for tax preparation software and for financial management systems.

The tax strategies provision applies to any patent pending and any patent issued after the date of enactment. Therefore, for example, it would not invalidate the SOGRAT patent.

b. *SOGRAT Patent Under Review*. The director of the U.S. Patent and Trademark Office, in a very unusual move, has instituted a formal review of the validity of the 2003 SOGRAT Patent, dealing with the transfer of stock options to a GRAT. Third parties can request patent reexaminations, but only about 1% of reexaminations are instituted by the PTO itself. As reported by Tax Analysts (May 13, 2011) the order for reexamination contains strong language suggesting the invalidity of the SOGRAT patent:

> "… it is apparent… that an examining procedure has not been followed, which has resulted in the issuance of a claim in a patent that is *prima facie* unpatentable."

The Tax Analysts report says the reexamination order listed several prior articles about the operation of GRATs that were not considered by the examiner. There is no indication of what prompted this unusual move by the Director of the PTO to order the reexamination of the SOGRAT patent.

Reexaminations are typically rather lengthy. Professor Ellen Aprill, Loyola Law School, indicates that the average reexamination time is 26 months.

Interestingly, the owner of the SOGRAT patent rights sued John W. Rowe, ex-CEO of Aetna, Inc., in 2008 regarding the transfer of Aetna stock options to a GRAT, and the lawsuit was reportedly settled. The settlement terms are unknown but it is conceivable that Mr. Rowe paid a substantial settlement with respect to the alleged violation of a patent, where the patent may ultimately be determined to be invalid.

28. Significant Stipulated Undivided Interest Discounts; Substantial Valuation Reduction for Property Subject to Long-Term Lease; Art Valuation; *Estate of Mitchell*, T.C. Memo. 2011-94.

Brief Summary. In *Estate of Mitchell,* T.C. Memo. 2011-94, large fractional interest discounts were created for fractional interest transfers made on the eve of death (both the fractional interests transferred and the fractional interests retained in the estate of the donor). The case does not discuss the "eve of death" issue but the parties stipulated to the discounts. The analysis used by the court to determine the value of property subject to a long term lease can lead to substantial discounts (depending on the appropriate growth assumptions and discount-to-present value factors at the time of the valuation).

In this case, the IRS and the estate stipulated to significant undivided interest discounts in valuing gifts of 5% interests and the remaining 95% interests owned at the donor's death in two separate real properties. The court rejected a novel approach by the IRS's expert in valuing those underlying real properties that were subject to long-term leases.

Basic Facts. Mr. Mitchell discovered that he had cancer in 2004. Mr. Mitchell owned Beachfront and Ranch properties. The two properties were also subject to long-term leases (20 years for one and 25 years for the other). Mr. Mitchell gave 5% undivided interests in the Beachfront property and the Ranch to trusts for his sons *six* days before he died. (The opinion does not reflect whether Mr. Mitchell knew that his death was imminent within the next several days at the time of the gifts.) The estate and the IRS ultimately agreed to all issues except the valuation of the Beachfront and Ranch properties and two paintings.

Undivided Interest Discounts. The opinion reflects that the estate and IRS stipulated to the following significant undivided interest discounts in the Beachfront and Ranch properties:

Beachfront property:	32% discount for 5% gifted interest; 19% discount for 95% interest owned at death
Ranch property:	40% discount for 5% gifted interest; 35% discount for 95% interest owned at death

The opinion does not reflect any of the factors that entered into the amounts of those discounts. The taxpayer's valuation expert has indicated that the IRS initially argued for very low undivided interest discounts on the 95% interests owned at death, by basing discounts just on the costs of partition, in reliance on the recent *Ludwick* decision. Hoffman, *Estate of Mitchell* Scores Lopsided Victory for Taxpayer, FMC Valuation Alert (May 5, 2011). Taxpayer's counsel distinguished the *Ludwick* case, because that article indicates a joint tenancy agreement governing the property in that case gave each owner a put right for their interest at a non discounted value. Based on that distinction and the taxpayer's expert reports (from FMV Opinions, Inc.), the parties ultimately agreed on the stipulated undivided interest discounts.

Neither the court's opinion nor the summary of the case by the valuation expert address whether the fact that the 5% undivided interest was given only *six* days before Mr. Mitchell's death was a factor in whether to recognize the undivided interests for valuation purposes. *See Estate of Murphy v. Commissioner*¸ T.C. Memo 1990-472 (minority discount not recognized where sole reason for gift 18 days before death was to create minority interest); *Estate of Frank v. Commissioner,* T.C. Memo 1995-132 (minority discount allowed where decedent's son made gifts under power of attorney two days before date of death); *cf. Pierre v. Commissioner*, T.C. Memo 2010-106 (step transaction doctrine applies to aggregate gifts and sales made to trusts, to value gift and sale interests to each of two trusts as combined 50% interests).

Valuation of Leasehold Interests. The parties agreed that the court would determine the value of 100% interests in the two properties, and then apply the stipulated discounts to determine the gift and estate valuations of the respective 5% and 95% interests. The IRS expert used a "novel lease buyout method," valuing the leased property at "the real property's fee simple absolute value less the amount a landlord would have to pay to buy out a tenant (buyout amount). The court rejected the lease buyout method as being "speculative at best" and because it "has not been accepted by any court or generally recognized by real property appraisers."

The court applied the method utilized by the taxpayer's experts, the income capitalization method, which:

(1) determines the appropriate term of the lease;

(2) determines the present value of the anticipated lease payments over that term using an appropriate discount rate, and adds to that value

(3) the value of the reversionary interest in the property, using an assumed growth rate from the current value of the fee interest and applying an appropriate discount rate considering inherent risks of real estate ownership and competitive alternative investments.

The court adopted the approach of one of the taxpayer's experts of using a discount rate of 9.5% for discounting the present value of the lease payments. The court also used a 3.5% assumed growth rate for the properties and a 9.5% discount rate for determining the value of the reversionary interest in the property following the lease term. Observe, that having an assumed growth rate that is much lower than the discount rate means that the reversionary interest is much lower for longer term leases. The properties are assumed to grow at only 3.5% over the 20 and 25 year terms from the current values of the fee interests, but the augmented values are then discounted at 9.5%, resulting in reversionary interest values that are much lower than the current values of the fee interests.

Interestingly, the decedent's father had leased the property under long-term arrangements even before the decedent acquired the properties, and the decedent was merely continuing the pattern of operation with respect to these properties. The properties were leased to third parties as a way of producing income for the family and maintaining the properties without expense to the family in light of the goal of maintaining ownership of these two properties within the family.

This analysis resulted in extremely large discounts because of the long leasehold interests — having nothing to do with having rental rates that were below market. In this case, even before taking into account the undivided interest discounts, the valuation of the 100% fee simple properties, but subject to the leasehold interests, resulted in the following values compared to the current unencumbered fee simple values of the properties:

Beachfront property: $6 million vs. $14 million

Ranch property: $3.37 million vs. $13 million

29. Circular 230

Circular 230 is extremely important, because it provides ethical rules (and possible sanctions — including suspension) for tax advisors. Circular 230 was amended August 2, 2011. Highlights of some of the changes are described.

a. *Changes to § 10.51* — eFiling and PTINs. If a preparer is required to file returns electronically under § 6011(e)(3), the failure to do so is a Circular 230 violation if the failure is "willful." Circular 230, § 10.51(a)(16). Last year, eFiling was required if a firm filed at least 100 returns; next year this number is reduced to only 10 returns or more. Many more firms will be subject to eFiling next year.

   Preparing a return or refund claim without a valid preparer tax identification number (PTIN) is a violation if done willfully. Circular 230, § 10.51(a)(17). There is an exception for paralegals (who prepare returns under the supervision of a valid return preparer). It is not totally clear whether every paralegal must get a PTIN, but advisors should not take any risk. Paralegals do not have to comply with the educational requirements of PTIN holders because they are supervised. If a secretary helps pull together information for a return, get a PTIN for that secretary as well.

b. *Changes to §10.36* — Firm Management Required to Take Steps To Ensure Firm's Compliance With Circular 230. The head of the tax department must adopt a program to implement Circular 230. Many department heads have taken no steps whatsoever in this regard. Possibilities could include holding department meetings to discuss the rules or requiring members to read Circular 230 (Alaska requires attorneys to file affidavits that they have read the state ethics rules every three years). Just having members meet state law CLE ethics requirements is not sufficient. The department head must adopt specific procedures to assure compliance with Circular 230. This is a very important affirmative duty.

c. *Provisions of §10.34* — Reporting Positions. The provisions of §10.34, as amended by the recent changes are summarized. The Preamble to the Circular 230 amendment indicates that §10.34 is designed to incorporate the rules under §6694 (which addresses preparer penalties) and specifically incorporates Notice 2009-5, which discusses what constitutes "substantial authority" under §6694.

- The reporting standards apply to pre-transaction and post-transaction advice about positions to take on a return.
- A preparer may not "willfully, recklessly, or through gross negligence" sign a return or advise a client to take a position on a return or prepare any portion of a return that, among other things, is an "unreasonable position" within the meaning of §6694(a)(2) (including regulations and published guidance to that section — which would include Notice 2009-5). Thus, Circular 230 generally incorporates the reporting position standards used in §6694 (but a practitioner violates Circular 230 only if the practitioner acts "willfully, recklessly or through gross negligence" in not satisfying those reporting position standards).
- Reading §6694(a)(2) and the regulations into §10.34 means that (a) for income tax returns there must be substantial authority but it can be reduced to a reasonable basis standard if there is disclosure of a disputed position on the return or the preparer delivered a disclosure statement to the taxpayer, and (b) for other returns, there must be substantial authority, but it can be reduced to a reasonable basis standard if the advisor advises the client about penalties that may apply and about opportunities to avoid penalties through disclosure. (However, as discussed immediately below, the practitioner is required to give this penalty advice in any event, so in effect the standard for returns other than income tax returns is a reasonable basis standard under Circular 230.)
- A practitioner must advise the client "of any penalties that are reasonably likely to apply to the client" with respect to a return AND ALSO "must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure." This requirement under Circular 230 to advise the client of penalties and of disclosure opportunities to avoid penalties applies even if the preparer is not subject to preparer penalties.
- Court cases and IRS guidance may be used to support the existence of "substantial authority," but not secondary authorities (such as Heckerling presentations, articles, or treatises).

30. Lapsing Voting Rights at Decedent's Death Considered Under §2704(a) in Valuing Stock, *Estate of Rankin M. Smith*

Synopsis

Rankin M. Smith and his family owned the Atlanta Falcons NFL franchise. Mr. Smith died in 1997, and the Court of Federal Claims over 20 years later has finally resolved an issue regarding the application of §2704(a) to Mr. Smith shares, which lost preferential voting rights at this death. *Estate of Rankin M. Smith v. Commissioner*, 109 AFTR 2d 2012-987 (Court of Federal Claims, February 13, 2012).

Section 2704(a), adopted in 1990, provides that for gift and estate tax purposes a lapse of voting rights of an individual's shares of stock is treated as a transfer in the amount of the value of the shares before the lapse (determined as if the rights were not lapsing) less the value of the shares after the lapse, but only if the individual and the individual's family controlled the corporation (meaning holding at least 50% by vote or value of the stock of the corporation).

The decedent's Class A shares, which had 11.64 votes per share, converted to Class B shares, which had one vote per share, at the decedent's death. The lapsing voting right provision was created in 1991, after §2704(a) was enacted.

The estate and government (with the agreement of the Joint Committee on Taxation) stipulated that the shares were worth $30 million with the preferential voting rights and $22.5 million without.

The court concluded that §2704(a) applied, and the value of the Class A shares, with their preferential voting rights, was included in the gross estate.

Planning Observations

1. *Coordination of Gift and Estate Inclusion.* While §2704 clearly applies for both gift and estate tax valuation purposes, the §2704 regulations do not address the coordination of applying §2704 to transactions that may result in a gift as well as estate inclusion. For example, the case does not directly suggest that the factual scenario addressed in Rev. Rul. 89-3 would not continue to result in a gift, even after the passage of §2704. Whether the IRS would continue to take the same position as in Rev. Rul. 89-3 is not clear because the Revenue Ruling specifically stated that it did not purport to address the application of §2036(c) and *Smith* indicates that §2704 replaced §2036(c). Assume that an individual agrees to receive shares with voting rights that lapse at the individual's death in exchange for shares with voting shares without any lapsing provisions. The shares with lapsing voting rights are undoubtedly worth less than the shares without that restriction, and if the individual's family members hold the remaining shares, the IRS may treat that transaction as a gift to the family members (generally reflecting the value by which the lapsing voting rights at the individual's death impairs the current value of the stock). Section 2704 would not apply in valuing that gift because, as *Smith* makes clear, §2704 applies when there is an actual lapse of the voting rights. At the individual's death, the voting right would actually lapse and under §2704 the decedent's shares would be valued for estate tax purposes as if there were no lapse in the voting right. This would seem to result in a double inclusion to some extent. For gift purposes, the reduction in value because of the lapse of voting rights at some future time (which may be the measure of the gift) may be less than the reduction in value at death, but still there would be some degree to which the additional value included in the decedent's estate was also included in the prior gift. Perhaps an adjustment would be permitted by the provision in §2001(b) stating that "gifts

which are includible in the gross estate of the decedent" are not included in the estate tax calculation as "adjusted taxable gifts." However, the meaning of those terms in this context is not totally clear. The gift was attributable to giving up the stock without lapsing voting rights, whereas that stock is not longer owned by the decedent to be included in the gross estate, but a fictional amount of value is included in the estate.

2. *Is the Lapsing Value Really Transferred?* The estate and gift tax applies to "transfers" because of the constitutional restriction against a direct tax on property. At first blush, it might seem that the lapsing voting rights are not transferred to anyone, and therefore should not be the subject of a transfer tax. However, that concern may be the reason in §2704 for requiring that the transferor and his or her family have control of the corporation both before and after the transfer. The value attributable to the lapsed voting rights generally inures to the benefit of the remaining shareholders who own voting stock, and therefore obtain additional control over the corporation. For example, if family members do not own any of the corporation's voting stock, the decedent is not actually transferring any value at all to family members, but the additional value attributable to obtaining voting control upon the lapse of the shares would pass to third parties, and presumably the "ordinary course of business" exception (see Treas. Reg. §§25.2511-1(g)(1), 25.2512-8) would apply.

   Under the facts of *Smith*, however, the family members did have their voting rights increased substantially with respect to their shares as a result of the lapse of the preferential voting rights at the decedent's death. Following the lapse of voting rights at the decedent's death, the total votes held by the family members attributable to their shares (not including any of the decedent's shares) increased from 15.7% to 55.35%. As a result of the voting rights lapse, the family members acquired control of the corporation and thus there was a "transfer" of real economic value to the family because of the lapsing voting rights. Taking into consideration the decedent's shares after death (with their reduced voting rights) that passed to family members, the family held 88% of the total votes (even beyond the two-thirds vote that might required under the laws of some states for extraordinary actions).

3. *Detailed Background Analysis Regarding Jurisdiction to Hear Refund Cases, Summary Judgment, Statutory Construction Principles, and Deference to Regulations.* The case has a comprehensive analysis of various background issues, including:

   - Jurisdictional requirements for courts (and the Court of Federal Claims in particular) to hear estate tax refund actions;
   - Procedural issues in summary judgment actions, including who bears the burden of showing the absence of genuine issues of material fact, and when summary judgment is appropriate;
   - Principles of statutory construction, including the relevance of legislative history; and
   - A detailed analysis of the considerable deference that courts give to regulations.

31. Retained Testamentary Limited Power of Appointment Not Sufficient to Make Transfer to Trust an Incomplete Gift, Effect of "No Contest" and Arbitration Clauses on Crummey Withdrawal Rights, *CCA 201208026*

CCA 201208026 was released February 24, 2012 from the IRS Chief Counsel office.

a. *Basic Facts*. In CCA 201208026 individuals made a gift to a trust, which provided that the trustee (the grantor's son) could make distributions to a variety of beneficiaries (including a charity) for "health, education, maintenance, support … or for any other purposes." The trust lasts for the grantors' lives (unless the trust is sooner terminated by reason of distributions of all of its assets). The grantors retained testamentary limited powers of appointment.

The trust provides that the construction, validity and administration of the trust will be determined by state law "but provision is made for Other Forum Rules" (presumably arbitration provisions). In addition, a beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the trust (referred to below as the "no contest" clause).

b. *Incomplete Gift Treatment — General Background*. The CCA concluded that the entire transfer was a completed gift despite the grantor's retained testamentary limited power of appointment.

If a donor makes a transfer to a trust and keeps the power to shift benefits from one beneficiary to another, that causes the gift to be incomplete for gift tax purposes unless the power is a fiduciary power limited by a fixed or ascertainable standard. Reg. §25.2511-2(c). No gift tax is payable with respect to the transfer. However, when distributions are made from the trust, the donor no longer has the ability to shift assets away from the beneficiary, so the gift is completed at that time to that extent of the distribution. Reg. §25.2511-2(f). Furthermore, the assets that remain in the trust at the donor's death will be in the donor's estate for estate tax purposes under §§2036(a)(2) or 2038.

A strategy that often has been used by planners when a person wishes to make a transfer to a trust but does not want it to be a completed gift is to retain a testamentary limited power of appointment. A classic example, is that if a person transfers assets to a "self-settled" trust in a jurisdiction that does not allow creditors to reach the trust assets merely because the settlor is a discretionary beneficiary, the person may wish to create a pool of assets as a protected nest egg in the remote event of a severe financial reversal, but the person does not want to make a completed gift subject to gift taxes. A classic strategy that has been used some planners in that situation is to provide that the settlor has a testamentary limited power of appointment to shift assets among a listed group of appointees. (However, that strategy by itself will likely no longer be used after the issuance of this CCA until there is further clarification of the incomplete gift issue.)

The regulations address a particular situation regarding retained testamentary powers of appointment. The complete discussion from the regulations is as follows:

> "For example, if a donor transfers property to another in trust to apply the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift." Reg. §25.2511-2(b).

The regulation addresses a situation in which the trustee can distribute income *to the donor* or accumulate it in connection with a retained testamentary power of appointment, but it does not address a situation similar to the CCA facts in which the trustee has the discretion to make distributions *to third parties* and the donor has retained a testamentary power of appointment.

c. *Incomplete Gift Treatment — CCA Analysis*. The CCA concluded that the retained testamentary powers of appointment *do* cause the *remainder interest* to be an incomplete gift, but concluded that the testamentary powers of appointment relate only to the remainder interest. During the grantors' lifetimes, they had no ability to keep the trustee from making distributions among the potential trust beneficiaries—which might potentially include all of the trust assets. Therefore, the CCA reasoned that the gift was complete as to the "beneficial term interest" that existed before the grantors' deaths—but was an incomplete gift as to the remainder interest.

The issue then became to determine the relative values of the term interest (a completed gift) and the remainder interest (an incomplete gift). The CCA reasoned that §2702 applied, and because the retained interest (i.e., the interest passing to "applicable family members") was not a qualified interest, it had to be valued at zero under §2702. Therefore, the completed gift of the term interest was the full value transferred to the trust.

d. *Impact of "No Contest" and Arbitration Provisions on Crummey Withdrawal Right*. The trust contains a "no contest" clause excluding any beneficiary from receiving further benefits if the beneficiary brings or participates in a civil proceeding to enforce the trust and a provision requiring that the construction, validity and administration of the trust be determined by an arbitration system (presumably that is what is meant by "Other Forum Rules"). The CCA concludes that the withdrawal rights are "illusory" because of these two provisions and the withdrawal rights do not create present interests that qualify for the annual exclusion.

e. *Planning Observations*.

(1) *Exercise Caution — Carefully Consider Whether Merely Retaining Testamentary Limited Power of Appointment Is Sufficient to Cause Incomplete Gift Treatment.* Respected commentators have differed over whether the conclusion of the ruling is correct. At a minimum, there are no clear authorities that the CCA is incorrect, and planners should be aware of the risk that this ruling raises by merely retaining a testamentary limited power of appointment to keep a trust transfer from being a completed gift.

(2) *Other Ways to Cause Incomplete Gift for Term Interest.* If the settlor has the power to veto contemplated trust distributions to beneficiaries, the settlor would retain the ability to shift benefits among beneficiaries, which should cause the entire transfer to the trust to be incomplete.

If the settlor has an inter vivos limited power of appointment, that would also cause the gift to be incomplete as to the term interest as well as the remainder interest. (The gift would be completed as to amount of any distributions to beneficiaries at the time of the respective distributions.) HOWEVER, having a retained inter vivos limited power of appointment would allow the donor's

creditors to reach the trust assets in some states (even including some of the self-settled trusts states, such as Delaware.) Because spendthrift protection against creditors of the grantor and beneficiaries is a common goal of most trusts, this is not a feasible alternative in some states (such as Delaware).

(3) *Self-Settled Trusts*. As discussed above, an individual may wish to create a pool of assets as a protected nest egg in the remote event of a severe financial reversal by transferring assets to a "self-settled" trust in a jurisdiction that does not allow creditors to reach the trust assets merely because the settlor is a discretionary beneficiary. However, the individual may not want to make a completed gift requiring the payment of gift taxes. While some planners in the past have relied upon giving the donor a testamentary limited power of appointment to avoid making a completed gift, that would seem risky now in light of knowing the IRS's position.

If the trust includes the donor as a potential current beneficiary and the trust is *not* in a self-settled trust jurisdiction, the donor's creditors would generally be able to reach all of the trust assets, which should cause the gift to be incomplete, Rev. Rul. 76-103, 1976-1 C.B. 293, and cause the trust assets to be included in the gross estate for estate tax purposes. *E.g.* Estate of Paxton, 86 T.C. 785, 818 (1986)(value of corpus of self-settled trust included in gross estate because grantor's creditors could reach trust assets). For example, this result would apply if the beneficiary of a custodianship transfers the assets to a trust for the individual's benefit upon reaching age 21. (If that person were the only current beneficiary of the new trust, it would also be an incomplete gift trust under the example in Reg. §25.2511-2(b) even aside from the creditor issue.)

(4) *DING Trusts*. "Delaware Intentionally Non-Grantor" Trusts are trust used to avoid state income tax by having the trust sitused in a jurisdiction that will not tax the accumulated income in a non-grantor trust. (Income of a grantor trust will presumably be subject to tax in the state of the grantor's residence.) The trust is merely designed to avoid state income tax, and the donor most certainly does not want to risk having to pay federal gift taxes (at a 35% rate) to have an argument of avoiding state income taxes at a much lower rate.

The DING trust typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor's lifetime. The grantor retains a testamentary limited power of appointment. Several PLRs have held that the grantor has not made a completed gift upon creating the trust because of the retained testamentary limited power of appointment. *E.g.,* PLRs 200148028, 200247013 & 200502014. CCA 2012 08026 seems inconsistent with that conclusion, and commentators are debating whether creating DING trusts is available any longer.

Some commentators have suggested giving the grantor a nonfiduciary power to alter the interests of the beneficiaries, which would result in incomplete gift treatment under Regulation §25-2511-2(c) (incomplete gift treatment if the donor

has "the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard"). *See Jeff Pennell on Chief Counsel Advisory 201208026,* Leimberg Estate Planning Newsletter #1937 (March 7, 2012). That apparently would work in Alaska under Alaska law, but it would not work in Delaware because retaining that power may allow the donor's creditors under Delaware law to reach the trust assets, which in turn would likely cause the trust to be a grantor trust.

(5) *Crummey Trust Design To Avoid Completed Gifts by Crummey Powerholders On Lapse of Withdrawal Right*. If beneficiaries have a withdrawal right under a Crummey withdrawal power in a particular year exceeding the greater of $5,000 or 5% of the trust corpus, the lapse of the power in excess of that amount would be treated as a release of the power and therefore a gift by the Crummey powerholder if the powerholder is not the sole vested beneficiary of the trust. There are two traditionally used methods of avoiding this result. One is to give the beneficiary a "hanging power" so that the power will lapse each year only to the extent that that the lapse does not exceed the "5 or 5" amount. The other is for the Crummey beneficiary to retain a testamentary limited power of appointment so that any lapse in excess of the "5 or 5" amount would not be a completed gift. *E.g.* Donald Jansen*, Giving Birth to, Caring for, and Feeding the Irrevocable Life Insurance Trust*, 41 Real Prop., Prob. & Tr. J. 571, 609 (Fall 2006)(citing PLR 8229097; facts of that PLR provided that the beneficiary having the withdrawal right was the sole beneficiary of the trust, so the reasoning of the CCA would not apply).

Under CCA 201208026, having holders of withdrawal powers retain a testamentary power of appointment may not be sufficient to avoid the potential gift issue if there are any other potential beneficiaries of the trust during the powerholder's lifetime, so the second alternative may no longer be available for most Crummey trusts.

(6) *Arbitration Clauses in Wills and Trusts*. Jeff Pennell points out that various recent cases have held that provisions in trusts requiring that disputes be resolved by arbitration are not enforceable. He cites the following cases. *Schoneberger v. Oelze* (Az. 2004)(superseded bv Ariz. Rev. Stat. Ann. §14-10205, not yet tested); *Diaz v. Bukey* (Cal. 2011); *In re Calomiris* (D.C. 2006); *In re Chantarasmi* (N.Y. 2012); *Rachal v. Reitz* (Tex. 2011). "The good news is that, if those courts are correct in holding that these provisions are not valid, then the government's conclusion that they prevent qualification for the annual exclusion also is invalid." *Jeff Pennell on Chief Counsel Advisory 201208026,* Leimberg Estate Planning Newsletter #1937 (March 7, 2012).

In light of the concern with the validity of arbitration provisions, using arbitration provisions in trust agreements has not yet become a mainstream practice. Some planners have indicated that they will cease using arbitration provisions in trust agreements until this Crummey withdrawal right issue has more clarity.

Bruce Stone (Coral Gables, Florida) reports that Florida has a statute allowing binding arbitration clauses in wills and trusts and that he routinely includes arbitration clauses in wills and trusts. Here's Bruce's reasoning on using arbitration clauses in estate planning instruments:

> "Florida law allows binding arbitration clauses in wills and trusts.
>
> > 731.401 Arbitration of disputes.—
> >
> > (1) A provision in a will or trust requiring the arbitration of disputes, other than disputes of the validity of all or a part of a will or trust, between or among the beneficiaries and a fiduciary under the will or trust, or any combination of such persons or entities, is enforceable.
> >
> > (2) Unless otherwise specified in the will or trust, a will or trust provision requiring arbitration shall be presumed to require binding arbitration under s. 44.104.
>
> In PLR 201117005, the Service ruled that the inclusion of a binding arbitration provision under the Florida Statute did not prevent a charitable remainder unitrust from qualifying under IRC §664, or a QTIP trust from qualifying for the marital deduction under IRC §2056. The ruling stated that any final decision reached in voluntary binding arbitration or volunteer trial resolution is subject to the scrutiny of the Service to determine if the decision is based on an enforceable right under state law properly interpreted.
>
> I routinely include arbitration provisions in the wills and trusts which I draft. I have found that the overwhelming majority of my clients are very much in favor of them, but a few clients (notably clients who are lawyers) have asked me to remove the provisions. I have yet to encounter a dispute under any of those documents (meaning that they probably haven't "matured" yet).
>
> Providing for arbitration of trust and estate disputes is essentially the privatization of the judicial system. Think about it: who better to resolve trust and estate disputes than people who are experts in the field, and what a great way to provide meaningful and significant employment for lawyers which truly does benefit the public. The effect of including such provisions in documents today will be to provide benefits both for the beneficiaries of our clients and for the legal profession for decades to come.
>
> The ACTEC Arbitration Task Force, which was chaired by my partner Bob Goldman, studied this topic extensively a few years ago."

32. Section 678 Trusts, Treated For Income Tax Purposes as Owned by Beneficiary With Withdrawal Powers

a. *Overview*. If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under § 678. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under § 678(a)(1) while the power exists and under § 678(a)(2) after

the power lapses if the holder has interests or powers that would cause §§ 671-677 to apply if such person were the grantor of the trust (and that is typically satisfied by the reference to §677 if the power holder is also a beneficiary of the trust). See Ltr. Ruls. 201216034, 200949012, 200011058, 200011054 through 200011056, 199942037, & 199935046.

b. *Recent Letter Ruling.* A recent private letter ruling was consistent with the prior rulings that have ruled that the trust is treated as owned by the Crummey powerholder/beneficiary under §678. Ltr. Rul. 201216034. In that ruling the beneficiary had a non-fiduciary substitution power, and the ruling reasoned that the existence of the non-fiduciary substitution power constituted the requisite retained interest or power that would cause §675 to apply if the power were held by the grantor. That ruling, like many of the other rulings issued by the IRS acknowledging that §678 applies to the trust, involved a trust that held S corporation stock, and the ruling held that the trust was a qualified shareholder of the S corporation, because it is a grantor trust.

The ruling appears to be wrong — because the existence of the beneficiary's non-fiduciary substitution power causes the trust to be a grantor trust as to the original grantor (and §678(b) makes clear that the trust is not treated as owned by the powerholder under §678(a) if the original grantor is treated as the owner). The IRS has made clear that third-party substitution powers (held by someone other than the grantor) cause the grantor trust rules to apply as to the grantor. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status. Similarly, Rev. Proc 2008-45 uses the same approach for the sample inter vivos CLUT grantor trust form. (Letter Ruling 9311021 similarly concluded (apparently inadvertently and incorrectly) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power.

c. *Rumor of Adjustment in IRS Ruling Position.* There have been informal indications from the IRS that the IRS is likely to continue to give favorable §678 rulings for a trust that receives or purchases S corporation stock. However, it will no longer issue §678 "comfort" rulings in other situations to trusts about to engage in leveraged transactions.

d. *Technical Issues Regarding §678 Application.* The IRS's position under § 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. [Sections 2041b)(2) and 2514(e) provide that "the lapse of a power … shall be considered a release of a power."] Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

A further complication is that under § 678(a), grantor trust treatment applies to "any portion" of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§ 671-677 to apply if such person were the grantor of the trust. The regulations discuss the "portion" issue in Treas. Reg. §1.671-2(e)(6) Ex. 4. In that example, the beneficiary holds an unrestricted power to withdraw "certain amounts contributed to the trust." The example concludes that the beneficiary is treated

as an owner of "the portion of [the trust] that is subject to the withdrawal power." Some planners believe that the "portion" refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under § 678. However, the term "portion" might refer to as the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust is worth $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. [Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey powerholder as the owner of a trust owning S stock, there would no longer be a wholly grantor trust if there were any growth in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs have even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust hat is attributable to the powerholder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.]

For example, a client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The beneficiary would be treated as the owner of the entire trust for income tax purposes under § 678. Because the beneficiary never contributes anything to the trust, the trust assets would not be included in the beneficiary's estate, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary's creditors if it contains a spendthrift clause. Furthermore, the trust could give the client a broad limited testamentary power of appointment. In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client's estate for estate tax purposes and cannot be reached by the client's creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise result from the assets that were sold to the trust) to interest on the note. Furthermore, if the trust gives the client a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. [The trustee could then divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.] The trust can deplete the client's

other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating "a freeze, a squeeze, and a burn." The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client's other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client's parents or other relatives, the planner may decide to use guarantees to support a large sale to the trust for a note and to have the trust pay fair value for the guarantees. For an excellent discussion of planning considerations, see Oshins, The Beneficiary Defective Inheritor's Trust ("BDIT") (2008).

33. Interesting Quotations

a. *Our Contribution to Society*. One of the joys of preparing Form 8939 is to know that we have spent endless hours worrying about things that we will never care about again for a return that will probably be put in a box in a warehouse and never really looked at by anyone. – Carol Harrington

b. *Value of the Institute*. As to the prospects of estate tax legislation, it is very clear that we don't know what will happen, we don't know when it will happen, and we don't know when it happens whether it will be retroactive. Aren't you glad you paid money to hear that? – Dennis Belcher

c. *Congress*. The responsible thing would be for Congress to act before the end of 2012. So I think we can count that out. – Carol Harrington

d. *Golden Age of Estate Planning*. I really believe that last year, this year and perhaps next year could be the golden age of estate planning. As much as we complain about uncertainty, it certainly gets our clients' attention. It is a bad use of resources, but we're not the ones creating the problem. – Dennis Belcher

e. *Congress and the Legislative Process*. Despair.com makes fun of motivational topics. One poster shows a grizzly bear getting ready to eat salmon with the caption — "Not every long journey ends well." Another poster on Government: "If you think the problems we create are bad, just wait until you see our solutions." Another poster of skydivers in a circle: "Never underestimate the power of stupid people in large groups." (Of course, Dennis Belcher cynically notes, those have nothing to do with Congress.) – Dennis Belcher

f. *Could It Be Any Clearer?* In Adler, Mr. Adler conveyed 1,100 acres in Carmel to his five children in equal shares as tenants in common. He specifically reserved to himself the use, income and possession of the property during his lifetime. He didn't specifically cite §2036 but he got pretty close to saying 'and I want to make sure this property is included in my estate under§2036.'" – Carol Harrington

g. *Cats and Dogs*. If you were to die alone with a cat it will wait less than 24 hours before it decides to eats you, whereas dogs will wait 3-4 days before they really get hungry. So the

next time your cat is purring looking at you adoringly, it is really just looking to see if you are breathing in and out. – Carol Harrington

h. *Fair Warning*. Is everyone having a good time? OK, we're going to change that. – Chris Hoyt

i. *Whose Younger?* If a trust is for the benefit of the decedent's surviving wife and children, who is the oldest beneficiary? – It's Mom, except in certain parts of southern Florida. – Chris Hoyt

j. *The Secret to a Long Marriage*. An older woman was asked the secret of a long successful marriage? She said, "On our 25th wedding anniversary I had my husband take me to Paris. On our 50th wedding anniversary, I had my husband go back to Paris and pick me up and bring me back home." – Chris Hoyt

k. *All Those Uncertainties About 2013*. With the Mayan calendar, we don't have to worry about the uncertainties in 2013. And China—good luck collecting that debt from us. – Chris Hoyt

l. *Congress*. In times like this I'm glad we live in America, and we have a Congress that will see this problem and will promptly resolve it and not wait until the last minute.

   President Obama's approval rating was previously 38% and now it's up to 44%. But Congress's approval rating last week is down to 11-- not 11%, but 11 people. – Chris Hoyt

m. *Tax Law Changes*. Can you imagine if we change our traffic laws as often as we change our tax laws? Just think about it. – Chris Hoyt

n. *Where the Buck Stops*. Jeff Pennell suggested that he thinks a gift of a portion of an asset with a fair market value of $X works. However, other planners are cautious in making transfers that way (rather than using defined value formula allocations of a transfer of an asset among two parties). Carol Harrington responded: "I suggest that your students probably won't sue you if you're wrong about that."

o. *Home Court*. "80% of the Tax Court judges worked for the federal government before they became Tax Court judges, and the IRS wins 80% of the cases in Tax Court. It's just a coincidence – I promise you. But obviously the United States Tax Court is the home court for the Internal Revenue Service." – Jonathan Blattmachr

p. *King Lear Effect of Estate Planning*. The next most important thing to owning a lot of money is controlling a lot of money. – Jonathan Blattmachr

q. *Divorce*. 55% of first marriages end in divorce in America, and 65% of second marriages end in divorce. It is lower for third marriages – because they die. – Jonathan Blattmachr

r. *I Love My Spouse But…* A client told me "I'm married to a beautiful woman. She's quite a bit younger than I am, and when I die before her and she remarries, I'm going to be unhappy when another man gets his hands on her. But I'll be damned if he gets his hands on my money." – Jonathan Blattmachr

s. *The Greatest Gift*. The $5 million gift exemption is the greatest gift estate planners have ever received. – Jonathan Blattmachr

t. *Prediction.* I think there is a very good chance the $5 million gift exemption will go away. – Jonathan Blattmachr

u. *Mutual Trusts Even For the Selfish Among Us.* Many spouses should do trusts for each other. There is a huge bonus — you have taken the property out of the reach of your creditors. Even if you're as selfish as I am, you ought to do this with your spouse not only to get estate protection for your kids and GST protection for your grandkids, but you also eliminate the assts from being subject from claims of creditors — provided you do not walk into the reciprocal trust doctrine. – Jonathan Blattmachr

v. *Great Literature.* The Tax Code was not written by J.K. Rowling.

w. *Artists.* Artists are into marrying, remarrying, and having more children — they are creative people. – Ralph Lerner.

x. *Younger Spouses.* Everybody hates a surviving spouse younger than the kids, especially if named after a woodland creature, a weather condition, or a spice. Bubbles and Cruella are also a bad sign. – Jonathan Blattamchr

y. *Sleepy Clients.* As estate planners, our job – our only job – is to help clients sleep better at night. We are trying to achieve beneficiary happiness and testator happiness and there are many roads of getting there. The goal is happiness and not the "best drafted document" or the "best clause." – Chris Kline

z. *Plain English Drafting.* Bruce Stone got interested in "plain English drafting" after hearing Dick Nenno complain about having to explain to clients over and over the meaning of "per STRIPES" [or Wendy Goffe adds, "the MARTIAL deduction"]. Bruce says that plain English drafting will pay huge dividends -- clients will really reward you and feel much happier about their documents. (On the other hand, some clients will say "why did I have to pay you to do this" because it sounds so simple.) – Bruce Stone

aa. *Best Compliment.* One of my best compliments, suggesting that I had arrived as a "plain English draftsman" came in a very complex matter involving six attorneys from different jurisdictions. The lawyer in Delaware criticized the drafting, saying that it was "colloquial." I knew I was there at that point. – Bruce Stone

bb. *Post Nuptial Agreements.* Pre-nups are one thing. But I would rather go through a root canal without anesthesia than tell a couple that has been married for a number of years that they need to do a post nuptial agreement. "You are not contemplating divorce, but we need to draft what happens when you guys get divorced." It is intensely difficult and painful, and it can be very damaging to the marital relationship … and the attorney-client relationship. Bruce had one client where there was a necessity of doing a post marital agreement. It turned out okay, but afterward, the client told Bruce "I don't want you to ever do that to me again or you will be fired." Bruce says, "And he meant it." – Bruce Stone

cc. *Dog Choice.* Rich people have big dogs. – Ralph Lerner

dd. *Secret 40-Year Old Ruling That Will Change Your Life.* In discussing Rev. Rul. 73-142, holding that a construction by a state court before a triggering event occurs will be respected despite *Bosch*: "This will change your life. Aside from Revenue Ruling 85-13, this is the most important revenue ruling the IRS has ever given you. And it's like it's a secret." – Jonathan Blattmachr

ee. *You Said What???* I'm probably the only Heckerling speaker who has ever used the word "copulation" in his materials. You can count it – the word "copulation" appears 20 times in that form that we discussed. I thought that some variations might be nice. I thought that I might use the 'f' word – 'fornication'-- but I stopped with 'copulation'. – Bruce Stone (Wendy Goffe responded: "Uh…I'm not going to use that word, so you still keep that record."]

ff. *What We're Here For.* Remember what we are here to do. Remember to consider what the client wants. – John Bergner

gg. *Changing Times.* "Many things happened over the last 30 years that we could not predict – the fall of the Berlin wall; in my case, casual Fridays at my law firm." – Stacy Eastland

hh. *Why 360?* The Florida rule against perpetuities statute is for 360 years because of the following. The initial idea was to add a finite period because of potential problems with the Delaware tax trap. Bruce originally suggested one million years. But he thought that would get laughed down. So the proposal to the legislature was 1,000 years. The legislators voted the proposal down thinking it was an asset protection abuse. The bar leaders explained the purpose to key Senators on the committee considering the bill. One Senator said he would take any multiple of 90 years and another senator said he would not go over 350 years. After lobbying that Senator, they ended up at 360 years. – Bruce Stone.

ii. *One is Better Than Two.* I've got clients that say "I want a one-handed lawyer." I don't want to hear "on the other hand." – Dennis Belcher

jj. *Check the Box.* Regarding the box on Form 709 to reflect gifts of interests in entities: I wouldn't fail to check the box. If you honestly think that 709s are being selected for audit purely because you checked that box, I think that's crazy talk. I don't think that checking the box ... Everybody's checking the box. So it's not helpful to not check the box. – Carol Harrington

kk. *Future of the Estate Planning Practice.* There's the old joke about the guy falling from the 10-story building, and as he passed each floor he said, "So far, so good." – Carol Harrington.

ll. *Collegiality.* A true story appeared in the ABA Journal Online recently telling the story of an attorney who had worked with several law firms, and was recently let go in this terrible market for lawyers generally. The only job she could get was as a topless waitress in a bar. What was really disturbing about this was that in describing her relationships with the other dancers, who all competed with her for dollars, she said that it was "the most collegial and cooperative" group of coworkers she had ever worked with – including all the law firms she had worked for. So… "You guys have to be nicer out there, because that's pretty sad." – Carol Harrington

mm. *Self-Help Planning.* A not uncommon reaction of clients is that at death the children will take the art off the wall, and the IRS will be left with picture hooks. "This is not tax planning – this is fraud!!!" – Ralph Lerner

nn. *Sleepy IRS Staff.* The regulations regarding qualified appraisers used to say: "A qualified appraiser is anyone who is qualified." I always thought they were tired when they wrote that regulation. – Ralph Lerner

oo. *Just Say No.* We as advisors have trouble saying no. I remember talking to my friend, Caesar. He said to me "Ralph, you can't act like a skinny New York lawyer. You have to be able to be firm with clients and say no like you really mean it." – Ralph Lerner

pp. *Yogi-isms—After Taxes.* "The key to Yogi-isms is Yogi's simple logic. What you would say in a paragraph, he says in a sentence. If you say it in a sentence, Yogi needs only one word. If you use one word, Yogi just nods. Yogi's conversation is normal dialogue-after taxes." – Joe Garagiola in Preface to The Yogi Book: I Really Didn't Say Everything I Said -as quoted by Dick Nenno

qq. *My Favorite Yogi-ism: I Think of This One Every Time I Enter a Crowded Restaurant.* "Nobody goes there any more — it's too crowded." – Yogi Berra.

rr. *"Can't Decide" Mentality.* I don't know what type of life insurance is best, but I know none is bad. – Yogi Berra

ss. *Decisions.* When you come to a fork in the road, take it. – Yogi Berra

tt. *Play it Again.* It's déjà vu all over again – Yogi Berra

uu. *Creative Arithmetic.* Whatever you do in life, 90% of it is half mental. – Yogi Berra

vv. *Last Chances.* It ain't over til it's over. – Yogi Berra

ww. *A Practical Choice.* I choose to use the term "trustor" instead of "settlor" because Microsoft Word invariably changes that to "settler"—and I get visions of pioneers crossing the prairie in covered wagons. –Dick Nenno

xx. *Bag Check.* "Last month we sent an American astronaut on the Russian Soyuz spacecraft to the International Space Station. We paid Russia $65 million----and if the astronaut checks a bag it's another $13 million" – Chris Hoyt

yy. *How Much Will You Pay For That?* Don't we always do what the client wants? Alexander Bove: "I suppose it depends on how much you're charging them."

zz. *Side Benefits.* People who live together and see each other naked die of melanoma less often—because someone is able to see their backs. – Wendy Goffe

aaa. *Marriage.* "Marriage is a wonderful institution, but who wants to live in an institution" – Groucho Marx, as quoted by Wendy Goffe

bbb. *Portability Disclaimer.* The following is a Public Service Announcement for the IRS on Portability. Picture some warm music in the background, a scenic vista, and a wealthy couple walking together, then the voiceover begins. "Portability. For those couples who may experience a loss of applicable exclusion amount following the death of your spouse you should use portability within 9 to 15 months to prevent a loss of exclusion. Using portability more than once may result in a decrease of benefits. Portability is not for everyone. Consult your attorney before using portability. Portability is not a substitute for credit shelter planning. If you experience sudden appreciation of assets you should not use portability. See your estate planning attorney immediately if your assets are subject to significant depreciation. The benefits of portability may only last 11 months. If you experience an election lasting more than 11 months then portability may be permanent. There is no need to see your attorney or a doctor. Permanent portability is good. If you experience dizziness, dry mouth, blurred vision, anxiety, breathing problems chest pains, hallucinations, redness, blistering or peeling of skin, or swelling of the hands and feet,

none of these symptoms are caused by portability. What else are you taking?" That is appropriate for portability because portability is much like a drug in clinical trials. – Tom Abendroth

ccc. *Complexity.* Complexity is at the top of the list of things that keep clients from moving forward and pulling the trigger on an advantageous tax planning strategies. – Ann Burns

ddd. *Real Solutions.* Providing a solution that is not implemented is not a solution.... Communicate client solutions in a way that empowers clients to move forward with those solutions. – John Bergner

eee. *GRATs for Who?* "I see GRATs as really fitting two types of clients-wealthy and very wealthy." – David Handler

fff. *Simplicity.* My clients like fewer boxes on their flowcharts. – David Handler

ggg. *Burial Instructions.* I had a client ask me to make sure her will provided that she would be cremated and that her ashes would be sprinkled in the local shopping mall so that at least her kids would visit. –Josh Rubenstein

hhh. *Creative Ferrari Purchases.* How many times, when you handle a new estate, do the kids—right after the funeral—need a new car, a really nice car, to make them feel better about their parent? (Josh suggests having a dying parent buy things children will want to buy after the parent's death, and then leave them those rapidly depreciating assets after the parent dies.) – Josh Rubenstein

iii. *It Goes Both Ways.* Both spouses may be uncomfortable leaving all assets to the other spouse but want to leave some assets in trust to assure they will pass to children eventually. They don't trust "that unknown second spouse." Both spouses may feel that way. She's always worried about Bubbles and he's worried about Ramone the dance instructor. – Josh Rubenstein

jjj. *Reduced Estate Tax Returns.* When President Bush took office, there were 110,000 estate tax returns filed each year. At a $5 million exemption, there will be about 8,600 returns filed. How many people do you know who have $5 million? I don't. Before I came to Heckerling, I looked up and down the street where I live. How many people on my block have $5 million? How many married couples have $10 million? With 8 trailers on my block, it's not a problem. – Chris Hoyt

kkk. *The Upside of Politics.* President Obama in 2010 campaigned in people's backyards. Mitt Romney announced in candidacy on a farm in New Hampshire. I personally hope in 2012 that all the candidates give all their speeches in backyards. Then, when the politicians are done talking, we can take all the stuff they said and spread it in our yards, our gardens, and our flowers, and we will have a great 2013. – Chris Hoyt