BESSEMER TRUST

Steinberg v. Commissioner, 145 T.C. No. 7 (Sept. 16, 2015)

September 28, 2015

"Net, Net Gift"; Tax Court Allows Gift Offset for Donee's Assumption of Potential Estate Tax Liability Under § 2035(b) Attributable to Gift If Donor Dies Within Three Years

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September 25, 2015

Synopsis

The donor made gifts in 2007 to her four adult daughters, with the donees agreeing to pay two separate liabilities of the donor (hence, these types of gifts have been referred to as "net, net gifts"): (1) the federal gift tax imposed as a result of the gifts, and (2) any federal or state estate tax liability imposed under § 2035(b) if the donor died within three years of making the gifts. The issues in this case are (1) whether the second element, the assumption of any estate tax liability under § 2035(b) if the donor died within three years, constitutes consideration in money or money's worth that can be subtracted in determining the amount of the gift under § 2512(b), and (2) the determination of the amount of such gift tax offset.

Section 2035(b) requires that if a donor dies within three years of making a gift, any federal gift tax paid regarding the gift must be added to the gross estate (effectively removing the advantage of the "tax exclusive" calculation of the gift tax as compared to the "tax inclusive" calculation of the estate tax). The donor's gift tax return had calculated the net, net gift after subtracting both the gift tax and the present value of the potential estate tax liability, taking into consideration the likelihood of the donor's death at some point within three years of the date of the gift. The Tax Court had previously rejected allowing an offset for this potential estate tax liability in *McCord v. Commissioner* (120 T.C. 358), but that holding was reversed by the Fifth Circuit Court of Appeals (461 F.3d 614).

In this case, the Tax Court previously rejected the IRS motion for summary judgment to deny a gift tax offset for the assumption of any estate tax liability under §2035(b) if the donor died within three years. The court held that the donees' assumption of the §2035(b) estate liability (if the donor died within three years of the gift) might be quantifiable and reducible to monetary value and that a willing buyer and a willing seller, in arriving at a sale price, might take the donees' assumption of this liability into account in appropriate circumstances. *Steinberg v. Commissioner*, 141 T.C. 258 (2013) ("Steinberg I").

Following a trial, the Tax Court held that the assumption of liability for estate tax under §2035(b) if the donor dies within three years of the gift does constitute consideration in money or money's worth that can be subtracted in determining the amount of the "net, net gift," and accepted the taxpayer's expert's calculation of that contingent liability. *Steinberg v. Commissioner,* 145 T.C. No. 7 (Sept. 16, 2015) (Judge Kerrigan) ("Steinberg II"). The court reasoned that the donees' assumption of the §2035(b) estate tax liability was a detriment to the donees and a benefit to the donor, and that a hypothetical willing buyer purchasing the property subject to that assumption of liability would demand that the price be reduced to account for the §2035(b) potential liability. The court rejected the IRS's contention that the assumption of the §2035(b) liability was merely a recognition of the apportionment of estate tax that would apply in any event, because there was no assurance at the time of the gift that the New York apportionment statute would continue to apply or that the donor would not change her will to remove the donees as the residuary beneficiaries, and the contractual obligation provided an additional enforcement mechanism not available under the state apportionment statute. The court also noted nothing in the record indicated that the net gift agreement was not bona fide or not made at arm's length.

Steinberg II accepted the taxpayer's expert's determination of the amount of gift tax offset attributable to the assumption of the §2035(b) potential liability. The expert used the government's actuary tables to estimate the likelihood that the decedent would die in each of the three years after making the gift. The court accepted that approach, reasoning that using the IRS's actuary tables "is the most common way to measure the value of a property interest that is dependent on the life expectancy of an individual," and noting that there were no specific facts or circumstances that would justify special consideration of the decedent's health or general medical prognosis beyond use of the tables. The expert also used the §7520 rate to discount the potential estate tax liability to present value; the government objected to the use of that discount rate, but the court concluded that the government "has not persuaded us that there was a more appropriate method that should have been used."

Basic Facts and Issue

The donor made gifts of assets having a value of about $109.4 million to her four daughters under binding gift agreements in which the daughters agreed to pay two of the donor's liabilities: (1) the federal gift tax imposed as a result of the gifts, and (2) any federal or state estate tax liability imposed under § 2035(b) if the donor died within three years of making the gifts (which is referred to as the "potential § 2035(b) estate tax liability"). The gift tax return subtracted both of these liabilities in reporting that there were net gifts of about $71.6 million (after subtracting about $5.8 million as the present value of the potential § 2035(b) estate tax liability) and reporting gift tax of about $32.0 million. The IRS objected to the subtraction of the potential § 2035(b) estate tax liability to determine the amount of the net gift and sent a notice of deficiency increasing the gift tax by about $1.8 million.

The only issue in this opinion is the IRS's motion for summary judgment that the donees' assumption of the potential § 2035(b) estate tax liability "did not increase the value of petitioner's estate and therefore did not constitute consideration in money or money's worth within the meaning of section 2512(b) in exchange for the gifts."

Brief General Background

Section 2512(b) provides that the amount of a gift is determined after subtracting any "consideration in money or money's worth."

Courts (and now the IRS) recognize that if, as part of a gift conveyance, the donee contractually assumes the donor's gift tax liability imposed as a result of the gift, that assumption of liability is consideration in money or money's worth that can be subtracted in determining the amount of the "net gift" on which the gift tax is imposed. Rev. Rul. 75-72, 1975-1 C.B. 310 (gift tax paid by the donee may be subtracted from the value of the transferred property if the payment of tax by the donee is a condition of the transfer; formula for determining gift tax for net gift is tentative tax/[1 + rate of tax]).

The § 2035(b) "gross-up" provision states that if a donor dies within three years of making a gift, the gross estate is increased by the amount of gift taxes paid on the gift. The purpose is to remove the advantage, if the donor dies within three years of making a gift, of the lower tax system that applies in calculating the gift tax as compared to the system for calculating the estate tax. The gift tax is imposed just on the gift amount that passes to donees (a "tax exclusive" system), whereas the estate tax is imposed on the entire estate, including the amount that is paid in estate tax (a "tax inclusive" system). By adding the amount of the gift tax back into the taxable estate, the combined gift and estate tax is the same whether or not the gift is made—thus removing the federal transfer tax advantage of making "deathbed" gifts.

STEINBERG I

The majority opinion (written by Judge Kerrigan, joined by seven other judges) denied the IRS's summary judgment motion. The majority reconsidered and reversed the Tax Court's position in *McCord v. Commissioner,* 120 T.C. 358 (2003), *rev'd and remanded sub nom. Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), reasoning that the potential estate tax liability was not too speculative to consider and that the § 2035(b) liability assumption satisfied the estate depletion theory because it would replenish the estate by relieving it of such estate tax liability. (The court noted that the case is not appealable to the Fifth Circuit so was not bound by the *McCord* result, but nevertheless reconsidered and reversed its prior position in *McCord*.) The majority concluded that there are genuine disputes of material fact as to whether the donees' assumption of potential §2035(b) estate tax liability constituted consideration in money or money's worth, and that the court would no longer follow its prior position in *McCord.* The majority opinion was not clear as to what issues would be decided following trial as a matter of law and what issues would be decided as a matter of fact. For example, the majority stated that the donees' assumption of potential § 2035(b) liability "could meet the requirements of the estate depletion theory" as a matter of law.

A concurring opinion (joined by six judges) believed that the IRS did not raise, and the court should not have addressed, whether the potential § 2035(b) liability was too speculative to be considered, but that the potential liability may satisfy the estate depletion theory. The concurring opinion took a more restrictive view, however, in its analysis of the estate depletion theory. It believed that the IRS might be able to establish at trial that the § 2035(b) liability assumption, under the surrounding facts of the case, was merely a method of apportioning estate taxes among the estate beneficiaries, or might be considered as merely adding some additional enforcement mechanisms beyond the state apportionment statute that apportions § 2035(b) liability to donees of gifts that give rise to such liability. A separate concurring opinion (joined by two judges) pointed out that if the donor dies within three years of making the gift, the contractual obligation to pay a portion of the estate's tax liability might possibly be considered an asset of the estate, and that possibility should be recognized in determining that the present promise to pay the contingent estate tax may be consideration to the donor.

A dissenting opinion (by Judge Halpern) stated that allowing an offset for the assumption of potential estate tax liability under § 2035(b) would frustrate the purpose of § 2035(b), which is to mitigate in part the disparity between the tax bases subject to gift tax and estate tax. In support of his thesis, Judge Halpern included a detailed example of the complicated interrelated calculations required in determining the net, net gift amount and the combined gift and estate tax effects of a net, net gift if the donor dies within three years of the gift. The dissent's analysis, however, does not take into account that the donee's assumption of the potential § 2035(b) liability may itself be an estate asset that is included in the donor's gross estate. As pointed out by Judge Goeke's concurring opinion, the potential estate tax liability may have an actuarially low value as a gift offset (because of the low probability at the time of the gift of the donor dying within three years), but may be included in the donor's gross estate at the full amount of the § 2035(b) liability if the donor actually dies within three years. Taking into account this factor, if the donor dies within three years of the gift the donor's estate typically would be much worse off by making the gift in this manner than if the donees had not assumed the potential § 2035(b) estate tax liability.

Steinberg II Analysis

1. *Burden of Proof.* The case is decided based on the preponderance of the evidence, and the burden of proof is irrelevant to the case.

2. *Willing Buyer/Willing Seller Test for Adequacy of Consideration.* In determining whether the assumption of the §2035(b) potential estate tax liability can be taken into account in determining the value of the net gift, the court began with stating that the "fundamental question posed by this case is the fair market value of the property rights transferred under the net gift agreement." Steinberg II at 15. The willing buyer/willing seller test is applied to determine the value of the donees' assumption of the §2035(b) potential estate tax liability.

> "The 'willing buyer/willing seller' test is the bedrock of transfer tax valuation. It requires us to determine what property rights are being transferred and on what price a hypothetical willing buyer and willing seller would agree for those property rights.
>
> …
>
> In Steinberg I we held that a willing buyer and a willing seller in appropriate circumstances could consider the donee's assumption of the section 2035(b) estate tax liability when determining a sale price. 141 T.C. at 281. We now decide whether the net gift agreement is such an appropriate circumstance. An appropriate circumstance arises when the donee's assumption of the section 2035(b) estate tax liability is a detriment to the donee and is a benefit to the donor." Id. at 15-16.

Thus, the court, without citing any authority, says the test for determining whether the assumption of §2035(b) estate tax potential liability can be considered as a gift offset under the willing buyer/willing seller analysis is whether the assumption of such liability "is a detriment to the donee and is a benefit to the donor."

a. *Detriment to Donee.* The assumption of the §2035(b) estate tax liability was a detriment to the donees because they did not have liability for that estate tax before assuming that liability under the net gift agreement. The net gift agreement was the product of lengthy negotiations, and the donor would not have made the gift without the donees' agreement to assume the §2035(b) estate tax liability. The court analogized to the built-in gain cases that have applied the willing buyer/willing seller test to reduce the value of transferred stock to account for the built-in gains tax liability. The court cites other cases in which transfer restrictions or business liabilities have reduced the value of transferred interests. E.g., Estate of Hull v. Commissioner, 92 T.C. 312, 338-339 (1989) (transfer restrictions); Sackett v. Commissioner, T.C. Memo. 1981-661 (business liabilities). The assumption of the §2035(b) potential estate tax liability is a detriment to the donees "because it might result in reductions in the values of the gifts they received."

b. *Benefit to Donor.* The court applied the estate depletion theory and concluded that it was satisfied.

> "Under the estate depletion theory, a donor receives consideration in money or money's worth to the extent that the donor's estate has been replenished…. Thus, the benefit to the donor in money or money's worth, rather than the detriment to the donee, determines the existence and amount of any consideration offset in the context of an otherwise gratuitous transfer. See Commissioner v. Wemyss, 324 U.S. at 307-308. [OBSERVATION: In light of that last sentence, why is a detriment to the donees required under the court's analysis?]

…

The daughter's assumption of the section 2035(b) estate tax liability might relieve petitioner's estate of a portion of its estate tax liability. If petitioner died within three years of the gift, her estate would have recourse against the daughters. Accordingly, the willing buyer would demand that price of the properties be reduced to account for the section 2035(b) estate tax liability." Steinberg II at 19-21.

3. *Apportionment Clause Does Not Negate Gift Offset.* The government argued that the assumption of §2035(b) potential estate tax liability "did not create any new burden on the daughters or benefit for petitioner because the daughters would have had to bear the burden of the section 2035(b) estate tax liability either under New York law or as beneficiaries of petitioner's residuary estate." Id. at 21. [OBSERVATION: Very few state apportionment statutes address apportionment of the estate tax due to the gross-up of gift taxes under §2035(b); New York may be the only state statute to apportion that tax to the donees.]

   The court pointed to various reasons for refusing to treat the contractual obligation to pay the §2035(b) estate tax as merely a reflection of estate taxes the donees would bear in any event: (1) the decedent could have moved to another state, in which event the special New York apportionment law would not have applied; (2) the decedent could have changed her will so that the donees were no longer the residuary beneficiaries responsible for estate taxes (the decedent at one time had removed one daughter as an estate beneficiary under her will); (3) the apportionment statute is merely a default provision that can be changed in a decedent's will; and (4) the net gift agreement included specific enforcement mechanism that were not explicitly available under the apportionment statute.

   The court concluded that the estate depletion theory was satisfied:

   > "For all these reasons, respondent's 'estate depletion' argument does not persuade us that the obligation assumed by petitioner's daughters to pay the section 2035(b) estate tax adds zero to petitioner's estate because that obligation is an obligation the daughters would have borne anyway under the New York apportionment statute. Because of factual uncertainties as to whether and how the New York apportionment statute would apply at petitioner's death, the daughters' contractual assumption of this tax liability gave rise to a new asset that could be deployed effectively by the executor. This new asset 'augmented' or 'replenished' petitioner's estate. [Citations omitted]. Id. at 23-24.

4. *Arm's Length and Ordinary Course of Business.* While intra-family transactions are subject to special scrutiny, intra-family transactions are not necessarily gifts merely because they are not in the ordinary course of business. There was no evidence that the net gift agreement was not bona fide or was not made at arm's length. Indeed, it was the culmination of months of negotiation.

5. *Fair Market Value of Assumption of Liability for §2035(b) Estate Tax Liability.* Having resolved the first issue, that the donees' assumption of estate tax liability under §2035(b) could offset the amount of the net gift, the court addressed the second issue—the fair market value of such assumption of liability. The donor's expert (William Frazier with Stout Risius Ross, Inc.) used the same approach that he used (and that the Fifth Circuit approved) in Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev'g 120 T.C. 358 (2003). His general approach was a three-step process: (i) use the mortality

factors in Table 90CM (which Table was applicable for transfers in 2007, see Treas. Reg. §20.2031-7(d)(7)) to determine the probability that the donor would die in each of the three years following the date of the gift, (ii) multiply that probability times the estate tax taxes that would have resulted under §2035(b) in each of those three years, and (iii) discounted such estate tax liabilities for each of those years to present value using the §7520 rate as the discount factor.

a. *Use of Government Mortality Table.* The government complained that the appraiser merely used the government mortality table without considering the donor's "health and general medical prognosis." The court disagreed, reasoning that using the government's actuarial table is a "common way to measure the value of a property interest that is dependent on the life expectancy of an individual," and there was no evidence of special medical issues involving the donor that would make reliance on the government's table unreasonable. Steinberg II at 29-30.

b. *Discount Rate.* The government also questioned the use of the §7520 rate as a discount rate to determine the present value of the potential future estate tax liabilities if the donor had died in any of the following three years after making the gift, under the theory that the §7520 rates "apply only to annuities, life interests, terms of years, and reversionary interests." [OBSERVATION: This is similar to the argument that the government made in Estate of Davidson v. Commissioner (now settled without a trial) claiming that §7520 does not apply to self-canceling installment notes.] The court noted that the fact that the potential estate tax liabilities are contingent does not preclude use of the § 7520 rates, and made short shrift of the argument: "Respondent has not persuaded us that there was a more appropriate method that should have been used. We conclude that the valuation was proper."

Observations

1. *Donee's Assumption of Potential § 2035(b) Estate Tax Liability Is Not Typical.* Having the donee assume the potential § 2035(b) estate tax liability typically results in a relatively small gift offset (depending on the age of the donor). Unless the donor is quite elderly, the actuarial likelihood of dying within three years is small enough that the present value of this assumption of potential liability results in a relatively low offset of the gift amount. (However, for an 89 year old individual—as in Steinberg—the gift offset can be significant; it was an offset of $5.8 million for a $109.4 million gross gift in Steinberg.) For a younger donor, it would be a much lower gift offset, but the estate inclusion might still be the full § 2035(b) liability if the donor in fact dies within three years. Indeed, the court referred to the donees' obligation to pay that portion of the estate tax as a "new asset" of the estate. Steinberg II at 24 ("new asset that could be deployed effectively by the executor"). The donor may not want to take that potential estate tax risk in return for a relatively small gift tax reduction.

   Whether the contractually assumed estate tax liability will be included in the donor's gross estate if the donor dies within three years is not a given. Conceivably, the estate in that situation would make the similar argument that the IRS is making in Steinberg—that the agreement is merely a matter of apportioning the estate tax among estate beneficiaries and does not really add anything to the gross estate.

In any event, for younger donors (say in their 50s or 60s), the actuarial likelihood of dying within the three years following the date of the gift is very low and the gift offset by having the donees assume the potential § 2035(b) estate tax liability would be low. Reducing the current gift by this small amount may not be worth of risk of the additional estate tax that would be incurred if the donee's contractual obligation to pay such part of the estate tax is treated as an additional asset of the decedent's gross estate that is itself subject to estate tax.

2. *Calculation Methodology.* The Fifth Circuit in McCord upheld the appraiser's use of actuarial life expectancy factors used in the § 2031 regulations (Table 80CNSMT effective from 4/30/89 to 5/1/99) and the § 7520 rate in effect on the date of the gift as the discount factor for discounting the potential future liability to a present value. (Table 90CM applied to transactions from May 1999-April 2009, and Table 2000CM applies to transactions from May 2009 forward. Table 2000CM is at the end of Treas. Reg. §20.2031-7(d) (7).)

The general approach for calculating the present value of the potential § 2035(b) estate tax liability was summarized by the court as follows:

> "Mr. Frazier testified that he used the actuarial tables promulgated by the Commissioner to calculate the probability that petitioner would die within each of the three years after the date of the net gift agreement. The report calculated petitioner's annual mortality rate for year 1, year 2, and year 3 to be 13.84%$, 13.04%, and 12.13%, respectively. The report used the section 7520 interest rate applicable on the date of the transfer to determine the present value factors for each of the three years. Then the report took the effective State and Federal estate tax rates for each of the three years and multiplied them by the gift tax included in the estate under section 2035(b). Using this methodology, the report calculated that the daughters' assumption of the section 2035(b) estate tax liability reduced the value of the combined gift by $5,838,540." Steinberg II, at 28-29.

The methodology for making the calculations of a net, net gift is rather complex, involving both an application of actuarial and discount factors as well as interrelated calculations. The calculation process is described in Michael S. Arlein & William H. Frazier, The Net, Net Gift, Trusts & Estates (August 2008), 25, at 31, modification of analysis described in Letter to the Editor and Response (Nov. 2008) 12-13. The process is summarized as follows.

(i) *Netting of gift tax liability.* The gift is calculated net of the gift tax. The formula for the actual gift tax paid is: tentative tax/(1+rate of tax). (For example, if the "tentative tax" based on the full amount transferred is $10,000, and if the rate is 40%, the actual gift tax paid is $10,000/1.4, or $7,143.)

(ii) *Determine present value factor of potential liability for an individual dying in the following three years.* The easiest way to approach this calculation is to use the procedure described in Publication 1457 (Version 3A) (Rev. 5-2009), Example 10. That example describes the procedure to determine the present worth of $1.00 due at the death of a person of a specified age who dies within a specified term. The example uses the "M-factors" and "D-factors" on Table H to determine the present value. That approach could be used to determine the present value of the potential estate tax liability based on the probability of death occurring sometime during the three years following the date of the gift for a donor of a specified age.

For example, assume the gift is made an individual age 65 when the §7520 rate is 2.0%.

Initial age =	65
Plus Term of years =	3
Terminal age=	68
M-factor, Table H (2.0), age 65=	16,208.97
M-factor, Table H (2.0), age 68=	15,092.22
Difference=	1,116.75
D-factor, Table H (2.0), age 65=	22,697.99
Required Remainder Factor	
(1,116.75/22,697.99)=	0.04920

Therefore, for a donor age 65, the present value of the potential estate tax liability is 4.92% of the estate tax liability due to the gift tax gross-up under §2035(b) if the donor dies within three years. (That factor conceivably could be further adjusted to reflect that the estate tax is not due until 9 months after the death of the individual.)

A more complicated approach is described in the Arlien and Frazier article, which is to determine the probability of dying in each of the following three years, and to determine the present value of the potential estate tax liability for each of those three years. That approach might be necessary if the estate tax rates were changing during those periods. (The analysis described in the article should be adjusted based on a Letter to the Editor by Dan Hastings, a consultant on the "NumberCruncher" software, and the response by Will Frazier.) Michael S. Arlein & William H. Frazier, *The Net, Net Gift*, TRUSTS & ESTATES (August 2008), 25, at 31, modification of analysis described in Letter to the Editor and Response (Nov. 2008) 12-13.

(iii) *Determine Applicable Tax Rate.* Particularly in light of the fact that the estate and gift tax rates are permanent (until changed by Congress), the 40% marginal estate tax rate is used as the tax rate.

(iv) *Determine Tentative Present Value of Potential Estate Tax Liability.* The present value of the additional estate tax liability attributable to the §2035(b) gross up is calculated by multiplying the added estate tax attributable to §2035(b) times the discount factor determined in step (ii). For the example of a 65-year old donor, this is: Gift tax paid x 40% estate tax rate x 0.04920.

(v) *Interrelated Calculations.* Interrelated calculations are repeated using these various factors. Subtracting the present value of the potential estate tax liability that is determined under step (iv) reduces the gift amount, so steps (i)-(iv) must be repeated. Eventually, the net, net gift is determined by subtracting the calculated gift tax and potential § 2035(b) estate tax liability from the amount transferred—and the result is that amount of net, net gift.