CURRENT DEVELOPMENTS IN ESTATE PLANNING

FALL 2009 ABA JOINT MEETING OF
THE SECTION OF TAXATION
AND
THE SECTION OF REAL PROPERTY, TRUST & ESTATE LAW

ESTATE AND GIFT TAXES COMMITTEE
CHICAGO, IL
SEPTEMBER 25, 2009

BENJAMIN G. CARTER
WINSTEAD PC
5400 RENAISSANCE TOWER
1201 ELM STREET
DALLAS, TEXAS 75270
WWW.WINSTEAD.COM
P. 214.745.5671
BCARTER@WINSTEAD.COM

STACEY DELICH-GOULD
SULLIVAN & CROMWELL LLP
125 BROAD STREET
NEW YORK, NEW YORK 10004
WWW.SULLCROM.COM
P. 212.558.4452
DELICHGOULDS@SULLCROM.COM

CURRENT DEVELOPMENTS IN ESTATE PLANNING

By Benjamin G. Carter & Stacey Delich-Gould[+]

I. SECTION 2032 –ALTERNATE VALUATION

In **Announcement 2009-52 (2009-25 I.R.B. 1106),** issued on June 22, 2009, the Internal Revenue Service (the "Service") corrected errors in final and temporary regulations (T.D. 9448) that revise the actuarial tables for valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

II. SECTION 2032A –VALUATION OF CERTAIN FARM REAL PROPERTY

Interest Rates Used for Valuing Farmland in Decedents' Estates. On July 27, 2009, the Service in **Revenue Ruling 2009-21 (I.R.B. 2009-30)** (the "Ruling") listed the average annual effective interest rates on new loans under the Farm Credit System. Section 2032A allows an executor to elect to value farm property based on the property's use as a farm, rather than the property's highest and best use if the property (1) comprises the majority of a decedent's estate and (2) passes to a family member. Under Section 2032A(e)(7)(A)(ii), the rates on new Farm Credit System bank loans can be used in computing this special use value for which an election under Section 2032A is made. For valuations made as of a date in 2009, the interest rates for the five Farm Credit System Bank Chartered territories are as follows:

- AgFirst, FCB 7.63%
- AgriBank, FCB 6.50%
- CoBank, ACB 6.17%
- Texas, FCB 6.59%
- U.S. AgBank, FCB 6.23%

The Ruling also lists the states that comprise each Farm Credit System Bank Chartered Territory.

III. SECTIONS 2036 & 2039 – TRANSFERS WITH RETAINED INTERESTS & ANNUITIES

A. **Tax Court Holds That Bona Fide Sale for Full and Adequate Consideration Exception Applies To Transfers Made to FLP.** On **May 27, 2009**, in ***Estate of Miller v. Commissioner***, T.C. Memo 2009-119, the Tax Court held that a portion of decedent's assets that were transferred to a family limited partnership ("FLP") thirteen months before decedent's death were not includible in the decedent's gross estate under Section 2036, because the transfer was a bona fide sale for adequate and full consideration. In reaching this conclusion, the court specifically noted that there were legitimate, significant non-tax reasons motivating decedent's contributions to the FLP.

Facts. Decedent's husband was an architect until his retirement at age 60. From his retirement until his death at age 86, Husband devoted a significant amount of his time to managing and investing his securities portfolio. Husband employed a specific investment methodology, charting stocks, and he kept detailed records of his investment activities.

Husband died on February 2, 2000, and his eldest son ("Virgil") was appointed as Executor. His gross estate was approximately $7.67 million, and 99.6% of his gross estate consisted of securities which were held by his revocable trust. Virgil, as Executor, made a QTIP election with respect to the $1,060,000 in assets passing to a QTIP trust for Decedent, which was funded on October 6, 2000. Virgil was the trustee of the QTIP trust. Decedent was entitled to all of the income from the QTIP trust, but no distributions were ever made to her.

On October 9, 2000 the remaining assets in Husband's revocable trust (then valued at approximately $3.6 million, apparently due to a steep market decline) were transferred to the Decedent's revocable trust.

On November 21, 2001, Decedent created the FLP, and a thirty-five percent discount was applied to its purported value. The stated purpose of the FLP was to continue to manage the assets in accordance with Husband's investment philosophy. Decedent gifted a 2% interest in the FLP to each of her four children – each owned a 2% percent limited partnership interested with the exception of Virgil, who owned a 1% general partnership interests and a 1% limited partnership interest. Decedent continued to own 92% of the units as a limited partner. In April of 2002, Decedent transferred approximately 77% of her assets to the FLP; however, as the court acknowledged, she retained adequate assets to fund her daily living expenses. During that same month, the FLP sold off securities and distributed cash to the Decedent's revocable trust accounts to pay off her margin account balances.

The FLP paid a company owned by Virgil to manage the FLP assets. Husband had taught Virgil his unique charting and analysis techniques, as he wanted his son to continue his investment philosophy. Virgil actively managed the FLP assets, devoting about 40 hours per week to this endeavor, for which he was compensated. Before Decedent's assets were contributed to the FLP, very few trades were made in her accounts, but this trading activity increased after the assets were transferred to the FLP (though overall trading activity in the FLP portfolio was relatively small).

Decedent, who was in her 80s, fell and broke her hip on April 25, 2003. This injury was followed by a slew of additional health problems. Within days, Decedent underwent pacemaker implantation surgery and hip repair surgery. She was subsequently removed to a continuing care facility, only to be returned to the hospital on May 12, 2003 with congestive heart failure. A CT scan performed a week later revealed a subdural hematoma. In the meantime, Virgil, in his capacity as co-trustee of Decedent's revocable living trust, transferred almost all of her remaining assets to the FLP on May 15, 2003 (with the knowledge that Decedent was in rapidly declining health). Decedent died on May 28, 2003.

Eight months later, the FLP made a pro rata cash distribution to its partners, about $1.1 million of which was transferred to Decedent's revocable living trust. A portion of this amount was used to pay Decedent's Federal and state estate tax liabilities. Decedent's estate tax return was filed on February 22, 2004, reporting a gross estate of $2,637,024 and tax due of $994,299. Almost the entire estate consisted of Decedent's limited partnership units in the FLP. A 35% discount was applied in valuing the units. The assets in the QTIP trust were not included in the Decedent's gross estate (though the return did disclose the existence of the QTIP trust).

Holdings and Analysis.

- <u>Includiblity of QTIP</u>. The court held that the QTIP assets were included in the Decedent's estate. The court rejected the estate's argument that because the Decedent never needed the income and never received income or distributions from the trust, she never had an actual interest in the trust (or if she did have an interest, it was refuted before her death). The court concluded that inclusion of QTIP assets in a surviving spouse's estate under Section 2044 cannot be prevented by failing to make distributions of income to the surviving spouse.

- <u>Transfer of Assets to the FLP</u>. The court, quoting *Estate of Bongard v. Commissioner*, stated that the "bona fide sale for adequate and full consideration" to Section 2036 applies in the context of an FLP "where the record establishes the existence of a significant and legitimate non-tax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred." To that effect, the April 2002 transfers qualified for the exception and were not includible in the Decedent's gross estate, because she established and funded the FLP to ensure that her assets would continue to be managed in accordance with her deceased Husband's investment philosophy. In reaching this conclusion, the court noted that the FLP assets were actively managed by Virgil, but that the level of activity of the FLP did not need to rise to the level of a "business" in order to qualify for the exception. The court also noted that though the Decedent was of advanced age at the time the transfer was made, she generally was in good health, and she retained sufficient assets after the transfer to cover her daily living expenses.

  With respect to the May 2003 transfers by the Decedent to the FLP, the court reached a different conclusion and held that the "bona fide sale for adequate and full consideration" exception to Section 2036 did not apply, because the decline in the Decedent's health and her desire to reduce her taxable estate were "clearly the driving forces" behind the transfers. The court rejected the estate's argument that the Decedent wished for these additional assets to be managed in accordance with her deceased Husband's investment philosophy, noting that if that were the case, the assets could have been transferred at the time the first transfer was made.

The court then held that the Decedent retained the right to the possession and enjoyment of the assets, primarily because of the post-death distribution of $1.1 million from the FLP to the Decedent's revocable trust, which then was used to pay federal and state estate taxes. The court viewed the pro rata distributions made to the other partners as "*de minimis* amounts." The court also noted that the May 2003 transfer significantly depleted the Decedent's assets.

B. **Tax Court Holds That Bona Fide Sale for Full and Adequate Consideration Exception Applies To Transfers Made to FLP Even Though Actual Transfers to FLP Were Implemented Following Death.** On **August 20, 2009**, the District Court for the Southern District of Texas in ***Keller v. United States***, 104 AFTR 2d 2009-6015 (S.D. Tx. August 20, 2009), held that a limited partnership negotiated before death but actually funded after death should be respected for federal estate tax purposes and Section 2036 should not apply to disregard the partnership.

In ***Keller*****,** the Decedent and her advisors spent more than a year prior to her death analyzing and documenting a proposed limited partnership that would own $250 million of bonds and cash owned by two different trusts for the primary benefit of Decedent. Decedent had over $100 million of additional assets available to her that she elected not to transfer to the partnership. Decedent's motivation for creation of the partnership was her strong desire to protect family wealth from spouses upon divorce. One of her children had previously been divorced and the process was "lengthy and expensive." In response to that divorce, Decedent and her family implemented various trust arrangements and diligently track separate and community property in an effort to minimize exposure of family wealth to spouses upon divorce. Decedent viewed a limited partnership structure as an additional tool to protect family wealth upon divorce. Under the proposed partnership structure, the trusts for Decedent would contribute approximately $250 million of bonds in exchange for limited partnership interests. A separate LLC would serve as general partner, which Decedent would initially own, and would be funded with $300,000. Decedent would then sell her interest in the LLC to other family members. Decedent's advisors attempted to persuade Decedent to contribute a larger portion of her assets to the partnership, but Decedent steadfastly refused.

While Decedent's advisors worked on structuring the partnership and preparing the necessary documents, the Decedent's health began declining although her death was not considered imminent. Decedent continued to be involved, however, in structuring the partnership. The Decedent signed the formation documents for the partnership and LLC in her hospital room. Her advisors wrote a check for $300,000 for contribution to the LLC, but the Decedent never signed it. She died five days after signing the formation documents, before any of the assets could be transferred to the partnership.

Following her death, her estate paid estate tax on the assumption that the partnership had never been created and funded. Thereafter, her advisors learned of the decision in *Church v. United States*, 85 AFTR 2d 2000-804 (W.D. Tex. Jan. 18, 2000), which upheld a partnership structure that was not fully implemented as of the decedent's death. As a result, the executors of Decedent's estate proceded to finalize all of the funding of the partnership, as planned, and filed a claim for refund for $40,455,322, on the theory that the decedent owned a limited partnership interest at death, subject to discounts, rather than the underlying assets she intended to contribute to the partnership.

The Court in *Keller* found for the taxpayer and held that, at the Decedent's death, she owned a limited partnership interest in a partnership that had a legal right to be funded with $250 million of bonds. The Court reasoned that at the Decedent's death, she clearly intended for the bonds to be transferred to the partnership and for $300,000 to be transferred to the LLC. Under Texas law, the Court held that the bonds were in fact partnership property at Decedent's death. It reasoned that the Decedent had a binding obligation to fund the partnership, to fund the LLC and to transfer her LLC interest to her children.

The Court rejected the Service's arguments under Section 2036. It held that the partnership was funded for full and adequate consideration and that spousal protection was the primary motivation for the partnership, with any transfer tax savings deemed an "incidental" benefit. The Court found particular significance in the Decedent's decision to retain more than $100 million of assets outside of the partnership. The Court noted that this fact distinguished *Keller* from the facts of *Strangi v. Commissioner,* 417 F.3d 468 (5th Cir. 2005). In *Strangi*, the Court held that the decedent and her son-in-law had an implied agreement under Section 2036 that decedent would retain possession and enjoyment of property decedent contributed to the partnership, based in part on the fact that the decedent contributed virtually all of her assets to the partnership. Finally, the Court in *Keller* rejected the Section 2036 argument by the Service, even though the Decedent's estate borrowed funds from the partnership to pay estate taxes, debts and other obligations. In fact, the Court allowed the Decedent's estate a deduction under Section 2053 for interest paid on such loan.

As with almost all family limited partnership cases, the *Keller* decision is largely a fact specific opinion. However, the decision reinforces the importance of establishing significant non-tax benefits for the partnership – in this case, concern about the impact of divorce that was not simply a hypothetical concern but was based on actual experience of the Decedent. Additionally, it also reminds practitioners of the importance of retaining significant assets outside of the partnership; in this case, Decedent retained over $100 million of assets outside of the partnership.

IV. SECTION 2511 – TRANSFERS IN GENERAL

In three separate cases issued within two months of each other, the District Court and the Tax Court added to the evolving jurisprudence governing the transfer tax consequences of the creation of closely held entities followed shortly by a transfer of an interest in the entity.

In ***Linton v. United States***, 104 AFTR 2d 2009-5176 (W.D. Wash. July 1, 2009), the District Court for the Western District of Washington held that the funding of a single member limited liability company and a transfer of an LLC interest to trusts for children was an indirect gift of the underlying LLC assets to the children's trusts in proportion to their membership interests. Additionally, the Court applied the step transaction doctrine to collapse the funding of the LLC and the gift of LLC interests to the children’s trust into a single gift of LLC property.

In *Linton*, Husband created a single member limited liability company (“LLC”). After creating the LLC, Husband and Wife executed a number of documents related to the LLC, all on the same date. First, Husband gave Wife a 50% LLC interest. Second, Husband and Wife transferred real estate and marketable securities to the LLC. Third, Husband and Wife executed irrevocable trust agreements for their children and assignments of LLC interests to the children’s trusts. Each trust agreement stated that it was effective upon contribution of the LLC interest to the trust. Husband and Wife executed the trust agreements and LLC assignments without dating them, but their attorney later inserted the date (which date was the same as the date of funding of the LLC). Husband and Wife reported the gifts to the trusts and applied a 47% discount against net asset value of the LLC.

The District Court held that the transfer of assets to the LLC by Husband and Wife enhanced the LLC interests of the children’s trust, thereby constituting indirect gifts to the trusts of a pro rata portion of the assets transferred to the LLC. In analyzing the facts of the case, the Court compared them to other “indirect gift” cases, namely *Shepherd v. Commissioner*, 115 T.C. 376 (2000), *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001), *Gross v. Commissioner*, 96 T.C.M. (CCH) 187 (2008), and *Senda v. Commissioner*, T.C. Memo 2004-160, *aff’d* 433 F.3d 1044 (8th Cir. 2006).

- Shepherd – In *Shepherd*, Taxpayers created a partnership and transferred real property to it. On the next day, Taxpayer’s children signed the partnership agreement. Because state law held that the partnership was formed on the second day, the Court held that Taxpayers made indirect gifts of the real property to their children. Taxpayers later transferred stock to the partnership, which was allocated pro rata among the capital accounts of the Taxpayers and their children. The Court concluded that such transfer was also an indirect gift of the stock to their children to the extent of the children’s percentage interests in the partnership.

- Jones – In *Jones*, Taxpayers and their children created limited partnerships and funded them pro rata according to their initial percentage interests in the partnership, with the contributions properly allocated to their respective capital accounts. On the same date as creation and funding of the partnerships, Taxpayers gifted interests in the partnership to their children. Because the capital accounts had been accounted correctly, the Court held that the gifts should be treated as gifts of partnership interests and not of the underlying partnership assets.

- Gross - The Court in *Gross* also rejected the indirect gift argument, based on facts similar to those in *Jones*. The primary difference in *Gross* was that eleven days transpired between the date of funding of the partnership and the transfer of partnership interests to the Taxpayer's children.

- Senda – In *Senda,* Taxpayers failed to present reliable evidence that the contribution of stock to the partnership occurred prior to the transfer of partnership interests to Taxpayer's children. Without this evidence, the Court held that the analysis in *Shepherd* applied, and it held that the Taxpayers in *Senda* made indirect gifts of the underlying partnership assets to their children.

The Court in *Linton* held that the facts more closely resembled those in *Shepherd* and *Senda* and, therefore, held that Husband and Wife made indirect gifts to their children's trusts of the underlying assets of the LLC, in proportion to the trusts' membership interests in the LLC. Taxpayers argued that their lawyer inserted the incorrect date on the trust agreements and LLC assignments, asserting that the date should have been nine days later. The Court rejected this argument, noting that the language of the trusts was unambiguous in stating that the trusts were created and the gifts were made on the same date as the funding of the LLC. The Court refused to allow parol evidence to contradict or modify the express language of these documents.

Although the indirect gift analysis disposed of the case, the Court in *Linton* also held that the step transaction doctrine applied and collapsed the various steps into a transfer of the underlying assets of the LLC to the children's trusts in proportion to their membership interests. The step transaction doctrine collapses separate steps into a single step if the steps are in substance "integrated, interdependent and focused on a achieving a specific outcome." The Court analyzed the three tests frequently utilized by the courts to apply the step transaction doctrine: (1) the binding commitment test, (2) the end result test, and the (3) interdependence test.

The Court held the facts of *Linton* met all three tests and, therefore, collapsed the LLC funding and assignment of LLC interests into a single transfer of the underlying LLC assets to the trusts for the children in proportion to their membership interests. The Court found that the most conclusive evidence for this holding was that Husband and Wife left the assignment and trust agreements undated so that they could first confirm that the asset transferred to the LLC occurred before making gifts to the trusts. Furthermore, Husband testified that he calculated the amount of property contributed to the LLC based on the anticipated discount that would apply to transfers of LLC interests to the trusts.

Finally, the Court distinguished the facts of *Linton* from those in *Gross* and *Holman v. Commissioner,* 130 T.C. 170 (2008). As discussed earlier, the funding of the partnership in *Gross* occurred eleven days before the transfer of partnership interests to the Taxpayer's children. In *Holman*, only six days elapsed from the funding of the partnership to the transfer of partnership interests to their children. However, the Court in *Holman* held that such time had economic significance because the assets of the partnership were publicly traded stock subject to market fluctuation, even over a short period. In contrast, there was no delay in *Linton* from the date of funding the LLC to the date of transfer of LLC interests; both occurred on the same day. Furthermore, Husband and Wife offered no evidence of market fluctuation that would affect the assets in *Linton.* In fact, most of the assets of *Linton* consisted of real estate, cash and municipal bonds, none of which typically faces short-term market fluctuations.

In ***Heckerman v. United States***, 104 AFTR 2d 2009-5551 (W.D. Wash., July 27, 2009), the District Court for the Western District of Washington reached an identical conclusion to that in *Linton*, based on substantially similar facts. In *Heckerman*, Taxpayers created a limited liability company and funded them with real estate. On a later date, Taxpayers transferred mutual funds to the LLC and, on the same date as funding of the LLC with the mutual funds, transferred LLC units to trusts for their children. The Service conceded that the transfer of real estate to the LLC was not an indirect gift but asserted that the indirect gift/step transaction arguments applied to the subsequent funding with mutual funds.

The Court in *Heckerman* held that Taxpayers made indirect gifts to their children's trusts of the mutual funds contributed to the LLC, in proportion to their percentage interests in the LLC. As in *Linton* the Court analyzed the case in comparison to *Shepherd*, *Gross*, *Jones* and *Senda*. As in *Linton*, the Court in *Heckerman* held that the facts more closely resembled those in *Shepherd* and *Senda*. The Taxpayers in *Heckerman* alleged that even though the LLC assignment documents were dated on the same date as the transfer of the mutual funds to the LLC, Taxpayer did not actually sign the assignments until a later date and did not deliver the assignments to the trustee until even later. However, the Court refused to consider this argument because Taxpayers failed to assert it in their original refund claim. Finally, the Court held that the evidence did not support Taxpayers' claim that their capital accounts were increased by the amount of the mutual funds contributed to the LLC. It pointed to a letter from Taxpayers' counsel that stated that no capital accounts were maintained that reflected the mutual funds as an asset of the LLC.

As in *Linton*, the Court in *Heckerman* also held that the step transaction doctrine applied to treat the gifts as gifts by taxpayers of the mutual funds, in proportion to the trusts' membership interests, rather than as gifts of LLC interests. The Court paid particular attention to an email to Taxpayers from their financial advisor that described the transaction only in terms of the impact of the valuation discounts and emphasized that the LLC transfer must occur after the LLC is funded. Also, Taxpayer stated in an email to his advisors that he would determine how much of his investment assets to transfer to the LLC once he knew the level of discount that would apply to a subsequent transfer of LLC interests to trusts for his children. Finally, as in *Linton*, the Court distinguished the facts of *Heckerman* from those in *Holman* and *Gross.* It reasoned that the Taxpayers in *Heckerman* funded the LLC on the same date that they made subsequent gifts of LLC interests, whereas six and eleven days, respectively, separated the entity funding from the subsequent gifts in *Holman* and *Gross,* during which time the assets were subject to market fluctuation.

Unlike *Linton* and *Heckerman*, the Tax Court in ***Pierre v. Commissioner,*** 133 T.C. 2 (August 24, 2009) held that the indirect gift and step transaction doctrines did not apply to gifts of LLC interests that occurred shortly after funding the LLC. In *Pierre*, Taxpayer transferred cash and marketable securities to a single member LLC. Taxpayer waited twelve days following funding of the LLC before she gifted and sold LLC interests to trusts for her children.

In arguing for application of the indirect gift and step transaction doctrines, the Service asserted that, because the LLC was a disregarded entity under the check-the-box regulations, the LLC should similarly be disregarded for federal transfer tax purposes. The Court rejected this argument, holding that the Taxpayer did not have a property interest in the underlying assets of the LLC under state law and that the check-the-box regulations relate only to the LLC's classification for income tax purposes.

The Court distinguished the facts of *Pierre* from those of *Shepherd* and *Senda*. Specifically, unlike *Shepherd* and *Senda*, it was indisputable that the Taxpayer in *Pierre* funded the LLC before making gifts of LLC interests.

Linton, Heckerman and *Pierre* offer important guidance to taxpayers who wish to create closely held entities followed by transfers of interests in those entities to third parties.

- Taxpayers should allow some time to pass between funding the entity and making gifts of interests in the entity. As a general matter, the risk of triggering the indirect gift/step transaction argument seems to diminish as more time passes between funding and gifting. If the assets of the entity are subject to short-term market fluctuation, a shorter time may be sufficient to avoid indirect gift/step transaction treatment (six and eleven days were sufficient in *Holman* and *Gross*). If the assets of the entity are not so volatile (such as cash, bonds or real estate), taxpayers should allow for a longer period of time between funding and gifting.

- Proper treatment of capital accounts upon funding of the entities is a necessary but not sufficient condition to proper treatment of gifts as transfers of interests in the entity.

- Taxpayers should be careful to avoid structuring the funding of the entity based solely on what level of discount would apply to subsequent transfers of interests in the entity.

- Finally, the holdings in *Linton* and *Heckerman* are clear reminders that taxpayers and advisors should approach all written correspondence with the expectation that it would be discoverable in a tax controversy proceeding. In those cases, the Court found email correspondence from the taxpayers and their advisors that substantiated the indirect gift/step transaction argument.

V. SECTION 2801 – GIFTS AND BEQUESTS FROM EXPATRIATES/IMPOSITION OF TAX

On June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act (the "Heart Act") added Section 2801 to the Code, which imposes a tax on any U.S. citizen or resident who receives a "covered gift or bequest" from a "covered expatriate." A covered expatriate is defined in Section 877A(g)(1) (also added to the Code by the Heart Act) as an individual who ceases to be a citizen after June 17, 2008 and (i) has an average annual net income tax liability in excess of $145,000 (adjusted in future years for inflation), for the five taxable years ending before the residency termination date; (ii) has a net worth of at least $2 million or (iii) fails to certify, under penalty of perjury, that he or she has complied with U.S. tax laws for the previous five years.[1] A covered gift is defined as property received from any individual who was a covered expatriate at the time the gift was made, and a covered bequest is defined as property received from a decedent who, immediately prior to death, was a covered expatriate. On July 20, 2009, the Service announced in **Announcement 2009-57 (I.R.B. 2009-29)** that it will issue guidance under Section 2801 that will specify the due date for reporting and paying the tax on covered gifts and bequests from covered expatriates. The guidance also will address new Form 708, to be used for reporting the receipt of gifts and bequests from covered expatriates, and will provide for a reasonable period of time between the date of issuance of the guidance and the due date for filing and payment of taxes.

VI. SECTION 6112 – MATERIAL ADVISORS OF REPORTABLE TRANSACTIONS MUST KEEP LISTS OF ADVISEES, ETC.

On September 11, 2009, Treasury issued proposed regulations (**REG-136563-07**) that contain rules for disclosure of listed transactions and transactions of interest relating to generation-skipping transfer ("GST") tax.

---

[1] An individual is exempted from classification as a covered expatriate under (i) or (ii) above (but not (iii)) under two limited circumstances. First, a covered expatriate does not include an individual who was born with citizenship in both the United States and another country if the individual (i) continues to be a citizen of the other country, and is taxed as a resident of that country, and (ii) has been a resident of the United States for not more than ten taxable years during a 15-year taxable period ending with the taxable year of expatriation. Second, a covered expatriate does not include a U.S. citizen who relinquishes U.S. citizenship before reaching the age of 18½, provided that the individual was a U.S. resident for no more than ten taxable years before such relinquishment.

Section 6011 authorizes the Service to require disclosure of certain transactions and of the taxpayers who have utilized those transactions. Section 6111 requires "material advisors" to provide information to the Service about certain reportable transactions. Section 6111(b)(1)(A) defines a "material advisor" as any person:

- who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and

- who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such aid, assistance, or advice.

Section 6111(b)(2) states that the "threshold amount" referenced above is $50,000 for reportable transactions for which substantially all of the tax benefits are provided to natural persons and $25,000 for all other transactions.

Section 6707A(c)(1) defines "reportable transactions" as any transactions which the Service has determined under regulations are of a type as having a potential for tax avoidance or evasion.

Section 6112 requires material advisors to maintain lists regarding reportable transactions that identify the person for whom the advisor acted as a material advisor. Such lists must contain additional information as Treasury sets forth in regulations.

On August 3, 2007, Treasury issued final regulations under Section 6112 (T.D. 9352) concerning the obligation of material advisors to prepare and maintain regarding reportable transactions. These regulations require that the list of reportable transactions must include an itemized statement of information about the transaction, a detailed description of the transaction and certain documents associated with the transaction. <u>See</u> Treas. Reg. § 301.6112-1(b)(3).

On August 3, 2007, Treasury also issued final regulations that added "transactions of interest" as a new category of reportable transaction (T.D. 9350). A transaction of interest is defined as "a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest." <u>See</u> Treas. Reg. § 1.6011-4(b)(6). The preamble to the final regulations notes that a transaction of interest "is a transaction that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which the IRS and Treasury Department lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction."

The proposed regulations issued on September 11, 2009 would require the disclosure of listed transactions or transactions of interest that attempt to reduce or eliminate GST tax. However, they do not identify any particular transactions of interest that would be subject to the rules.

The proposed regulations also set forth guidance on the timing for production of the lists that material advisors must maintain – these changes are not limited to GST tax matters. Under these regulations, once a material advisor is required to maintain a list of clients involved in reportable transactions, the advisor will have thirty days from the date that obligation begins (or more if granted in published guidance) to prepare the list. A request by the Service for the advisor's list is deemed made on the date after the thirty-day period ends. The proposed regulations also clarify that a group of material advisors may designate one advisor, by written agreement, to maintain the required list. However, such an agreement will not prevent the Service from requesting the list from any advisor within the group.

VII. SECTION 6166 – EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS

A. In ***Carroll v. United States***, 2009 U.S. Dist. LEXIS 73174 (N.D. Ala. July 29, 2009), the United States District Court of the Northern District of Alabama affirmed the decision of the Bankruptcy Court denying an executor discharge in bankruptcy of the Executor's personal liability for Federal estate taxes owed.

Facts. The appellant and his siblings were appointed co-executors of their father's estate. The Executors and the Service agreed that the Estate would pay the estate tax owed ($2,554,547) in installments pursuant to Section 6166. The Estate ceased making payments after paying approximately $1.2 million of the tax debt owed. However, even though the estate tax remained unpaid, the Executors distributed estate assets to themselves.

An executor of an estate becomes personally liable for any Federal estate tax due if the executor distributes property of the estate before paying the taxes owed.[2] The appellant filed for bankruptcy, seeking discharge of his personal liability for the unpaid estate taxes.

Holding. The District Court upheld the Bankruptcy Court's judgment denying the discharge and held that the tax debt was excepted from discharge, because the appellant willfully attempted to evade payment of the estate tax due.

B. Service Outlines Estate Tax Installment Procedures. In a memorandum dated June 12, 2009 **(SB/SE-05-0609-010)**, the Service outlined the procedures for establishing installment payments and requesting a bond or special lien when making a Section 6166 installment election.

Section 6166 allows for up to ten, equal annual installment payments of estate tax attributable to the decedent's interest in a closely held business, and the first installment payment can be deferred for five years following the date on which the taxes

[2] *See* 31 U.S.C. 3713(b) and Treas. Reg. § 20.2002-1.

would have been due had the taxpayer not elected the extension. An estate qualifies for the Section 6166 election if (1) the value of the decedent's interest in the closely held business exceeds thirty-five percent of the adjusted gross estate; (2) the decedent was a U.S. citizen or resident at his or her death; and (3) the estate attaches a notice of election to the timely filed federal estate tax return.

According to the cover memorandum, the purpose of the fifty-eight page document is to reflect changes in responsibilities and provide updated procedures for the processing of cases in which an executor makes a Section 6166 election. Once it has been determined that an estate qualifies for the election, the Service now will determine on a case-by-case basis whether a bond or the special estate tax lien is necessary (under Section 6324A) and will negotiate the bond or special lien for all cases.

VIII. OTHER ITEMS OF INTEREST

A. Delaware Reinstates Estate Tax. On July 1, 2009, the Governor of Delaware signed into law a bill reinstating that state's estate tax. The tax applies to the estates of Delaware residents and Delaware nonresidents who own Delaware real property or tangible personal property. This marks the first time Delaware has had a separate state estate tax since the phase-out of the Federal state estate tax credit in 2005. The new Delaware estate tax is tied to the Federal state death tax credit as it existed on January 1, 2001 and (evidently) will apply to estates of $3.5 million or more.

B. Consequences of Conversion of Nongrantor Trust to Grantor Trust. In **CCA 200923024**, the Service concluded that the conversion of a nongrantor trust to a grantor trust was not a transfer for income tax purposes of the property held by the nongrantor trust to the owner of the grantor trust. In the CCA, a Parent and three children owned stock in an S corporation. The family formed a limited liability corporation ("LLC"), to which they contributed the S-corp shares, along with some cash. Each family member then created and funded an irrevocable, nongrantor trust. The beneficiaries of each trust were the then-living issue of each grantor, and the trustees were Parent's spouse, an independent trustee and an independent corporate trustee. The family members eventually sold their partnership interests to the trusts in exchange for unsecured private annuities.

The partnership made an election under Section 754 to step up the inside basis of the S-corp stock to fair market value. The shares were then sold in an initial public offering. The corporate trustee then was removed and replaced with a trustee who was an employee of a corporation in which the family members were executives, thereby causing the trusts to become grantor trusts pursuant to Code Section 672. As a result, the family held direct interests in the partnership, and as owners of the grantor trusts, they each reported no further annuity income.

The Service reached two conclusions. First, it held that no transfer/recognition event occurred when each trust converted from a nongrantor trust to a grantor trust, because to find otherwise would effect many non-abusive situations where a nongrantor trust becomes a grantor trust, even though "this [situation] appears to be an abusive transaction."

Second, the Service held that the sale of the partnership assets to the trusts in return for annuities did NOT amount to an indirect borrowing of trust assets that would cause the trusts to become grantor trusts at an earlier date. Again, however, the Service noted that the transaction presented an "apparent abuse," and noted it would like to explore "further case development that may lead to other arguments to challenge the transaction."

C. Gifts Made Pursuant to a Power of Attorney Includible in Decedent's Gross Estate. In ***Barnett v. United States*,** 2009 U.S. Dist. LEXIS 71232 (W.D. Penn. May 27, 2009), the United States District Court of the Western District of Pennsylvania held that gifts made by an attorney-in-fact on behalf of a decedent were includible in the decedent's gross estate, because the power of attorney did not specifically authorize the attorney-in-fact to make the gifts.

D. Final Regulations on Declaratory Judgment for Determine of Value of Gifts When No Tax Due. On September 9, 2009, Treasury issued final regulations (**T.D. 9460**) under Section 7477 regarding petitions filed with the Tax Court for declaratory judgments regarding gift tax adjustments when the proposed adjustment by the Service would not result in a imposition of gift tax.

The final regulations generally adopt the proposed regulations that were issued on June 9, 2008 (**REG-143716-04**), which proposed regulations were summarized in detail in this Committee's Current Developments report for September 2008. However, the final regulations make a few minor clarifications from the proposed regulations. First, the proposed regulations required the donor to exhaust all administrative remedies before initiating the declaratory judgment procedure. As part of this standard, the donor was required to request a conference with the Appeals division and to "participate fully" in the appeals process. The final regulations clarify that full participation means that the donor must timely submit all requested information and disclose to the Service all information relevant to the tax controversy. See Treas. Reg. 301.7477-1(d)(4)(vi). Also, if Appeals refuses to grant the donor's request for a conference, then donor can petition for declaratory judgment but must fully participate in the Appeals process while the declaratory judgment action is in docketed status. See Treas. Reg. 301.7477-1(d)(4)(iii).