A complete listing of the proceedings and speakers is available on **[the Institute's Web site]**

Report 14 A

As we have done in January for the last nine years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 40th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 9-13, 2006 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida. A complete listing of the proceedings and speakers is available on the Institute's Web site. The URL for that site is http//www.law.miami.edu/heckerling.

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This Report contains some errata to certain portions of the report that was included in the original Report No. 14 dealing with the Wednesday morning Q&A Session and Prof. Pennell's comments that were made at that time about IRC Section 2043. For the sake of completeness on this issue, we are also including below, in addition to this errata, the **additional comments that were made about this Code Section by another reporter in Report No. 5 as well as (with permission) the detailed comments of Prof. Pennell about this Section from his Recent Developments materials.**

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Question and Answer Session
Wednesday morning Main Session, 1/11/06
Presenters: Dennis I. Belcher [DB], Prof. Jeffrey N. Pennell [JP] and Carol S. Harrington [CH]

Reporters: Jeff Weiler Esq. and Gene Zuspann Esq.

1) Report filed by Jeff Weiler Esq. contained in Report No. 5

JP: IRC Section 2043 and application to FLP's (Reporter: warning this is real bad news!). If taxpayer loses on FLP IRC Section 2036, estate may not be back to square one and may be in much worse shape. JP has provided the following information to IRS agents at classes that he has presented. He notes that the IRS has not pursued this issue to date. He speculates that the results are so bad for the taxpayer that the IRS may be concerned that a court will back off on the IRC Section 2036 argument to avoid having the taxpayer subject to the application of IRC Section 2043. This involves the relationship between the purge and credit rule in IRC Section 2001 (b) where an asset is brought back into the gross estate and the previous gift of the assets is eliminated from the estate tax calculation. Assume IRC Section 2036 applies. First the asset owned at the date of death is included in the gross estate under IRC Section 2033. Then under IRC Section 2036, the transfer of assets is brought into the gross estate due to retained control or enjoyment. There is a double inclusion of assets in the gross estate unless there is an adjustment. IRC Section 2043 provides an adjustment but it does not work correctly for the taxpayer. The value of the adjustment, or offset, is based on the

value at the time of transfer.
The taxpayer's benefit is based on the value of assets at the time of transfer. If the assets brought back into the gross estate have appreciated since the time of the original transfer the "offset" is only the original value. If there is death shortly after the original transfer, with little appreciation is assets, the impact should not be too bad. However, in older FLP where time has elapsed and the value of assets has appreciated, the estate will get hit hard. Solution: get rid of FLP so no IRC Section 2033 inclusion at death.

2) Edited version of report by Gene Zuspann Esq. contained in Report No. 14 (edits in italics - supplied by Prof. Pennell)

JP: Section 2043: Transfers for insufficient consideration - issue is why have they not been pursuing this tract.

Response is that they have never studied 2043. This would not be applicable in the Abraham case, which did not involve a transfer for consideration relating to the 2036(a) application in that case. In Abraham the concept to apply would be the purge credit rule in 2001(b).

If 2036 applies in the more traditional FLP case - transfer of underlying assets come back in because of retained control or enjoyment. In addition, the interest received on creation (or their proceeds) also are includible, which constitutes double inclusion. Congress used 2043 to remedy the effect of double taxation.

IRS worried that 2043 is so bad that they fear raising 2043 because the court may reject 2036.

Hypo: G transfers assets to an entity but only receives back 99% of the value of the assets transferred. Under 2036, all transferred assets are still in the estate because I missed value. If close to death, this does not matter because the value of the consideration offset is probably no different than the amount includible. However, if the transferred assets have doubled before death, there is a major problem. 200% of the value originally transferred is includible but 2043 only reduces the estate by the fair market value that was in the original deal - the fair market value of what was received on creation - which is half the amount includible at death. To avoid this issue you should get rid of the FLP interests so that you no longer have the 2036 inclusion.

3) Detailed comments by Prof. Pennell on Section 2043 from his Recent Developments materials.

There is a final element of some apparent significance that should be addressed, although it has not been on the radar of any of these cases. It is demonstrably not well understood, involving a section of the Code that hardly ever is taught and about which most experts have limited knowledge.
In addition, it may be off the radar because (1) death occurred so quickly after any life time transfers that it didn't matter, (2) perhaps because no party thought to raise it, or (3) because the implications of it are so apparently inequitable that even the government is afraid to raise it, for fear of a backlash in the courts. Assume that §2036(a) properly applies to drag into the decedent's gross estate the estate tax value of all assets transferred into the partnership. The critical element then becomes the rule in §2043 (the consideration offset rule) that is meant to prevent inappropriate double taxation.
The gist of this little known provision is:
if a taxpayer engages in a transaction for less than full and adequate consideration, and the transferred property is includible in the gross estate at death, then the consideration received should not also be subject to estate tax. That is, the taxpayer should be treated as if the transaction never

occurred. The double tax consequence is meant to be avoided by operation of §2043, which provides that the transferred property is brought back into the decedent's estate as if there never was a transfer, and the consideration received in the transaction is excluded from the gross estate.

The problem is that the §2043 "offset" (it really works like a deduction) does not work "properly," simply because Congress does not want to impose on anyone the requirement to trace the consideration received, to identify it at death as the property that ought to be excluded if the transferred property is included. So the rule works like this: all property owned by the decedent at death is includible in the gross estate, even the consideration received in the transaction, and then the value of the consideration received is excluded. The problem is: the exclusion is measured only by the value of the consideration received as of the date of the transaction, not the value of that consideration as finally determined for federal estate tax purposes. To do otherwise would require tracing the consideration received, which §2043 is meant to avoid.

To illustrate, assume that the property transferred was worth $100x on the date of transfer, and that the consideration received was worth $99x on the date of the transfer. Also assume that each doubled in value over the taxpayer's remaining life. Includible at death will be the estate tax value of the consideration received and still owned at death ($198x) along with the full estate tax value of the property transferred (another $200x) and the consideration offset will subtract the value of the property received at the time of the transfer ($99x), which leaves all the appreciation in the consideration received in the gross estate. Maybe that growth was minimal, because the consideration received is a partnership interest with restrictions that limit the value for federal estate tax purposes, but any appreciation in the property received is improperly includible in the gross estate. And this is the result any time the consideration received is even a peppercorn shy of full and adequate. If §2036(a) applies at all, the result is full inclusion of the transferred property, full inclusion of the consideration received, and the consideration offset using date of transfer values. The Tax Court opinion in Strangi II correctly notes that includible may be a percentage of the partnership assets at death, rather than a pure tracing of the actual assets transferred by the decedent into the partnership, but the question is not addressed in the appellate court opinion and in most cases there will be little or no difference because little time, reinvestment, or contribution by others was involved.

There is an added bit of discomfort in the way these rules operate. If the transaction was conducted in a year in which the taxpayer and the taxpayer's spouse split gifts (for example, because immediately following creation of the partnership the taxpayer made annual exclusion (or unified credit sheltered) gifts of the partnership interests received), the result of §2036(a) inclusion of the transferred property is as if no transaction had occurred. In that case both the decedent and the surviving spouse ought to be restored to the positions they would have been in had there been no transaction, and no subsequent gifts of partnership interests. The Code accomplishes this result for the decedent under the "purge and credit"
rules of §2001(b), and the Code ought to (it really seeks to) accomplish the same thing for the surviving spouse under §§2001(d) and 2001(e).
Unfortunately, those provisions fail in the objective, most notably §2001(e), which only works the intended purge and credit for the consenting spouse in a split gift situation if inclusion at the taxpayer's death is under §2035. This rule does not apply at all if the taxpayer who was the original transferor generates inclusion under any of the other string provisions, such as §2036 or §2038. In addition, the rule in §2001(e) does not work at all for the consenting spouse's subsequent gift tax purposes:
it only even purports to restore the spouse for subsequent estate tax purposes, when the consenting,

surviving spouse subsequently dies. So gift splitting in the wake of (or coincident with) a botched transaction that is caught by §2036(a) is especially ugly for the consenting spouse.

A final bit of mess is created by the Tax Court in Thompson and probably wrongly decided as well, although this element is much more uncertain. This relates to the taxpayer's subsequent gifts of the partnership interests received in exchange for the lifetime transfer that is ignored at death.
The question is whether there should be a purge of any subsequent transfer of the consideration received in the transaction, so as to put the taxpayer back in the same position as if no transaction had occurred. That is, if
§2036(a) operates to treat the taxpayer as if no transfers had been made, should the system also work as if no partnership interests had been created or subsequently given away? The Thompson Tax Court permitted a §2001(b) purge of the decedent's subsequent gifts of those partnership interests, which seems inappropriate.

Consider an "extreme" case that illustrates the point: The taxpayer transferred $100x of marketable securities and real estate to the Taxpayer Family Limited Partnership and received TFLP interests in exchange. We can assume that no gift was made on that original transfer, so there is no purge-and-credit operation of §2001(b) from this first transaction. (Let's also assume that, notwithstanding the no-gift character of this initial transfer, the government successfully argues the §2036(a) case at the taxpayer's death and defeats the taxpayer's full and adequate consideration exception argument.)

So the taxpayer has TFLP interests and, instead of giving them away, holds them until years later the taxpayer finds someone who will exchange X Corporation stock for the TFLP interests. X Corp. then declares dividends in cash, dividends in stock, and declares a stock split. Meanwhile the taxpayer acquires Y Corporation using other wealth, and then X Corp. merges with Y Corp., after which they are bought by Z Corp., which issues Z Corp.
stock in the deal. Thereafter the taxpayer sells the Z stock and invests the proceeds in Blackacre, and then swaps Blackacre for Greenacre, and finally purchases adjoining land to create Farmacre and ultimately makes a fractional interest gift of an undivided interest in Farmacre (or incorporates Farmacre and gives stock in the new farm corporation).

Meanwhile the assets in TFLP have grown and have been invested and reinvested, so nothing looks the same at the taxpayer's death as it did at the time of the original transfer. The intended operation of §2036(a) is to ignore the transfer into the partnership and include the estate tax value of the transferred assets, as if the taxpayer never engaged in any of this.
In this case the inclusion rule probably will be applied to the partnership the way it is applied to a trust in such a case, meaning that the decedent's pro rata percentage of the value of the partnership assets held at death, reflecting all the partnership investment and reinvestment changes, will be includible rather than trying to identify and trace and value the actual assets transferred. But that's not our issue.

The question raised in Thompson relates to the gift of the fractional interest in Farmacre (or the stock in Farm Corp.), the distant relative of the consideration received in the original transfer that §2036(a) is ignoring and that §2043 is going to make right. The Tax Court in Thompson said that the gift made of Farmacre or Farm Corp. stock should be removed from the taxpayer's gift tax base because, if the transaction never had occurred, the taxpayer never would have had that asset to give away during life, and treatment as if the transfer never occurred is what §2036(a) and then the purge-and-credit rule in §2001(b) is all about. That is easy to do if the taxpayer just holds TFLP interests and makes a gift of some of them and then dies. But because facts can be as complex as the illustration, this system is not meant to work as the Tax Court applied it.

The Tax Court result requires a tracing through all the permutations to identify the proceeds of the original transfer to know that Farmacre or Farm Corp. stock was the consideration received. How do we know in such a case that the gift of Farmacre was not the product of the Y stock that the taxpayer merged with X Corp. and then sold to Z Corp., or the adjoining land to Greenacre that was used to constitute Farmacre?

To avoid all this the simple rule in §2043 says to just apply all the gift and estate tax rules as if nothing was being included under §2036(a) and then, to make everything right, we'll just reduce the gross estate by the value of the consideration received in the first transaction, valued at that time so we don't need to trace or identify or revalue. That offset is meant to treat the decedent's estate as if nothing was received (or subsequently owned or given away), and that exclusion/deduction/offset is the sole mechanism that is needed or available to make things right.
Indeed, it works this way even if the consideration has declined in value rather than having appreciated or, indeed, if none of the actual consideration is still owned at death. Sure, you say, it looks like a gift of TFLP interests following creation of the partnership constitutes double taxation if the partnership assets are included in the taxpayer's estate at death as if the transfer never occurred, but as seen the system is set up to deal with that in a far more administrable manner. It just doesn't often/always work as cleanly or "fairly" as some might like. The Tax Court result in Thompson may appear to be "right," but it is improper under the rules as they are written and likely impossible to administer in complex cases.

In the FLP context proper application of §2043 could be catastrophic and may show that those who have said that these are "no lose" transactions (you either get a discount or you're no worse off than if you had done
nothing) may be dramatically wrong. Avoiding §2036(a)(2) requires that the taxpayer never had control or divested it and outlived the §2035(a) three year period, or otherwise avoided that rule, perhaps by a sale to an intentionally defective grantor trust to avoid gain, so as to trigger the §2035(d) full and adequate consideration exception. In that regard it pays to remember that, in a proper §2035(d) analysis, the evaluation whether any consideration was "full and adequate" is whether the taxpayer received an amount equal to the amount that would have been includible in the decedent's gross estate at death had no §2035(a) transfer occurred during life.[1] Any consideration received must be adequate to replace the wealth that would have been includible had the decedent done nothing during life.
For example, with a life insurance policy it is not the interpolated terminal reserve or gift tax value but, rather, an amount equal to the full proceeds that would have been §2042(2) includible.

[1]. See United States v. Allen, 293 F.2d 916 (10th Cir. 1961); Estate of Pritchard v. Commissioner, 4 T.C. 204 (1944).

We want to thank Prof. Pennell for taking the time to assist us with clarifications of our reports on this subject and for supplying us with his most helpful Recent Developments summary regarding the same.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Bruce Stone of Goldman, Felcoski & Stone, PA in Coral Gables, Florida (a member of the Institute's Advisory Committee), Herb Braverman of Walter & Haverfield, LLP in Cleveland, Ohio, Jeff Weiler of Benesch, Friedlander, Coplan & Aronoff, LLP in Cleveland, Ohio, Merry Balson of Wade, Ash, Woods, Hill & Farley in Denver, Colorado, Barbara Dalvano of Isaacson & Rosenbaum, PC in Denver, Colorado, Paul Hood of Dickenson, Peatman & Fogarty in Napa, CA, and Joanne Hindel of Fifth Third Bank in Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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