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AUTHOR: Carter, Eric J.

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CURRENT DEVELOPMENTS IN ESTATE PLANNING

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ERIC J. CARTER
GIORDANI, SCHURIG, BECKETT & TACKETT, LLP
100 CONGRESS AVENUE, SUITE 2200
AUSTIN, TEXAS 78701
WWW.GSBTLAW.COM
P. 512.370.2720
ECARTER@GSBTLAW.COM

CURRENT DEVELOPMENTS IN ESTATE PLANNING

By Eric J. Carter [+]

I. LEGISLATIVE DEVELOPMENTS

A. Tax Increase Prevention and Reconciliation Act of 2005. The Act, signed by President Bush on May 17, 2006, makes a few changes that estate planners should know about.

1. **Extension of Lower Rate on Capital Gains and Dividends.** Section 102 of the Act extends the 15% top tax rate applicable to long-term capital gains and qualifying dividend income until December 31, 2010. (This lower rate was enacted as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and was originally set to expire on December 31, 2008.)

2. "**Kiddie Tax" Now Applies until Age 18.** The so-called "kiddie tax" imposes a tax on the unearned income (e.g., dividends and interest) of a child who has not attained the age of 14 years at the end of a taxable year at the parent's marginal income tax rate (if higher). Section 510 of the Act increases the age limit from 14 to 18 years, but also provides that the tax does not apply if the child files a joint return with his or her spouse. These amendments are effective for taxable years beginning after December 31, 2005.

3. **No Income Limit on Roth IRA Conversion.** Beginning with the 2010 taxable year, § 512 of the Act permits all taxpayers, regardless of income, to convert their traditional IRAs to Roth IRAs. If the conversion occurs in 2010, the taxpayer will include one-half of the income attributable to the conversion in his gross income for 2011 and the other one-half in his gross income for 2012.

B. Pension Protection Act of 2006. On August 17, 2006, President Bush signed the Pension Protection Act of 2006. While the Act primarily concerns qualified retirement plans, there are a number of tax provisions in the Act that have an effect on estate planners. A brief summary of the tax provisions follows.

1. **Non-Spousal Rollovers to IRAs.** Section 829 of the Act amends the rules governing retirement plans to permit non-spousal beneficiaries to roll over distributions from qualified plans to IRAs. Before this amendment, a non-spousal beneficiary was often required by the terms of the decedent's qualified plan to take a lump sum distribution from the plan within a short period after the decedent's death and did not have the option of rolling over the distribution to an IRA. Effective January 1, 2007, a non-spousal beneficiary may continue the

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deferral of income tax on the plan assets by executing a direct trustee-to-trustee rollover of the plan assets to an IRA. The transferee IRA is treated as an inherited IRA, meaning it is subject to the minimum distribution requirements applicable to inherited IRAs and cannot be rolled over again.

2. **Charitable Contributions Permitted from IRAs in 2006 and 2007.** Section 1201(a) of the Act amends IRC § 408(d)(8) to allow certain taxpayers to exclude from their gross income up to $100,000 per year for charitable distributions made directly from a traditional or Roth IRA to a qualifying charity in 2006 and 2007. The taxpayer must be over the age of 70 ½ at the time of the distribution, and no charitable income tax deduction may be claimed. A "qualifying charity" means a public charity or a "conduit private foundation." Thus, contributions to donor advised funds, supporting organizations, and most private foundations do not qualify. Qualifying distributions may be taken into account in satisfying the owner's minimum distribution requirements even though a charity received the distribution.

3. **Charitable Reforms.** The Act includes several charitable reforms. The reforms include: (i) new substantiation rules for gifts by cash or check (§ 1217); (ii) a requirement that donations of clothing and household items must be in good used condition or better in order to take a deduction (§ 1216); (iii) a reduction or recapture of the deduction for gifts of tangible personal property in excess of $5,000 if the charity disposes of the property within three years of contribution (§ 1215); (iv) a definition of the term "qualified appraiser" for charitable deduction purposes (§ 1219); (v) additional requirements for contributions of façade easements (§ 1213); (vi) an increase in the percentage limitation applicable to donations of conservation easements in 2006 and 2007 (§ 1206); (vii) new limitations on gifts of fractional interests in tangible personal property (§ 1218); and (viii) new rules and limitations on private foundations, donor advised funds, and supporting organizations (§§ 1221, 1231–1235, and 1241–1245).

4. **Substantial and Gross Valuation Penalty Tests Changed.** Section 6662 of the IRC imposes an accuracy-related penalty equal to 20% of the portion of a tax underpayment attributable to a substantial valuation misstatement and a penalty equal to 40% of the portion of a tax underpayment attributable to a gross valuation misstatement. However, the penalties apply only if the misstatement results in a tax underpayment in excess of $5,000. Section 1219 of the Act makes it easier for the Service to impose these penalties for both income tax and estate and gift tax purposes by adjusting the percentages required for finding a misstatement. The following changes apply to tax returns filed after August 17, 2006:

a. **Income tax:** A **substantial** valuation misstatement occurs if the value or adjusted basis of property claimed on an income tax return is 150% to 200% (previously 200% and 400%) of the correct value or adjusted basis. A **gross** valuation misstatement occurs if the amount reported on a return is 200% (previously 400%) or more of the correct value.

b. **Estate and gift tax:** A **substantial** valuation misstatement occurs if the value claimed on an estate or gift tax return is from 65% to 40% (previously 50% and 25%) of the correct value. A **gross** valuation misstatement occurs if the amount reported on a return is 40% (previously 25%) or less of the correct value.

c. **Reasonable cause:** The Act eliminated the reasonable cause exception for a **gross** valuation misstatement with respect to charitable deduction property under IRC § 6664(c)(2).

5. **Appraisers Subject to New Penalty for Valuation Misstatements.** Section 1219(b)(1) of the Act adds new § 6695A to the IRC. This new section imposes a penalty on *any* person if (i) that person prepares an appraisal and knows, or reasonably should have known, that the appraisal would be used in connection with a tax return or a claim for refund, and (ii) the appraised value reported on the return or claim for refund results in a substantial valuation misstatement or a gross valuation misstatement. The penalty is the greater of $1,000 or 10% of the underpayment attributable to the misstatement, but limited to a maximum of 125% of the fee charged for preparing the appraisal. However, no penalty will be imposed if the appraiser persuades the Service that the appraised value was more likely than not the correct value.

There has been some debate among practitioners as to whether the penalty applies for estate and gift tax purposes. The reason for the debate is due to the insertion of the words “under chapter 1” after “substantial valuation misstatement” in § 6695A(a)(2). The debate seems to have settled on the conclusion that the penalty applies for estate and gift tax purposes to **gross** valuation misstatements, but not **substantial** valuation misstatements.

Section 6695A applies to returns or submissions filed after August 17, 2006. Thus an appraisal prepared before the effective date but filed with a return or submission after the effective date is subject to the penalty. The application of this new section is enhanced by the changes in the accuracy-related penalties described in 4. above.

6. **Section 529 Plans.** The 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) expanded and liberalized the rules applicable to § 529 plans to make them the popular education savings vehicle that they are today. The expanded rules were set to expire on December 31, 2010, after which time the less favorable pre-2001 EGTRRA rules would apply again. Section 1304(a) of the Act repeals the sunset provision. Thus, § 529 plans will continue to operate under the current rules beyond 2010 and remain a valuable

tool to save for future education costs. In a related matter, § 1304(b) of the Act authorizes the Service to issue regulations to prevent abuses of these plans.

II. SECTIONS 2031 AND 2512 – VALUATION ISSUES

A. Defined Value Clause Respected and Net Gift Allowed. In *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), the Fifth Circuit reversed the Tax Court and upheld a defined-value gift formula used by the taxpayers. Mr. and Mrs. Cord, the taxpayers in the case (the "Taxpayers"), formed an FLP known as McCord Interests, Ltd., LLP ("MIL") with their four sons and an existing partnership, McCord Bros. The Taxpayers contributed $12.3 million to MIL in exchange for their 82.33% Class B limited partner interests (the "LP interests").

In January of 1996, the Taxpayers gifted all of their Class B LP interests in MIL pursuant to an Assignment Agreement (the "Assignment"). Rather than expressing the donees' gifts in percentages of LP interests, the Assignment used a cash-based value formula clause, which expressed the gifts in terms of dollar amounts of the net fair market value of MIL. Under the Assignment, the first $6.91 million of interests were divided between trusts for the Taxpayers' descendants and the Taxpayers' sons (the "non-charitable donees"). To the extent the value of the LP interests exceeded $6.91 million, the excess was given to charity: the Shreveport Symphony, Inc. was to receive the next $134,000 in value, and the balance, if any, was to pass to Communities Foundation of Texas, Inc. Thus, the purpose of the defined value clause was to freeze the taxable value of the transfers at $6.91 million with any excess qualifying for the charitable deduction.

The Assignment conditioned the gifts of LP interests to the non-charitable donees on their agreement to pay the gift taxes incurred as a result of the transfers, and their agreement to pay any estate taxes that would be imposed under § 2035 if either Taxpayer died within three years of the date of transfer.

In March of 1996, all of the donees entered into a Confirmation Agreement, under which the donees agreed that a 1% assignee interest in MIL was worth $89,505 and converted the dollar value of the gifts made under the Assignment into percentage interests in MIL.

The Taxpayers filed gift tax returns in which they calculated the gifts to the non-charitable donees at $89,505 per 1% interest, less the gift tax and contingent § 2035 estate tax liability. The Service issued a notice of deficiency, claiming that the gifts should have been calculated based on $171,749 per 1% interest, and the Taxpayers brought suit in the Tax Court.

1. **Tax Court Opinion.** The Tax Court held the following:

- the interests transferred by the Assignment were assignee interests;
- the Tax Court was not required to follow the Assignment's terms in evaluating the fair market value of the transferred interests;

- the fair market value of the total interests transferred was $9,888,832, or $120,046 per 1% interest;
- the value of the interests transferred should be based on the value determined by the Tax Court on a per unit basis times the percentage interests determined by the donees in the Confirmation Agreement two months after the date of the transfers; and
- the Taxpayers were not entitled to a discount for the non-charitable donees' contractual obligation to pay any estate tax liability under § 2035 because its value was too speculative.

Further, the Tax Court disregarded the Assignment's defined value clause, in part, due to the fact that the clause based its allocation of dollar amounts on the fair market value of the transferred interests without a requirement that the value be "as finally determined for Federal gift tax purposes."

2. **Fifth Circuit Opinion.** The Taxpayers appealed to the Fifth Circuit, which reversed the Tax Court's decision under a *de novo* standard of review.

a. **Defined value clause upheld.** In its opinion, the Fifth Circuit emphasized the Tax Court's disregard of the Taxpayers' defined value clause in the Assignment as the principal issue in the case, stating:

> The Majority's key legal error was its confecting *sua sponte* its own methodology for determining the taxable or deductible values of each donee's gift valuing for tax purposes here. This core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording.

McCord, 461 F.3d at 626 (citations omitted).

b. **Taxpayers' determination of fair market value upheld.** The Fifth Circuit held that the Tax Court committed reversible error by

- valuing the partnership interests on its own;
- relying on the Confirmation Agreement (reached by the donees two months after the gifts were made) in its calculations; and
- rejecting the Taxpayers' discount for the potential § 2035 estate tax liability.

The Fifth Circuit concluded that the Taxpayers' valuation of the LP interests controlled because all of the other valuations failed: the Tax Court's *sua sponte* valuation was clearly erroneous, and the Service's valuation had been rejected by the Tax Court (which ruling was not clearly erroneous).

c. **Net gift feature respected.** On the issue of the discount for the non-charitable donees' assumption of the contingent liability for the additional estate tax imposed under § 2035, the Tax Court had denied the discount as too speculative. The Fifth Circuit rejected that reasoning, explaining that there is "nothing speculative about the date-of-gift fact that *if* either or both Taxpayers were to die within three years following the gift (as did Mr. McCord)," the non-charitable donees would be obligated to pay the additional estate taxes imposed under § 2035. *See McCord*, 461 F.3d at 629.

d. **No public policy argument.** Neither the Tax Court nor the Fifth Circuit addressed the public policy argument that defined value clauses effectively nullify gift tax audits because transfers under such clauses cannot produce additional gift taxes. *See Commissioner v. Proctor*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944).

e. **Remanded to the Tax Court.** The Fifth Circuit remanded the case to the Tax Court for entry of judgment consistent with its opinion, including, without limitation, assessments of all costs to the Service.

B. Post-Death Reorganization Taken into Account When Valuing Stock; Service's Appraisal Disregarded. In *Kohler v. Commissioner*, 92 T.C.M. (CCH) 48 (2006), the taxpayers (the Estate of Frederic C. Kohler and several family members who made gifts of Kohler stock) prevailed on the issue of valuation of the shares in Kohler Co., a privately held family corporation engaged in the business of manufacturing kitchen, bath, and home furnishings.

The decedent died holding 12.85% of the company's voting stock. After the decedent's death and before the alternate valuation date, the corporation entered into a tax-free reorganization under § 368(a). Due to a number of nonfamily shareholders being cashed out, the reorganization resulted in the estate owning 14.45% of the company's stock. To determine the fair market value of this stock, the estate retained an independent appraiser who was well-known and highly regarded in the field and who was familiar with the company from past experience. Based on the appraiser's valuation, the stock had a value on the date of death of $50.115 million and a value on the alternate valuation date of $47.010 million. The estate elected to value its assets as of the alternate valuation date and thus reported the stock at its lower value.

The Service determined that the fair market value of the stock on the alternate valuation date was $144.5 million, not $47.010 million, and issued estate and gift tax deficiency notices and accuracy-related penalties to the estate and the decedent's family members who had made gifts of the stock. The parties agreed to consolidate the estate and gift tax cases and stipulated that the value of the shares at issue should be the same as the value determined in the estate tax case.

1. **Service has the burden of proof.** As a preliminary matter, the Tax Court granted the estate's motion to shift the burden of proving value to the Service pursuant to § 7491, which permits such a shift where the taxpayer introduces credible evidence with respect to a factual issue that is relevant in determining its tax liability and cooperates with the Service's reasonable requests for information. The fact that the estate filed a motion to quash an IRS summons on the grounds that the information requested was irrelevant and contained sensitive business information did not prevent the shifting of the burden of proof since the estate promptly complied with the summons after its motion was denied.

2. **Which stock should be valued?** With respect to which stock should be valued, the Service argued that the court should value the stock as of the alternate valuation date in its *pre-reorganization* form rather than its *post-reorganization* form. The Service based this argument on Treas. Reg. § 20.2032-1(d)'s rules for certain types of property interests, such as dividends and leased property, which may undergo changes in form between the date of death and the alternate valuation date. The Tax Court held that this regulation section was not relevant to form changes resulting from tax-free reorganizations and that there was no authority to support the Service's argument. The court also rejected the Service's contention that the tax-free reorganization constituted a distribution, sale, exchange or other disposal under § 2032, citing Treas. Reg. § 20.2032-1(c)(1), which states that the term "otherwise disposed of" does not include transactions such as tax-free reorganizations where no gain or loss is recognizable. Finally, the Service alternatively argued that the court should disregard the transfer restrictions and purchase option, which were not present in the pre-reorganization shares, when valuing the post-reorganization shares. Again, the court dismissed this argument and concluded that the Kohler stock would be valued in its post-reorganization form on the alternate valuation date, including the transfer restrictions and purchase option.

3. **What is the proper value?** On the issue of the stock's fair market value, the Tax Court dismissed the Service's appraisal completely based on the appraiser's poor qualifications, mathematical errors, and questionable valuation methods. As a result, the Service failed to meet its burden of proof and the estate's valuation was accepted. The court emphasized that the report of the Service's appraiser was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP), and that his methods made it clear that he failed to adequately familiarize himself with the business he was valuing or to review his major valuation assumptions with the company's management.

4. **No accuracy-related penalties in this case.** Since the estate's valuation was upheld, the taxpayers were not subject to accuracy-related penalties.

C. Owner Could Testify as to Value of FLP Interests and Entitled to Refund in Excess of Amount Stated in Claim. In *Smith v. United States*, No. 02-264 Erie (W.D. Pa. July 13, 2006), the dispute was over the value of FLP interests gifted by Smith to his son and daughter. In 1997, Smith formed an FLP to hold 100% of the common stock of Erie Navigation Company, a closely held business in which Smith and his son operated. At the time of formation, Smith held a 2% general partner interest and a 95.15% limited partner interest; Son held a 1% general partner interest and a 0.90% limited partner interest; and Daughter held a 0.95% limited partner interest. In 1998, Smith gave a 20.235% limited partner interest in the FLP to each child. Smith reported the value of the transfers as being $1,025,392 on his 1998 gift tax return and paid $262,243 of gift tax in connection with the transfers. In 2001, the Service increased the value of the gifts to $1,828,598 and assessed a deficiency of $360,803. Smith paid the deficiency and filed a suit for refund in district court.

At trial, the jury found that the Service erred in valuing the gifts over fair market value and determined the actual value of the gifts, based partially on Son's testimony as to the value of a 1% limited partner interest in the FLP, to be lower than the value reported on the gift tax return. The Service then filed a motion for a new trial based on two points of error.

1. **Son, as business owner, could testify as to the value of the FLP interests.** The Service argued that the district court erred when it allowed Son, as a general and limited partner in the FLP, to testify as to the value of a 1% limited partner interest. The Service contended that Son's testimony would need to be based on specialized knowledge and that Son had not been qualified as an expert. The district court denied the motion, ruling that Son's personal knowledge and experience with the operations of the company was particularized knowledge admissible under Federal Rule of Evidence 701. "An owner of a business is competent to give his opinion as to the value of his property. Whether [or] not his opinion is accurate goes to the weight of the testimony and not its admissibility." *Smith*, No. 02-264 Erie, slip op. at 2 (citing *Robinson v. Watts Detective Agency*, 685 F.2d 729 (1st Cir. 1982) (internal citations omitted).

2. **Smith was entitled to the jury's greater award.** The Service also argued that the jury award of $648,117 should be reduced to the amount stated in the refund claim plus interest, or $439,865. In support of its position, the Service relied on the variance doctrine, which prohibits a court from considering any basis for refund that was "neither specifically raised by, nor included within the general language of, a timely claim for refund." *First National Bank of Fayetteville v. United States*, 727 F.2d 741, 744 (8th Cir. 1984). The purpose of the doctrine, however, is to give the Service notice of the nature of the claim and the facts upon which it was predicated, providing the Service with an opportunity to correct errors, and limiting litigation to those grounds on which the Service is willing to defend. The Service's argument was that Smith should not be

permitted to offer a valuation theory that differed from the theory used by Smith's expert in the report filed with the Service. The Service did concede that the issue of the extent of the applicable discounts for lack of marketability and control is subject to review by the jury. In denying this second motion, the court stated:

> At trial, Plaintiffs did not deviate from or vary the claims raised before the Commission. Rather, Plaintiffs carefully complied with our order barring any testimony about valuation methods other than those used in the reports submitted before the Commissioner. That the jury's ultimate finding as to the fair market value of the gifts at issue, determined on the basis of the same valuation theories utilized before the Commissioner, resulted in an award larger than that claimed, does not implicate the Variance Doctrine. Thus, we reject the government's contention that there was a violation of the Variance Doctrine in this case.

Smith, No. 02-264 Erie, slip op. at 7.

III. SECTION 2036 – TRANSFERS WITH RETAINED INTERESTS

Value of Property Transferred to FLP Included in Estate. In *Estate of Rosen v. Commissioner*, 92 T.C.M. (CCH) 130 (2006), an FLP was established by D's daughter acting pursuant to a power of attorney when D was 88 years old and in poor heath. The daughter transferred substantially all of D's assets (cash and marketable securities) to the FLP. Upon D's death four years later, the Service took the position that the FLP should be disregarded for estate tax purposes and assessed a $1.1 million deficiency. Not surprisingly, the court agreed with the Service, finding that the transfer was not a bona fide sale and that there was an implied retention of the transferred assets, based on the following factors:

- D was 88 years old and suffered from dementia and Alzheimer's disease when the FLP was formed.
- Neither D nor her children were actively involved in creating the FLP; it was set up by the estate planning attorney for D's daughter.
- D transferred substantially all of her assets to the FLP and was unable to meet her financial obligations without receiving distributions from the FLP. After D's death, additional distributions from the FLP were made to her estate to satisfy bequests and to pay expenses and death taxes. The estate contended that these distributions were loans, but the court was not persuaded.
- The assets transferred to the FLP were marketable securities and cash, which were not actively traded by the FLP. The court specifically noted that the mere holding of an untraded portfolio of marketable securities weighs against the finding of a non-tax benefit in creating the FLP.
- The partners did not comply with the terms of the partnership agreement such as maintaining the books; making capital contributions simultaneously with the

signing of the partnership agreement (in this case, the initial capital contributions were made approximately three months after the partnership agreement was signed); and holding formal documented meetings.

- D's children were given FLP interests before the general partners made their contributions.
- Approximately 65% of D's limited partner interests were given away during the first four years of the FLP's existence, which also happened to be the last four years of the D's life.
- The court did not agree with the petitioner's argument that the FLP was formed to create centralized management. It noted that the D already had centralized management through her existing revocable trust.
- The court was not persuaded by the petitioner's argument that the FLP was formed to protect the assets from creditors because this was never discussed prior to formation of the FLP and because the D did not drive a car or face any other specific type of liability.
- The court noted that the facilitation of gift giving is not a significant non-tax reason for purposes of characterizing the transfer of assets to an FLP as a bona fide sale.

IV. SECTION 2042 – LIFE INSURANCE

No Estate Tax Inclusion if Proposed Insured Resigns as Trustee. In Priv. Ltr. Rul. 200617008 (Apr. 28, 2006), W is the current beneficiary of an irrevocable trust created by H. At W's death, the remaining trust assets will be distributed among H's descendants. W and F are currently serving as co-trustees of the trust and want to purchase a life insurance policy on W's life. Before the policy is purchased, W will resign as a co-trustee. The insurance premiums would be paid from trust principal, as W is entitled to all of the income.

The Service ruled that the proceeds of the policy would not be includible in W's gross estate under § 2042(2). The Service further ruled that the proceeds of the policy would not be includible in her gross estate under § 2035(a), even if she were to die within three (3) years of resigning as co-trustee. The Service's ruling assumed that W would not be reinstated and serving as a co-trustee at the time of her death.

The lesson here is that almost any irrevocable trust can effectively hold life insurance, not just an "ILIT," so long as the proper planning is executed before the policy is acquired.

V. SECTION 2055 – ESTATE TAX CHARITABLE DEDUCTION

A. Loss of $399,000 Deduction Due to Nonqualifying Split-Interest Trust. In *Galloway v. United States*, 2006-1 T.C. ¶ 60,525 (2006), the Decedent's ("D") revocable trust provided that the residue of the trust would pass in four equal shares to two natural persons—his son and his granddaughter—and two charitable beneficiaries. Each beneficiary would receive one-half of its share in 2006 and the remaining one-half of its share ten years later. If D's son or granddaughter failed to survive until the final distribution in 2016, the deceased beneficiary's share would be distributed to the remaining beneficiaries. The estate claimed a charitable deduction on its federal estate tax return in the amount of $399,000, the amount it anticipated would ultimately pass to the charities.

The Service disallowed the deduction on the grounds that D had created a nonqualifying split-interest trust that violated the rules under § 2055(e). The court agreed that the deduction was not warranted because "[t]he trust [was] created from one document and one set of property, and is held for both individual and charitable beneficiaries." *See also Estate of Tamulis v. Commissioner*, 92 T.C.M. (CCH) 189 (2006) (denial of $1,495,526 deduction because trust failed to qualify as a charitable remainder annuity or unitrust and timely reformation proceedings were not commenced).

The lesson here is that if property is to pass in trust for the benefit of both individual and charitable beneficiaries, the trust must take one of three forms approved of under § 2055(e)(2)—namely, a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund—in order for the charitable gift to qualify for an estate tax deduction. If the trust does not so qualify, the governing instrument should be reformed pursuant to the provisions of § 2055(e)(3).

B. Reformation of Split-Interest Trust Results in Charitable Deduction. In Priv. Ltr. Rul. 200622005 (June 6, 2006), D's will created a split-interest trust in which A, an individual, was to receive a four percent unitrust payout during A's lifetime, with the balance passing to charity at A's death. The estate recognized that the trust did not qualify as a charitable remainder unitrust because the payout percentage did not meet the minimum requirement of 5% and sought the Service's approval of its proposed judicial reformation pursuant to § 2055(e)(3). As reformed, the trust would pay a 5% unitrust amount, with A receiving 4% of each payment and charity receiving the additional 1%. The Service ruled that this is a qualified reformation so long as the judicial proceedings to reform the trust are commenced within 90 days of the due date of the federal estate tax return (including extensions). *See also* Priv. Ltr. Rul. 200632013 (Apr. 11, 2006) (qualified reformation of split-interest trust entitled estate to charitable deduction).

VI. SECTION 2642 – ALLOCATION OF GST EXEMPTION

A. Substantial Compliance Results in Effective GST Allocations. Section 2642(g)(2) provides that an allocation of GST exemption is effective so long as the allocation demonstrates the taxpayer's intent to make an allocation. In determining the taxpayer's intent, the Service will take into account all relevant circumstances, including any evidence of intent in the trust instrument, the instrument making the transfer, or otherwise.

1. In Priv. Ltr. Rul. 200622015 (Feb. 8, 2006), the Service ruled that H and W's failure to complete Schedule C, Computation of Generation-Skipping Transfer Tax, of their gift tax returns did not prevent the allocation of GST exemption to their gifts since the returns included a notice of allocation that provided: (i) the gifts to which the allocations applied, (ii) the value of the gifts, and (iii) the amount of the exemption allocated to the gifts.

2. In Priv. Ltr. Ruls. 200622029 (Feb. 23, 2006) and 200622030 (Feb. 23, 2006), the Service ruled that H and W's completion of Schedule C, Computation of Generation-Skipping Transfer Tax, of their gift tax returns was sufficient to allocate GST exemption to their gifts even though (i) they misclassified the gifts as direct skips (which resulted in them improperly completing Parts 1 and 3 of Schedule C), and (ii) the proper method of allocating exemption to the gifts was by attaching a notice of allocation to the returns.

B. Section 9100 Relief Trumps Automatic Allocation of GST Exemption at Death. In Priv. Ltr. Rul. 200618001 (Jan. 12, 2006), D established two irrevocable trusts during his lifetime, both for the benefit of his son, daughter-in-law, and grandchildren. D failed to file gifts tax returns to report his transfers to the trusts. Furthermore, when D died, his estate failed to allocate GST exemption to the transfers to the trusts or file a Schedule R with the estate tax return.

The estate requested and was granted an extension of time to allocate GST exemption under Treas. Reg. § 301.9100-3, which offers relief when the taxpayer provides evidence establishing that he acted reasonably and in good faith and that the relief will not prejudice the government. The Service allowed the effective date of the allocation to be the date of transfer, and ruled that since this allocation preceded the automatic allocation at the date of death, that automatic allocation was null and void.

C. Section 9100 Relief Prevents Taxable Termination. In Priv. Ltr. Ruls. 200619015 (Jan. 25, 2006) and 200625013 (Jan. 25, 2006), H created a separate trust for the benefit of each of his daughters in Year 1. H and W's accounting firm prepared their gift tax returns to report the transfers to the trusts, but failed to allocate any of their GST exemptions to the trusts. In Year 2, one of the daughters died and a taxable termination occurred with regard to her trust.

The error was discovered by another accounting firm hired by H and W in Year 3, and H and W requested an extension of time to allocate their GST exemptions under Treas. Reg. § 301.9100-3. The Service granted the extension to allocate their exemptions, which it ruled would be effective as of the date of the transfers to the trusts. As a result, the taxable termination was deemed to have never occurred.

The lesson here is that the standards for granting "9100 relief" are relatively easy to satisfy. One could surmise that H and W never intended to allocate GST exemption to the trusts but for the death of their daughter and the resulting taxable termination. Consider the following scenario:

> H and W create Trust 1 and Trust 2 for the benefit of S. They transfer member interests in LLC A to Trust 1 and member interests in LLC B to Trust 2 for three consecutive years. The transfers are reported on timely filed gift tax returns and a permanent election out of the GST automatic allocation rules is made pursuant to § 2632(c)(5). By Year 15, the member interests in LLC A have not increased significantly in value, but the member interests in LLC B have increased tenfold. H and W now wish that they had allocated their GST exemptions to Trust 2, but are glad they did not do so with respect to Trust 1. They discuss the situation with their new accountant who proposes that H and W request 9100 relief to allocate their GST exemptions to Trust 2 at the date of transfer values. The relief is granted because H and W represent in their ruling request that their prior accounting firm failed to properly advise them. Under these facts, it is unclear whether H and W were properly advised, but, with the leniency in which 9100 relief seems to be granted, there is certainly some room for gamesmanship in this area. *See* Priv. Ltr. Rul. 200633014 (May 8, 2006).

VII. SECTION 2702 – TRANSFERS OF INTERESTS IN TRUSTS

A. Unhappy With QPRT, Grantors Take Residence Back. What Happens Now? In Priv. Ltr. Rul. 200617002 (Apr. 28, 2006), D and S created separate QPRTs and conveyed a one-half interest in their personal residence to their respective trusts. After eight years, the trusts were to terminate and the remaining assets distributed to their daughters. In Year 2, S developed severe health problems and became concerned about the potential loss of the home upon termination of the trusts. In Year 7, without the daughters' knowledge or consultation, D and S executed deeds conveying the residence to their revocable trusts. The daughters did not learn of the transfers until several years later when the residence was sold. On the advice of counsel, the daughters made a demand against their parents for the sales proceeds from the residence. After D died, D's estate and S offered, in order to avoid the costs of litigation, to transfer the sales proceeds to the daughters in exchange for the release of their claims. What are the gift and income tax consequences of this mess?

The Service ruled that the daughters did not make taxable gifts of the residence to the revocable trusts because the transfers were not authorized by the terms of the QPRTs and because the daughters were not aware of, and did not consent to, the conveyances to the revocable trusts. Further, the Service ruled that S and the beneficiaries of D's revocable trust and D's estate did not make taxable gifts in paying over the proceeds to the daughters. As the owners of the residence, the daughters were the proper taxpayers to report the sale for income tax purposes. The daughters took a carry over basis in the property and were not entitled to exclude any of the gain on the sale under § 121.

B. QPRT Can Hold Residence Located on Two Parcels of Land. In Priv. Ltr. Rul. 200617035 (Dec. 22, 2005), T holds a vacation property that consists of two contiguous parcels of land on a rural, agricultural island that was improved by a residence, a bathhouse, and a pavilion. The two parcels are part of a larger tract of land owned by T. The residence, bathhouse, and pavilion are located on one of the parcels, and a road that provides access to the residence and related structures is located on the other parcel. T proposes to transfer the parcels to a QPRT, but before doing so will place a qualified conservation easement on the property.

The Service ruled that the property as a whole was considered a personal residence within the meaning of § 2702(a)(3)(A)(ii) and Treas. Reg. § 25.2702-5(c)(2). The Service specifically noted that the size of the property was comparable to other nearby properties that were also used for residential purposes; that the taxpayer used the property exclusively for residential purposes; and that no commercial activity was conducted on the property. *See also* Priv. Ltr. Rul. 200626043 (Feb. 23, 2006) (personal residence consisted of (i) a five-bedroom house, three-car detached garage, (ii) an artist studio without bedrooms or kitchen, and (iii) an unheated bunk house with two bedrooms, a bathroom, a small common area, and no kitchen).

XIII. SECTION 6166 – EXTENTION OF TIME FOR PAYMENT OF ESTATE TAX

Revenue Ruling Expands Real Estate Interests that Qualify for § 6166 Deferral. Section 6166 allows an executor to elect to pay estate taxes attributable to a closely held business in up to ten installments if the value of the decedent's interest in the business exceeds 35% of the adjusted gross estate. The executor may defer the first installment payment for up to 5 years and 9 months after the date of death. This deferral may help the estate avoid selling assets and enable it to use future income to pay the tax.

To qualify under § 6166, the decedent must have conducted an *active* trade or business or must have held an interest in a partnership or corporation that itself carries on an active trade or business—mere management of assets will not suffice. An interest in a partnership qualifies as a closely held business if the decedent held at least a 20% capital interest in the partnership or there were 45 or fewer partners, and an interest in a corporation qualifies as a closely held business if the decedent held at least 20% of the value of the voting stock of the corporation or the corporation had 45 or fewer shareholders.

In Rev. Rul. 2006-34, I.R.B. 2006-26, the Service provides new guidance as to when real property interests qualify as an asset of a closely held business under § 6166. In making this determination, the Service will consider all of the facts and circumstances, including the following non-exclusive factors:

- the amount of time the decedent devoted to the trade or business;

- whether an office was maintained from which the decedent's activities were conducted or coordinated, and whether the decedent maintained regular business hours for that purpose;
- the extent to which the decedent was actively involved in finding new tenants and negotiating and executing leases;
- the extent to which the decedent provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;
- the extent to which the decedent personally made, arranged for, performed, or supervised repairs and maintenance of the property; and
- the extent to which the decedent handled tenant repair requests and complaints.

The five examples set forth in the Revenue Ruling illustrate the application of the above factors, and demonstrate the following key principles on qualification:

- The decedent does not necessarily have to directly perform the services on behalf of the business. Rather, the Service will take into account the activities of agents and employees of the decedent or the business when determining whether the business is active.
- The Service will consider the activities of independent contractors, such as affiliated property management companies provided that their activities are not so extensive as to reduce the decedent's or business's activities to the level of merely holding investment property. In general, the Revenue Ruling says that the use of a management company to operate the property tends to weigh against a finding that an active trade or business existed at the decedent's death. However, the use of a management company will not be a negative factor if the decedent owned at least 20% of the capital interest in the company.
- The land and improvements on which a business is located can be held by an entity separate from the business and still qualify under § 6166 so long as the decedent owned a substantial interest in both entities and the business actively managed the real property.

The Revenue Ruling also updates a series of rulings on this topic that were issued in 1975: Rev. Rul. 75-365, 1975-2 C.B. 471 is revoked, Rev. Rul. 75-367, 1975-2 C.B. 472 is revoked with regard to the portion of the ruling dealing with eight rental homes, and Rev. Rul. 75-366, 1975-2 C.B. 472 remains in effect.

IX. SECTION 6324 – ESTATE TAX LIENS

Granting of Security Interest in Property Divests Estate Tax Lien. In F.A.A. 20061702F (Apr. 28, 2006), S inherited a parcel of land from F. S then obtained a loan from Lender and used the land as collateral. After S defaulted on the loan, Lender wanted to foreclose on the land, but was aware that a federal estate tax lien attached to the property upon F's death and that F's estate had not paid its estate taxes in full. Lender requested guidance from the Service as to the priority of its lien.

The IRS Chief Counsel's Office explained that if property encumbered by a § 6324(a)(1) estate tax lien is "transferred" by a beneficiary to a purchaser or holder of a security interest, § 6324(a)(2) says that the property is no longer subject to the lien. Instead, a "like lien" is then attached to all of the beneficiary's property. In this case, the pledge of the land by S to Lender was a "transfer" to a holder of a security interest within the meaning of § 6324(a)(2). Accordingly, the Chief Counsel's Office concluded that: (i) the § 6324(a) lien was divested to the extent of the security interest held by Lender; (ii) to the extent the value of the land exceeded Lender's security interest, the lien remained in place; and (iii) S was personally liable for that portion of the unpaid estate tax equal to the value of the property, including a "like lien" against S's property.

In summary, the estate tax lien that attached to the land at F's death did not prevent S from granting a valid security interest in the land. Further, the estate tax lien did not prevent Lender from foreclosing on the land when S defaulted on the loan.

X. OTHER ITEMS OF INTEREST

If This Trust Won't Save Taxes, I Want My Money Back. In *Generaux v. Dobyns*, 134 P.3d 983 (Or. Ct. App. 2006), Ms. Dobyns sought rescission of an irrevocable trust she created on the basis of a mistake of law. Her sole purpose in creating the trust was to reduce estate taxes, and the attorney who assisted her in creating the trust advised her that placing assets in the trust would result in a significant savings in estate taxes. Because the trust provided for distributions to Ms. Dobyns during her lifetime, the trust could not in fact produce any estate tax savings.

When Ms. Dobyns sought to rescind the trust, the beneficiaries objected on the premise that an irrevocable trust cannot be rescinded based on mistake of law. The court disagreed with the beneficiaries and adopted the principle set forth in the *Restatement (Second) of Trusts* § 333 (1959), which provides that a trust may be rescinded based on the same grounds used for rescinding a contract, including mistake, when such trust is created without payment of consideration. The court further noted that the standard required for obtaining rescission based on mistake is clear and convincing evidence; the party seeking rescission must prove that the mistake was not a result of gross negligence; and the rescission must be sought promptly after discovering the mistake.