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Estate Planning Hot Topics Update

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Introduction

This outline addressing various estate planning hot topics includes observations from various conferences this year. I attribute all the good ideas to the many speakers at the various conferences. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers.

1. Estate Tax Repeal

a. Thomas Bill.

The uncertainty about what the House of Representatives would do in the event that the Senate could reach a compromise was dramatically changed by the very surprising compromise proposal introduced by Representative Bill Thomas, Chairman of the House Ways and Means Committee, on June 19, 2006, and that was passed by the House on June 22 by a vote of 269-156. The bill retains the estate tax with a $5 million exemption (indexed for inflation) and lower rates. A Joint Committee on Taxation Report estimates that the ten-year cost of the bill will exceed $283 billion. A cloture vote in the U.S. Senate on June 8, 2006, to bring the permanent repeal proposal up for debate, failed by three votes (57-41). The following is an overview of the general provisions of H.R. 5638, the "Permanent Estate Tax Relief Act of 2006:"

(1) Permanent estate tax relief. The estate tax would not revert to 2001 law beginning in 2011.

(2) Increased and unified estate, gift, and generation-skipping transfer tax exemption. The exemption would be $5 million for all three taxes, indexed for inflation by rounding up to the nearest $100,000 increment. (The indexing provision was added at the last minute before the House vote.) There would no longer (after 2009) be the scenario of an estate and GST exemption that is much larger than the current $1 million gift exemption.

(3) Lower rates. The rates would be the long term capital gains rate (15% in 2010 and 20% thereafter under current law) on the first $25 million of cumulative transfers and two times the long term capital gains rate on cumulative transfers above $25 million. (There is a good example in the Technical Explanation of the bill describing how the mechanical calculations will work where there have been prior gifts.)

(4) Portability between spouses of unused exemption amount. The act "would simplify estate planning" by allowing any unused exemption amount at the death of the first spouse to be used by the surviving spouse (in addition to his or her own exemption). The aggregate amount of unused exemption amounts that can be used by a surviving spouse from all predeceased spouses cannot exceed $5 million. (Many clients will want to continue using bypass trusts planning so that future income and appreciation in the bypass trust will also be excluded from the taxable estate at the second spouse's death and so that they can take advantage

of the asset protection features of a typical spendthrift trust. However, couples with combined assets well under $10 million may decide to forego bypass trust planning under this proposal.) The carryover amount can be used by the surviving spouse for transfers made during lifetime or at death. The unused exemption is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse (regardless of whether the predeceased spouse otherwise is required to file an estate tax return). The IRS can examine the return of a predeceased spouse for purpose of determining the amount of unused exemption available for the surviving spouse, notwithstanding the statute of limitations for assessing estate or gift tax with respect to the predeceased spouse.

(5) No federal estate tax deduction for state estate taxes. No federal credit or deduction will be allowed for state estate taxes. (For residents of states that have state estate taxes, this will generate a significant additional cost.)

(6) Stepped up basis. Stepped up basis will continue to apply.

(7) Effective date. The effective date of the above provisions is for transfers after 12-31-2009. (Therefore, substantial differences would continue between the gift exemption [fixed at $1 million] and the estate and GST exemptions from now to 2010.)

(8) New timber deduction. There is a new 60% deduction for qualified timber capital gains (effective for qualifying gains recognized from the date of enactment through 2008). (This income tax provision was reportedly added as a “sweetener” to garner some key votes for the bill, an Oregon Senator and the two Washington Senators.)

Observations and Planning Implications.

1. When Senator Kyl agreed to a 30% bracket for large estates, the Republican position over the last year insisting on a flat 15% rate was dead. It was then apparent that the rate is “in play” for negotiation.

2. The $25 million rate bracket break is not indexed for inflation.

3. The portability provision allows portability of the estate and gift tax exemption, but NOT the GST exemption.

4. The rate is tied to the capital gains rate, so it is not a “permanent” fix. The rate floats; indeed, the rate returns to 20% in 2011 unless the law is changed.

5. Portability Issues.

a. The portability provision will make planning simpler for many. But an estate tax return must be filed at the first spouse’s death to make the portability election on a timely filed return. There is no possibility of 9100 relief if the election is not filed timely. If the election is made, the statute of limitations stays open forever for purposes of determining the amount of the first deceased spouse’s unused exemption. (That would only be important if there are bequests to beneficiaries other than the surviving spouse or charities.)

b. If there is unused exemption at the first spouse's death, making the election is almost always desirable. (The only downside is the cost of preparing the estate tax return for the deceased spouse.)

c. Using the portability provision rather than creating a bypass trust gives up removing future growth and income from the surviving spouse's estate.

6. There would no longer be a flat tax. Equalization clauses may again become important to minimize the amount that would be subject to a doubled rate (for the portion of the estate over $25 million).

7. GST Planning. Planning in the past was to give children a general power of appointment over sufficient assets to minimize the overall estate and GST tax, in light of the fact that the GST tax rate is automatically at the highest estate tax rate. The importance of that approach has diminished over the last several years with the advent of a flat estate tax rate. That planning will become important again, if the highest rate is 30% vs. the lower 15% bracket (or 40% vs. 20% if the capital gains rate increases to 20%, as scheduled, in 2011).

8. State Disparities. There would be even greater differences in the future between coupled states (i.e., no state estate tax) and de-coupled states. The difference would be a 15% rate in coupled states compared to (15% federal +16% state), or a 31% combined rate in decoupled states. That's more than double as much estate tax, depending on the state of domicile. Also, the greatly increased federal exemption makes it even more difficult to get back to unity among the states, which already have many different exemption amounts.

9. The bill is premised on providing certainty and the title refers to a "Permanent" estate tax change. Ron Aucutt is skeptical—he asks how permanent can it be when it is the "Permanent …Act <u>of 2006</u>."

10. There is no possibility of Section 9100 relief if the portability election is not made on a timely filed return following the first spouse's death. There seems to be no valid policy reason for that. Indeed, what is the policy of having to make an election at all? However, Representative Thomas has said that he is not willing to make ANY changes to this bill other than correcting clear mistakes. (For example, there is a technical mistake in the calculation provision and that change would be made.)

b. <u>Senate Bill 3626; Democratic Response</u>

1. <u>Basic Provisions</u>.

(1) Rate is flat 35%. (Observe, in 2011 that is less than the 40% top rate that would apply under the Thomas bill [if the capital gains tax rate increases as scheduled to 20% in 2011].)

(2) $5 million applicable exclusion amount for estate and GST purposes. The gift exemption would stay at $1 million.

(3) Phase out of the exemption for estates over $100 million, by 5% of the amount above $100 million, but not below zero. (So for a $200 million or larger estate, there would be no applicable exclusion amount.)

(4) The exemption amount is indexed for inflation at $10,000 increments (compared to $100,000 increments in the Thomas bill).
(5) The aggregate reduction in value under the §2032A special use valuation would be increased from $900,000 to $5 million, indexed for inflation.
(6) The QFOBI deduction under §2057 is increased from $675,000 to $2.5 million, which is not indexed for inflation. (Therefore, for §2032A and 2057 combined, there would be a maximum reduction of $7.5 million.)
(7) Stepped up basis would continue to apply.
(8) There is no provision for portability of exemptions.
(9) The deduction for state estate taxes under §2058 is preserved.

2. Effects.

The Democratic Senate bill is more favorable for small businesses. It is ironic that the superrich are better under the Democrat bill than the Republican Thomas bill (largely because the 35% rate is lower than the top 40% rate under the Thomas bill).

c. House Attempt to Combine Estate Tax Compromise With Minimum Wage Increase (H.R. 5970).

On July 29, 2006, the House of Representatives passed a bill combining estate tax compromise with an increase in the minimum wage and a two-year extended of the R&D credit. The principal changes in the estate and gift tax provisions as compared to H.R. 5938, previously passed by the House (and rejected by the Senate) include:

(1) Exemption—the $5.0 million exemption is phased in, in annual $250,000 increments from 2010 (3.75 million) to 2015 ($5.0 million).
(2) Rate—the rate for estates up to $25 million (indexed for inflation) is equal to the long term capital gains rate (currently 15%, set to increase to 20% in 2011). The rate over $25 million (indexed for inflation) is 40% in 2011 and phased down, in annual 2% increments, to a fixed rate of 30% in 2015 and thereafter.

The Senate cloture vote on this bill failed by a vote of 56-42 on August 3, 2006

d. Conclusion. Many think it is still unlikely that a compromise will be reached this summer. The alternative for permanent estate tax relief window is closing. With the anticipated loss of seats, Republicans are becoming more conciliatory and Democrats are becoming less conciliatory. The political difficulty in the negotiations is that if the magic rate is increased very much to get the last 3 senators, they will be in jeopardy of losing some of the first 57 senators. So it may be that nothing will happen this year. At this point there is no discussion of substantive reforms.

e. Other Reform Measures; Joint Committee Proposals. Major tax legislation supposedly cannot happen in mid election year, but remember that the 1986 Act happened in a mid election year.

Sweeping Tax Reform effort seems to be under long-term study at this point.

A 434 page report was issued from the Joint Committee on Taxation in January 2005. There were five proposals in estate and gift tax area. The proposals would raise $4.2 to 4.7 billion. The proposals include: 1. Limit perpetual dynasty trusts if state law would otherwise allow over two generations. 2. Valuation discounts dealing with transferor and transferee aggregation. Also, there would be a look through rule if an FLP had 30% or more of marketable securities. 3. Tighten the rules for recognizing Crummey withdrawal provisions. 4. Consistent basis between the estate and beneficiaries. 5. 529 plans. Usually Joint Committee proposals do not become law, so don't get overly excited about them.

2. Pension Protection Act of 2006; Overview of Items of Particular Interest to Estate Planners

President Bush signed the Act on August 17, 2006.

a. Charitable Contributions in 2006-2007 of Individual Retirement Accounts. A person over age 70 ½ (at the time of charitable gift) may make charitable gifts directly from an IRA of up to $100,000 per year without having to report the distributions as taxable income (but no charitable income tax deduction can be claimed). The effect is even better, in some respects, than the Katrina legislation that allowed contributions from IRAs in late 2005 that qualified for a 100% charitable deduction. The effect is to change the rules for lifetime charitable gifts (but not charitable bequests).

(1) Charitable gifts from IRAs can also satisfy the annual minimum distribution requirement (in whole or in part). For example, if the minimum required distribution is 4% in a year, that requirement could be satisfied by a 3% contribution to charity and a distribution of 1%.
(2) The exclusion applies only to traditional IRAs and Roth IRAs, not other types of retirement plans.
(3) The exclusion applies only for transfers made during 2006-2007.
(4) The individual must be at least age 70 ½ *at the time of the contribution*. (This is different from the rule requiring minimum distributions *in the same year* the individual reaches 70 ½.)
(5) The charitable organization must be a public charity or a "conduit private foundation." Contributions to donor advised funds, supporting organizations and most private foundations do not qualify.

(6) The distribution must be the type of contribution that would qualify for a complete income tax charitable deduction (for example there can be no financial benefit to the donor from the contribution).
(7) Charitable distributions from IRAs are deemed to come first from the taxable portion. This is favorable, because distributions from the nontaxable portion (attributable to nondeductible contributions to the IRA) are normally tax-free in any event.
(8) The distribution must pass directly from the IRA to the charity.
(9) The new law permits distributions directly to charities, but does not required administrators to make such distributions. Administrators will be reluctant to make numerous distributions to satisfy every $20 contribution that the IRA owner wishes to make. Presumably, each administrator will adopt its own rules to apply this new flexibility in a reasonable and cost effective manner.

This new opportunity is especially favorable for individuals over age 70 ½ who want to make charitable contributions who may be in any of the following situations:
(1) If the donor does not itemize deductions. High income taxpayers who do not itemize deductions often live in states that do not have a state income tax.
(2) If the donor is a high income taxpayer who is subject to the phaseout of itemized deductions as income increases over $150,500 ($75,250 if married filing separately). (The phase out has been 3%, but is only 2% in 2006 and 2007.)
(3) Social security recipients will be benefited if excluding the IRA income keeps their income below thresholds that cause social security benefits to be subject to income tax.
(4) Donors who make such large gifts that they are subject to the 50% charitable deduction limitation are benefited. It is better for them to have income exclusion than to have a charitable deduction that cannot be fully utilized.

b. Nonspouse Beneficiary Rollovers. Employer sponsored retirement plans often require benefits to be paid in a lump sum or within 5 years of the participant’s death to the participant’s “designated beneficiary” Under current law, if the beneficiary is a spouse, he or she can roll over the distribution into an IRA, but a non-spouse beneficiary could not use a rollover IRA, and was therefore often forced to receive the benefits in a lump sum and incur an immediate income tax liability. The new law allows non-spouse beneficiaries to utilize IRAs as well, which enables them to defer distributions (and income taxation). To qualify, the distribution must be a direct “trustee-to-trustee” transfer into an IRA. The IRA is treated like an inherited IRA, so benefits must be distributed in accordance with the minimum distribution rules that generally apply to IRAs, including inherited IRAs. The new law applies to distributions made after 12/31/2006 (and the date of participant’s death apparently makes no difference.)

Accordingly, the beneficiaries of plans for participants who die during 2006 should consider waiting until 2007 to take distributions under the plan, in order to take advantage to directing that the distribution be made to an IRA.

c. Charitable Contribution Reforms. The Act made a number of charitable reforms. Only a few of these reforms measures are summarized.

(1) Contributions of Fractional Interests in Tangible Personal Property. A charitable deduction is allowed under current law for gifts of an undivided fractional portion of a donor’s entire interest in tangible personal property (such as an undivided interest in a piece of art). If the gift is used in a manner related to the exempt purposes of the donee, the deduction is based on the relevant fraction of the entire fair market value of the property at the time of the contribution. If the donee’s use is unrelated, the deductible amount is limited to the donor’s basis in the property.

Several very important changes are made under the new law, effective for gifts made after the date of enactment.

(i) All interests owned by donor or donee. All interests in the item must have been owned by the donor and the donee immediately before the contribution. An exception exists if all persons who hold an interst in the property make proportional contributions of an undivided portion of the entire interest they hold.

This rule also applies for gift tax as well as for income tax purposes.

(ii) Deduction for future gifts of undivided interests in the same property. If the use of the property is related to the donee’s exempt purpose, and the deduction is based on the fair market value of the property, there is a special limit on future gifts of additional undivided interests in the same property (and the gift must be made to the same donee or else no deduction is allowed under the first new rule described above). In that situation the fair market value of any additional contribution is determined by using the lesser of (1) the property’s fair market value at the time of the initial fractional contribution, or (2) the property’s fair market value at the time of the additional contribution. Therefore, there will be no increased deduction allowed attributable to increases in the fair market value of the entire property after the time of the initial fractional gift. (However, consistency is not required where the property goes down in value after the initial gift.)

This rule also applies for estate and gift tax as well as for income tax purposes. This is critically important. For example, if an individual makes a gift of a fractional interest in property, and leaves the balance of the property to the charity at the individual's death, there can be a mismatch of estate inclusion and allowable deduction. The individual's remaining undivided interest would be included in the estate at its full value, but the estate tax charitable deduction would be allowed based on the value of the property at the time of the initial contribution.

(iii) Recapture of deduction and recapture penalty. A recapture of the income or gift tax (but not estate tax) charitable deduction will occur where the following events have not occurred with a within 10 years of the initial fractional gift or the donor's earlier death:
(I) if the donor does not contribute all of the remaining interest in the property to the donee (or if the donee is no longer in existence, to another §170(c) organization); AND
(II) if the donee has not (a) had substantial physical possession of the property, and (b) used the property in a use related to the organization's exempt function.

Accordingly, a gift of a fractional interest in property that is unrelated to the charity's exempt function can still be deducted initially based on the donor's basis (but not the full fair market value). However, if the property is not given a related use within the 10 year or earlier death period, the charitable deduction (plus interest) is recaptured.

There is also a recapture penalty of 10% of the amount recaptured.

(iv) Contributions before date of enactment. The legislative history states that a contribution of an undivided interest in tangible personal property before the date of enactment is not treated as the initial fractional contribution for purposes of these rules. The first additional undivided interest contribution after the date of enactment would be treated as the initial contribution for purposes of these new rules. (Therefore, for example, the 10 year period would run from the date of the first contribution after the date of enactment, not the date of prior contribution(s) of undivided interests in the same asset.)

(2) Miscellaneous Other Charitable Provisions. There are numerous other provisions, including:

- Some additional limits on deductions of clothing and household items (the items must be in good used condition and must have more than minimal monetary value).
- A charitable deduction for contributions of tangible personal property exceeding $5,000 must be reduced or recaptured if the donee sells the property within three years of the contribution.
- A charitable contribution by an S corporation will reduce the shareholders' basis only by the contributed property's basis (rather

than by his or her share of the full charitable contribution) for contributions made in tax years beginning in 2006 or 2007.

- There are additional restrictions for façade easements or certain conservation gifts in historic districts. (A deduction is allowed for conservation easements for buildings located in historic districts only if the easement preserves the entire exterior of the building, prohibits any change inconsistent with the historical character of the exterior, and if the donee is a qualified organization that has the resources to manage and enforce the restriction. Taxpayers claiming a deduction for building easements greater than $10,000 must pay a filing fee of $500, beginning six months from the date of enactment. The deduction is eliminated for conservation easements on vacant land in historic districts.)
- Conservation contributions by individuals are deductible up to 50%, rather than the prior 30% limit for contributions of long term capital gain property unless the taxpayer elected to limit the deduction to basis of the contributed property, (and 100% for farmers and ranchers provided that the property is “generally available” for agriculture or ranching) with a 15 year carryover (rather than the usual 10 year carryover). However, these relaxed percentage limitation and carryover rules are only available for conservation easements made in tax years beginning in 2006 and 2007; this is critical because locating organizations willing to accept the easement and negotiating the easement can be a quite lengthy process.
- The requirements for donor advised funds of certain organizations are made stricter. For example, donor advised funds of certain Type III supporting organizations are not recognized.
- There are new taxes on taxable distributions from donor advised funds (i.e. distributions to other than qualified charities and to certain [but not all] supporting organizations).
- There are new taxes imposed on distributions from donor advised funds that have more than an incidental benefit to certain donors, donor advisors, or related persons.
- The excess business holdings tax that applies to private foundations is extended to donor advised funds (donors, donor advisors and investment advisors are disqualified persons for this purpose) and to certain supporting organizations. Accordingly, like private foundations, they would have to dispose of closely-held business interests within five years of receipt if donors and related parties owned over 20% of the business.
- A special tax applies if there are certain distributions (including grants, loans or compensation) to donors, donor advisors or related persons of donor advised funds or to specified disqualified persons of supporting organizations.
- Distributions by private foundations to certain supporting organizations are not treated as qualifying distributions for

purposes of the minimum distribution requirements of private foundations.
- The requirements for supporting organizations (especially Type III supporting organizations) are made stricter.

d. Valuation Penalties.

(1) Substantial and gross valuation penalty tests toughened. Income tax: Substantial valuation misstatement--If there is an underpayment of income tax by more than $5,000 and if the value claimed on the return is from 150% to 200% (down from 200% to 400%) of the “correct” value, there is a penalty of 20% of the underpayment of income tax attributable to the overvaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 200% (down from 400%) of the “correct” value. I.R.C. § 6662(a & e).

Estate and gift tax: Substantial valuation misstatement--If there is an underpayment of estate or gift tax by more than $5,000 and if the value claimed on the return is from 65% to 40% (up from 50% to 25%), there is a penalty of 20% of the underpayment of estate or gift tax attributable to the undervaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 40% (up from 25%) or less of the “correct” value. I.R.C. §6662 (g-h). For example, the 20% substantial valuation misstatement penalty could apply if an estate or gift tax return claims a 35% discount that is disallowed totally.

Reasonable cause is no longer a defense to a gross valuation misstatement penalty for income, estate, or gift tax purposes.

These tougher rules apply to any returns filed after the date of enactment.

(2) Penalty imposed on appraisers. Rather than the aiding and abetting penalty under §6701 (generally limited to $1,000), appraisers are now subject to a penalty equal to the greater of $1,000 or 10% of the underpayment attributable to the valuation misstatement, up to a maximum of 125% of the gross income received for preparing the appraisal, in certain circumstances. The appraiser penalty applies if the appraiser knew or should have known that the appraisal would be used in connection with a return or refund and if the appraised value results in a substantial valuation misstatement or a gross valuation misstatement. No penalty is imposed on the appraiser if the appraiser establishes that the appraised value was “more likely than not” the correct value. The appraiser penalty applies for appraisals prepared for returns or submissions filed after the date of enactment.

3. McCord—Does the Fifth Circuit Approve Defined Valuation Clauses?

A. Facts.

1. Creation of Partnership. Mr. and Mrs. McCord created a family limited partnership with the bulk of their assets on June 30, 1995. A partnership formed by their children also contributed substantial assets to the partnership. The partnership was restated in October 1995, among other things, to give the partnership a call right over any Class B limited partnership interest given to a charitable organization, if the charity was not admitted as a limited partner.

2. Assignment Under Defined Value Clause. On January 12, 1996, parents assigned their Class B limited partnership interests by a formula clause, very simply summarized by the Fifth Circuit as follows:

   "We have observed that these gifts divested the Taxpayers of their entire interest in MIL then remaining. It did so, however, *not* in *percentages* of interest in MIL, however, but in *dollar amounts* of the net fair market value of MIL, according to a *sequentially* structured "defined value clause":

Donee	Gift
First, to the Generation Skipping Tax Trusts ("GST trusts")	A dollar amount of fair market value in interest of MIL equal to the dollar amount of Taxpayers' net remaining generation skipping tax exemption, *reduced by* the dollar value of any transfer tax obligation owed by these trusts by virtue of their assumption thereof.
Second, to the Sons	$6,910,932.52 worth of fair market value in interest of MIL, *reduced by* the dollar value of (1) the interests in MIL given to the GST trusts, and (2) any transfer tax obligation owed by the Sons by virtue of their assumption thereof.
Third, to the Symphony	$134,000.00 worth of such in interest of MIL.
Last, to CFT	The dollar amount of the interests of the Taxpayers in MIL, *if any*, that remained after satisfying the gifts to the GST trusts, the Sons, and the Symphony."

   The assignment agreement contains the following instruction concerning valuation: "For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this Assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Any dispute with respect to the allocation of the Assigned Partnership Interests as among Assignees shall be resolved by arbitration as provided in the Partnership Agreement."

3. Assignment Conditioned on Donee Paying Transfer Taxes, Including §2035(b) Estate Tax. As a condition to the gift, the McCords required their sons and the donee trusts (the "non-charity donees") to proportionately pay any federal or state transfer taxes imposed as a result of the gifts. These taxes expressly included gift taxes, estate taxes, generation-skipping transfer taxes, and any state taxes based on those federal taxes. In addition, if either of the McCords were to die within three years of making the gifts, the gift tax paid would be included in his or her gross estates under §2035(b), and the non-charity donees would be obligated to pay the resulting federal estate tax.

4. Confirmation Agreement Among Donees. About two months after the assignment (in March 1996), the various assignees agreed (in a "Confirmation Agreement") to specific percentage amounts that would pass to the various assignees. The charities (and their outside counsel) reviewed an appraisal report that had been prepared by Howard Frazier Barker Elliott, Inc. (the "Frazier appraisal") after the gifts were made. The Frazier appraisal concluded that a 1% assignee interest was worth $89,505. The charities determined that it was not necessary for them to obtain their own appraisals. The donees agreed on the percentages passing to the various donees, using a value of $89,505 per 1% interest.

5. Exercise of Call Right to Acquire Charities' Interests. About three months later (in June 1996), the partnership exercised its call right to acquire the charitable interests. The appraiser updated his appraisal. The partnership and the charities reviewed it and agreed to accept its $93,540 value of a 1% interest. (The Fifth Circuit concluded that the donors had nothing to do with the exercise of the call rights or the redemption prices.)

6. Gift Tax Returns. Gift tax returns were filed, calculating the taxable gifts for the gifts to the non-charitable donees as $89,505 per 1% interest, less the gift tax and actuarially determined contingent estate tax liability under §2035(b).

7. Notice of Deficiency. The IRS Notice of Deficiency claimed that the gifts should have been calculated based on $171,749 per 1% interest (almost double the donors' $89,505 figure).

8. Trial. At trial, the donors continued to take the position that the gifts should be determined based on a value of $89,505 per 1% interest. The IRS trial expert (Dr. Bajaj) used a value of $150,665 per 1% interest. The parties agreed that the Commissioner had the burden of proof, and Judge Foley determined that the Commissioner had failed to meet his burden of

proof, which would result in a total taxpayer victory. However, the Fifth Circuit summarized that the Acting Chief Judge of the Tax Court “issued an unusual order that resulted in a proceeding that resembles an en banc rehearing. In essence, the case was taken away from Judge Foley retroactively and reassigned to Judge James S. Halpern who, on the same day, filed an opinion on behalf of the Majority.”

B. Tax Court Opinion, 120 T.C. 358 (2003). The Tax Court opinion did the following.

1. Assignee Interests Recognized. The court recognized that assignee interests, rather than full-fledged partnership interests, were transferred and the gift values should be determined accordingly.

2. Discounts. Minority discounts were assigned for each of the five categories of interests. The minority discounts were 10% (for equities and bonds), 23.3% for real estate partnerships, 40% for directly owned real estate, and 33.5% for oil and gas. The weighted minority interest discount was 15%. A marketability discount of 20% was allowed (in large part based on the IRS's expert's private placement study.) The overall discount was 32%, after applying seriatim the 15% minority discount, and a 20% discount on the remaining value.

   The Fifth Circuit used a calculator and rather pointedly observed that the Tax Court’s value of a 1% interest was almost exactly halfway between the values urged by the taxpayers and the Commissioner: “Thus the Majority split this almost $10 million baby precisely halfway between the experts' respective values."

3. Defined Value Clause Not Recognized Because of Interpretation of Clause. In light of the defined value clause, gift value to the non-charitable donees should have been a fixed dollar value, regardless of what percentage interests were determined to pass in implementing that clause. The court did not decide whether this type of "defined value clause" would be disregarded on public policy grounds. Instead, the court held that the specific clause was not "self-effectuating" because the formula was based on the "fair market value" of the transferred interest, rather than being based on the "fair market value as finally determined for Federal gift tax purposes." The Court, in effect, ignored the Defined Value Clause, and gave effect to the percentages recognized by the parties in the Confirmation Agreement—despite the fact that the percentages agreed to in the Confirmation Agreement were based on appraised values that were far different than the finally determined gift tax values. The agreed percentages passing to the children and the GST trusts times the value of a 1% interest as determined by the court resulted in substantial additional gift and GST taxes. Curiously, the court allowed a full charitable deduction for the percentages that passed to the charities,

even though the charities had cashed in their interests for far less than the values determined by the Tax Court.

Under the court's reasoning, the parties to the assignment documents were supposed to determine what interests passed to the various parties "based on the assignees' best estimation" of the value, and the Court gave effect to the percentage interests agreed to by the parties. The Court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interst determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes," the Court "might have reached a different result."

Interestingly, a dissent by Judge Chiechi points out that the formula clause was based on "fair market value" as defined in the Agreement, and the majority opinion acknowledged that the definition of "fair market value" in the Agreement is the same definition of that term as applies for Federal gift tax purposes. She points out that in essence, “the majority opinion concludes that the donees of the gifted interest made a mistake in determining the fair market value of that interest and that petitioners are stuck with that mistaken value solely for purposes of determining the respective assignee percentage interests transferred to the donees under that agreement.”

Another dissent by Judge Foley points out that the IRS never made the "interpretation argument"—the court came up with that theory on its own. The Foley dissent (which was agreed to by Judge Chiechi) also concluded that the clause did not violate public policy and is distinguished from the Procter case because no assets were to be returned to the donor based on the results of the gift tax determination. Judge Foley, who was the trial judge, obviously was most displeased that the majority of the full Tax Court did not agree with his conclusions. His dissent opens with this volley: "Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law."

4. Net Gift Calculation Could Not Consider Liability For Additional Estate Tax. The gift was valued by the taxpayers as a net gift, with an offset for federal and state gift taxes and for the present value of the contingent liability for additional estate taxes attributable to the gift (if the donor died within 3 years of making the gift) that the donees had agreed to pay However, the court refused to consider the donees' agreement to pay any estate tax liability that would arise if the donor died within 3 years of making the gift as an offset in determining the net gift. The primary reason for refusing to consider the possible estate tax liability is that it is too speculative and the taxpayers failed to show that their computation of that potential liability was reliable.

5. Summary. The Fifth Circuit quoted the concise summary of the Tax Court's holdings in the taxpayer's brief:

"[t]he Majority held that (1) the interests transferred [by the Assignment Agreement of January 12, 1996] were assignee interests in [MIL]; (2) the Majority was not required to follow the terms of the assignment agreement in determining the fair market value of the interests of the partnership transferred by [the Taxpayers]; (3) the fair market value of the total interests transferred was $9,888,832, or $120,046 per 1% interest; (4) the value of the interests transferred should be based on the value determined by the Majority on a per unit basis times the *percentage interests determined by the donees* in a Confirmation Agreement reached by the donees *two months after the gifts* were made; and (5) the value of the [non-exempt] donees' contractual obligation to pay estate tax liability [under § 2035] could not be deducted in determining the value off [the Taxpayers'] gift."

C. Fifth Circuit Opinion Holdings. Oral argument to the Fifth Circuit Court of Appeals was in May 2004. For some unknown reason, the three judge panel took almost 27 months to issue this unanimous opinion. (In light of the long delay, many had theorized that there must be a huge difference of opinion among the judges, which would suggest that there would have been a dissent. That was not the case.)

1. The case involved, at most, a mixed question of law and fact, and because it turns on a legal conclusion, the court reviews the case de novo.

2. The IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The values of the transferred interests, for purposes of calculating gift and GST taxes, are the values used by the taxpayers (i.e., $89,505 for a 1% interest). The Tax Court erred in using the Confirmation Agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Tax Court should have applied the defined value clause under its plain wording (although the Fifth Circuit stated that the Commissioner chose not to argue the public policy issue and the court did not explicitly consider that issue).

3. The contingent estate tax liability under §2035 that is assumed by the non-charitable donees if either donor died within three years of the gift is not so speculative that it cannot be considered in determining the net value of the gifts.

D. Fifth Circuit Analysis.

1. Standard of Review. Conclusions of law, conclusions of fact (such as valuation) that require legal conclusions, and the determination of the nature of property rights are all reviewed de novo. The appellate court draws its own conclusion in place of those of the trial court. The determination of whether the defined value gifts are given effect and the nature of the property afforded by those gifts are law conclusions reviewed under a de novo standard. (If the court had determined that the defined value clause in the assignment should be ignored and the interests to be valued are the percentage interests agreed to by the donees in the Confirmation Agreement, the Tax Court's factual valuation findings would have been reviewed under a clear error standard. But that was not the case.)

2. Burden of Proof. The parties had stipulated that the Commissioner had the burden of proof.

3. Commissioner's Theory on Appeal. The Commissioner did not argue in the body of its brief what many believed to be its strongest arguments in fighting the defined value clause (substance over form, public policy, etc.). However, it did note those arguments (citing the Procter, Ward, Gregory, and Court Holding cases) in footnote 18 of its brief, and requested the Fifth Circuit to remand the case to the Tax Court if the court determined not to accept the Tax Court's "interpretation argument" that refused to apply the defined value clause. The Fifth Circuit's position is that the Commissioner waived those arguments, and the Fifth Circuit did not consider them. The Commissioner just sought to uphold the various steps of the Tax Court majority, as summarized in Item 5 above regarding the Tax Court opinion. Similarly, the Commissioner did not include in its brief the argument that the transferred interests should be valued as full limited partnership interest rather than assignee interests. (The Fifth Circuit specifically noted that its failure to address this issue should not be viewed as either agreeing or disagreeing with the treatment of the transferred interest as an assignee interest. Rather, the Fifth Circuit concluded that it did not need to reach that issue under its conclusion that the defined value clause should be respected.)

4. Defined Value Assignment Should be Respected. The Fifth Circuit spotted this as the key issue in the case: "[T]he feature that most fractionated the Tax Court here is the Taxpayers' use of the dollar-formula, or "defined value," clause specified in the Assignment Agreement … to quantify the gifts to the various donees in *dollars* rather than in *percentages*…"

a. Fair market value must be determined on date of gift. The Fifth Circuit emphasized that values must be determined on the date of the gift. The court observed that the Commissioner's value in the Deficiency Notice was significantly more than the values used by the IRS's valuation expert at trial. The taxpayers provided evidentiary underpinning of their proffered values (through the Frazier appraisal). Judge Foley would have rendered judgment for the taxpayers based on the Commissioner's failure to meet his burden of proof. The Tax Court Majority independently appraised the donated property (reaching a value "precisely halfway between those of Mr. Frazier and Dr. Bajaj). The Majority's methodology is grounded in significant part on the donees' post-gift Confirmation Agreement. That constitutes legal error."

b. Reallocating values of gifts based on post-gift acts of donees is improper. The Tax Court Majority made its own determination of the value of a 1% interest, and allowed a gift tax charitable deduction for the percentage interests that passed to the charities under the Confirmation Agreement times the court's determined value of a 1% interest. The total value of the transferred interests, less such charitable deduction, was the amount of taxable gifts to non-charitable beneficiaries (less annual exclusions and the offset for gift taxes assumed by the donees). Judge Chiechi's dissent pointed out that in essence, "the majority opinion concludes that the donees of the gifted interest made a mistake in determining the fair market value of that interest and that petitioners are stuck with that mistaken value solely for purposes of determining the respective assignee percentage interests transferred to the donees under that agreement." The taxpayer's brief to the Fifth Circuit very simply summarized its objection to this approach by noting that "if the donees made a mistake in allocating the interests on a percentage basis, such error cannot result in a gift being made by Mr. or Mrs. McCord, who were not even parties to the Confirmation Agreement." Brief of Appellants n.8.

The Fifth Circuit summarized that "the Majority in essence suspended the valuation date of the property that the Taxpayers donated in January until the date in March on which the disparate donees acted, *post hoc*, to agree among themselves on the Class B limited partnership *percentages* that each would accept as equivalents of the *dollar values* irrevocably and unconditionally given by the Taxpayers months earlier." The "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's 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." The court pointed to the "immutable rule" that fair market value is determined, snapshot-like, on the day the donor *completes* the gift. The Fifth Circuit concluded that the Tax Court Majority's application of its "smell test" resulted in its failure to give effect to the dollar gifts in the assignment:

"Judge Foley's use of 'olfaction' is an obvious, collegially correct synonym for the less-elegant vernacular term, 'smell test,' commonly used to identify a decision made not on the basis of relevant facts and applicable law, but on the decision maker's 'gut' feelings or intuition. The particular olfaction here is the anathema that Judge Swift identifies pejoratively in his concurring opinion as 'the sophistication of the tax planning before us.'

The Fifth Circuit quoted with approval from Judge Foley's strong dissent, which had pointed out that "[t]here is no factual, legal, or logical basis" for the Tax Court Majority's approach. The Fifth Circuit concluded that because the gift was of a dollar value, whether the controlling value on the date of the gift was the value in the Frazier appraisal, the "halfway" value determined by the Tax Court, the value in the IRS's deficiency notice, or the (lower) value espoused by the IRS's expert has "no practical effect on the amount of gift taxes owed here."

c. Concluding logic. The Fifth Circuit concluded that given the Majority's non-erroneous rejection of the Commissioner's experts' values, its own legal error of refusing to discount the gift by the present value of the assumed liability for §2035 estate taxes, the fair market values "are, by a process of elimination, those determined by the Frazier report and used by the Taxpayers in preparing their gift tax returns for 1996." This logic reflects the organization of the gift tax return in reporting the gifts. The gift tax returns determined the taxable gifts by starting with the total value of the transferred interests (using the Frazier appraisal), subtracting the assumed gift tax liability and the actuarial present value of the assumed estate tax liability, and the charitable deductions for amounts passing to charity. While the court's logic follows the organization of the gift tax returns, it might seem that even the Frazier appraised value is irrelevant to determining the amount of the gift to the non-charitable donees, which was merely stated as a dollar amount. That would seem to be the only basis for refusing to remand the case to the Tax Court to determine the factual value consistent with the court's opinion (or reviewing the Tax Court's determined value under a clear error standard).

d. Court's logic is confusing; Did court actually recognize defined value clause? Some commentators have concluded that the Fifth Circuit case merely held that the Commissioner did not meet its burden of proof, and that it was error to use the Confirmation Agreement to impact the determination of the gift tax. I concur that the concluding logic is confusing, and that planners should not treat this as an unqualified validation of defined value clauses (even apart from the refusal to address the public policy issues). However, there are indications in the opinion that the court was doing more than just saying that the IRS did not meet its burden of proof and that gift values must be determined on the date of the gift without regard to post-gift acts of the donees.

The case states in the last sentence of section II.C.3.a of the opinion that "the results of the Majority's independent appraisal of the donated interests in MIL and their values for gift tax purposes *become irrelevant* to the amount of the gift taxes owed by the Taxpayers." (emphasis added). The clearest indication of this is the court's opening sentence of its concluding paragraph of the section II.C.3 of the opinion dealing with the fair market value of interests in the partnerships transferred by the taxpayers:

"In the end, whether the controlling values of the donated interests in MIL on the date of the gifts are those set forth in the Assignment Agreement based on Mr. Frazier's appraisal of $89,505 per one per cent or those reached by the Majority before it invoked the Confirmation Agreement (or even those used by the Commissioner in the deficiency notices or those reached by the Commissioner's expert witness for that matter), have no practical effect on the amount of gift taxes owed here."

The court specifically says that the appraisals and the Tax Court's determination of the value of a one percent interest in the partnership are irrelevant in determining the amount of gift taxes. What can be the basis for that statement unless the court is saying that the value of the gift is the dollar value stated in the Assignment Agreement where the agreement requires that the fair market of the assigned partnership interests be determined under a willing buyer willing seller test that is identical to the standard that is used in the gift tax regulations?

The court's logic that follows after that sentence seems questionable. The court seems to reason that (i) the Tax Court's rejection of the IRS's expert was non-erroneous, (ii) the government had the burden of proof, therefore (iii) the fair market value is the value used in the taxpayer's expert's report. (In the court's words, "the fair market values applicable in this case are, *by a process of elimination*, those determined by the Frazier report and used by the Taxpayers in preparing their gift tax returns for 1996." (emphasis added))

If that logic is correct, almost every Tax Court valuation case is incorrectly decided. The Tax Court rarely accepts the valuation of either side's expert and typically determines a value somewhere between the two experts' values. The <u>McCord</u> panel's logic seems to say that if the court does not accept the expert report from the side that has the burden of proof, the expert's report for the other side sets the fair market value.

The panel at no place in the decision addresses the Tax Court Majority's determination of the value of a one percent interest under a clear error standard. If the value of a one percent interest was really critical to determining the gift amount, why did the court not review the Tax Court Majority's determination of the value of a one percent interest (i.e., $120,046 per one per cent interest) under a clear error standard of review? The answer seems to be the opening sentence of that tortured paragraph—stating that the values reached by the appraisers "or by the

Majority before it invoked the Confirmation Agreement … have no practical effect on the amount of gift taxes owed here."

Perhaps the court's tortured path to reaching its conclusion, and referring to the $89,505 per one per cent interest suggests that the panel had some concern with just reaching a simple conclusion that the gift value was the dollar amount listed in the Assignment Agreement for non-charitable donees. Which, again, would suggest that planners should not view this case as an unqualified acceptance of defined value clauses, but as one panel's refusal to find these clauses to be abusive or to ignore them under a smell test.

5. Reducing Gift by Present Value of Potential Taxes under §2035. The non-charitable donees explicitly assumed liability for additional estate taxes under §2035 if either of the donors were to die within three years of making the gifts. The Tax Court Majority viewed that contingent liability as "too speculative" for allowing a gift offset.

The Fifth Circuit reasoned 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 beneficiaries were obligated to pay the additional estate tax imposed under §2035. The court acknowledged that some contingent liabilities can be too remote to consider, and that determining whether a contingent liability is too speculative is "a very elastic yardstick indeed." The court viewed that as a mixed question of law and fact, to be reviewed de novo. The court's approach was to determine if the "ubiquitous 'willing buyer'" would take that contingent liability into account in valuing the transfer at the date of the gift. It isolated each variable in the contingency and determined "which of those factors a willing buyer would (and we, as a matter of law, must) take into consideration in deciding whether it is too speculative for him to insist on its being used in reaching a price that the seller is willing to accept."

The court identified the following factors in estimating the present value of the potential liability for additional estate tax under §2035(b):

a. The amount of *gift* taxes owed by the Taxpayers;

b. Whether there would be an estate tax (or essentially identical death related transfer tax) at the date of death of the donors;

c. Whether gift taxes would be taxable under §2035 at the donor's death if a donor died within three years;

d. What estate tax rate would apply to any such §2035 amount at the donor's death;

e. Will §2035 still be conditioned on survivorship for three years at the donor’s death;

f. What discount rate should be applied in determining the present value of the future contingent liability; and

g. What discount should be applied for determining the actuarial odds that a donor would die within three years.

As to item a, the court concluded that while the final amount of gift tax depended on the final result of the case, a willing buyer would apply the transfer tax law and rates in effect on the date of the gift.

As to items b-e, the court analogized to the “built-in gains discount” cases and reasoned that other courts have repeatedly held that the potential changes in the income tax and the capital gains tax (and the capital gains tax rate) are not contingencies that a willing buyer would consider (citing Dunn and Jameson). The court observed that while the rates and particular features of the capital gains tax and estate tax have and will change with irregular frequency, “despite considerable and repeated outcries and many aborted attempts,” neither the capital gains tax nor the estate tax have been repealed.

As to item f, the court concluded that the appropriate discount rate is not a matter of speculation, because “§7520 dictates precisely the rate of interest to be applied; and here, it is the rate that was applicable on the date of the gift.” (Observation: That seems to be an overstatement; §7520 deals with the valuation of term interests and does not specifically apply to discounting contingent future liabilities.)

As to item g, the court observed that the IRS did not contest the Frazier appraisal’s actuarially determined mortality factors (which apparently were based on Table 80CNSMT, in Treas. Reg. § 20.2031-7A(e)(4) (effective 4/30/89 through 5/1/99), as cited in footnote 46 of the opinion.

The court concluded that a willing buyer would take into account the contingent liability for §2035 estate taxes:

“… we are convinced as a matter of law that a willing buyer would insist on the willing seller’s recognition that – like the possibility that the applicable tax law, tax rates, interest rates, and actuarially determined life expectances of the Taxpayer could change or be eliminated in the ensuing three years—the effect of the three-year exposure to § 2035 estate taxes was sufficiently determinable as of the date of the gifts to be taken into account.”

Footnote 47 distinguishes three other cases (Armstrong Trust, Murray, and Robinette) that had rejected considering speculative contingencies—on the basis that those other cases involved situations with considerably more speculative contingencies.

6. Conclusion. The Fifth Circuit case concludes that given the Tax Court Majority's reversible errors in evaluating the interest on its own, employing the Confirmation Agreement in its calculations (i.e., by subtracting as the gift tax charitable deduction only the amount of interests that passed to the charities under that Agreement times the Majority's determined value per 1% interest), and rejecting the §2035 estate tax liability, the taxable value of the gifts to the non-charitable beneficiaries is not that determined by the Tax Court, but are those determined and used by the Taxpayers. The case details the dollar values passing to each of the donees. (At first blush, one might question why the Fifth Circuit did not remand back to the Tax Court to determine the factual values of the assignee interests; however, the value of a 1% interest is irrelevant under the Fifth Circuit's analysis. The taxable amounts passing to the non-charitable donees are the dollar amounts prescribed for the non-charitable donees under the Assignment Agreement, and the amount of gift tax charitable deduction is the amount of the total transferred amount less the dollar amounts passing to the non-charitable donees.)

7. Why Did It Take So Long? It is most curious to everyone why the three judges needed over two years to issue a unanimous opinion. I would have guessed that there must a great deal of dissension in reaching an opinion, and that there would be a strong dissent in the case whoever won. That obviously did not happen. There must have been some issue that was troubling to the judges even though they eventually reached a unanimous decision without a concurring opinion. Wouldn't it be fascinating to know what the troubling issue was? It makes you wonder if there was some difference of opinion among the three judges as to whether to address the policy issues—or whether to remand the case to the Tax Court to consider those issues.

E. Planning Issues in Light of Fifth Circuit Opinion.

1. Is This Decision The "Green Light" for Using Defined Value Gifts?

a. Huge taxpayer victory. Although there are limits on the decision (it basically just rejects the Tax Court's reasoning that few could even understand let alone support), it is a seminal case of a federal court of appeals case recognizing and applying a defined value gift transfer. The Tax Court has apparently been troubled by these types of clauses, and has rejected several defined value transfers in the recent past, in each case on technical grounds without agreeing with the IRS's broad position that "dollar amount" gift transfers should not be recognized for public policy reasons. See Knight v. Commissioner, 115. T.C. 506 (2000) (court did not respect the clause because taxpayers did not); McCord, 120 T.C. 358

(2003). Tax Court judges referred pejoratively to the “sophistication of the tax planning before us.” This federal court of appeals case at least turns the tide of courts viewing these clauses as abusive and troublesome under a smell test.

b. Court did not consider public policy or substance over form doctrines. The taxpayer’s trial brief and brief to the Fifth Circuit summarized the response to the Commissioner’s public policy and substance over form arguments: “The Commissioner erred in relying on such cases [Procter, Ward, and McClendon] because (i) the fixed-value clause in the Assignment Agreement was materially different from the ‘savings arrangements’ in *Procter, Ward,* and *McClendon*, (ii) similar formula clauses are used commonly and have been approved by the Commissioner, and (iii) the Commissioner’s ‘substance over form’ argument ignores the independent character of both the Symphony and [Communities Foundation of Texas] as unrelated parties.”

The Court said that the Commissioner did not make the public policy or substance-over-form arguments in its brief, and that it waived those arguments to the Fifth Circuit. Some commentators have suggested that this opinion is not comforting at all because of that aspect of the opinion. Indeed, everyone has thought that the public policy arguments are the IRS best arguments against these types of clauses (i.e., that they discourage audits because anything the examining agent does adds no additional gift tax).

Why did the Commissioner not make the public policy argument to the Fifth Circuit?

Only two of the Tax Court judges who participated in the McCord decision specifically agreed with the Commissioner’s public policy argument. Some attorneys have suggested that the taxpayers’ arguments in the trial brief responding to the public policy arguments and in Judge Foley’s dissent were so strong that it is not surprising that the Commissioner did not make the argument again on appeal. Did the Commissioner view the argument as such a loser that there was no point in making the argument? Or did the Commissioner specifically strategize not making the argument before the perceived taxpayer-friendly Fifth Circuit to preserve the argument in other more receptive courts?

I do not think either of those happened. Despite the fact that the Fifth Circuit said that the Commissioner did not make the argument in its brief and waived the argument, the Commissioner’s brief DID restate the argument (albeit in a footnote—but are footnotes not still part of the brief?) and specifically requested the Fifth Circuit to remand the case to the Tax Court to consider the policy issues if the Fifth Circuit decided not to approve the Tax Court’s “interpretation argument” about the defined value gift:

“In the Tax Court, the Commissioner argued that the estate planning device utilized here was akin to those in *Commissioner v. Procter*, 142 F.2d 824, 827 (4th Cir. 1944) and in *Ward v. Commissioner*, 87 T.C. 78, 110-14 (1986), which the courts rejected as contrary to public policy. The Commissioner had also argued that the series of transactions should be treated as a single integrated transaction pursuant to the substance-over-form doctrine. *See Gregory v. Helvering*, 293 U.S. 564 (1935); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). Although Judge Laro’s dissent (Op. 109-117) is based on his view that the Court should have adopted the Commissioner’s position on both matters, and Judge Foley’s partial dissent (Op. 101-106) would have rejected it, the eight judges comprising the Tax Court majority specifically declined to deal with these arguments and made no finding with respect thereto. (Op. 64 n.47.) Therefore, if this Court disagrees with the Tax Court’s conclusions with respect to the interpretation of the Assignment Agreement, it should remand the case to the Tax Court so that it can address these arguments in the first instance.” Appellee Brief, n.18.

Indeed, one wonders in light of this very specific request how the Fifth Circuit procedurally avoided either dealing with this issue specifically requested by the Commissioner in making its own decision regarding the public policy and substance over form argument under de novo review, or remanding the case back to the Tax Court to consider those issues that the Tax Court did not have to consider in light of the reasoning in its opinion. If the Fifth Circuit was correct in ignoring the Commissioner’s specific request for remand, on the basis that the Commissioner waived the argument despite the request for remand, the Commissioner made a critical procedural error in its approach.

The Fifth Circuit opinion gives no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised “smell test” concerns. To the contrary, the court went out of its way to chide the Tax Court for ignoring the “plain wording” of the dollar value assignment on the basis of its perceived “olfaction.” If there had been concerns that the clause was abusive, would the judges not at least have expressed some concern about the policy concerns, to be decided another day? (It is interesting that the court went out of its way to say that the Commissioner waived its argument about whether the transfer should be valued as an assignee interst or as a full limited partnership interest, but “[o]ur failure to address it should not, however, be viewed as either agreeing or disagreeing with the Majority’s determination on this point.” The court did not make a similar statement about the public policy or substance over form argument.)

In sum, I have no doubt that this same three judge panel would have recognized a dollar amount assignment despite public policy or substance over form issues. As to the substance over form issue, the court went out of its way to emphasize the independence of the charitable donees and that there were no side understandings, which would seem important in a substance over form situation. (See item 4 below.)

A fundamental difficulty with the public policy or substance over form argument for defined value clauses for gifts is that the clauses are practically identical to long recognized dollar amount clauses used in wills for marital or charitable bequests. For example, if there is a dollar amount (e.g., the remaining “exemption” amount) bequest to individuals in a will with the balance passing to a spouse, no one questions that this results in a zero estate tax situation, even though actual funding of percentage interests is based on later actions of the executor. The IRS tried (lamely, in this author’s view) to identify why defined value clauses during lifetime were so different from testamentary marital deduction clauses from a policy viewpoint in TAM 200245053.

The taxpayer’s trial court brief observed that these types of clauses are not abusive. “Petitioners simply were trying to determine and establish with certainty, through the use of a formula clause specifying a dollar value of the interst in MIL passing to each donee, the amount of gift tax that would result from such transfers.” Transfers under clauses that fix the amount of estate taxes or GST taxes are routinely recognized. Why should it not be possible to make a transfer in a manner that established with certainty the dollar value that passes as a taxable gift, with any excess passing in a manner that does not result in a taxable gift?

c. Will defined value transfers become more common? Individual IRS agents have informally indicated that they view defined value transfers as being extremely abusive and that returns reporting defined value transfers are viewed with great skepticism. At least in the Fifth Circuit, my prediction is that we will see attorneys using dollar amount transfers (often referred to as defined value transfers) on an increasing basis. Despite the skepticism of IRS agents, they know that the circuit level court has (at least arguably) upheld a defined value clause and certainly did not comment on it pejoratively or treat it as being abusive. Beyond the Fifth Circuit, attorneys will be somewhat more comfortable using defined value clauses than in the past, now that one federal court of appeals has refused to treat them as being abusive. However, in light of the confused logic in McCord, the failure to address the policy concerns in McCord, and the perception of the Fifth Circuit as a taxpayer-friendly circuit, attorneys may feel a much greater degree of comfort when another circuit court recognizes defined value clauses.

2. Crafting the Defined Value Clause.

a. McCord defined value clause. The precise language of the defined value clause used in the McCord case is in the attached Appendix I. (This paragraph from the Assignment document is included in the taxpayers’ brief to the Fifth Circuit.)

b. Should “values as finally determined for Federal gift tax purposes” be used? The Tax Court said the particular clause was not "self-effectuating" because the formula was based on the "fair market value" of the transferred interest, rather than being based on the "fair market value as finally determined for Federal gift tax purposes." The opinion said the donees were left the task of dividing the interests. The Tax Court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest *as finally determined for Federal gift tax purposes*," the Court "might have reached a different result." (Interestingly, a dissent by Judge Chiechi points out that the formula clause was based on "fair market value" as defined in the Agreement, and the majority opinion acknowledged that the definition of "fair market value" in the Agreement is the same definition of that term as applies for Federal gift tax purposes.)

There are various reasons why using a clause that refers to same valuation standard that is used for gift tax purposes but not requiring the use of finally determined gift tax values is preferable.

(i) Mechanical difficulties. The difficulty in requiring the use of values “as finally determined for Federal gift tax purposes” is that the ownership percentages could be in abeyance for many years. Knowing the precise fractional interest owned by the various transferees will be uncertain until the gift tax value is “finally determined” in accordance with the principles of section 2001(f)(2) of the Internal Revenue Code. Until that time, there may be questions regarding the distribution of income earned on the transferred property, the reporting of income from the transferred property for federal and state income tax purposes, and exercise of various ownership rights with respect to the property. In addition, there can be practical difficulties in re-registering shares, where the transfer agent will want to register a specified number of shares in each transferee’s name.

What if a court never determines the values for Federal gift tax purposes? Under the logic of the clause, the non-charitable donees receive a stated dollar amount, and as of the date of the gift, the percentage interests represented by that dollar amount are irrelevant. Indeed the logic of the Fifth Circuit opinion is that the court really did not need to determine the value of the partnership interests passing to the donees (although the court did proceed to determine the values in that case.)

The McCord children and their charities have had to wait over *10 years* to get a value as finally determined for Federal gift tax purposes. Instead of being required to use finally determined gift tax values (requiring a

10 year wait), they were allowed to reach agreement among themselves as to the percentages that each of the donees acquired under the assignment. If any of them had disagreed, that party could have brought an independent legal action (they were contractually bound to use an arbitration proceeding) to determine the amounts passing under the clause that assigned dollar amounts under the same valuation standard that is used for Federal gift tax purposes.

(ii) Having an arm’s length transaction as evidence of value. The subsequent arm’s length transaction among the donees is itself outstanding evidence of value—where the parties have some adverse interests. An arm’s length transaction is typically viewed as the best evidence of value. In McCord, there were two different charities that had fiduciary obligations to ensure that they received no less than the appropriate percentage interests of the partnership to which they were entitled. They had independent counsel. Having this arm’s length transaction close in time to the original transfer involving parties who had a direct economic stake in the outcome may be preferable to merely waiting for a court to make its determination of value years later. Using a clause with valuation standards that are the same as the gift tax valuation standards, rather than using finally determined gift tax values, invites such a subsequent arm’s length transaction. (However, if the donees are all family members who all have incentive to maximize the value passing to one donee, the subsequent agreement about percentages that pass under the dollar amount formula will not appear arm’s length. Even then, if the donees are all trusts, there are fiduciary duties on the trustees to maximize the value for their respective trusts.)

(iii) Rebutting policy argument. The Procter and Ward public policy position is that a savings clause, returning a portion of transferred property to the donor that exceeds a specified value, is not respected where the event that triggers the readjustment was a determination by the IRS or a court. The cases reasoned that if such terms were given effect, there would be no way to determine the amount of the transfer until a court determined whether the transfer was subject to the gift tax. Using an approach that does not depend on final gift tax values removes some of the steam from that argument. An independent arm’s length transaction determines the percentages rather than having the percentages set in a gift tax proceeding.

(iv) Court precedent. The one opinion that rejected the defined value clause specifically because it did not require using finally determined gift tax values (i.e., the McCord Tax Court decision) has been reversed.

(v) Conclusion. Many attorneys drafted defined value clauses following the Tax Court decision in McCord to refer to values as finally determined for Federal gift tax purposes. Despite the practical problems that arise in using gift tax values, I anticipate that defined value clauses for inter vivos transfers will often continue to refer to values as finally determined for Federal gift tax purposes. "Final determination" is now delineated in the Internal Revenue Code and regulations. The Code and Regulations address how gift tax values are "finally determined" in four different circumstances: (1) Uncontested return; (2) Unchallenged IRS audit determination, (3) Court determination, or (4) Settlement agreement. I.R.C.§2001(f)(2) (added by 1997 Act and amended by the 1998 Act); Treas. Reg. §20.2001-1. The formula allocation will likely make reference to those provisions.

However, there are certainly strong reasons to consider using a clause that refers to the same valuation standards that are used for gift tax purpose but that do not require the use of finally determined gift tax values. Following the McCord reversal of the Tax Court's decision criticizing a defined value clause that did not refer to finally determined gift tax values, there are stronger reasons to consider the advantages of not depending on finally determined gift tax values. This is particularly true if some of the donees are non-family members or if some of the donees are trusts represented by independent trustees.

c. Transfer everything; nothing returns to donor. A key feature of defined value clauses, as opposed to Procter type clauses, is that the donor is making a transfer of a particular block of assets, and the clause merely allocates who receives that block of assets according to dollar amounts or formula clauses. No part of the transferred block of assets will ever revert back to the donor. Under defined value clauses, no assets are returned to the transferor. In this manner, the formulas will operate like the formula clauses in hundreds of thousands of wills that have been through federal estate tax audits. The goal is to mirror standard marital deduction clauses that dispose of all of a decedent's estate, leaving the largest amount possible without generating estate taxes to individuals (or a bypass trust) and leaving the balance to a surviving spouse.

For example, in TAM 200337012 the taxpayer transferred to a trust "that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $A." The IRS ruled that this is not recognized because it is similar to the clauses in Ward v. Comm'r, and Rev. Rul. 86-41, 1986-1 C.B. 300, and is void as contrary to public policy. The taxpayer argued that this clause is distinguishable from the clauses in Procter because the donor never receives anything back. The IRS did not agree: "However, pursuant to the assignment, Trust received an X% interest in Partnership from Taxpayer. If Paragraph B is given effect and the value of the X% interest, as finally determined by the Service, is greater than $A, a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in Procter and Ward conclude are void as contrary to public policy."

d. Building in some taxable element to refute public policy argument. An example fractional formula transfer clause, with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes, is as follows:

"I hereby transfer to the trustees of the Trust a fractional share of the property described in the Schedule A. The numerator of the fraction is (a) $1,000,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the "Gift Tax Value") over $1,000,000. The denominator of the fraction is the Gift Tax Value of the property." McCaffrey, Tax Tuning The Estate Plan By Formula, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. 3-14 (1999).

The "1% of the excess" provision is designed to result in some gift tax if the IRS audits the gift tax values of the assets. This will assist in avoiding the public policy argument that a contest by the IRS would be a moot issue because the clause would take away any gift consequences.

The McCord case does not specifically address the public policy issue. However, as discussed above, the judges certainly left the clear impression that they did not find the "dollar amount" assignment to be abusive. In light of the Tax Court's refusal to reject the defined value clause on policy grounds and in light of the impression from the Fifth Circuit that the clauses are not abusive, we may see fewer attorneys building in 1% (or greater) taxable amount clauses to rebut a public policy argument. That would seem particularly true in the Fifth Circuit.

e. Advantage of using grantor trusts. The uncertainty of ownership for a long period of time emphasizes the advantage, if at all possible, of making transfers to grantor trusts under defined value clauses. In that case, regardless of the percentages owned by the grantor and the various donees, all of the income is reported for federal income tax purposes on the grantor's income tax return. If there is any subsequent adjustment in the percentages passing under the formula, there would be no change in income tax liabilities of any person and there may be no necessity of amending income tax returns. (Of course, having all of the donees as grantor trusts diminishes the perceived arm's length character of the subsequent negotiation to determine the percentages that pass under the dollar amount clause. Having separate independent trustees of the trusts, each with fiduciary duties to maximize the amount passing to their respective trusts, would increase the appearance of the arm's length character of the negotiations.)

f. Allocation to single trust with formula subdivision alleviates mechanical registration difficulties. If property is transferred to a single trust under which the trustee is required to allocate the assets among various subtrusts, the transferred property could be registered in the name of the trustee under the trust agreement until the gift tax values have been finally determined. At that time, the trustee can make allocations of shares among the various sub-trusts, and re-register the shares in the names of those particular trusts at that time. (However, using a single trustee for all family trusts that are donees will weaken the perceived arm's length nature of negotiations among the donees to determine the percentages passing under the dollar amount clause.)

3. Using Defined Value Clauses in Sales Transactions.

The same type of defined value clause that was used for a gift transfer in McCord could also be used in sales transactions to identify the donees of various blocks of assets that are being transferred. The client could sell assets to children and a spouse, a lifetime marital trust (if a lifetime QTIP is used, a Form 709 would have to be filed making the QTIP election and describing the assets of the QTIP), or a charity, or a zeroed out GRAT under an agreement providing that the child purchases a fractional share of the assets, the numerator of which is the "intended value" and the denominator of which is the finally determined gift tax value. The remaining fractional interest in the assets will be allocated to the spouse, marital trust, charity, or GRAT (all of which would not be gift tax-free transfers). See Trapp, Thinking About Valuation Adjustment Clauses, ACTEC 1999 Annual Meeting HT II-16-JMT. (Another alternative is to leave the excess to a trust in which the grantor has retained a sufficient interest/control to make the gift incomplete. Handler & Dum, The LPA Lid: A New Way to "Contain" Gift Revaluations, 27 EST. PL. 206 (June 2000).)

Assume that the liquidation value of a partnership is $10.0 million, and that the appraised value of the limited partnership interest is $6.0 million. The client could sell the first $5.9 million worth of the limited partnership interest to the client's children for a note. The sale document (i.e., the bill of sale) could indicate that if the value exceeds $5.9 million, the excess will pass to a Communities Foundation. The $5.9 million would be described as the value determined under U.S. gift tax principles (i.e., under a willing buyer willing seller test that is identical to the gift tax valuation standard). (Observe that the state law statute of limitations is typically four years and the gift tax statute of limitations is typically three years. Therefore, if the transaction is reported on a gift tax return, the valuation typically will be finally determined for gift tax purposes before the state law four-year statute of limitations has run.)

In the past, IRS agents have viewed defined value cause as abusive, reasoning, "if your values are right, why do you need a defined value clause?" There has been a reluctance to use defined value clauses in some sale transactions, for fear the clause might invite greater IRS scrutiny.

That concern is still present, though the existence of a circuit level case upholding the clause is at least some indication that the courts will not view the clauses as abusive. I anticipate that we will see more frequent use of defined value clauses in sales transactions.

4. Critical Importance of Avoiding "Wink-Wink" Side Understandings. The Fifth Circuit opinion emphasized at various points that there were no understandings between the donor and the donees as to how the transferred assets would be divided among the donees in implementing the dollar amount transfers. In stating the facts of the case, the court emphasized that "[n]o other agreements—written or oral, express or implied—were found to have existed between the Taxpayers and [the various donees] as to what putative *percentage* interest in MIL belonged to, or might eventually be received by, any of the donees under the dollar-value formula clause." The court emphasized that the facts before Judge Foley as the lone trial judge included "the absence of any probative evidence of collusion, side deals, understandings, expectations, or anything other than arm-length, unconditional completed gifts by the Taxpayers on January 12, 1996, and arm's-length conversions of dollars into percentages by the donees alone in March." Another place in the fifth Circuit opinion observed that "[n]either the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement—not so much as an implicit, 'wink-wink' understanding…"

5. Advisability of Post-Gift Cash Out? If a defined value transfer involves a charity, it is likely that there will be significant pressure by the charity to "cash out" its interest under the "bird in a hand" theory, and under the theory that charities need cash for their special projects, not interests in closely held family entities. However, doing so raises the risk of the situation in the Tax Court opinion, where the court determined that the values of the interests are much greater than the amounts used by the parties, thus resulting in values of the residual percentage interests passing to charities that are much lower than the requested gift tax charitable deduction. Cashing out the charities soon after the transfer highlighted that the court ended up allowing a charitable deduction for a larger amount than what the charities actually received. There is obviously a smell test problem with allowing a charitable deduction for a greater amount than what the charity actually receives. That risk is minimized if the charity does not "cash out" before the gift tax proceeding is concluded.

Even so, charities and families will both want to get dollars to the charities and cash out the interests. If the individual donees and the charities all demand an early cash out, at the least take steps to help document the independence of the cashed out charities in the negotiations. In McCord, the court noted that the Communities Foundation of Texas retained experienced outside counsel (which trial briefs identify as Michael Graham, a very experienced Dallas attorney), and the president and director of development of the charity were both attorneys. They had the opportunity to retain their own outside appraiser, although they chose not to in this case because of their confidence in the appraisal, the appraiser and his firm's reputation. I suspect that the donor's attorneys would have liked for the Communities Foundation to have hired its own independent appraiser, but they obviously could not force the Foundation to spend its assets to do so.

6. Structuring Net Gifts to Obligate Donees to Assume Potential §2035(b) Gross Up Estate Tax Liability. In an unusual and creative move, the net gift transaction was structured so that the donees assumed liability for all gift, estate and GST taxes attributable to the transfer, specifically including estate tax attributable to the rule under §2035(b) requiring gross-up rule of gift taxes if the donor died within three years. The court recognized that some potential contingent liabilities are too speculative to take into consideration, but the contingent §2035(b) liability could be considered.

a. Actuarial determination. The court upheld the appraiser's use of actuarial life expectancy factors used in the §2031 regulations (the Table 80CNSMT effective from 4/30/89 to 5/1/99). (The analogous table would be the Life Table 90CM, found in Treas. Reg. §20.2031-7(d)(7), for transfers after April 30, 1999.) This seems reasonable.

b. Discount factor. The appraiser used the §7520 rate in effect on the date of the gift as the discount factor for discounting the potential future liability to a present value. The court said that §7520 mandated the use of that factor, but §7520 only deals with valuing term interests, and does not directly apply to discounting potential future liabilities. The IRS did not dispute the use of the §7520 rate as the discount rate in McCord, and its use seems reasonable for that purpose. One could argue, however, that the short term AFR may be a more appropriate rate. The AFRs are presumably based on real life interest factors, and the §7520 rate is 120% of the mid-term rate. Using a rate that is based on actual current interest factors rather than 120% of that amount may be more reflective of actual interest rates. In addition, the tax would be due nine months after the date of death. The death must occur within three years of the gift in any event. If a death occurs sometime within three years, it may be more likely than not that the death would occur sometime in the first two years rather than in the last year. If that were the case, the short term rate (which applies to transactions up to 3 years) may be more appropriate than the mid term rate. However, in light of the fact that the Fifth Circuit has blessed using the §7520 rate as the discount factor, planners will probably use that approach. The added advantage of using the lower short term AFR as the discount factor would be minimal.

c. §2035(b) offset. The Tax Court thought the potential liability under §2035(b) was too speculative to consider; the Fifth Circuit did not.

Other than the actuarial likelihood of dying within three years, taking into account the potential §2035(b) tax seems no more speculative than taking into consideration the built-in capital gains tax if a corporation sells assets. In many ways, the §2035(b) tax is much less speculative; the primary unknown is the likelihood of dying within three years and firm statistical data of that actuarial likelihood is used for a wide variety of tax purposes. On the other hand the likelihood that a corporation will actually sell assets and when it might sell those assets seems much more uncertain. If the built-in gains tax can be estimated and considered in valuations, it would seem that the §2035(b) potential tax liability could also be considered.

The case distinguishes other cases cited by the Commissioner as representing situations with much greater uncertainties than the specifically assumed §2035(b) gross up liability. For example, the most recent of those cases was Armstrong Trust v. United States, 132 F. Supp.2d 421 (W.D. Va. 2001) that dealt with the donees' general transferee liability under §6324(a)(2) for additional estate taxes under §2035(b) if the donor died within three years of the gift. That involves much more uncertainty, because not only must the donor die within three years, but the estate must be depleted to the point that it cannot pay the additional estate tax before the donees are liable under the transferee liability rule.

The Fifth Circuit opinion seems a reasonable approach. We have routinely seen net gift transfers (i.e., net of gift taxes) for decades. For donors trying to reduce the current gift tax outlay, we may begin seeing an increasing number of net gift transfers also considering potential §2035(b) liability. However, the offset would typically be much less than the standard gift tax offset for net gifts.

For example, assume that a 70 year old individual makes a gift in September 2006 (when the §7520 rate is 6%) in which the donee assumes the potential §2035(b) liability. For a 70 year old individual, the likelihood of surviving three years is 65,154/71,357 [the "l(x)" factors from Table 90CM for a 73 and 70 year old, respectively], or 91.3%, and the actuarial likelihood of dying within three years is 8.7%. The 3-year discount factor, using a 6% discount rate, is 0.84. Therefore, the gift tax offset because of the §2035(b) assumed liability for a 70 year old donor would be the amount of gift tax times 8.7% times 84%, or only 7.3% times the gift tax (as compared to 100% times the gift tax for the standard assumed gift tax liability for net gifts.) This obviously presents a circular calculation because this factor in determining the gift tax depends on the amount of the gift tax itself. If the gift tax bracket is 45%, running the math shows that the net gift, after subtracting the present value of the potential §2035(b) liability for a 70 year old using a 6% present value discount rate is 96.82% of the initial gift amount, representing a decrease of 3.18% of the initial gift amount. This would decrease the *gift tax by 45% of that, or just 1.4% times the amount of the initial gift. To check the math:*

Gift Tax = .45 x Net Gift
= .45 x .9682 x Initial Gift
= .43569 x Initial Gift
And

Gift Tax = .45 x (Initial Gift – Offset for §2035(b) liability)
= .45 x (Initial Gift – [.073 x Gift Tax])
= .45 x (Initial Gift – [0.73 x .43659 x Initial Gift {inserting from above calculation}])
= .43569 x Initial Gift

It checks out.

Particularly in the Fifth Circuit, it is highly likely that the IRS will allow an offset of gift tax value for that purpose. The planner will have to decide whether decreasing the gift tax by about 1.4% of the gift amount (for transfers by a 70 year old individual when the §7520 rate is 6.0%) is worth the added complexity of this approach.

7. Formula Disclaimer Approach. The IRS is currently litigating a somewhat similar post-mortem planning approach involving a formula disclaimer. Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding “x” dollars (before payment of debts, expenses and taxes) in which the decedent’s will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate’s appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. John Porter (who argued the McCord case) is representing the taxpayer in the Tax Court litigation in Morfeld. The case is currently set for trial on October 10, 2006.

8. Actual Defined Gift Clause in McCord Assignments. The taxpayer’s brief to the Fifth Circuit in the McCord case includes the full actual language of the assignment used in the transfers by Mr. and Mrs. McCord:

“Paragraph 2 of the Assignment Agreement allocated the assigned partnership interests among the assignees as follows:

(a) that portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount (“Assignors’ GST Amount”) obtained by adding (i) the GST exemption provided for Assignors in section 2631(a) of the Internal Revenue Code of 1986, as amended (the

"Code"), which has not been allocated by them or by operation of law to any property transferred or deemed transferred by them before the date of this Assignment Agreement, to (ii) the value of any consideration received or deemed received by Assignors from Charles T. McCord, III, Michael S. McCord, Fredrick R. McCord, and Stephen L. McCord, as trustees of the McCord Issue GST Trusts, as a result of the transaction effectuated by this Assignment Agreement , is assigned in equal shares to Charles T. McCord, III, as trustee of the Charles T. McCord, III GST Trust, Michael S. McCord, as trustee of the Michael S. McCord GST Trust, Fredrick R. McCord, as trustee of the Fredrick R. McCord GST Trust, and Stephen L. McCord, as trustee of the Stephen L. McCord GST Trust;

(b) any remaining portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount obtained by subtracting Assignors' GST Amount from $6,910,932.52, is assigned outright and in equal shares to Charles T. McCord, III, Michael S. McCord, Fredrick R. McCord, and Stephen L. McCord;

(c) any remaining portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount obtained by subtracting the dollar value of the portions assigned under subparagraphs (a) and (b) above from $7,044,932.52 is assigned to Shreveport Symphony, Inc.; and

(d) any remaining portion of the Assigned Partnership Interest is assigned to Communities Foundation of Texas, Inc. for benefit of the McCord Family Fund.

For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant acts. Any dispute with respect to the allocation of the Assigned Partnership Interests among Assignees shall be resolved by arbitration as provided in the Partnership Agreement."

4. FLP Planning

a. Model LLC or FLP Agreement. The ACTEC Business Planning Committee has an outstanding project developing a model LLC Agreement with very extensive annotations. Various interesting aspects of the form are summarized.

(1) Section 2036(a)(2). A footnote to the Agreement has some suggestions, in light of §2036(a)(2) concerns, where the client will continue to be involved in some way as manager. Some of the possible approaches include:

- Mandate tax payment distributions to partners/members.
- Consider having the senior family member resign.
- Consider delegating the distribution authority to someone other than the parent and having the parent just retain investment authority.
- Consider having two classes of managers, one that deals with investments (which could include the parent) and the other that deals with distributions (which would not include the parent).

Interesting §2036(a)(2) observation: How do you distinguish the FLP/LLC situation (with the parent having an interest in the general partner or managing member) from standard planning with voting and non-voting stock for an operating businesses? Typical example: Create voting and nonvoting stock of an operating business. Give 90% of the nonvoting stock to children. Father dies owning the voting stock. If Strangi is correct, some say that causes all assets transferred to the entity to come back into the estate under §2036(a)(2). But planners do that all the time. It would seem that §2036(a)(2) is only an issue when one sets up an FLP to save taxes. If an FLP is set up for other reasons, you should not have to completely change what the client wants to do. We should not totally change how we plan just based on Judge Cohen's dicta in Strangi. In Thompson, the Third Circuit court says the IRS won in that case, but the court told the IRS they would lose if there are substantial non-tax reasons for setting up the FLP.

(2) Distributions. This is where the §2036(a)(2) issue arises. A footnote to the ACTEC form gives alternatives.

- Distribution of "Available Funds."
- Distribution of certain amount of Available Funds.
- Ascertainable Standards.
- Tax Distribution.
- Someone other than parent or a non-family member makes distribution decisions.

(3) Fiduciary Duty. The fiduciary duty of the manager is emphasized in various places in the form (for example, in the distribution clause). The exculpation clause says it does not exculpate for breach of fiduciary duty. (Including a fiduciary duty exception in the exculpatory clause is not included in many FLP/LLC agreements, but it is a good idea.)

b. Senda v. Commissioner. The Eighth Circuit recently approved this indirect gifts case. 433 F.3d 1044, *aff'g*, T.C. Memo. 2004-160. There is dictum in the Tax Court case suggesting that a step transaction doctrine might apply even if the contribution is made to the partnership prior to gifts of partnership interests. The Eighth Circuit also had dicta that might be interpreted to support that approach: "The tax court recognizes that even if the Sendas' contribution would have first been credited to their accounts, this formal extra step does not matter." The case specifically said that the step transaction doctrine applies broadly to estate and gift transactions.

Several speakers said that the step transaction doctrine should not apply here. The step transaction doctrine ignores unnecessary steps to determine tax consequences. If an individual wanted to give LP interests to his or her children, forming the FLP was a necessary step. If a client wants to give an interest in an entity, creating the entity is a necessary step and should not be ignored.

Nevertheless, the client should wait some period of time after funding the partnership before making transfers. Some planners would wait a day, to clearly document that the contribution to the partnership was made prior to gifts of the limited partnership interests. Other planners suggest waiting 6 months. Those who suggest just waiting one day say that waiting 6 months should not really make a difference if there was the intent at the outset to make the subsequent gift and if that intent is enough to apply a step transaction theory.

Stacy Eastland's position: Applying the step transaction argument to treat the individual assets contributed to the partnership as indirect gifts requires three steps: (1) Contribution of assets to the partnership; (2) Give (or sell) partnership interests to children; (3) Liquidate partnership so children get the assets. That third step never happened, so the step transaction doctrine should not apply. He emphasizes that the courts should first look to state property rights in determining the tax effects of those rights.

Another planner's recommendation: Make clear that assets are held by the partnership and verify that before making gifts of limited partnership interests. That planner may discuss with the client the possibility of making gifts, but he will never discuss with the client how much the client wants to give when the FLP is created. Leave that as an open question so no one can argue step transaction or prearranged transaction.

Another planner for some time has left a long "curing" period between the creation of the partnership and a gift of limited partnership units. He likes to wait 6 months. Sometimes he has reduced that to 60 days. But especially with dicta in Senda, he strongly suggests waiting. *He understands that IRS attorneys are happy with the dicta in Senda and plan to argue it in other cases.*

c. Potential Double Inclusion Issues And Section 2043.

Professor Jeff Pennell points out that there can be potential double inclusion issues under both §2033 and 2036. At the date of death, the decedent owns partnership interests, so they are includable under §2033. Also, §2036 may cause the transfer of underlying assets to the FLP to come back into the estate because of retained enjoyment or control. That would result in double inclusion. There is not the same "purge and credit" rule that applies for gifts under §2001b. This is true double inclusion. Congress dealt with double inclusion by the §2043 consideration offset.

Example of how §2043 works. 100x of assets is transferred to an FLP. The parent receives units worth 99x. However, the bona fide sale for *full* consideration exception to §2036 does not apply because the parent only receives partnership interests back worth 99x. At death, include the assets transferred (100x) and the FLP units received (99x). If there is no appreciation, include 100x and 99x and get a §2043 offset for 99x (the consideration received for the transfer). That avoids double inclusion. In a close to death situation, the IRS has no motivation to raise this issue. However, if parent transfers 100x and the partnership assets double to 200X, and if we assume the units are worth 198x (ignore discounts for simplicity) at death, the gross estate will include 200x (under §2036) and 198x (under §2033). However, the offset amount under §2043 is just the value of the consideration received on the date of the transfer, or 99x. So now, the estate is far worse off than if the decedent had never created the FLP.

Some IRS agents have responded that this result is so ugly to the taxpayer, "we worry about raising it because court might reject the 2036 argument at the front end." So the IRS may be unwilling to raise this issue as to FLPs.

Professor Pennell observes that §2043 has been flawed in this manner since inception. The IRS refuses to change the rule, because it does not want to open up tracing problems. The parent may sell the FLP units and invest in something else. The IRS does not want to have to determine which of the assets that are owned at death are traced to the initial consideration. Therefore, the concept of §2043 is to apply it using the value we know—the value of the units received at the time of creation of the entity.

An opposing view is that there should not be double inclusion under both §2033 and 2036. For example, in the life insurance area, if the value of life insurance proceeds is included in the estate under §2033 (for example, if an entity owns the insurance, that the decedent's interest in the entity is included in the estate under §2033), §2042 does not also include the proceeds in the estate. E.g. Rev. Rul. 83-147,1983-2 C.B. 158 (reviewed Estate of Knipp, 25 T.C. 153 (1955), aff'd on another issue, 244 F.2d 436 (4th Cir. 1957, cert denied, 355 U.S. 827 (1957), acq. in result, 1959-1 C.B. 4, and indicated approval of not including insurance proceeds in estate where proceeds are payable to the partnership because the insurance is already partially included under section 2033; indicated that "it does not agree with any implication [in Estate of Knipp] that incidents of ownership possessed by a partnership should not be attributed to an insured partner when the policy proceeds are paid other than to or for the benefit of the partnership").

d. Observations From IRS Attorneys at 2006 Heckerling Institute.

The IRS has a national coordinated plan for FLPs. FLP cases are identified at the classification level and sent in for national coordination. There are monthly FLP conferences attended by appeals agents, FLP specialists, etc. There is an active examination program and the main tool is §2036.

IRS agents are being told not to settle §2036 cases. IRS attorneys are asking for a lot of documentation in §2036 cases. If there are no §2036 issues and the issue is just a standard business valuation, the IRS attorney may discuss averages. But every case stands on its own. The IRS estate and gift tax attorneys reflect that the FLP cases in their respective groups are fairly abusive. They are not real business cases. Many are set up by elderly people who are critically ill and their children get involved. Some of the reported cases involve bad facts cases for the taxpayer that should have settled and not gone to court. (John Porter rebuttal: Many of the cases were not settled because there was no opportunity to settle. In Bongard, the IRS said there was only a 5% risk of litigation—but the estate ended up with a $42 million discount. In many of the cases, there is no settlement proposal by the IRS, and the IRS will not concede anything.)

Each of the IRS attorneys has 70-80 FLP cases working currently. Mary Lou Edelstein is the IRS appeals national FLP coordinator. She shares some information from appeals with the IRS attorneys around the country. She says there are 206 active FLP cases in appeals. There are 74 cases docketed and scheduled for trial.

Mary Lou takes the position that in a well developed §2036 case, where the IRS estate tax attorney has done a good job and assembled records, reviewed the checking account, examined how assets are being used, determined that FLP assets were used as the back pocket for the taxpayer, etc., she will only settle these now at appeals for 5-10%.

The IRS agents say they will not give a settlement for more than what Appeals will give or more than district counsel will give when it is tried.

Also, there is more emphasis on §2703 (presumably, meaning the effect of §2703 on specific buy sell provisions and transfer restrictions in partnership agreements). IRS counsel thinks it was wrong to have dropped those arguments.

e. <u>General Observations About FLP Planning at 2006 Heckerling Institute</u>.

(1) The key is to respect the integrity of the entity. If the partnership is just used to pay personal expenses, or if it makes disproportionate distributions just to the parents, it won't be respected. Often the problems arise by having no contact with the planning attorney for five years after partnership is created, and the parties have not respected the integrity of the entity.
(2) A carefully formed entity with significant business purpose continues to be successful and get significant discounts.
(3) Courts are carefully reviewing the motivation in forming entities.
(4) Post formation facts are important. Was the business plan actually carried out?
(5) Courts are carefully reviewing governing instruments to see if there is anything out of the ordinary.
(6) Courts carefully review the funding of entities to see if personal use assets are contributed, if all of the decedent's assets are contributed, if there is a delay in funding, and if there is proper documentation.
(7) Section 2036a1 is a significant obstacle—there needs to be a substantial non-tax reason. [SRA Observation—that is a sound conservative approach, but having a substantial non-tax reason theoretically should not be needed if the estate can show that there is no implied agreement that decedent will receive current distributions and can access partnership assets or income as needed. In that case, meeting the bona fide sale exception to §2036a1 would not be necessary. However, the courts apply a smell test approach and as Bongard indicates, judges may stretch to apply §2036a1 in what they perceive as "stinking" cases.]
(8) Taxpayers are winning some cases they shouldn't win, and planners should not rely on those cases as a blueprint.
(9) If successful, discounts are substantial--30-35%. (So we have an obligation to tell our clients that they should consider these.)
(10) Respect the partnership. If there are restrictions on liquidation, follow them. Don't just distribute money whenever needed.
(11) The analysis is more strategic than legal. "You don't need to outrun the bear, you just need to outrun the other people who are also trying to outrun the bear."

(12) It is best to give up holding any general partnership interest or being managing member. If the parent will not have control, why hold a minority interest in the general partner either? Section 2036a2 includes "in conjunction with others."

(13) Can the client retain the ability to control investments? The client should be able to, but if client will give up all control, it may look better.

(14) The courts seem to be applying a smell test. So help clients make judgment calls.

(15) The ability of the decedent, as a limited partner, to join with other limited partners to dissolve the partnership should not be a §2036a2 power. That is a stretch the Tax Court is not willing to go to (other than Judge Cohen). But IRS agents are still raising the arguments. "You don't want a philosophical debate with an IRS agent when there's lots of money on the table."

(16) If the client continues to own any limited partnership interests, Belcher thinks there is some risk (albeit small) that §2036a2 could apply. To avoid that risk, the most conservative planning is to contribute the limited partnership interests to an irrevocable trust (with a third party trustee) that is an incomplete gift (i.e., have the client retain a testamentary power of appointment over the trust). However, most clients are not willing to go that far.

(17) Belcher takes a very conservative view: ("I'm not a one handed lawyer. My clients will hear 'the other hand.'")

(18) Can gifted partnership interests be pulled back under §2036? Yes, IF there is an implied agreement that the donee will give money back to the donor when asked to do so or that the partnership will make disproportionate distributions just to the donor. What gives rise to an implied agreement?—if the parent puts all of his or her assets in the partnership. Assume the client just puts 20% of his or her assets in the FLP, and the client makes some gifts of limited partnership interests. Unless there is other evidence of an agreement that the client will receive all distributions from the partnership, those gifts should not be included under §2036a1, but Dennis Belcher worries—especially if there are financial assets in the entity.

(19) Belcher thinks the client should never have control over the general partner at death. After the gifts occur, the client should get rid of control over the corporate general partner. The client could give 50% of stock of the corporate general partner to the client's spouse. But it is better to give up all of the stock.

(20) If active business interests are going into the FLP, Belcher is not as conservative. In that situation, the client is not as willing to get rid of control. Belcher thinks that situation doesn't smell as much to courts. Indeed, the IRS lost Schutt and Stone.

f. <u>Rosen v. Commissioner</u>.

Facts. In Rosen v. Commissioner, T.C. Memo 2006-115, the decedent, at age 88 with Alzheimer's disease, created a partnership in 1996 (by her daughter acting under a power of attorney). The daughter's husband was an attorney who had attended seminars about FLPs and coordinated with the decedent's estate planning attorney to structure and create the partnership. The attorney never met with other family members in planning the partnership. Revocable trusts for the daughter and a son each held 0.5% general partnership interests. The decedent was the 99% limited partner, but she made a gift of about 33% of the limited partnership interests to family members the same date the partnership was created. (She gave about an additional 31% percent partnership interests prior to her death, leaving her with about 35% of the partnership interests of the limited partnership interests at her death. Out of the 64% limited partnership interests that were given away, 39.2838% of the interests were given more than three years prior to her death.) The partnership consisted solely of marketable securities. The decedent transferred almost all of her investment assets to the partnership, retaining only about $50,000 cash, a one-half interest in a condo, and an annuity paying $1,600 per year. After the partnership was created, there were some significant investment allocation changes (but Judge Laro did not view them as significant).

About $258,000 was dispersed from the partnership to pay the decedent's living expenses and to pay for her substantial annual cash gifts. These disbursements were treated as loans from the partnership to the decedent. There was a single note during the decedent's lifetime, which acknowledged that additional advances would be made pursuant to this same note. The decedent made no payments on the note prior to her death. The decedent died about 3 ½ years after the partnership was funded. Soon after the decedent's death, the partnership advanced an additional $97,000 to pay claims against the estate, funeral expenses, administration expenses, and $70,000 of bequests. About 6 ½ months after the decedent died, her remaining approximately 35% limited partnership interest was redeemed. The prior advances were netted against her share, and the estate received a net payment of about $342,000. No other partners received any distribution advances during the decedent's lifetime or prior to the redemption of her partnership interest. Five years after the decedent's death, (when the decedent was no longer a partner) the partnership paid about $1.1 million to the IRS has a deposit against the proposed estate tax deficiency.

Holding. Judge Laro held that the bona fide sale for full adequate consideration exception does not apply and that section 2036(a)(1) does apply to include all of the partnership assets in the decedent's estate.

Bona Fide Sale Requirement for Exception to §2036. Judge Laro gave seven reasons for finding that there was not "a legitimate and significant non-tax reason" for forming the partnership. 1. The partnership was not a valid functioning business operation. For investment partnerships, Judge Laro observed that some level of investment activity might be sufficient to constitute "a legitimate business operation," not concluded that the extent of the partnership's economic activity was not sufficient to characterize the partnership as a legitimate business operation. He also observed that there were no financial books and records and there were no general partner meetings. 2. There were no negotiations by the partners in structuring the partnership. 3. Decedent's contributions were made before any contributions by the general partners (her son's and daughter's revocable trusts) and the children's contributions were de minimis. 4. Substantially all of decedent's assets (and all of her investment assets) were transferred to the partnership; management of the transferred assets was the same before and after the transfer; no meaningful change occurred in decedent's relationship to her assets; and decedent's daughter (as her attorney-in-fact) gave away over 64 percent of decedent's limited partnership interests. 5. Decedent was unable to meet her financial obligations without using the partnership funds, and indeed all funds that were drawn from the partnership were used for decedent's benefit. 6. Assets contributed to the partnership consisted solely of marketable securities and cash. The court viewed Estate of Thompson v. Commissioner, 382 F.3d 367 (3rd Cir. 2004) as suggesting that the "the mere holding of an untraded portfolio of marketable securities weighs against the finding of a non-tax benefit for a transfer of that portfolio to a family entity." 7. "The fact that decedent was 88 years old and in failing health strongly supports our finding that the transfer of the assets was purely for the purpose of avoiding Federal estate and gift taxes…. Such is especially so where, as here, decedent's daughter (as decedent's attorney-in-fact) transferred substantially all of decedent's assets to the [FLP] and did not retain sufficient assets to support decedent for the rest of her life."

The estate suggested several non-tax purposes that motivated the formation of the partnership, all of which were rejected by the court. 1. Centralization of management was not important, because management was already centralized through the decedent's revocable trust. 2. Protecting the decedent from her creditors was not viewed as important for two reasons. Factually, the decedent did not seem to have significant creditor concerns and the decedent's attorney never discussed with the decedent or her children the personal liability issues. (This would be distinguished in situations where the contributing partner factually has substantial creditor concerns.) In addition, Judge Laro was not persuaded, from a legal point of view, "that decedent's creditors would not have been able to foreclose on substantially all of decedent's assets transferred to the [FLP]." He also was skeptical that the transfer would withstand scrutiny in Bankruptcy Court, citing the Ehman case, 319 Bankr. 200 (Bankr. D. Ariz. 2005). 3. Facilitating decedent's gift giving, even if it were an actual reason for the partnership's formation, is not a significant non-tax purpose.

Implied Retained Enjoyment Under §2036(a)(1). Judge Laro easily concluded that there was an implied agreement that the decedent retained possession or enjoyment of all assets has contributed to the partnership. The court observed that the partnership was created by the decedent's attorney-in-fact (her daughter) who had a fiduciary duty to her. The decedent's children as general partners could make distributions to the decedent and the court concluded that she had the same enjoyment of her assets that she had before the assets were transferred to the partnership. The court cited several reasons for its conclusion that an implied agreement existed. (1) The partnership was not a business operating for profit but was a testamentary device to reduce the estate tax value of decedent's assets. (2). The decedent's relationship to her assets did not change and she transferred substantially all of her assets to the partnership. The presence of an implied agreement is further revealed where partnership funds "were used to pay decedent's living expenses, make gifts to her descendants, and, after her death, pay the bequests … and expenses of her estate including, 5 years after her death [when he was no longer a partner), her estate taxes." (3) Assets were transferred to the partnership on the advice of counsel to minimize taxes. (4) Purported "loans" to the decedent were instead treated as distributions by the court. There was an extended discussion of actions required to establish bona fide loans. Among the factors mentioned by the court are that the decedent never intended to repay the advances, there was no fixed maturity date or payment schedule, no interest (or principal) payments were made, the decedent had no ability to honor a demand for payment, repayment of the note depended solely on the FLP's success, transfers were made to meet the decedent's daily needs, and there was no collateral. The court also questioned the adequacy of interest on the note.

Application of §2036 to Assets Attributable to Transferred Partnership Interests. The estate argued that the partnership assets attributable to limited partnership interest that were given more than three years prior to death should not be included under §2036(a)(1). The court disagreed, holding
that all partnership assets were included even though the decedent had given away over 64% of the limited partnership assets before here death (and had given away over 39% of the interests more than 3 years prior

to her death). Distributions were made only to the decedent, and the court concluded very simply that §2035 was not relevant because "Decedent continued to possess and enjoy the transferred assts up until her death." It is interesting that the decedent never received distributions from the partnership that exceeded her pro rata share of the partnership assets represented by her remaining limited partnership interests. The case illustrates the importance of making only pro rata distributions from partnerships following gifts of partnership interests, to take away any implications that the decedent would receive partnership assets attributable to the interests that had been given away.

Interestingly, the Bigelow case concluded that all FLP assets were brought back into the decedent's estate even though the decedent made gifts of over 50% of the limited partnership interests by the time of his death. T.C. Memo 2005-65. The court did not discuss its reasons for that conclusion. The court may have concluded that the decedent by implied agreement retained the right to distributions of all FLP assets, and not just the assets attributable to the 45% limited partnership interest that she still owned at her death because it appeared that distributions were made only to the decedent from the FLP, and not proportionately to all partners. (Alternatively, the Bigelow court may have concluded that § 2035 would cause estate inclusion of the FLP assets attributable to the gift interest because the gifts were made within three years of the decedent's death.)

A planning strategy, if there are subsequent gift transactions of partnership interests, is to separate the creation and subsequent transfer transactions as much as possible. To strengthen the taxpayer's argument, there should be a business purpose for the initial creation of the partnership, separate and apart from the subsequent transfers of partnership interests. *Most importantly, following gifts of partnership interests, only proportionate distributions should be made, and nothing should be done to create any implication that the decedent will receive any distributions of partnership assets attributable to gifted interests.*

Summary of Judge's Laro's FLP Analysis in Rosen. Judge Laro took what could have been an easy decision (substantially all of the elder Alzheimer's patient's assets were transferred to the partnership), as an opportunity to expound his views in great detail. He went through a long analysis of 7 reasons for the creation of this partnership not being a bona fide sale, some of which are: 1. No legitimate business operations. (This sounds like the business purpose test that he tried to push through in Bongard, but he acknowledged that the majority did not agree with him.) He acknowledged that investment activities could represent legitimate business operations. However, despite the fact that there was a substantial shift in the asset allocation, far beyond the investment activity in the other reported FLP cases where there was typically just a continued holding of investment assets, the court regarded that as insufficient activity to rise to the level of business operations. 2. No negotiations (ignoring various other cases, such as Kimbell and Bongard that have not required negotiations). 3. De minimis contributions by children who contributed 1%, a throwback to the old recycling of value argument in the pre-Bongard Tax Court cases, again failing to cite the contrary law in Kimbell . 4. Substantially all assets of decedent were transferred to the partnership. The Judge then considered and rejected the various non tax reasons offered by the estate.

Having concluded that the bona fide sale exception did not apply, the court then found that §2036(a)(1) applied because there was an implied agreement that the decedent had access to partnership assets. In the analysis, Judge Laro seems to say that following advice of estate planning counsel in an effort to minimize estate taxes of and by itself reflects retained enjoyment.

Distributions to the decedent during her lifetime were treated as advances, documented by a single note (which contemplated that additional advances would be governed by the same note terms.) Judge Laro had an extended discussion of the factors suggesting that a debt relationship is created. He did not respect the distributions as mere advances, and treated them as distributions to the decedent. (Distributions were made only to the decedent despite the fact that the decedent only owned about 35% of the partnership at her death.)

At trial, when Judge Laro did not feel IRS attorney had elicited enough testimony, he questioned the witnesses himself to get the testimony that he needed to write his opinion. One attorney concludes: “If you go before Laro on an FLP case, you will lose.”

g. ***Smith***—Jury Trial Sets Value of Gifts of Limited Partnership Interests. The district court recently rejected a motion for new trial and motion to alter or amend the judgment. Smith III v. United States, 98 AFTR2d 2006-5383 (W.D. Pa. July 13, 2006). Before discussing this latest decision, review the interesting (and somewhat tortured) history of this case.

Basic Facts. Mr. Smith made gifts of 20% limited partnership interests in 1998 in a family limited partnership, the sole assets of which was 100% of the stock of an operating company. The Delano overvalued the gifts on his gift tax return at $1,025,392. The IRS increased the total value the gifts to $1,828,598 in assessing a deficiency of $360,803. The donor paid the additional deficiency and filed a claim for refund. After six months passed, the donor filed this refund suit.

Initial Summary Judgment Re §2703 Impact on Transfer Restrictions. The Smith case first hit the scene as one of the few reported decisions dealing with the application of §2703 to transfer restrictions in a partnership agreement. In a case of first impression, the district court held in a summary judgment action that the value of gifts of limited partnership interests (combined gifts of 40.47%) must be determined under § 2703 without regard to specific transfer restrictions in the partnership agreement (in particular, that transfers were subject to a right of first refusal by the partnership to purchase the interests in return for a 15 year note bearing interest at the long-term applicable federal rate). The sole asset of the partnership was 100% of the common stock of an operating company. The court held that § 2703(a) applies to the restrictive transfer provision contained in the partnership agreement, thus meaning that the restriction would be disregarded in determining the value of the gift unless all of the safe harbor requirements in § 2703(b) apply. The court held that it could not rule in the summary judgment proceeding whether the safe harbor tests in § 2703(b) are satisfied. (As to the last “comparability test” in §2703, the Smith opinion suggested a rather strict evidentiary standard (similar to the recent opinion dealing with buy sell agreements in Estate of Blount v. Commissioner, T.C. Memo 2004-116. aff’d (11^{th} Cir. 2005).) Smith v. Comm’r, 94 AFTR 2d 5283 (W.D. Pa. June 30, 2004).

Magistrate Decision Re Whether to Consider Transfer Restrictions. There were subsequently further summary judgment cross motions. In a decision dated July 22, 2005, the magistrate continued to believe that there were genuine issues of fact as to whether §2703(b) (2-3) applied. However, the magistrate determined that pre-section 2703 cases required that a restrictive agreement meet certain requirements, including that “the agreement must be binding on the parties both during life and after death.” The magistrate cited cases that considered whether the price set in a buy-sell agreement would be binding for *estate tax* purposes. The magistrate concluded that the donor had the power under the terms of the agreement to amend the agreement unilaterally (based on his retained rights as a 2% general partner and as a more than 50% limited partner). Therefore, the magistrate concluded that the terms of the restrictive provision were not binding on the donor during his lifetime, so the restrictive provisions should be disregarded when determining the value for federal gift tax purposes.

The magistrate’s reasoning seems flawed because of the different effect of a buy-sell agreement in determining value for estate vs. gift tax purposes. I don’t remember ever seeing any gift tax cases saying that the agreement must be binding before it can be considered for gift tax purposes. The “buy sell agreement fixing the value” cases are estate tax cases. In that context, it does make sense that the agreement must be binding on the estate during life and at death (i.e., the estate

MUST sell at the agreement price either under a mandatory sale agreement or if the entity or another owner exercises call rights under the agreement.) However, in the gift tax context, it does not seem to me to make sense that the agreement must be binding on the donor in determining the gift tax value of a block of the stock (or partnership interest) that is transferred, as long as the agreement is binding on the donee for the block of stock (or partnership interest) that is given to the donee. The Smith case involved gifts of 40.47% limited partnership interests to the donor’s two children. They had no ability to change the partnership agreement or to block a change to the partnership agreement that was made by the general partners and approved by 50% of the limited partners (under the terms of that partnership agreement.) Similarly, if a parent gives a child an undivided 10% interest in a vacation home, the courts value that 10% interest just based on the rights of that 10% donee owner--not based on the combined rights of the 10% donee and the 90% donor after the gift transaction. There have been cases indicating that a buy-sell agreement cannot "fix" the value for gift tax purposes, but stating that the agreement is a factor to be taken into consideration in determining the gift tax value of interests that are given that are subject to the agreement. Therefore, it does not make sense to ignore the restrictions under the buy-sell agreement for purposes of valuing the gift of the limited partnership interests based on a perceived "binding on the parties" requirement under pre-2703 law.

Jury Trial Re Value. The case proceeded to trial with the instruction from the magistrate that the jury would not hear any evidence regarding the effect on valuation of buy-sell provisions in the partnership agreement. The IRS apparently instructed the IRS expert not to visit the company or visit with officers of the company or consult with appraisers who appraised some of the underlying assets of the business that were used in the overall process of valuing the business. The IRS expert testified that the maximum discount would be 20%. The taxpayer’s expert testified to a 48% discount.

The jury reportedly gave a 67% discount. (This is the result of a jury trial and not a reported case, so I have not been able to confirm this result in writing.) Apparently, there were various factors that had a depressing value on the operating company of which the experts were not aware when they prepared their appraisals, such as the fact that numerous lawsuits had been filed against the company.

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Post Trial Motions.

The district court rejected a motion for new trial and motion to alter or amend the judgment. Smith III v. United States, 98 AFTR2d 2006-5383 (W.D. Pa. July 13, 2006).

a. Lay Opinion Testimony. The IRS requested a new trial, contending that the court erred in allowing the donor or his son, as a general partner and a limited partner and as vice president of the operating company, to offer a lay opinion as to the value of a 1 percent limited partnership interest in the partnership, because he did not have specialized knowledge and had not be qualified as an expert witness. The court cited to cases in support of allowing the lay opinion. Robinson v. Watts Detective Agency, 685 F.2d 729 (1st Cir. 1982) ("An owner of a business is competent to give his opinion as to the value of his property."); Lightning Lube, Inc. v. Witco Corp., 4 F.3d 1153 (3rd Cir. 1993) (allowing business owner to testify as to the company's lost profits, based on his knowledge and participation in the day-to-day affairs of the business). Advisory Committee Notes for the 2000 amendments to the federal rules of evidence cited Lightning Lube with the following explanation: "[s]uch opinion testimony is admitted not because of experience, training, or specialized knowledge within the realm of an expert, but because of the particularized knowledge that the witness has by virtue of his or her position in the business." Federal R. Evid. 701, 28 U.S.C.A. Advisory Committee Notes, 2000 Amendments. Advisory Committee Notes for 2002 amendments states that "most courts have permitted the owner or officer of the business to testify as to the value of projected profits of the business, without the necessity of qualifying the witness as an accountant, appraiser, or similar expert." (citing Lightning Lube).

The son was asked about the value of a 1% limited partnership interest (in addition to detailed testimony about the operating company). His opinion considered dividends, partnership distributions, company management (the donor was in charge of all decisions and "it was too bad if he didn't agree with you"), net asset value and cash flows (including some "tough years"). The court concluded that “[w]hether … his conclusions were accurate does to the weight of his testimony, not the admissibility.”

b. Jury Award Greater Than Refund Claim. The government argued that a refund award for the jury could not exceed the amount claimed in the proceedings before the IRS. The government relied upon the Variance Doctrine, derived from treasury Regulations 301.6402-2(b)(1), which prohibits judicial consideration of any basis for refund that wise "neither specifically raised by, nor included within the general language on, and timely claim for refund." The purpose of the rule is to give the IRS notice of the nature of the claim and facts upon which it was predicated, providing an opportunity to correct errors, and limiting ensuing litigation to those grounds that the IRS is willing to defend. The government's primary concern at trial was that the taxpayer not be permitted to offer a value for the operating company that was inconsistent with the value used by the taxpayer’s appraisal presented to the Commissioner. The court concluded that the government had conceded that the issue of the extent of the marketability and control discounts was properly a subject of argument before the jury. The court determined that the taxpayer complied with the prohibition on discussing new valuation methods. The fact that the jury's ultimate finding of the value the guests, determined on the basis of the same valuation theories utilize before the Commissioner, resulted in a larger award does not implicate the Variance Doctrine.

5. ***Huber***: Valuation Based on Appraisals Used in 90 Other Transactions

In Huber v. Commissioner, T.C. Memo 2006-96, the court addressed the appropriate gift tax value of stock in a closely held corporation. The value was based on values that the company used in numerous shareholder stock transactions, and the issue was whether those sales constitute arm’s length transactions.

The Huber Company was a family owned business for many generations. There were 250 family members who were shareholders as well as charitable shareholders. For 7 years, Ernst & Young annually appraised the stock based on publicly traded company comparables and a 50% discount. The EY appraisals were used to determine the purchase price in over 90 transactions (some involving close family members, remote family members [some as distant as between a trust and a spouse of a second cousin], and charities). None were required to use the EY appraisals. The EY appraisals were also used in valuing gifts of stock to nonprofit organizations, valuing both the grant and exercise of stock options issued to the company’s CEO, determining the compensation of directors, and for performance comparison purposes.

The IRS argued that these were not arms length comparable sales for purposes of determining the gift tax value of transfers. The court disagreed, emphasizing among other things the independent appraisals.

The EY appraisal always applied a 50% marketability discount. The IRS's appraiser applied marketability discounts of 30%, 25%, 45% and 30%, respectively, in the years from 1997-2000. IRS maintained that the various sales at the EY values were not arm's length transactions.

The court looked primarily to Morrissey v. Commissioner, 243 F.3d 1145 (9th Cir. 2001), revg. Estate of Kaufman v. Commissioner, T.C. Memo. 1999-119. In that case, two shareholders sold shares to the largest shareholder on the basis of a Merrill Lynch appraisal. The Ninth Circuit found that these two transactions satisfied the arm's length requirement because (1) family connections were not particularly close, (2) sellers were under no compulsion to sell; (3) sellers had no reason to doubt an independent valuation of the shares by a reputable firm; and (4) there was evidence that there was no intention to make a gift to the buyer. The court in Huber concluded that the taxpayer had prevailed on each of these factors.

The IRS arguments were interesting.

1. Close relationship. The court have consistently closely scrutinized purported transactions between related parties and concluded that they were not arm's length transactions. The court noted that some of the 90 transactions were not between close relatives, and some even involved independent nonprofit organizations and some involved transactions by executors and trustees having fiduciary responsibility to obtain the best price for their respective beneficiaries.

2. Compulsion. The taxpayer pointed to two transactions as representative examples of the 90 transactions. The IRS argued that those sales were under compulsion and not representative of arm's length sales. The court said there was not "very decided pressure" to have to sell. In one case, an estate had 5 months to pay an estate tax liability, and in another case, the trust that sold shares had other options to raise money.

3. Timing of Appraisals. The IRS said that the IRS appraisals were 11 and 8 months old at the time of the two representative transactions. The court responded that none of the parties who testified about those transactions believed there had been a change in the company's finances since the last valuation. The court concluded—"we do not find the time lapse in this case to be unreasonable" (citing Hooker Indus. V. Commissioner, T.C. Memo 1982-357 which relied on a 13 month old appraisal).

4. Did Not See EY Report. The IRS said the parties to the various transactions were not reasonably informed because they did not see the EY

appraisals. The court responded that the shareholders regularly received reports from the company, attended shareholder meetings, and some participated on the board and committees. The court emphasized that whether or not the parties saw the appraisal, there were very well informed because of the modus operandi of the company for informing its shareholders.

5. Donative Intent. The IRS asserted that the other transactions had involved donative intent. The court said that in some of the transactions, an artificially low value would be contrary to the economic interest of the shareholder [i.e., stock option exercises, value of charitable gifts, etc.]

6. Lack of Negotiation. The IRS said that the lack of negotiation connotes the lack of an intent to realize the best price for the shares. The court responded that the IRS failed to cite any case holding that negotiation is a necessary element of an arm's length transaction, and indeed the weight of authority is to the contrary (citing Kimbell and Hooker). (This case is an example of the IRS making its standard FLP arguments in the context of valuing corporate stock.)

7. Company Should Have Gone Public. Somewhat laughably, the IRS argued that the company should have gone public and the value should be the anticipated stock price if the company had gone public. The court said there are business reasons that they did not do so, and there is no obligation to go public.

8. Device to Pass Interest to Natural Objects of Bounty at Less Than Full Consideration. The IRS pointed to buy-sell agreement cases in arguing that the bona fide purpose of maintaining family control should be set aside if it serves as a device to "pass an interest to the natural objects of one's bounty or to convey that interest for less than full and adequate consideration" (citing Estate of True and Bommer Revocable Trust). The court replied that the IRS narrowly focuses on some transactions without taking into account that the EY appraisal was used in many instances, in some of which a higher value would be preferable to the shareholder (such as charitable donations). "We reject respondent's suggestion that almost 250 shareholders would harmoniously accept an artificially low valuation of the Huber stock so that a few people who may or may not be related to them can pay less estate tax." [Observation: This suggests that upholding the formula under a buy-sell agreement as fixing estate tax values may be easier if there are many owners subject to the agreement or it there have been numerous transactions under that buy-sell formula.]

9. Higher Right of First Refusal Formula Price Under Shareholder Agreement. The company's bylaws give the company a right of first refusal to purchase shares offered outside the Huber family at the lower of the

offer price, the book value, or the formula price set in the bylaws. Apparently, the formula price was at a price higher than the EY appraised value. The IRS said this should be a basis for rejecting the EY appraised value and transactions based on that value. The court's response: "While the formula price set in the bylaws may be higher than the E&Y value, respondent ignores the fact that any buyback would be at the lower end of the formula price, book value, or price offered by a third party. There is no basis to suggest that there was a market available wherein a potential buyer would purchase Huber shares at a price higher than the E&Y value."

6. GRAT Planning Update

a. Creation/Formation--When is it created? Transfer Issues. To have a valid trust, there must be a trust "res." Is there a res when there is just a recital to transfer assets to the trust? Is it an incomplete gift until the transfer is made?

Mil Hatcher puts some cash into the GRAT on day one to make sure there really is a legally existing trust on that day. An exhibit to the instrument would list other assets that are being transferred to the GRAT.

What if the assets are difficult to transfer? Transfers of closely held business interests may require consents, complying with buy-sell agreement, etc. There may be securities disclosure issues. The planner should clear up all third party consents before signing the GRAT. (The consent issues may also arise each year when in-kind distributions are made.)

Make sure the transfer documents are ready to go on the day the trust is signed.

Another approach is to put hard-to-transfer assets into an LLC. Include withdrawal provisions in the LLC so there are no discounts. A simple LLC assignment could then be made without the mechanical difficulty of complying with transfer details of the underlying business interests.

Conclusion: Regulations say that annual payment dates are keyed to the date of creation. As long as there is a trust res on that date, Mil is comfortable that the signing date is the date of creation, and that annual payments dates are tied to that date.

Query: If $10 is transferred to the trust (and stapled to it) when the trust agreement is signed, is the second transfer of assets listed on the Exhibit an "additional creation" that is prohibited? As a practical matter, no. It is the only practical manner of creating the trust, and it is all stated up front in the GRAT document (i.e., what assets will be transferred to the trust in the immediate future).

b. Zero Out? One attorney indicates that he has an audit pending now where the zero-out issue is being questioned. TAM 200245053 might suggest that a GRAT with a 1% remainder is or may be contrary to §2702 principles. That has raised questions. But that TAM is in the context of an installment sale to a very thinly capitalized grantor trust. (It addresses a formula clause). The Preamble to the §2702 regulations acknowledges that there are issues about being able to reduce the remainder value to a very low amount. The conclusion of the regulations is to recognize there is a balancing act, which the IRS resolved by requiring a 20% limit on the amount of the increase each year. The regulations did NOT conclude that there must be a minimum remainder value. So most planners think we can "zero out" a GRAT (although a minimal value should be left for the remainder interest).

   Rev. Proc. 2005-3 says that to get a PLR on a GRAT, the value of the remainder must equal at least 10%. (As a consequence, no one is seeking PLRs on new GRATs.)

   One attorney has been told that if and when estate tax reform occurs, the GRAT remainder would have to be at least 10%, and possibly 20%.

   An article by Jonathan Blattmachr and Diana Zeydel that was distributed at the meeting includes a formula for the annuities that is designed to adjust if the IRS succeeds in taking the position that the GRAT remainder must have a value greater than just a nominal amount. The annuity in the first year is a "fixed percentage" of value on the creation date. In each succeeding year, the annuity increases by 20%. The formula provides that the "fixed percentage" is the percentage that will cause the gift tax value of the remainder interest to equal the greater of (1) a specified [very small, such as .01%] percentage of the fair market value of assets contributed to the trust, or (2) the smallest amount required for the annuity to be a qualified annuity under §2702.

c. Short Term GRATs. The Kerr case involved a 366 day GRAT. Many planners use two year GRATs. One attorney reported that he had a case where the IRS said the GRAT had to be at least 5 years (although there is no support for that in the regulations). One attorney suggested using a formula for the term of the GRAT, providing that the term is the longer of X or the date required so that it is a qualified annuity. (Some planners point out that the regulation requires a fixed term and have concern that the formula might not satisfy that requirement.).

d. Using 105 Day Grace Period After End of Year For Making Payments. The regulations provide that the trustee has a grace period of up to 105 days after the anniversary date of the GRAT before making the annuity payment. Do you have to consider that grace period for valuation purposes (to value the present value of the annuity payments made at the end of the 105 day period) if there is an intent to delay each payment for the 105 day grace period? Some planners think not and that this creates an opportunity for an interest free loan. If the trustee waits 1/3 of year to make the payment, that makes a big difference in the economics. The planners suggesting this approach do not think this would be treated as an interest free loan for tax purposes (but they hasten to add that you can’t rely on that to avoid penalties). For a two-year GRAT, taking full advantage of the 105 day delay actually results in a lower hurdle rate than the interest rate on a note using the AFR as the interest rate.

The regulations do acknowledge that the GRAT may provide for monthly payments (from the anniversary date of creation). The regulations do not discuss applying the 105 day grace period from the end of the trust anniversary date differently if the trust provides for payments other than annual annuity payments. Therefore, the 105 day grace period seems to apply to the end of the annual anniversary date (for all payments due during that year). If the GRAT uses a monthly payment approach, that would allow the flexibility to “prepay” (see subparagraph h. below regarding prepayments) because the trust has until 105 days after the end of the YEAR to be technically timely payment as required by the regulations, but the trustee can make the payments monthly. (The attorney suggesting this strategy acknowledges that he has actually not used it.)

One attorney pointed out that delaying making the payment has economic risks. If the trust asset declines in value during that 105 day period, more units will have to be distributed in satisfaction of the fixed annuity amount. An approach to address this risk is to have the grantor buy back the assets from the GRAT for cash and have the GRAT invest the cash on a short term basis. In effect, the interest for that 105 days is transferred.

Some planners have been concerned that the 105 day period is just intended as a grace period, but is not intended to authorize routinely delaying every annuity payment for 105 days. These planners are concerned that if the IRS could establish that intent when the GRAT is created, the IRS might take the position that the present value of the delayed payments would apply in that situation to determine the amount of the gift upon the creation of the GRAT.

e. Effect of Late Payments (Beyond 105 Day Grace Period). One attorney has a case where the trustee inadvertently failed to make the annuity payment within 105 days of the end of the year. The Atkinson case said that a charitable remainder trust was an invalid CRT from inception because it did not administer the trust pursuant to the requirements of the regulations. IRS took the same position in the GRAT case involving late payments. They take the position that the GRAT is invalid and that the taxable gift is the FULL AMOUNT transferred to the trust. The attorney in that case thinks they can resolve the case favorably under a theory of constructive payment under state law.

f. What if the GRAT Works Too Well? Discuss with the client whether a cap should apply to what will pass to beneficiaries. Planners feel comfortable that works without requiring the client to live an additional three years after the end of the GRAT term. Interesting Dichotomy: The instrument says the value of the remainder is $150 million, but any value over $150 million is returned to the client after two years. That must smell goofy to the IRS.

g. GRAT Expenses. What if there is a sale of the closely held business interest? Acquisition expenses can be very expensive. If the grantor pays those expenses, that may very well be an impermissible additional contribution to the GRAT. It appears permissible for the grantor to loan money to the GRAT to pay expenses. (The regulations merely prohibit the GRAT from giving a note in satisfaction of the annuity amount.) Address this issue by having the grantor loan funds to the GRAT to pay its administrative expenses. (The preamble contemplates allowing loans from the grantor that can be traced to purposes other than making annuity payments.)

h. Prepayment of Annuity. The regulations prohibit commutation, so various planners believe that it is not possible to prepay the annuity amount. (Akers Observation: But the word “commutation” connotes paying a present value for future obligations. Does that necessarily prohibit paying the full amount early? However, there certainly is no ruling specifically allowing prepayment.) Instead of taking a risk of prepaying the annuity at a time when the in-kind assets have spiked in value, have the grantor purchase the in-kind asset for cash, and then the GRAT could use the cash to make the annuity payment at the end of the term.

i. GST Planning. The GST exemption amount is $2.0 million in 2006-2008 and increases to $3.5 million in 2009. In 2010, there is repeal so there is no exemption amount. So, in 2006 consider using a 3 year GRAT so it terminates in 2009 rather than 2008. (It is not clear what would happen if the GRAT were to terminate in 2010 when there is no GST tax at all, and no GST exemption that could be allocated to the trust. In any event, most planners believe that a compromise will be reached before 2010 and that the estate and GST tax will not disappear for that one year.)

j. Drafting Formula to Leave GST Exemption Amount to Dynasty Trust at End of GRAT Term. Assume the instrument says that the remaining available GST exemption amount passes to the dynasty trust and the balance goes to children outright at the end of the GRAT term. Is that a problem? The donor can control how much goes to the dynasty trust by whether subsequent gifts are made with GST exemption allocation before the end of the GRAT term. If the donor retains rights under §§2036-2038, there may be an additional 3 year problem at the end of the GRAT. If this provision is drafted in terms of the "then available GST exemption," the grantor still has control over how much passes to the dynasty trust from the GRAT. Solution: Draft as the "maximum GST amount at the time the initial term ends less $X" ($X would be the amount of GST exemption that has already been allocated when the trust is created.)

One speaker thinks this is very important to do—it is not just academic.

(Akers Observation: There are arguments that there would not be an additional 3 year period under §2035. Since the donor is not actively relinquishing the right to control how much is passing to the dynasty trust at the end of the GRAT term, but it just lapses, §2035 would not seem to apply. An analogy is that §2036 applies during the term of the GRAT because of the right to receive the annuity payments from the GRAT, but the lapse of that right at the termination of the GRAT does not give rise to an additional 3 year inclusion period under section 2035. Of course, a possible distinction is that the annuity payments are mandatory whereas the control over the amount passing under the GST formula is discretionary with the grantor.)

k. Valuation Date for In-Kind Annuity Payments Back to Grantor. Do you value the assets on the stated annuity payment date or on the date the distribution is actually made? Many planners think you can value the assets on the stated distribution date. Speakers think that is incorrect. By analogy to the marital deduction area, we should use date of distribution values.

The pig theory comes into play. Don't play games with valuation dates—the goal is to get the big shift in value from the GRAT.

l. Is the GRAT Still a Grantor Trust When The Last Annuity Payment Is Made After the Stated Termination Date? If there is anything left at the end of the term, there must have been appreciation, that could potentially have income tax consequences. When the final distribution is made in-kind back to the donor in satisfaction of the last annuity payment, is the GRAT still a grantor trust on that date? The speaker thinks that if the trust makes the payment within the 105 day grace period, it should be a nonevent for income tax purposes. The instrument specifically referred to the 105 day grace period, so the grantor trust should continue for that time frame.

m. Extend Substitution Power Past Stated Termination Date. It may be helpful to be able to substitute assets so the assets that the grantor really wants to pass to the children can be substituted into the GRAT even after the end of the initial GRAT term.

   Drafting Tip: The grantor trust trigger (whether it is a substitution power or any other trigger power) should continue until all annuity payments have been made back to the grantor.

n. Planning in Advance for Potential Sale of Remainder Interest--Advantage of Having GRAT Pass to Another Pre-Funded Grantor Trust. If a grantor has mortality concerns before the end of the GRAT, the grantor may consider purchasing the remainder interest from the owners of the remainder interest. The fair market value that the grantor would pay for the remainder interest would arguably be excluded from his estate. Under that scenario, what is the basis of the remainder beneficiaries? The uniform basis rules deny basis if there is a sale of the term interest. They do not address a sale of the remainder interest. Observe that this income tax issue does not arise if the remainder interest owner is a grantor trust. One attorney reported doing this in a transaction where the grantor of the GRAT was about to die. The remainder would pass to a slightly prefunded grantor trust. That trust was selling its remainder back to the grantor—so the sale was from a grantor trust to the grantor and was not a recognition event. That sale was audited. In that case, there were different trustees of the grantor trust remainder owner and the GRAT itself (to help show no merger). The attorney even had the grantor trusts file a Form 1041 when initially created, reporting them as grantor trusts. The grantor borrowed money from a bank to pay for the remainder interest. The IRS agent didn’t like it, but it passed the audit. (Akers Observation: I do not know if that was just an income tax audit, or if the auditor also considered the estate tax and GST tax effects of the remainder purchase transaction.)

7. Sale to Grantor Trust Planning Update

a. Is 10% Equity Required? In PLR 9535026, the IRS insisted on a 10% floor. One speaker (who considers himself a conservative planner) has used less than 10% sometimes, and on occasions he is concerned whether 10% is enough. The legal issue is whether there is debt or equity. (For example, if it is debt, it is permissible to use the AFR as the interest rate.) The issue is whether there is comfort that the “debt” will be repaid.

The Karmazin v. Commissioner case (T.C. Docket No. 2127-03) involved the creation of an FLP, funding a grantor trust with limited partnership interests for a 10% "seed" gift, and selling limited partnership units to the trust. The IRS made a number of arguments, including that the 10% equity was not sufficient, and that the note constituted equity for purposes of §§2701 and 2702. The IRS settled that case favorably to the taxpayer, in effect conceding the debt/equity issue in that case.

McDermott v. Commissioner, 13 T.C. 468 (1949), *acq*. 1950-1 C.B. 3 had a 19.6 to 1 debt equity ratio (which translates to a 5.6% equity amount). The IRS acquiesced in McDermott. One attorney uses that as a base point – he never uses less than 5.6% seeding. On the other hand, there is a published ruling involving a 20% contribution, and the IRS ruled it was debt. (That was not a sale to grantor trust situation.) So for the really daring, 5.6% is the absolute base for those who want to go under 10%.

The outline points out that if the 10% seeding is based on analogy to §2701(a)(4), the initial seeding gift should be 11.1% of the amount of the later sale to the trust (if values remain constant.) If the grantor transfers $11.10 to the trust, and later sells an asset for a $100.00 note, the "$11.10 "seeding" would be 10% of the total $111.10 assets in the trust following the sale. That means there would be a 9:1 debt equity ratio.

In determining whether the note represents debt or equity, one must consider a variety of factors, including the nature (and volatility) of assets in the trust, and the risk profile of the clients. If there is experience of assets actually increasing in value after sales to the trust and payments actually being made, when the next grantor trust sale is considered, the grantor would seem to have good reason to be more comfortable using a lower equity cushion.

b. Equity is Always at Risk. Realize that equity contributed to a grantor trust is really at risk. Also, appreciation in the grantor trust is at risk if there is a subsequent reversal before the note is repaid. If you continue to use the trust for new purchases, that can have great benefit – but it also has risks.

c. Guarantees. Is seed money not needed if someone makes a guarantee of the 10% equity cushion amount? That should work. If there is a guarantee by a third party, the trust should compensate that party, or else that would be an additional gift from the third party to the trust (and the trust would no longer be a wholly grantor trust).

Guarantee by beneficiary – that could be a guarantee of just the 10% equity cushion amount. If the beneficiary has a real interest in the trust, and the beneficiary gives a guarantee to protect his or her own investment, that appears not to be a gift to the trust. (If the beneficiary is making a gift to the trust, the beneficiary is a grantor to that extent, and the trust is no longer a wholly grantor trust as to the original grantor, so there could be bad income tax consequences.)

The best analogy is to the life insurance area. There are various cases and acquiescences that if a beneficiary pays premiums to maintain the policy that is owned by a trust, that is not a gift to the trust. Indeed, that is an actual transfer, not just a guarantee.

If you are squeamish about guarantees by beneficiaries, you could provide an annual fee to the beneficiary in return for the guarantee. Typically, the fee would be between 1%-2%. The trust could even use a bank letter of credit.

Mil Hatcher co-authored an article about using beneficiary guarantees. Hatcher and Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, 92 J. TAX'N 152 (March 2000).

Grantor spouse guarantee? The income tax risk is much less if a spouse guarantees the cushion amount rather than another individual. If there is a gift by the spouse in making the guarantee, there would be dual grantor trusts – between spouses. So there are probably no material adverse income tax consequences. However, using a spouse as the guarantor may have an impact on recognizing the transaction as a debt transaction rather than a retained equity interest in the assets "sold" to the trust. To recognize the sale as a debt transaction, it must meet various factors, one of which is that it is a "bona fide" sale. Having the spouse give a guarantee raises questions about the bona fides of the overall transaction. So it does create some additional estate tax risk. The speaker addressing this issue said that he has used a spouse guarantee on occasion, but be very careful. There is also an economic consideration: Realize that the guarantee may actually be enforced at some point.

Another speaker said he has used guarantees only once. But he buys into the theory that it should be ok if done right.

d. Tax Reimbursement. Rev. Rul. 2004-64 purports to say that including a discretionary reimbursement right is ok, without causing estate tax inclusion for the grantor, but the ruling had caveats. The IRS may consider that there is a prearrangement, so it is really a "right" to reimbursement, not just discretionary with the trustee. It is interesting that people are even less inclined to use a discretionary right of reimbursement than before the issuance of Rev. Rul. 2004-64. Furthermore, instruments are renouncing any reimbursement rights even if local law would allow reimbursement.

e. Defined Value Clause. A defined value clause helps provide an argument, but there is no assurance that it works. One speaker discussed using a formula in dividing the assets transferred to the trust into two portions, Portion 1 and Portion 2. Portion 1: 100% to the taxable trust for the children. Portion 2 may be divided to two portions: (a) 10% is added to the taxable trust; (b) Balance is going to a general power of appointment marital trust for spouse or charity, or an incomplete gift trust, or back to the grantor. The effect of the defined value clause: If there is a $5 million gift element to the trust, but only 10% is taxable; the rest is not a completed gift or qualifies for a gift tax deduction. This is better than nothing, but there are no guarantees it will work.

f. Discounting Note For Estate Tax Purposes. There may be advantages to not prepaying a note during life (despite the income tax uncertainties about what happens in that event when note payments are later made.) Discounting the note for estate tax purposes may be appropriate if interest rates on the note are less than commercial rates. Section 7872(h)(2) makes clear that Congress intended this should not be the result. But the statute says “under regulations prescribed by the Secretary.” There are no regulations yet. There are proposed regulations issued in 1985, but no final regulations yet. (They could be finalized at any time, presumptively back to date of issuance in 1985.) Therefore, one speaker thinks there is a legitimate argument to discount the note for estate tax purposes.

Also, rates have gone up. Even if the regulations were in place, the note with a lower rate (due to rising rates) could be discounted.

g. Substitution Power. PLR 200606006 said that §2036 would not apply in a situation where the substitution power was held in a fiduciary capacity. Without changing the trust under state law so that the trustee would hold the substitution power in a fiduciary capacity, George Masnik (with the IRS) would not give a favorable ruling on §2036. (In the facts of that ruling, there were other grantor trust triggers, so the trust was a grantor trust even without a non-fiduciary substitution power. The substitution power was important to the grantor in that ruling, because the grantor planned to transfer closely held business interests to the trusts, and the grantor wanted a substitution power to be able to substitute cash for those interests.) There are dozens of previous private letter rulings saying that §2036 does not apply to a substitution power even if it is held in a non-fiduciary capacity. George Masnik is now unwilling to grant favorable §2036 rulings to non-fiduciary substitution powers.

Jordahl is often quoted to say that a substitution power does not trigger §2036, but under the facts of Jordahl, the grantor held the power in fiduciary capacity. However, the regulations and other authority under §§2036 and 2038 say that it makes no difference how the power is held. If there is a bad power, it does not help that it is held in a fiduciary capacity. So if the substitution power was bad in Jordahl, holding it in a fiduciary capacity would not have helped. Therefore, Jordahl does protect us.

The consensus of the speaker is that this “is not a big deal.” Another speaker concluded “This does not spook me.” There is no need to change prior trusts. But at least consider giving substitution power to a spouse or child instead of routinely giving the grantor a substitution power.

h. Power to Add Beneficiaries. One speaker worries whether just the naked ability to add beneficiaries without any standard on distributions is sufficient to trigger grantor trust status. He believes that to be safe, someone should have the power to add beneficiaries, and direct distribution to the additional beneficiaries. Many planners feel comfortable with the power to add beneficiaries under a standard for distribution that can be enforced.

i. Compare Installment Sale to GRAT.
   (1) Interest rate lower.
   (2) Can commute note at any time.
   (3) Leverage outstanding for a longer period of time. (With a GRAT, the trust is constantly paying back the annuity. But the client could use rolling GRATs to re-GRAT each annuity payment.)
   (4) There are potential uncertainties even with a GRAT. How small can the remainder be? How short can you make the GRAT term?
   (5) 105 day rule for GRATS in effect allows an interest free loan (without tax consequences) for 1/3 of the year.

8. Sale to Grantor Trust – New Twist to Entity Sale to Grantor Trust

a. Karmazin Case Background. The Karmazin case (settled before trial) involved the creation of an FLP and combined gifts and sales of LP interests to a grantor trust under a 10% seeding approach. The IRS made a wide variety of arguments including: (a) Not a bona fide sale because unrelated parties would not do this; (b) Interest payments on the note were recharacterized as an annuity; (c) So the transaction was treated as a transfer to a trust in return for annuity to which §2702 would apply, and the annuity did not reduce the gift value because it did not meet the §2702 requirements. Various §2702 requirements were not met: No prohibition against paying to persons other than the holder; No prohibition against commutation; No prohibition against issuance of a trust note to satisfy payments; No prohibition against having additions to the trust.

(In the Karmazin case, a charitable lead trust was a 10% partner. There was a practical requirement to fund the charitable lead trust so that it could make the required charitable distributions. The IRS focused on that to eventually uphold the bona fides that there would be sufficient cash flow to make the note payments.)

b. How Can Grantor Trust Sale Transactions be Structured to Help Counter These Possible Arguments?

Structure: Form a single member LLC or a regular LLC. (The single member approach has the advantage of not requiring reporting.) The sale is structured as an annuity for a term of years instead of as a note. No note is given. Special provisions include:

- Annuity is designed so that the value of the payments equals the value of the interest sold as finally determined in a federal gift tax proceeding (following the §2702 regulation);
- Annual payments are self adjusting (using the same interest rate that would be used for GRAT calculations);
- Trust should say that it cannot issue a note to the grantor – in order to satisfy the GRAT regulations prohibiting the issuance of notes from the trust to the grantor in satisfaction of annuity payments;
- Trust is designed as a traditional GST trust for children/grandchildren;
- Provide in trust for no additions;
- Provide for no distributions to any beneficiaries during the term of the annuity payments to the grantor; and
- Purchase agreement would preclude the prepayment of trust obligations.

c. Effects (Goals) of Redesigned Transaction. If the IRS claims the transaction is not a sale but a gift to the trust, the taxpayer will respond that it is intended to qualify for §2702 treatment, and that the payments meet the §2702(d) requirements. If death occurs during the annuity period, and if the transaction is characterized as a sale, just include the value of the remaining annuity payments, not the entire value transferred.

d. Should You Report on Gift Tax Return? If three years go by, the legal issue is whether there was a bona fide sale. Is the IRS then precluded under §2036 from saying it is not a bona fide sale? At least the estate would have an argument if the transaction had been reported on a gift tax return.

e. Downside Risk. If IRS does recharacterize the transaction as a gift for annuity payments under §2702, there are adverse GST consequences. Under the ETIP rules, the donor could not allocate up front GST exemption (until the end of the ETIP period). Therefore, with this transaction always have a non-skip person, so at least it would not be a direct skip with immediate GST tax consequences.

9. Preferred Partnerships

There is an exception under §2701 for a specific amount payable at a specific time in the future. For example, the partnership might provide for the right to receive a specific payment in 15 years. The fair market value of that payment right is determined using an appropriate discount rate (not just the AFR or the 7520 rate). Appraisers indicate that a 12% discount rate is not an unreasonable assumption. The grantor might sell this partnership interest to the trust for a note bearing an interest rate of 4.68% (for March 2006). In effect, this results in a net transfer of 700 basis points of annual appreciation. So even if there is no appreciation or substandard appreciation inside the partnership, the transaction can still transfer substantial value to the grantor trust. One can almost assure that a transfer will occur.

10. Section 6166 Trade Or Business Requirement For Real Estate; Rev. Rul. 2006-34.

This is the first time the IRS has given public guidance since 1975 on whether real property interests owned by a decedent or an entity in which decedent had an interest qualifies under §6166.

<u>Five Example Situations</u>. The ruling addressed 5 different situations.

Situation 1. A owned a ten store strip mall. A personally handled all day to day maintenance and repairs. When A could not do repairs, A hired third party independent contractor, but A selected the contractor and reviewed the contractors work. Conclusion: qualified as an active trade or business. (The result would have been the same if the strip mall had been held by a single member LLC owned by A.)

Situation 2. (This situation is the opposite of Situation 1.) B owned a small office park. B had virtually no hands on involvement. B hired a management company. B had no ownership interest in the management company. The management company advertised, showed the property to new tenants, collected rents, negotiated leases, contracted with independent contractors for maintenance, and rendered monthly rent checks and accounting of expenses. Conclusion: did not qualify as an active trade or business.

(Some attorneys maintain this conclusion is incorrect, and the issue should be financial responsibility. If the owner leases the property under a triple net lease with no financial responsibility, it should not qualify. However, if the landlord is financially responsible for maintenance of the property, it should qualify. The IRS does not agree with a financial risk analysis but requires hands on involvement.)

Situation 3. Same as Situation 2, except that B owned 20% of the stock of the prop management company. Conclusion: "Because B owned a significant interest in [the management company] the activities of [the management company] with respect to the office park allow B's interest in the office park to qualify as an interest in a closely held business." (Having 20% ownership of a management company is an important new safe harbor, as discussed below.)

Situation 4. C owned a 1% general partnership interest and a 20% limited partnership interest in a limited partnership that owned 3 strip malls. The value of the 3 strip malls was 85% of value of equity in the partnership. C had to provide all necessary services to operate the business including daily maintenance. C received annual salary. C personally or through employees or agents of the partnership performed management functions, negotiated leases, collected rent, made repairs, and approved the work of independent contractors. C made decisions about periodic renovations. Conclusion: whether the partnership was carrying on a trade or business is made with reference to the partnership's activities. Because of the activities of C as general partner of the partnership, the partnership carried on an active trade or business. Furthermore, because the strip malls were used in carrying all the partnership's active trade or business, they're not passive assets under section 6166. (Because C owned at least 20 percent of the partnership, the conclusion will be the same even if the management activities had been performed by another employee partner or agent rather than directly by C.)

Situation 5. (This is the common situation of a business owner who directly owns real estate that is leased to the business.) D owned 100% of the stock in an auto dealership. D made all decisions about advertising, mgt supervision of employees, etc. D also personally owned solely the real property on which the dealership conducted its business. The real prop had buildings constructed uniquely for the conduct of the dealership (a showroom, etc.). The company leased the property under a net lease and its employees performed all maintenance and repairs to the property. Conclusion: The company was conducting an active trade or business, and real property owned by D was used exclusively in the business under a net lease. Because D owned a significant interest in the company, whose activities with regard to the real property constituted active management, D's interest in the real property also qualifies as an interest in a closely held business.

<u>Guiding Principles</u>. Some of the principles gleaned from the new ruling are:

a. To qualify, the decedent must conduct an active trade or business or hold interests in a partnership, LLC or corporation that carries on an active trade or business as opposed to “the mere management of passive investment assets.” (When the IRS or a court uses the word “mere,” bad news follows.)

b. The activities of agents or employees are properly considered in determining if an active trade or business exists. The use of independent contractors will not disqualify the interest so long as the decedent has not ceded so much of the day-to-day operations that the decedent’s activity is reduced to “merely holding investment property.” The IRS is acknowledging that the use of an independent contactor is not fatal. The Ruling broadens the way the IRS will look at facts and circumstances.

c. When an unrelated management company is employed to perform most of the management activities, the ruling says that suggests that an active trade or business does not exist. Reading between the lines, you are “dead in the water” if you use an independent management company to perform most of the activities.

d. The IRS is offering a **new safe harbor** we did not have before. If the decedent owns at least 20% of the management company that performs most of the management activities, the decedent will likely meet the trade or business requirement. There is no requirement that the decedent be actively involved in the management activities of the management company—it is just a 20% ownership test. This is not the same 20% test as in 6166(b)(1), which refers to the portion of the business that is in the estate. This 20% rule has nothing to do with the ownership of the business for which §6166 treatment is sought. It is just the ownership of the management company that is managing that interest.

e. One of the situations allows 6166 treatment in the common situation where the real estate is owned separate from the operation of the business (an auto dealership in that example).

f. Revokes portions of prior rulings. The IRS is changing some of the positions that it took in the earlier 1975 Rulings. In Rev. Rul 75-365, the decedent owned a fully equipped business office that handled management of the decedent’s real estate. (It collected rental payments, received payments on notes receivable, negotiated leases, made occasional loans, directed maintenance of the properties by independent contractors, maintained a records and kept regular office hours.) The prior ruling said section 6166 was not available. That prior ruling is revoked.

Rev. Rul 75-367 concluded among other things that where the decedent owned residential tracts and performed daily repairs, maintenance, etc, the residential tracts did not qualify for section 6166. That portion of Rev. Rul 75-367 is revoked.

g The Ruling does not address a QTIP situation. To the extent the Ruling provides safe harbors, there is no discussion of how it applies to QTIP trusts. If a client wants to use the safe harbors, it may be necessary at the first spouse’s death to leave interests outright to the first spouse. The issue is whether activities by the trustee satisfy the trade or business requirement or do you have to look only to activities of the surviving spouse? In that situation, utilizing the 20% ownership in a management company would be preferable; however, it is not clear whether the surviving spouse must own that 20% or whether it is sufficient for the surviving spouse and QTIP trust collectively to own the required 20%.

11. Patenting Estate Planning Techniques.

a. SO-GRAT Patent. A patent was issued on May 20, 2003 for contributing options to a GRAT. (The patent application was filed December 1, 1999.) In January of 2006, an infringement action lawsuit was filed in Connecticut by the holder of the patent. (D. Conn. Cause No. 06CV00024) A large New York law firm set up the GRAT, funded with options. Disclosure of the transfer was filed with the SEC. The patent holder apparently watches those filings for transfers of options to GRATs.

Summary of Effect on Planners: If a client is considering doing a GRAT with options, some estate planning attorneys conclude that they will always advise the client about the patent. The concern is that if the client funds a GRAT with options, gets sued for patent infringement, and has to pay big bucks to defend the infringement suit or pay damages, the client will come back to the attorney seeking recompense because the attorney did not advise about the existence of the patent.

b. Practical Concern for Estate Planning Attorneys. A practical concern is how an estate planning attorney would know of the existence of patents that might cover what seem to be standard estate planning strategies. The New York State Bar Association recently sent a letter to key Congressmen expressing concern about the impact that patenting tax advice and tax strategies might have on the integrity and administration of the tax laws, on taxpayers, and on tax practitioners.

c. Tax Strategy Patents. The United States Patent and Trademark Office (“PTO”) has a separate category for tax strategy patents (Subclass 36T of Class 705). The PTO website shows that about 50 patents have been issued in that subclass and about 80 such applications are pending. These tax strategy patents have involved many aspects of the tax law, including financial products, charitable giving, estate planning, and tax-deferred exchanges.

d. House Ways and Means Committee Hearing. The House Ways and Means Committee called for hearings on the issuance of patents for tax strategies. Dennis Belcher, among others, was invited to testify at that hearing.

e. Joint Task Force. An "Intellectual Property/Estate Planning Task force, comprised or representatives from ACTEC, the American Bar Association Real Property, Probate and Trust Law Section, and the American Bankers Association, is exploring issues surrounding the issuance of tax patents. One proposed focus of the Task Force is to establish a structure for organizing the review of the PTO website to identify tax strategy patent applications to publicize them broadly in the tax and estate planning community. Practitioners who are aware of other public discussion of the strategy would be able to post comments that the PTO hopefully would be able to locate. (Unfortunately, there is no procedure for formally giving input to the PTO during the patent application process.)

12. Life Insurance – Nonrecourse Loan for Two Years

a. Description. This is marketed as free insurance for persons between 75 and 90. (Sometimes, the insured is even paid a substantial amount upfront to do this.) The insurance company would issue a policy on the insured's life. The insured (or an ILIT) would own the policy for two years. The premiums are advanced under a non-recourse loan. After 2 yrs, the owner of the policy has a choice: 1. Walk away from the policy with no liability. 2. Keep the policy by repaying the premium advance with interest. If the owner chooses not to keep the policy, outside investors would then own the policy.

The market has taken off for this. Lots of these are being sold. Some agents have made between $25-50 million a year selling this!!!!!!!!!

b. Income Tax Aspects of Premium Financing.

(1) Discharge of indebtedness income? There is discharge of indebtedness income; the important question is whether the owner's basis will cover that deemed income. (Professor Jay Soled is going to publish an article about this.) The IRS originally was going to say that the owner's basis is equal to the cash surrender value of the policy at the end of the two-year period. Some planners believe that Rev. Rul. 70-38 concedes that the basis is not limited to CSV but is the total premiums paid for purposes of determining gain. (For purposes of determining loss, basis may just be CSV.) If there is gain, many planners believe the gain should be long term capital gain income. In any event – there can be significant income tax consequences. The client should have enough cash to pay the income tax if IRS says that there is gain recognition.

(2) Upfront payment – The upfront payment may be ordinary income.

c. New York Insurance Commissioner Opinion. A problem has arisen in New York with these policies. Skadden Arps requested a ruling from the New York Insurance Commissioner. New York law says an insured can give a policy to anyone he wants, even if that person does not have an insurable interest. That was clarified several years ago. On Dec. 19, 2005, the Insurance Department issued an opinion saying there is no insurable interest in these policies. The opinion concludes that the contract violates the insurable interest rule. The opinion reasons that "…the transaction presented involved procurement of insurance solely as a speculative investment for a disinterested third party." The opinion says that if there is no insurable interest, the contract would be "impermissible" [it's not clear what that means]. The opinion also treats the transaction as creating an impermissible rebate.

The opinion does not make sense in light of the New York statute. The statute has a comprehensive definition of insurable interest. In New York, there is a one time test—at the issuance of the policy. The New York program had some unusual facts. There was a put option to force the issuer to buy back the policy, and that obligation was guaranteed. The loan was recourse.

This NY ruling is so adverse that the hedge funds that are acquiring these policies have decided they have serious problems with this. Therefore, it is unclear whether these 2 yr "free" policies will continue.

d. Example of Company's Reactions: Rescission of Policy. Steve Leimberg's Estate Planning Email Newsletter #1013 reported that a major insurer, New York Life Insurance Annuity Corporation has served notice to the trustee of a trust holding life insurance that it intends to rescind a $1.0 million policy on its insured's life. The complaint alleges that it has come to the attention of the insurer that the policy was issued at the behest of investors who have no familial or economic interest in the insured's life and those non related investors are the beneficiaries and premium payors. This, the insurer alleges, violates New York's insurable interest law and the policy is therefore voidable. The insurer is electing to rescind the policy and return the premiums (plus interest).

13. Life Insurance Insurable Interest; Chawla

Chawla v. Transamerica addresses whether a life insurance trust has an insurable interest. The insured had health problems and lied on the application. The federal district court ruled that there was (1) fraud in the application, and (2) no insurable interest in the trust. (The case was decided in Virginia applying Maryland law.) The 4th Circuit Court of Appeals vacated the portion of the decree dealing with insurable interest. The court said that the alternative ruling regarding insurable interest was not necessary to resolve the case and that portion was vacated. We had hoped the appellate court would address the substantive issue, but at least they vacated that part of the decision.

14. PLR Re Prepayment of Private Tuition; PLR 200602002

This ruling concluded that prepayments to an educational institution for future tuition payments qualified for the tuition exclusion for gift and GST tax purposes. The attorney who obtained this ruling said that the key in getting a favorable ruling was that there were payments for each individual grandchild, and that the payments were irrevocable. A particular grandchild's tuition would be forfeited if the grandchild left the school. Left open in the contract was whether the institution could move the funds to another grandchild. The case involved a transfer of $750,000. (The transfers were for a number of very young grandchildren in kindergarten and early elementary school at an expensive private school.) In that ruling, the grandchildren were already enrolled in the school.

This is a great pre mortem planning strategy. But there is risk – if the student should leave the school. For a 529 plan, you can only use annual exclusions for 5 years to cover contributions (whereas this ruling addresses the tuition exclusion, which is unlimited), and if the donor dies before 5 years, the gifts attributable to unused years will be treated as taxable gifts.

Some schools have their own prepayment plan contracts. Some colleges would agree to send the tuition to another school if the child leaves the school. The attorney who obtained the ruling said the irrevocability was extremely important in her discussions with the IRS. Some planners have seen contracts that allowed portability, in the discretion of the school.

Conceptually, the return of fees if the child drops out should not matter. Under every payment of tuition, many schools will return the fees or a portion of them if the child withdraws within a certain time. That has never endangered the tuition exclusion. There is no abuse – if the tuition is returned, it is in the donor's estate. So portability or even a return of fees should not be a conceptual problem.

15. Income Tax Deductions of Estate Administration Expenses/Application of the "Hubert" Regulations

At the first spouse's death, unless the income tax bracket is very low or unless the parties expect huge appreciation, the family is probably better off deducting transmission expenses on the income tax return rather than the estate tax return. That has the effect of reducing the bequest to the bypass trust. However, the idea is to take the “bird in the hand” income tax savings in light of the uncertainty of the estate tax savings that may be achieved years later with the bypass trust. One attorney coined this maxim: “A bird in the hand is worth relying on Bush.” Another exception might be if the surviving spouse is expected to die in the next several years, and there would not be much appreciation in the bypass trust assets.

Most attorneys in the session are tending to take the deduction on the 1041 now and give up on the bypass trust reduction. But there is no one answer that fits all.

If the surviving spouse can pay the transmission expenses directly, you get the best of both worlds. (The spouse would pay expenses under the rationale that much of the advice is to advise the surviving spouse.) That reduces her taxable estate. But she would not get an immediate income tax deduction – unless it is an expense deductible under §212. Section 212 is not a perfect deduction; for example there is the 2% floor.

Could you allocate part of fee to the marital trust? Presumably, yes.

16. Top Quotes of the ACTEC and Heckerling Meetings

(1) In Kelley , there were certificates of deposit and cash in the FLP. The IRS did not raise §2036 (the decedent was in relatively good health when the partnership was created and he had a pension that provided his living expenses.) The estate claimed a 50% discount and ended up receiving a 32.2% discount. Carol Harrington: “I guess this shows the best defense is a good offense.”

(2) Carol Harrington: The analysis for FLP planning is more strategic than legal. “You don’t need to outrun the bear, you just need to outrun the other people who are also trying to outrun the bear.”

(3) “You don’t want a philosophical debate with an IRS agent when there’s lots of money on the table.”

(4) Dennis Belcher: “I’m not a one handed lawyer. My clients will hear ‘the other hand.’”

(5) Eric Manterfield: We are losing the tax saving mantra as a hook to motivate clients to plan. Clients have the Scarlett O’Hara approach: “I’ll worry about tomorrow tomorrow, because tomorrow may never come.”

(6) Eric Manterfield: “Who would have thought in 1972 that the exemption would increase from $60,000 to $2.0 million. An equivalent increase in

the exemption in another 30 years would yield an estate tax exemption of $64 million.

(7) Lou Mezzullo: Will clients move their domicile to save a 9% state estate tax? “They get upset if I don’t validate their $5 parking bill. What do you think they’ll do to save a 9% tax in a $100 million estate?”

(8) Carol Cantrell: “Trustees spend $5 billion a year on investment management. IRS statistics of income say that trustees spend more on investment management than any other expense, including trustee fees.”

(9) Marty Basson (Supervisory attorney for estate and gift tax in S. Florida): The IRS is ecstatic over Bongard and Strangi. “For the first time in my career, we’re winning more cases than we’re losing.”

(10) Calvin Coolidge (as quoted by Marty Basson): “Nothing I never said ever hurt me.”

(11) Porter: “I like to be hard on the substantive issues and easy on the procedural issues.”

(12) Jon Gallo: “Less than 2% of persons who buy term life insurance end up keeping the policy until death.” “If your client is going to keep a life insurance policy over about 10 years, my view is that the client is better off economically buying some type of insurance with a building cash value.”

(13) “The thin line between tax avoidance and tax evasion is a prison wall.”

(14) Roy Adams: “Circular 230 is not an appetizer. It is a main course, and you have to eat it.”

(15) Marshall v. Marshall is the U.S. Supreme Court case addressing whether federal courts have jurisdiction in a probate matter. The case involves the rights of Anna Nicole Smith in the Marshall estate. Carol Harrington: “We’ll all be watching that with baited breath – at least the guys will.”