RECENT WEALTH TRANSFER TAX DEVELOPMENTS

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1. Inflation Adjustments

Every year the Treasury Department is required to update certain figures that are indexed for inflation. For year 2007 the index figure for the annual exclusion remains at $12,000. The estate tax applicable exclusion amount and generation-skipping transfer tax exemption both became $2 million in 2006 and remain there until 2009. Other figures for 2007 include the following:

§6601(j) 2% Portion increased to $1,250,000
Special Use Value Maximum Reduction increased to $940,000
Noncitizen Spouse Annual Exclusion increased to $125,000

The maximum wealth transfer tax rate dropped to 45% in 2007 and, with the estate tax applicable exclusion amount (and GST exemption) at $2.0 million, we continue to have a "flat" tax at the 45% rate. Recall, however, that the gift tax applicable exclusion amount remains at $1 million notwithstanding any of these other changes.

Meanwhile, it would appear that Congress will not continue to threaten to make repeal of the estate and generation-skipping taxes permanent and, notwithstanding some political grandstanding in the run up to the 2008 elections, Congress is not likely to address the repeal issue in this term. Reform may be on the agenda when Congress next addresses the folly of the one year repeal slated for 2010, which may not come up until very late in 2009 (or, it seems possible, even in 2010 with a retroactive effective date to the beginning of that year). At that time the applicable exclusion amount will be $3.5 million, and all the debate may center around the appropriate maximum rate, "three-five and thirty-five" having a certain ring to it that may inform freezing the exclusion at the 2009 level and reducing the rate by ten percentage points. Other potential changes, all revealed in hearings that were conducted during summer 2005 by Congressional tax committee staffs, include:

- Making the unified credit portable (reflected, but not adopted, in H.R. 5638 in 2006)
- Precluding lapsing *Crummey* withdrawal rights (a §2642(c) "tax vesting" requirement would be easiest and most sensible but was not one of the three options noted in 2005)
- Elimination of certain valuation discounts, perhaps by an aggregation rule
- Refinements to special interest provisions for farmers and small business owners
- Restoration of the §2011 state death tax credit (unlikely, according to most observers)
- A generation-skipping transfer tax fix to preclude tax free perpetual dynasty trusts

2. Priority Guidance Plan

Among the more useful guidance coming from the government these days is its "business plan," by which the Treasury Department announces the projects it intends to pursue during the coming year: A very good indication of what bothers Treasury can be gleaned from an inspection of the business plan (as well as whatever is released in satisfaction of it). In the last several years most of the items of significance that the Treasury indicated it would provide were issued. The updated business plan for the 2006-2007 fiscal year reflects a few items that rolled over from prior years, however, and some of those may not ever be completed. The list

of items that likely are of interest to most estate planners includes the following (in the government's own terms; annotations are in brackets):

GIFTS, ESTATES AND TRUSTS

1. Guidance under section 67 regarding miscellaneous itemized deductions of a trust or estate. [This presumably addresses the *Rudkin Testamentary Trust* issue discussed at page 51.]

3. Guidance regarding the consequences under various estate, gift, and generation-skipping transfer tax provisions of using a family-owned company as the trustee of a trust. [This rolled over from 2004-2005. See also the no-rule list in Rev. Proc. 2007-3, 2007-1 C.B. 108. The government has indicated that it simply is overwhelmed with ruling requests that involve many voluminous documents and evaluation of an array of possible tax consequences — for examples see Private Letter Rulings 200548035, 200546053-200546055, 200531004, 200523003 200410014 and 200410015, 200406040 through 200406044, and 200345006; this is a workload they now are seeking to avoid.]

4. Proposed regulations under sections 2036 and 2039 regarding the amount of a split-interest trust that is includible in a grantor's estate in certain circumstances in which the grantor retains an annuity or other payment for life.

5. Guidance under section 2053 regarding the extent to which post-death events may be considered in determining the value of a taxable estate. [This has rolled over for four years.]

6 Revenue procedures under sections 2055 and 2522 containing sample charitable lead trust provisions. [This has rolled over since first listed in 2005.]

7. Final regulations under section 2642 regarding the definition of, and procedures for making, a qualified severance of a trust. Proposed regulations were published on August 24, 2004. [See page 35]

8. Guidance under section 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership. [This has rolled over three times.]

Copies of the entire 2006-2007 Priority Guidance Plan promulgated by the Office of Tax Policy on August 15, 2006, can be obtained from the IRS website at www.irs.gov under Tax Professionals, Resources for TaxPro, Administrative Information and Resources, 2006-2007 Priority Guidance Plan. Copies can also be obtained by calling Treasury's Office of Public Affairs at (202) 622-2960.

3. Sections 2031 and 2032: Estate Tax Valuation

Valuation of Family Limited Partnership Holding Only Cash and CDs. **Estate of Kelley v. Commissioner**, 90 T.C.M. (CCH) 369 (2005), was remarkable only because the government conceded over a 25% valuation adjustment, and the taxpayer's estate ultimately generated over a 32% reduction in value, for a nearly 95% interest in a family limited partnership that held only cash and certificates of deposit. In a similarly dissatisfying valuation decision also involving Texas taxpayers, **Temple v. United States**, 423 F. Supp. 2d 605 (E.D. Tex. 2006), addressed the proper gift tax valuation of interests in a family limited partnership holding a ranch, a limited liability company holding a winery, and two family limited partnerships holding publicly traded stock. Nowhere in the opinion does the court give a clear indication of the values assessed by the government, although the opinion states that the court accepted the government's valuation expert's results in all but the winery LLC, yielding discounts in the 38% range for the ranch partnership, 12.5% lack of marketability discounts and varying minority interest discounts for the publicly traded stock partnerships. For the winery LLC, two different 60% and 38% discounts were applied, presumably (but not clearly) reflecting taxpayer assertions.

In the process the court made various statements that leave little clue how a similar case might be decided. Among the bizarre statements are these findings of fact: "19. A critical factor in this case is determining the appropriate diminution in value between a hypothetical willing buyer and hypothetical willing seller . . . ." What is a *diminution* in value *between* willing buyer and willing seller? "107. . . . [Taxpayer] is factually entitled to recover over $7 million in discounts from the United States." Say: did the court mean recover *refunds* from the government? Among other items of potential interest were a finding that no discount for built-in capital gain was available for the winery LLC because

> §754 allows a buyer to increase their basis in the partnership assets to equal the basis in the acquired partnership interest. Doing this allows a buyer to avoid future tax liability and carries no adverse tax consequences to existing partners. The Court concludes that it is reasonable to expect [an] economically rational partnership and buyer to negotiate an I.R.C. §754 election into the partnership acquisition.

Citing Estate of Jones v. Commissioner, 116 T.C. 121 (2001), the court said that "When a partnership interest is valued, I.R.C. §754 allows the partnership (i.e., the general partner) to elect to increase the buyer's basis in the partnership assets to an amount equal to the basis in the acquired partnership interest. A willing buyer can then avoid any future tax liability." And "there is no discount for built-in capital gains because it is likely that the hypothetical buyer and seller would negotiate with the understanding that the election would be made and the price itself would not reflect a discount for built-in gains." Finally, the court allowed the valuation expert to value the publicly traded stock partnerships as "essentially investment holding companies . . . analogous to closed-end funds." There is no mention whether the government asserted §2036 application to the family limited partnerships, and the net valuation results illustrate why courts so strongly encourage parties to settle these disputes. (§15.3.1.4 n.143 (6th ed.))

Alternate Valuation of the Same Asset. Involving three siblings and both gift and estate tax valuations, the primary wealth transfer tax issue of lasting interest in **Kohler v. Commissioner**, 92 T.C.M. (CCH) 48 (2006), was the §2032 requirement that an asset valued on the alternate valuation date must be the same as the asset that was included in the decedent's estate at death. Postmortem changes that alter the nature of the includible asset cannot be reflected in the alternate valuation.

The deceased sibling and two survivors were among family members who held about 96% of the stock in their privately held company (known primarily for its plumbing products). The deceased sibling died in March and the company completed a tax-free reorganization of its stock in May, such that on the alternate valuation date in September the asset to be valued was arguably either the stock owned pre-reorganization or the post-reorganization replacement stock. Presumably that made a difference because the reorganization forced outsiders to sell their stock and imposed transfer restrictions and granted purchase options that were designed to keep the reorganization stock within the family's control. Unexplained by the opinion, however, was why the government was exercised about the issue, given a stipulation that the stock-for-stock exchange was a tax-free §368(a) reorganization (apparently a §368(a)(1)(E) recapitalization) and, as a condition to qualify, the stock value before and after the reorganization had to be the same. Indeed, Judge Kroupa expressed surprise in her footnote 7 that the government continued to make the §2032 argument.

Treas. Reg. §20.2032-1(c)(1) provides that a §368(a) tax-free reorganization is "a mere change of form" and not a disposition that accelerates the alternate valuation date. In large part based on this slightly different issue, the court held that valuation of the post-reorganization stock owned on the alternate valuation date was appropriate, because it meant that only the form of the stock had changed (it was essentially the same), and because of necessity the values had to be the same on the date of the reorganization. The court cited no precedent on point and a quick computer search reveals only Technical Advice Memorandum 7103129640A (involving the related "disposition/acceleration" issue rather than the question of the proper asset to be valued).

Other issues of interest to some students include the burden of proof, which shifted to the government based on the court's finding that the taxpayers cooperated with the government's reasonable discovery requests (albeit not without a challenge that, when denied, the taxpayers then put behind them). "Simply because the estate filed a motion to quash a summons due to legitimate concerns about the relevancy of the information sought does not require a finding that the estate failed to cooperate with [the government]." And then, because the government had the burden of proof, the court found that it totally failed to make its case, resulting in a finding of value that "g[a]ve no weight to [the government] expert's conclusion. [The government] has therefore not met [its] burden of proof. Accordingly we find the value of the estate's stock to be the amount the estate reported on its return." No split-the-baby result here!

The court totally rejected the government's report, found credible the estate's two appraisals, and therefore found for the taxpayer (with a $97.5 million difference in value for the decedent's roughly ⅛ interest in the corporation). Readers who supervise or actually produce appraisals of close corporations may find the opinion of interest on a number of specific issues relating to methodology and credibility. (§15.3.2 n.147 (6th ed.))

Aggregation Valuation for Inclusion and Deduction. **Technical Advice Memorandum 200648028** is reminiscent of Technical Advice Memorandum 9403005 in that both involved a control block of corporate stock included in the estate of a decedent, only a portion of which passed in a deductible manner (charitable in 200648028, marital in 9403005). Notwithstanding that the control block properly was valued as a single block (because the ultimate destination of estate property is irrelevant for purposes of determining its value under §2031 for inclusion in the gross estate), the government limited the deductions available for the portions transferred to the deductible recipients — which were minority interests — to the discounted value of the respective minority interests.

For valuation purposes another interesting aspect of 200648028 was the government requiring aggregation of property includible in the gross estate under the string provisions with property includible under §2033. Similar in this respect to Technical Advice Memorandum 9403002 (a different Memorandum than 9403005; both were issued on the same date but the requests were made on different dates), in 200648028 the decedent's estate included some property under §§2036 and 2038 because the decedent made a transfer inter vivos to a revocable trust and retained enjoyment until death, and the balance was includible under §2033 because the decedent retained ownership until death. Aggregation of the two components was proper because at one time the decedent actually owned all of the property involved and the string provisions are designed to produce the same estate tax result as if the decedent had not made the transfer that triggered the estate tax inclusion. See Rev. Rul. 79-7, 1979-1 C.B. 294 (aggregation of property owned by the decedent and transferred within three years before death, at that time triggering the §2035(a) three year rule).

One final aspect of 200648028 of interest was that there was a lurking Superfund cleanup potential for an environmental tort, as to which the question was the proper valuation reduction to reflect those possible costs. Rather than state that these costs were too speculative, or suggest that the taxpayer should make a protective claim to a refund based on a §2053(a)(2) deduction for any costs that actually were incurred and paid (a position that scuttlebutt indicates has been a government response to similar issues in other cases), the Memorandum stated that the costs could be taken into account based on the facts presented, "including: (i) the extent to which the clean-up problem was known [on the valuation date]; (ii) whether it was foreseeable that [the entity] would be required to pay the clean-up cost, and, if so, when;" and whether there were any available sources of state or federal funding incentives that might allay part of those costs. That position is surprisingly flexible. (§§7.3.7 nn.212, 214; 13.7.3.1.1 (6th ed.))

4. Sections 2036 and 2038: Retained Interests or Powers

Walking the Defective Grantor Trust Tightrope. The classic cause for concern in drafting intentionally defective grantor trusts for income tax purposes is whether the defect of choice is sufficient to cause application of estate tax inclusion §2036(a)(1) or (a)(2) at the grantor's death. In this regard many will want to regard **Private Letter Ruling 200603040** as an oasis, because on casual reading it appears to say that the ever-popular §675(4)(C) power to substitute assets is benign under §2036. The catch is the power to swap assets in the Ruling "may only be exercised in a fiduciary capacity," and that condition precludes application of

§675(4)(C) (indeed, the government often refuses to rule on a swap power because exercise must be in a nonfiduciary capacity and that is a question of fact). In ruling that the power in the Ruling did not create §2036(a) exposure the government relied on Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), acq., 1977-1 C.B. 1, which held that a power limited by fiduciary duties was not adequate to cause §2038(a)(2) inclusion (applicable with respect to a pre-June 23, 1936 trust).

Notice that *Jordahl* involved §*2038* and is not a §*2036* authority, which places it slightly off the mark. Here is what *Jordahl* held:

> This Court [has] considered cases involving settlors who have retained the power to direct trustees as to investments and, where settlors have been bound to act in good faith and in accordance with fiduciary standards, the retained powers over investment have not been treated as [§2038(a)] powers to alter, amend, or revoke. Estate of Budd v. Commissioner, 49 T.C. 468, 476 (1968); Estate of Graham v. Commissioner, 46 T.C. 415, 429 (1966); Estate of King v. Commissioner, 37 T.C. 973, 981 (1962); Estate of Downe v. Commissioner, 2 T.C. 967 (1943); Estate of Hall v. Commissioner, 6 T.C. 933 (1946); United States v. Powell, 307 F.2d 821 (10th Cir. 1962). See also United States v. Byrum, 408 U.S. 125 (1972). Decedent's power to substitute property "of equal value" would modify or alter the trust no more than those powers to direct investments . . . . Moreover, like the settlors involved in those cases, decedent was bound by fiduciary standards. Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity . . . . Stix v. Commissioner, 152 F.2d 562, 563 (2d Cir. 1945), aff'g 4 T.C. 1140 (1945); Restatement (Second) of Trusts §185.

Because the fiduciary constraint that saved the taxpayer in *Jordahl* and in the Ruling makes §675(4)(C) inapplicable, the Ruling is a chimera for intentionally defective grantor trust planning purposes, and care must be exercised not to be lulled into a false sense of relief. (§§5.11.6, 5.11.9, 5.11.10, 8.5 (6th ed.))

Continued Enjoyment of Transferred Property. The classic case for §2036(a)(1) application is a transferor who conveys title to a principal personal residence but does not vacate the premises, the transferees do not move in (not even to share occupancy), the transferor continues to pay all utilities, taxes, debt service, homeowner association fees, and other expenses, and literally nothing changes until the transferor dies. Even if the transfer purports to convey fee simple title, the government and the courts have little difficulty implying an agreed retention of enjoyment that brands the transfer as "testamentary" in nature and triggers estate tax inclusion as if title remained in the transferor until death. See, e.g., Estate of Honigman v. Commissioner, 66 T.C. 1080 (1976); Estate of Hendry v. Commissioner, 62 T.C. 861 (1974); Estate of Kerdolff v. Commissioner, 57 T.C. 643 (1972); Estate of Linderme v. Commissioner, 52 T.C. 305 (1969); Estate of Trotter v. Commissioner, 82 T.C.M. (CCH) 633 (2001); Estate of Bianchi v. Commissioner, 44 T.C.M. (CCH) 422 (1982); Estate of Stubblefield v. Commissioner, 42 T.C.M. 342 (1981); Rev. Rul. 70-155, 1970-1 C.B. 189. In these types of cases the implied agreement to retain possession is a difficult presumption for the taxpayer to disprove. See Estate of Whitt v. Commissioner, 751 F.2d 1548 (11th Cir. 1985); Estate of Garner v. Commissioner, 44 T.C.M. (CCH) 903, 907

(1982) ("The burden of proof is on [the taxpayer] to establish that an implied agreement or understanding did not in fact exist. The burden is especially difficult . . . where all objective evidence implies a pre-arrangement. Further, as we have recognized, the task of disproving the existence of an agreement or understanding between family members is a heavy one"). On occasion, however, continued exclusive residence will not result in inclusion, but the circumstances are not ordinary.

Estate of Tehan v. Commissioner, 89 T.C.M. (CCH) 1374 (2005), was representative of an easy case for the government in which the taxpayer failed to fit into one of the rare exceptions. Important in *Tehan* was an exception if retention of possession or enjoyment is for full and adequate consideration in the form of market rent. See Estate of Barlow v. Commissioner, 55 T.C. 666, 671 (1971), acq., 1972-2 C.B. 1 (gift of land to children who immediately leased it back for a reasonable rent; there was "no evidence whatever of a contemporaneous agreement, oral or written, express or implied, qualifying in any way the terms of the deed and lease"). But careful attention to the bona fides of the arrangement and rent paid is essential and, on this alternative argument in *Tehan* the evidence simply did not stack up for the taxpayer.

For example, in *Tehan* the parties agreed at the outset that the decedent would retain sole and exclusive possession, "shall not pay any rent, but shall be solely responsible for the payment of any mortgage secured against the Property, the monthly condominium assessment, the annual real estate taxes and insurance premiums for the Property, and all costs or expenses in connection with the maintenance and repair of the Property." Rather than seeking to determine the rental value of the ownership interest given to his transferees, and then paying fair market rent along with his own share of the carrying charges and other periodic expenses of his retained portion, this agreement made it undeniably clear to the court that "the decedent retained possession and enjoyment . . . within the meaning of §2036(a)(1)."

The existence of a lease will not necessarily salvage such a situation, as illustrated more recently in **Disbrow v. Commissioner**, 91 T.C.M. (CCH) 794 (2006), in which the taxpayer transferred the residence into a partnership, then transferred by gift all interests in the partnership, but continued to reside in the residence until death. Although the taxpayer executed a lease and paid rent, the stated rent was less than half the fair rental value and the taxpayer paid most expenses, taxes, and other carrying charges related to the dwelling without regard to the true arm's length rental value of the property. In addition, the partnership, as landlord, failed to treat the taxpayer as it would an arm's length tenant, agreeing to accept rental payments late and in lesser amounts than the lease required. Testimony from partners (children and their spouses) made clear that the lease was subterfuge and the court had no trouble finding the implied retention that triggered estate tax §2036(a)(1) inclusion.

Most recently in **Estate of Stewart v. Commissioner**, 92 T.C.M. 357 (2006), the decedent transferred a tenancy in common interest in two different parcels of real estate to a child but continued to receive all the rental payments from one of them and to reside in and to pay most of the expenses with respect to the properties until death. Notwithstanding a finding that the inter vivos transfers were completed gifts, the Tax Court had no trouble concluding that the property was fully includible in the decedent's gross estate under §2036(a)(1). In the process the estate lost what otherwise might have been a significant discount for transfer of a fractional interest in the property. Saying that the decedent's "retention of the property's income stream after the property was transferred is 'very clear evidence that the decedent did indeed retain "possession or enjoyment,"'" the court concluded that the decedent and the child

"had an implied agreement that decedent would retain the economic benefits of the . . . property." Also denied was a §2053(c)(1)(B) deduction for property tax assessments that arose postmortem because they were not the decedent's obligation. (§§2.7.6; 7.3.4.1, 15.5.3.3 n.58 (6th ed.))

Failure to Respect Discount Entities. [Note to readers: At some point the following discussion had to be reduced to just developments in the past year or so, rather than just getting longer, as added cases are decided and reflected in the analysis. For most of the "historical" aspects of this controversy see Pennell, *Recent Wealth Transfer Tax Developments,* 58 MAJOR TAX PLANNING ¶ 2104.2 (Univ. of Southern Calif. 2006). New to this iteration is *Estate of Rosen*, decided in June 2006. There have been noticeably few developments in over a year. Which in its own right may be revealing as an important metric.]

Creating an entity such as a family limited partnership or limited liability company as a vehicle for valuation planning is no more reliable than the client's ability and willingness to respect the underlying entity. After all, it is hard to expect the government or the courts to respect an entity that the client did not. That was the situation in a long and growing line of taxpayer loses including **Estate of Rosen v. Commissioner**, 91 T.C.M. (CCH) 1220 (2006), **Estate(s) of Korby v. Commissioner**, 89 T.C.M. (CCH) 1143 and 1150 (2005), aff'd 471 F.3d 848 (8th Cir. 2006) (two separate cases of spouses who died within five months of each other), **Estate of Bigelow v. Commissioner**, 89 T.C.M. (CCH) 954 (2005), **Estate of Hillgren v. Commissioner**, 87 T.C.M. (CCH) 1008 (2004), **Estate of Strangi v. Commissioner**, 85 T.C.M. (CCH) 1331 (2003), aff'd, 417 F.3d 468 (5th Cir. 2005) (*Strangi II*), **Estate of Thompson v. Commissioner**, 84 T.C.M. (CCH) 374 (2002), aff'd, 382 F.3d 367 (3d Cir. 2004), and **Estate of Harper v. Commissioner**, 83 T.C.M. (CCH) 1641 (2002), in which the government scored victories under §2036(a)(1) by causing inclusion of property transferred by the decedents into family limited partnerships because the decedents' history of dealing with the entities and the properties transferred to them belied a complete relinquishment for transfer tax purposes. In a sense it is an explanation for the result in **Senda v. Commissioner**, 88 T.C.M. (CCH) 8 (2004), aff'd, 433 F.3d 1044 (8th Cir. 2005), which was a gift tax case and not really in the same genre as these estate tax decisions. Still, the partnerships involved essentially were ignored by the parties (the government actually stipulated that they were valid for state law purposes) and therefore the transfers of partnership interests were regarded, for gift tax purposes, as gifts of the underlying partnership assets. In **Kimbell v. United States**, 244 F. Supp. 2d 700 (N.D. Tex. 2003), vacated and remanded, 371 F.3d 257 (5th Cir. 2004), the district court did not discuss the nature of the decedent's dealings with the entities in upholding a government motion for summary judgment on the §2036(a) issue. Instead, it was the fact that the decedent retained the power to designate the general partner that constituted the ability to personally benefit from the income of the partnership or to designate the persons who would, which the court said would run afoul of both §§2036(a)(1) and 2036(a)(2). That holding was vacated on appeal. *Strangi II* similarly relied on both §§2036(a)(1) and (a)(2) in its earlier iterations, but did not address the §2036(a)(2) issues at all on appeal, the court stating (in its footnote 17) that it need not delve into §2036(a)(2) because it reached inclusion of the transferred assets under §2036(a)(1).

Estate of Bongard v. Commissioner, 124 T.C. 95 (2005), was the 13-to-4 Tax Court reviewed opinion favoring the government, with ten judges signing the majority opinion that represents what may be the next wave of family limited partnership litigation, in which the

taxpayer dots every I and crosses every T but still is precluded from using the entity to generate valuation discounts. The government successfully applied §2036(a) to ignore the family limited partnership and value the underlying assets as if they were not held in the entity. In *Bongard* that only meant that a *second* level of discounts was denied, because the family business was already held in a holding company and the units in that entity *did* receive valuation discounts. So restraint is appropriate in any analysis of that case. Nevertheless, *Bongard* — as a reviewed decision that essentially embraces and marries the results in both *Kimbell* and *Thompson* — likely reflects the test/law that will inform these cases going forward. At least until a more definitive decision, if any. Given that *Bongard* had so many opinions, however, it also is the case that subsequent cases will reflect the views (differing on many refinements) of the various Tax Court judges, so at best a big-picture message may be the most that can be gleaned even from this high profile decision.

In a nutshell, the facts in *Bongard* reveal that neither poor timing nor neglect were involved. The taxpayer died unexpectedly at age 58, almost three years after creating a holding company to own family business stock. The government's challenge to discounts with respect to that entity were unsuccessful. The FLP that was ignored was formed about two years before the taxpayer died, to hold only the nonvoting units in the holding company. Also involved but unaffected by the ultimate treatment of the FLP were a variety of transfers made at the same time the FLP was created, conveying control units of the holding company to trusts for the taxpayer's children, grandchildren, and spouse (an inter vivos QTIP trust). Not quite a year before death the only inter vivos transfer of FLP interests was made (about 8%) to the taxpayer's spouse, *not* into the inter vivos QTIP, as part of a postmarital agreement. (This transfer apparently was not linked to a divorce or separation and there is no mention of any potential §2516 full and adequate consideration treatment; it may have been motivated by a state law minimum net worth requirement to support a valid postmarital agreement). The three year rule in §2035(a) was applied to defeat this transfer, which caused all the FLP interests to be valued as if the underlying assets were owned by the taxpayer at death. According to the facts, the partnership did not perform any management activities or transactions, never diversified its assets, and made no distributions. The holding company was deemed instrumental in a plan for "corporate entity liquidity," but not the FLP.

In contrast, perhaps, the facts in *Rosen* suggest that timing and neglect were the least of the taxpayer's problems, sufficiently so that the court concluded that only the first prong of the test ultimately adopted by the Tax Court in *Bongard* required the court's determination. See page 15. These facts included that the decedent was incompetent and demented when the partnership was created, the drafting attorney never once talked to the decedent or her son (one of the general partners), alleged asset protection motives were not viable explanations for creation of the entity because the decedent had no creditors (and was not likely to generate any), the children serving as general partners didn't even know the amount of their contributions before the partnership was created (indeed, the decedent made alleged gifts of partnership interests before the children made any contributions to the partnership, potentially indicating that there was no partnership at the time those gifts allegedly were made, which is an issue the court did not address), nor were there any negotiations with the children or others regarding any element (material or otherwise) relating to the creation or management of the partnership. There were no material changes in the care and feeding of the decedent or of her assets, the partnership conducted no business activity of any kind, and there were no partnership meetings, books, or minutes. The decedent contributed substantially all her assets,

retaining insufficient wealth to live on without depending on distributions from the partnership (and retaining insufficient funds also to continue gifting to descendants who were dependent on the decedent's annual exclusion gifts). Alleged loans to the decedent (in lieu of distributions) were without commercially reasonable terms and there was no repayment (nor any likelihood thereof). Not surprisingly, the court found that there was no credible business purpose for any of this — there was no creditor problem (and none was likely to arise), property management prior to the transfer was being performed perfectly well by a trust, and purported gifting strategies were both made more difficult (due to valuation issues) and could not constitute legitimate *nontax* purposes.

Senda involved a partnership, the interests in which ostensibly were transferred to trusts for the taxpayers' children, but no trust agreements existed and those trusts never filed income tax returns. So in addition to a total failure to respect the partnerships involved, the taxpayers consistently played fast and loose on the trust ownership level as well. The government stipulated to discounts of a relatively generous amount, *if* discounts were available at all. But Tax Court Judge Cohen simply found that: (1) Gifts should be measured by what the donor relinquished rather than by what the donees received. This a major determination in its own right, the court citing Treas. Reg. §25.2511-2(a), which is hardly ever even mentioned in cases of this nature. Judge Goeke merely referenced the rule in **Huber v. Commissioner**, 91 T.C.M. (CCH) 1132 (2006), but he relied upon it in **Koblick v. Commissioner**, 91 T.C.M. (CCH) 959 (2006),[1] to reduce a lack of control discount and thereby increase the value of a taxpayer's part-sale/part-gift transfer of a 45% stock interest to a charity as part of a prearranged transfer of 100% ownership involving simultaneous transfers by two other shareholders. Because of the next holding this was an unimportant statement in *Senda*, but this notion was repeated in substance by Judges Laro and Halpern in their separate opinions in *Bongard*. (2) The alleged contribution of assets to the partnerships followed by gifts of partnership interests to the trusts for the children were in reality just indirect gifts of the underlying assets directly to the children, to be valued by looking at the value of those assets proper, and not the alleged value of the partnership interests ostensibly transferred.

The facts in most of the recent cases are not very important — in the sense that the jurisprudence has turned a corner and now seems to be focused on several distinct and individuated issues or tests that appear likely to define the next chapter in this litigation saga, and perhaps amount to the end game in this entire book. In a nutshell the partnerships in *Strangi II*, *Thompson*, *Bongard*, and *Rosen* were regarded as disguised testamentary transfers, a method by which the decedents purported to make transfers that would minimize value but in fact retain possession and enjoyment pursuant to an express or implied understanding. To be clear, in all of these cases the partnerships were respected as valid under state law, but the transfers to them essentially were ignored because of these understandings. And prior to *Rosen* there was no concerted effort in any of these cases to fully articulate the §2036(a)(1) interest or §2036(a)(2) control elements that justify inclusion. It is as if the facts and circumstances in their totality simply inform a conclusion that one or another of the string provision inclusion rules applies. Said the Tax Court in all of these taxpayer defeats, each arrangement was a testamentary disposition in reality, serving no legitimate lifetime purposes.

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1. Involving "La Chalupa" — see it at www.photolib.noaa.gov/nurp/images/big/nur08013.jpg — which was a submersible laboratory used as an undersea hotel; the term is Spanish for "boat" or "launch," it also is Czech for "little house," or the name for a game of "Mexican bingo," all of which having some significance in the case. Most Americans know it as a corn tortilla formed into a small boat shape, fried until crisp (a tostada), and filled with meat, vegetables, and cheese.

Judge Laro actually addressed the §2036(a)(1) retained enjoyment issue in *Rosen*, although the opinion doesn't give much guidance. Indicative of retention of enjoyment until death were the fact that distributions were made (and the court found an understanding was implicit that they *would* be made) as needed by the decedent. Furthermore, no distributions were made to other partners (neither the decedent's children, who were original partners, nor donees of partnership interests that were gifted by the decedent's durable power of attorney holder prior to the decedent's death), the entire fund being held for the care and feeding of the decedent. In addition, substantially all of the decedent's assets had been transferred into the partnership, meaning that the decedent was completely dependent on partnership distributions. And efforts that presumably were intended to make the transaction appear more legitimate were deemed to be a mere façade — including purported loans in lieu of distributions and gifts that the estate claimed should preclude application of §2036(a)(1) to that portion of the partnership that no longer was subject to the decedent's enjoyment at death.

Although not in so many words, the *Rosen* opinion basically concluded that it didn't matter whether the decedent's assets were owned by her or by the partnership, nor whether partnership interests were owned by the decedent or her alleged donees; the net result was that she enjoyed the underlying assets and their income for the balance of her life, as needed, essentially without question or change. Essentially nothing changed by virtue of the creation of the partnership, as indicated by the decedent's use during life, payments made on the decedent's behalf postmortem, and the absence of any true enjoyment by other partners prior to the decedent's death.

A curious dichotomy arises in such cases. If the Tax Court was right in *Strangi I* when it held that creation of such an entity does not entail a taxable gift (the government's failed "gift on creation" argument, which a two-judge concurring opinion in *Thompson* also rejected), then quaere whether the decedent received full and adequate consideration for the property transferred on creation and funding of the entity. Said the concurring opinion in *Thompson*: "To me nothing could be clearer than a conclusion that if the discount was justified . . . in a valuation sense then the decedent could not have received an adequate and full consideration for his transfers . . . ." Full and adequate consideration for a transfer makes the exception to §§2036(a)(1) and 2036(a)(2) applicable by its own terms. And *that* becomes the true crux of all these most recent cases, on which the courts are making a mash of the law from which we may never recover.

The good news in that (if it can be deemed such) is that the courts have largely (but with *Rosen* not entirely) avoided making a mess of the §2036(a)(1) rule itself; the manipulation (as some would regard it) or elaboration that the courts are making in these cases is almost entirely centered on the full and adequate consideration exception that, until these cases came along, was largely a dead letter in wealth transfer tax considerations. That the courts are making a mash of this is much less significant to other forms of unrelated planning than if the courts were making law to defeat this form of perceived abuse with alterations to aspects of §2036 that are relevant in planning situations that are not regarded as abusive.

Tax Court Judge Nims rejected the full and adequate consideration exception in *Harper*, saying that it requires "a bona fide sale, meaning an arm's-length transaction," as well as full and adequate consideration. In *Harper* the court held that creation "at a minimum falls short of meeting the bona fide sale requirement" because the decedent controlled all aspects of the creation and operation of the entity.

The district court in *Kimbell* reflected a similar reasoning when saying that the decedent controlled 99.5% of the ownership interests involved and that "one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a 'bona fide sale'." That was found to be error by the Court of Appeals for the Fifth Circuit in *Kimbell* and by the Third Circuit Court of Appeals in *Thompson*.

Tax Court Judge Jacobs in *Thompson* raised a different impediment to the taxpayer's reliance on the full and adequate consideration exception. "[W]here a transaction involves only the genre of value 'recycling' and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of [§2036(a)] has taken place." According to the court, the full and adequate consideration exception was belied by such facts as none of the individual partners was involved in the conduct of an active business, that they did not actually pool their assets in a business enterprise with the decedent, there was no substantial change in investment strategy or activity, the partners did not conduct the partnerships in a business like manner, nor did the partnership engage in transactions with anyone outside the family or for business purposes. The Third Circuit Court of Appeals affirmed on this score, notwithstanding that it appears to improperly conflate the Treas. Reg. §25.2512-8 *business transaction exception* to the gift tax itself (no transfer for less than full and adequate consideration in money or money's worth is a gift if it is an arm's length business transaction free of donative intent) with the *full and adequate consideration exception* to §2036(a).

The business transaction exception does not require a business, nor does the full and adequate consideration exception to §2036(a). Rather, the former is about a "sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)," and there are plenty of intra-family transactions that are not at arm's length and not bona fide business transactions that still qualify for the full and adequate consideration exception to §2036(a)(1): a sale in exchange for a private annuity or a sale to a defective grantor trust are obvious examples. So too were the transactions in *Stone* and *Schutt*, as discussed beginning at page 18 below, along with the appellate court's view of the transactions in *Kimbell*, and the Tax Court's confirmation of this notion in *Bongard*, which said that an arm's length transaction is one between two parties conducted *as if* they were strangers. This test does not require unrelated parties. Rather, the record simply must show that unrelated parties would have agreed to the same terms and conditions, negotiating at arm's length. As said by Judge Laro in *Rosen*, " we test whether the resulting terms and conditions of the transfer of decedent's assets to the [FLP] were the same as if unrelated parties had engaged in the same transaction."

Nevertheless, the appellate court in *Thompson* rejected both the transfer for consideration and the bona fide sale aspects of the exception, essentially on the same grounds:

> Where, as here, the transferee partnership does not operate a legitimate business, and the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of section 2036(a).
>
> . . .
>
> . . . objective indicia that the partnership operates a legitimate business may provide a sufficient factual basis for finding a good faith transfer. But if there is no discernable purpose or benefit for the transfer other than estate tax savings, the sale is not "bona fide" within the meaning of section 2036.

Strangi II on appeal is even more confused, finding full and adequate consideration to exist but not a bona fide sale, the former based on the pro rata partnership test of the earlier decision of the same court in *Kimbell* but the latter based on the absence of any "substantial non-tax business purposes." What the courts' struggle in each case therefore reveals is that the full and adequate consideration exception is the most difficult element of the government's transfer with retained enjoyment case under §2036(a)(1). In *Kimbell* and *Thompson* both the courts on appeal held that the arm's length transaction position was error, and correctly so: as ably illustrated in Gans and Blattmachr, *Strangi*: A Critical Analysis and Planning Suggestions, 100 Tax Notes 1153, 1161-1163 (2003). Said the appellate court in *Kimbell*:

> the requirement that a sale be "bona fide" takes on heightened significance in intrafamily transfers and . . . a court should inquire beyond the form of a transaction between family members to determine whether substance justified the claimed tax treatment. However . . . just because a transaction takes place between family members does not impose an added requirement . . . . [Nor is] the absence of negotiations between family members over price or terms . . . a compelling factor in the determination as to whether a sale is bona fide . . . .

Both concepts were mirrored in *Thompson*, which stated: "[N]either the . . . Code nor the . . . Regulations define 'bona fide sale' to include an 'arm's length transaction.' . . . [W]e see no statutory basis for adoption of an interpretation of 'bona fide sale' that would automatically defeat the section 2036 exception for all intra-family transfers." *Bongard* ruled similarly and, as a reviewed opinion, probably puts to rest that error of the Tax Court in its earlier decisions.

The courts' struggle in these cases is evident in the *Harper* court stating as a matter of law that "where a transaction involves only the genre of value 'recycling' . . . and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of section 2036(a) has taken place." *That* aspect was the basis for half the holding in *Thompson*, which said "[w]here . . . the . . . partnership does not operate legitimate business . . . there is no transfer for consideration" for these purposes. It is not clear why a business purpose informs a transfer for consideration, which would exist if two taxpayers merely swapped Blackacre for Greenacre of equal values. Unnecessary dicta in *Harper* also wrongly stated that "a gift requires a donee: some other individual must be enriched" and, on that score, that there was no gift in this case, which need not be inconsistent with the lack of full and adequate consideration. The *Thompson* concurring opinion said virtually the same thing: "Even if the . . . discount is justified . . . that . . . does not mean that the value decedent lost upon creation of the partnerships went to someone else. . . . Therefore, . . . there were no gifts at all when the partnerships were formed."

That aspect of both decisions is improper: the gift tax does not require a donee; it only requires a transfer, for less than full and adequate consideration. What counts is that the donor no longer has the property and not that some other person does.[2] But in this both cases reveal something that is made clear by the concurring opinion in *Thompson*:

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2. *Strangi II* added unfortunate dicta suggesting that if other partners had contributed more than de minimis amounts to the partnership a general pooling of interests might better support a transfer for consideration argument. That odd statement appropriately might be directed at validity of the partnership itself and not to the full and adequate consideration exception, and in any event it was rejected by *Kimbell* on appeal, the court stating the government's challenge based on "the de minimis contribution to the partnership made by the other partners . . . does not justify treating the transaction as a sham. In addition, we know of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide."

> . . . the logic of the court in this case should not be applied too broadly. . . . Here . . . we have a narrow situation in which the partnerships were created in furtherance of what the estate calls an "estate plan" with [t]he primary purpose to . . . save taxes [and] . . . not to engage in or acquire active trades or businesses . . . . I do not want it thought that the court's reasoning here should be applied in routine commercial circumstances . . . even within families.

If you're getting a dizzy headache from all this it is because these cases have so many either wrong or (at a minimum) inconsistent statements within them. Yet a few clear conclusions can be stated.

For example, all these quibbles in each case aside, the clear message from *Rosen*, *Bigelow*, *Harper*, and *Thompson* is that entities must be created and treated properly, and it seems relatively clear that proper supervision and oversight might have averted the trap into which these families fell. That may *not* be sufficient, however, in a case like *Bongard*, *Strangi II*, or *Kimbell* in the District Court, in which control over the partnership was apparently the linchpin to operation of the §2036 string provision in the first instance. In those types of cases the first line of defense must be the full and adequate consideration exception to §2036(a) in its entirety, which the courts found in *Stone* and *Schutt* (discussed at page 18 below) and on appeal in *Kimbell* but not in *Strangi II* or *Thompson* on appeal, nor in *Bongard*, *Bigelow*, *Korby*, or *Rosen* at the Tax Court. Among all of these it is *Kimbell* that is worth discussing first.

The *Kimbell* court on appeal found that the full and adequate consideration exception was applicable, and correctly stated the nature of that exception as focused on a diminution in net worth determination. To wit: if Blackacre and Greenacre are of equal value, and two parties choose to exchange them, there is no reason for the wealth transfer tax to apply in any respect — neither the gift tax inter vivos nor the estate tax string provisions at death — because neither taxpayer has caused a reduction in their net worth by virtue of their swap. This would be true even if, for whatever reason, one party allowed the other to retain the right to control the enjoyment of both assets. That retained control might actually increase the controlling transferor's net worth, but this transfer with retained control is of no concern to the wealth transfer tax. It is only when an inter vivos transfer *diminishes* the transferor's net worth that any of the estate or gift tax string provision rules is needed to protect the fisc. So retained enjoyment or control in a full and adequate consideration transfer is irrelevant.

Thus stated, the critical inquiry for analysis of this exception is whether the transfer reduced the transferor's net worth. The court on appeal in *Kimbell* correctly held that this is the proper standard, stating that full and adequate consideration *is* determined under a diminution in net worth approach and that the full and adequate exception is met *if* there is no reduction caused by the exchange. This is an objective test, not based on subjective intent. And it is completely consistent with the proper operation of the estate tax string inclusion provisions.

But then the *Kimbell* court on appeal held that full and adequate should focus on three elements that really don't speak to the diminution in net worth analysis at all. Said the court:

> The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the

> partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

If that is correct it must be an indication that, to this taxpayer, the transaction presents a fair or proportionate opportunity to benefit from any business success, which speaks to a subjective determination that to the taxpayer this is fair consideration for the assets transferred into the entity. In a sense, that speaks to the bona fide business transaction exception to the gift tax, and not to the full and adequate consideration exception to the string provision. Still, *Bongard* referenced it as a factor in the full and adequate consideration exception, along with factors it borrowed from *Thompson* and characterized by Judge Halpern as "bearing on whether the transfer was in the ordinary course of business" — which also informs the business transaction exception and not the full and adequate consideration exception. In any event, it doesn't square with a diminution in net worth analysis.

Oh, and by the way, notice that this formulation does not consider contributions to a partnership other than of assets (such as services). And this formulation — available to the court in *Thompson* (which specifically held off ruling until *Kimbell* was decided and the parties were allowed to submit briefs that reflected that opinion) — was *not* embraced there, the court in fact finding a lack of consideration and a lack of bona fide sale, in both respects based on the absence of any legitimate business purpose ("the record demonstrates the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests" and "there is no discernable purpose or benefit for the transfer other than estate tax savings"). Further, *Strangi II* limited the pro rata partnership test to the full and adequate consideration aspect of *Kimbell* and, like *Thompson*, also rejected the notion of a bona fide sale as found in *Kimbell*.

By all appearances *Bongard* tries to marry the *Kimbell* proportionality approach and the *Thompson* business purpose tests, as shown by the following articulation of the test the Tax Court majority established:

> In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. [Citing *Stone* and *Harrison* but not *Kimbell* — which generated the proportionality test — or *Thompson* — which relied on the nontax reasons approach.] The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. [Citing *Harper* and again *Harrison*.] A significant purposes must be an actual motivation, not a theoretical justification. [Citing no authority.]
>
> By contrast, the bona fide sale exception is not applicable where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose. [Citing *Hillgren*, *Thompson*, *Harper*, and *Reichardt*.] A list of factors that support such a finding includes the taxpayer standing on both sides of the transaction [citing *Hillgren*]; the taxpayer's financial dependence on distributions from the partnership [citing *Thompson* and *Harper*]; the partners' commingling of partnership funds with their own [citing *Harper*]; and the taxpayer's actual failure to transfer the property to the partnership [citing *Hillgren*].

Notice that *business* reasons were not required — only "nontax" purposes ("significant and legitimate" being the only adjectives used) but elsewhere *Bongard* referenced both business and nontax purposes, when finding that the holding company in that case met the full and adequate consideration exception and in Judge Laro's concurring opinion, which said the full and adequate consideration exception would be met if the transfer was "an ordinary commercial transaction . . . made with a business purpose or, in other words, a 'useful nontax purpose . . . '." In *Rosen* Judge Laro stated the test in this manner: "We must find that the reason was an important one that actually motivated the formation of the partnership from a business point of view." Is this a true "business purpose" test or something slightly different, and what evidence would suffice?

In this regard, there is an end game that appears to be developing. It is not more clearly defining the approach that courts are going to pursue in cases of this ilk, because today that big-picture approach seems pretty clear. Rather, it entails refinement of the particular "test" being applied, in terms of what the courts are looking for and the types of facts or factors that might establish the kind of legitimate, significant, important, business, nontax, or . . . (you name it) other kind of circumstance that must exist to establish the distinction that the concurring opinion in *Thompson* was trying to articulate. It would be honest today to say that no one can do more than guess at what might suffice, especially because the myriad factors that did not carry the day in a variety of these cases was different in each. This is a facts and circumstances test — a subjective analysis (notwithstanding statements to the contrary in *Strangi II* on appeal), and there is (yet?) no way to establish a checklist or "best reasons" kind of summary of the things that will succeed.

Indeed, it may be the folly of those seeking bright lines to ask "what business purposes will suffice" — because courts are not likely to give a pass to those who dummy up a rationale that doesn't fit the circumstance. A sense of smell is probably the best tool to use, because at the end of the day what courts appear to be doing is opening the taxpayer's file and flipping through all the pages to see if the propriety of the planning is plainly apparent or whether the reasons propounded merely attempt to mask the stink of abuse. It ought to be clear to an objective observer that the entity used was the right plan under the circumstances — a judge, for example, should be able to peruse the file and say "oh, sure, I understand why this approach made sense," without regard to any tax motives or savings that might *also* flow. Trying to cobble together a check list of possible successful motives is likely to be perceived as just sprinkling cologne on illegitimate planning. Indeed, trying to dress up what otherwise would be legitimate planning to make sure it will pass muster may actually hurt a taxpayer, by burying a perfectly beautiful and legitimate case under layers of cosmetics that sully rather than improve the appearance of the situation.

None of the foregoing should be taken to say that there is uniformity in the approach that the courts are following. There is a clear trend, but not unanimity. For example, Judge Halpern in his dissent to *Bongard* argued that both components of the Tax Court's test are corrupt ("the majority has strayed from the traditional interpretation of the bona fide sale exception by incorporating . . . an inappropriate motive test ('a legitimate and significant nontax reason'), and by concluding that a partnership interest 'proportionate' to the value of the property transferred constitutes adequate and full consideration in money or money's worth"), which just confirms how the courts are struggling to preclude abuse while employing traditional precedent without creating inappropriate consequences to legitimate businesses. To

give more significance to this notion, study *Strangi II*, which tries valiantly not to overrule the prior authority in the same circuit, making the following statement:

> We think that the proper approach was set forth in Kimbell, in which we held that a sale is bona fide if, as an objective matter, it serves a "substantial business [or] other non-tax" purpose. As noted supra, Congress has foreclosed the possibility of determining the purpose of a given transaction based on findings as to the subjective motive of the transferor. Instead, the proper inquiry is whether the transfer in question was objectively likely to serve a substantial non-tax purpose. Thus, the finder of fact is charged with making an objective determination as to what, if any, non-tax business purposes the transfer was reasonably likely to serve at its inception.

Notable about this — shocking, perhaps — is how it twists what actually was said in *Kimbell*, as reproduced in its entirety here:

> As stated previously, the district court found that the transfer by Mrs. Kimbell of assets to the Partnership in exchange for pro-rata partnership interest was not a bona fide sale. Ignoring circuit precedent established in Wheeler, the district court's conclusion was based on its erroneous assumption that an arm's length transaction, defined as one between persons who are not related, was a requirement of this exception. The district court also concluded that the transaction resulted only in a change in form, a recycling of value, which would also preclude a conclusion that this transaction was a bona fide sale. However, its analysis ignored record evidence in support of the estate's position that the transaction was entered into for substantial business and other non-tax reasons.

It is difficult to see in this extract from *Kimbell* (to which *Strangi II* cites) that the court created any kind of a test, much less the one the *Strangi II* court embraces and attributes to *Kimbell*. Note especially the not insignificant one word change of "and" to "or" in the *Strangi II* rendition. To the court's credit in *Strangi II* on appeal, the court contorted to avoid creating dissonance in the Fifth Circuit, but as counsel to the taxpayer in *Strangi II* said in Leimburg Information Services, July 20, 2005, "I think that *Strangi* undercuts *Kimbell*."

Herein lies the critical component in all this mess: the bona fides of the family limited partnership as anything legitimate other than a transfer tax reducing device that should not succeed. Only the most ardent purveyors of this endeavor fail to appreciate the impropriety of the claimed discounts in cases in which the entity is merely a "wrapper" designed to do nothing other than fabricate valuation adjustments. And the courts are telling taxpayers and their advisors that the courts are savvy about the distinction between what *Bongard* called "the true nontax reasons for [an] entity's formation [and] those that merely clothe transfer tax savings motives. Legitimate nontax purposes are often inextricably interwoven with testamentary objectives." *Rosen* said it thus: "The reason must be an actual motivation, not a theoretical justification, for a limited partnership's formation." What that means remains to be established, but there are some cases that may help.

Two rare Tax Court victories for the taxpayer emerge from facts that, upon close inspection, are so fundamentally different from the typical §2036 case as to raise the question whether any run-of-the-mill cases can be so treated. Much like Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶60,369 (W.D. Tex. 2000), the facts as developed during the course of litigation reveal that the government probably never should have sought to make a case in

Estate of Stone v. Commissioner, 86 T.C.M. (CCH) 551 (2003), or in **Estate of Schutt v. Commissioner**, 89 T.C.M. (CCH) 1353 (2005), because the realities as finally uncovered suggest situations so unlike the manipulations illustrated by the likes of *Strangi* or *Thompson*.

By way of example, in the *Stone* consolidated cases involving the estates of a husband and wife who died within less than 17 months of each other, the overwhelming evidence showed family limited partnerships created with the primary objective of putting an end to protracted squabbling by the couple's four children, and not for the purpose of ginning up valuation discounts. The parents ultimately hired their own lawyer, who held a dozen different meetings and prepared five rounds of partnership drafts that circulated among the children and each of their separate independent counselors, who generated numerous changes in the agreements. At the heart of the ultimate creation of five separate partnerships was a desire on the part of each child to play an instrumental role in the management and devolution of separate properties, in addition to the family business. So each child essentially became the sole second generation partner with the decedents in separate partnerships that divvied up the assets in which each child had a particular interest. A fifth partnership essentially held the family crown asset.

It is critical to note that not all the decedents' assets went into these five partnerships: a bevy of accountants were hired to work with the decedents' attorney to calculate (using different income yield and life expectancy factors) the amount of wealth the decedents would likely need to maintain their accustomed life styles. So, quite unlike *Strangi* or *Thompson*, in which the decedents apparently did not retain enough outside assets to finance normal day-to-day needs *or* end of life health care, the court specifically found that the *Stone* taxpayers intentionally and quite carefully estimated their needs and retained adequate independent assets.

A final distinction from cases such as *Strangi* or *Thompson* was that the residence placed in one *Stone* partnership was abandoned by both decedents: no continued occupation of that property was involved after creation of that partnership. In addition, partnership distributions and accountings were consistent with legitimate partner contributions by the children.

Among the issues addressed in *Stone* were: (1) whether the transfer on creation was made for adequate and full consideration in money or money's worth: the court found that it was; and (2) whether the taxpayers retained sufficient enjoyment as to trigger application of §2036(a)(1). The court did not reach this final issue, because its finding regarding the full and adequate consideration exception was adequate to quash the government's §2036 case. In that respect the court reached what it regarded as two essential conclusions: that there was a bona fide agreement reached at arm's length, with each party to the transactions being separately represented, and that the consideration received by the taxpayers was full and adequate.

The various facts and circumstances in this unusual case belied the government's allegation that it was yet another "mere recycling of value." The court found that the taxpayers did more than "change the form in which [they] held [the] beneficial interest in the contributed property" and that the five partnerships "had economic substance and operated as joint enterprises for profit," such that each child was an active participant with respect to management of the respective assets that each child cared about. Most telling was the court's footnote 75, distinguishing *Strangi* and *Harper* because each "patently fail[ed] to qualify as the sort of functioning business enterprise that could potentially inject intangibles that could lift the situation beyond mere recycling." *Stone* differed because the court found there to be a legitimate pooling of assets with a joint enterprise expectation and profit motive. *Thompson*

and *Rosen* made the same kind of inquiry and found the lack of any active trade or business motive. In a nutshell, *Stone* is the type of case in which taxpayer allegations regarding all the business purpose reasons for creation of the partnership actually were true! In a *Kimbell* context it also may be that there were legitimate expectations that intrinsic value was created by these partnerships.

Schutt is another very interesting decision that thrice reminds readers of "the unique circumstances of this case," probably signaling that the decision therefore is not predictive of the result to expect in other cases. Among the salient facts is that the decedent had a 30 year relationship with the planning attorney, the significant nontax purpose involved was an investment philosophy ("buy-and-hold") supported by a 20 year documented record of intent (and one that likely is the opposite of what good investment advisors would recommend today but that the decedent strenuously wanted to force on family wealth that he did not have the power to control).

The planning was not a single party endeavor in any sense, there being an independent third party (Wilmington Trust Company) that was not under his control, that was separately represented, and that very carefully evaluated its potential for liability from engaging in the transaction, which itself took over 13 months to structure and accomplish, with numerous conferences, memoranda, drafts, and indemnifications from every living (adult? — the opinion is contradictory) beneficiary of any of the three affected family trusts that the Trust Company administered. Funding of the Delaware business trust (similar to a partnership) was timely and proper, with all the appropriate forms correctly completed, and distributions following creation were carefully monitored, periodic and timely, and made pro rata. There was no commingling of assets or personal use by contributors, and the decedent withheld approximately $30 million of his own wealth to "scrape by" on without needing to invade the entity for his support.

The *Schutt* opinion relied heavily on the test adopted by *Bongard* and on the appellate court opinion in *Thompson* (because appeal would be to the Third Circuit Court of Appeals) and made clear that the Tax Court regards those two positions as correlated and consistent. Regarding the legitimate and significant nontax factors involved, the Tax Court held that

> various factual circumstances weighing on this analysis . . . include whether the entity engaged in legitimate business operations, whether property was actually transferred to the entity, whether personal and entity assets were commingled, whether the taxpayer was financially dependent on distributions from the entity, and whether the transferor stood on both sides of the transaction.

Among other things, discovery revealed that tax aspects of the transaction did not predominate in either the taxpayer's focus or selection of the mechanism employed. In this particular case one factor normally regarded with disfavor was exactly the opposite — the fact that the portfolio was untraded following creation, which was appropriate only because the objective of the planning was the decedent's desire to impose dead hand restraints on future family generations.

It is not clear whether the availability of other devices to accomplish that goal would matter, but other factors noted by the court in passing relating to the bona fides of the transaction included (1) the contributed property was actually transferred (2) in a timely manner, (3) personal and entity assets were not commingled, (4) the decedent was not financially dependent on distributions from the entity, (5) nor was the decedent standing on both sides of the transaction. (6) The situation "bears the earmarks of considered negotiations,

not blind accommodation," (7) others contributed more than half the property involved, and (8) the decedent used his own property primarily to alter his relation to those other assets — a reference to the fact that the decedent was "leveraging" his wealth in his desire to control the investment future of the wealth in trusts created by others (his wife and her father) over which he had no long term control. Perhaps more than any single factor, the notion that the decedent was motivated to accomplish real control over property that was not his to govern is a distinction that likely will differentiate *Schutt* from most any other situation.

So one piece of learning to be garnered from these decisions is that factually a taxpayer is likely to be somewhere on a continuum between cases like *Strangi* and *Thompson* with very poor facts in the taxpayer's favor, and *Stone* or *Schutt* in which the facts are quite favorable. In judging what to do about existing discount entities it pays to step back and make a clear eyed assessment of the facts of a particular case and seek to place the situation in the appropriate position on that spectrum. The only predictably successful cases these days are those with an active trade or business — not just a basket full of alleged nontax reasons for the entity — and a legitimate profit motive that is enhanced by the chosen entity. Shy of those kinds of bona fides, it is anyone's guess what will come of such planning. (§§7.3.1; 7.3.4.1 n.101; 7.3.6; 15.3.1.4 n.137 (6th ed.))

5. Section 2053: Deduction for Debts and Administration Expenses

Consideration of Postmortem Facts to Value Deduction. As evidenced by the fact that the government's priority guidance plan has listed a project on the subject that has rolled over for over four years (see page 2 regarding the business plan), and given its implications for inclusion valuation purposes as well (see *McCord*, at page 28), the topic of greatest concern in **Estate of Hester v. United States**, *** F. Supp. 2d *** [2007 U.S. Dist. LEXIS 14834] (W.D. Va. 2007), is much more important than the particular situation involved. The decedent allegedly embezzled from a trust by commingling trust funds with the decedent's personal funds. That breach ostensibly created an obligation to repay the trust remainder beneficiaries, for which the estate claimed a refund based on a §2053(a)(4) deduction that it claimed it should have taken when it filed its estate tax return. It is not clear whether the claim was nonclaim statute unenforceable because notice was published and no objections were timely filed in the probate proceeding. Nevertheless, the court treated the claim as if it was viable and the running of a standard statute of limitation was relevant to the proper valuation of the deduction that otherwise might be available. In doing so the court followed a line of cases that "consider post-death events in determining deductibility of theoretical liabilities," which is how the court viewed a potential claim that never was brought. Citing *Estate of Hagmann v. Commissioner*, 60 T.C. 465, 468 (1975), the *Hester* court held that "[a]llowing a deduction here, where a taxpayer is attempting to secure a refund for a theoretical liability that will never be paid and that is now barred by the statute of limitations, would essentially 'exalt form over substance.'" Because neither the decedent nor the estate had an unconditional and legally enforceable obligation for the payment of money, the court concluded that there was no indebtedness for §2053 deductibility.

Numerous prior courts have struggled with the fundamental issue of the admissibility of postmortem information in determining the deductibility of the decedent's debts and claims

against the estate. The Tax Court in particular has characterized this question as falling into two primary categories. In the first, enforceability of the debt after the decedent's death was the issue (because no §2053 deduction is available for a debt that expires with the decedent or that was contingent or otherwise not yet mature at the decedent's death). Postmortem developments are regarded as relevant in these cases to determine whether the debt was enforceable at the decedent's death. In the other category the issue is regarded simply as the value of the debt or claim for deduction purposes, which must be determined based on the facts and circumstances that existed at the decedent's death. Postmortem facts may be relevant in these cases to determine the date of death value, but postmortem events or circumstances that change the value of the debt may not be considered. At least the theory is that the amount deductible in all these cases should be the value of the liability as of the date of death, which need not match *either* the amount owed or actually paid. In practice, however, that amount may not be known or knowable until well after death, and the proper treatment of postmortem discovery of facts that did exist at death will continue to vex taxpayers, the government, and ultimately the courts alike. In this respect, the amount paid is likely to be the best indicator of the value of a claim as well as the likelihood of it being asserted. For postmortem administration purposes, the message of these cases may be that, at a minimum, creditors should be required to prove up their debts and to accelerate payment of claims during a probate proceeding so that any legitimate obligation in fact will be paid during probate and thereby be deductible. (§15.5.2.2 (6th ed.))

6. Section 2055: Charitable Deduction

Application of Split Interest Trust Rules. The unfortunate reality is that some charitable gifts, drafted exactly as the settlor intended, will not generate a charitable deduction. There are a slew of unanswered questions raised by **Galloway v. United States**, 2006 U.S. Dist. LEXIS 28637 (W.D. Pa. 2006), in which the estate tax charitable deduction was disallowed, because the trust in question did not comply with the highly technical §664 charitable split interest trust rules. For example, it is not stated whether the settlor intended to qualify for the charitable deduction, or whether the drafter considered with the settlor whether the trust might generate that benefit if it were modified in a slight respect. Nor does the opinion articulate why the decedent's 1991 inter vivos trust called for a two-stage distribution, half in 2006 and the other half in 2016, in equal shares among two individual beneficiaries (a child and a grandchild) and two charities. If either named individual predeceased either distribution (in 2006 or 2016) the corpus would be divided among the remaining beneficiaries — with the potential that 100% ultimately might pass to just the two charitable entities — but with the damning potential that the trust would benefit the private beneficiaries prior to distribution to charity.

The opinion actually does not say what happened to income prior to final distribution, although a reference to the rationale for the split interest trust rules (which the court says anticipate abuse through investment "in high-income, high risk ventures, . . . to maximize income . . . in the short-term, and deplete the corpus of the trust prior to distribution in 2016") makes it appear that income was distributable among the four equally in the years prior to either distribution. The opinion does not indicate why the trust was includible in the estate of the settlor, although it says the settlor was the original trustee and perhaps §§2036 and 2038

were applicable because of trustee powers retained by the settlor. We don't even know whether that inclusion was anticipated. Finally, there is no indication whether an effort was made to reform, disclaim, or even just sever the trust to salvage a charitable deduction for the half that surely would pass to charity. And therein lay the §664 violation.

None of this matters: the important point is that the trust was not a proper split interest charitable remainder trust, albeit the trust provided for private and charitable beneficiaries together. According to the court, this plan therefore needed to comply with the §664 split interest trust rules to qualify for the estate tax charitable deduction (and the same would be true had the income tax charitable deduction been involved). Sadly, a deduction would have been available for half the value of the trust if the corpus had been divided at inception into two separate shares — one exclusively for charity. The other half, held for the private individuals with a potential (but nondeductible) remainder for charity would not have been deductible, but it is not apparent from the decision whether a deduction was sought by the estate for more than just the half that definitely would pass to the two charities.

In the less sympathetic but somewhat similar case of **Estate of Tamulis v. Commissioner**, 92 T.C.M. (CCH) 189 (2006), the decedent (a priest) created a trust to make annual payments to several relatives until the death of two named individuals (or ten years, if longer), remainder to a Catholic Diocese. Unfortunate was that several parties endeavored to reform the trust but no court modification or §2055(e)(3) reformation ever was instituted, leaving this estate also without the charitable deduction. Because of the same flaw — shared enjoyment by private and charitable beneficiaries without compliance with the §664 split interest trust rules.

For planning purposes the important lesson from both cases is simply that combination of private and charitable beneficiaries in one trust, without complying with the charitable split interest trust rules, is almost certainly going to generate an unnecessary tax. That may be a price the settlor was willing to pay, because the structure that the settlor anticipated was more important. And it may be that the drafters in *Galloway* and *Tamulis* properly advised the settlors and drafted exactly what the settlors requested, even after being fully advised. But the loss of any charitable deduction in either case that begs for equitable relief and a less severe (but technically correct) result meant that the Treasury benefited from more tax, which the charitable remainder beneficiaries bore (in *Galloway*, equally with the private beneficiaries). In *Galloway* the facts did not even create an opportunity for abuse in the half that was destined exclusively for charity, making loss of the deduction for that half a total waste. (§§14.3.2, 14.3.7 (6th ed.))

7. Section 2056: Marital Deduction

Qualification of IRA or Qualified Plan Installment Payment. **Rev. Rul. 2006-26**, 2006-1 C.B. 939, modifies "and, as modified, supersedes" Rev. Rul. 2000-2, both dealing with the all-income-annually requirement for marital deduction qualification. This relates to an IRA or defined contribution plan (an account) as to which the designated beneficiary is the surviving spouse or a QTIP trust. The two rulings are not relevant to a lump sum beneficiary distribution, and the new ruling adds nearly nothing to prior understandings of the government's relevant concerns. Which remain the notion that the all-income-annually

requirement must be met, which may require several special tweaks to an account or to the QTIP trust named as its beneficiary.

In a nutshell, the primary requisite is that the surviving spouse must be entitled to the greater of (1) the minimum required distribution amount (this is a qualified plan or IRA requirement) and (2) an amount equal to all income earned in the account for the year (this is a marital deduction requirement). Situation 2 in the new ruling is a reminder that a 3% to 5% unitrust regime authorized under state law is deemed the equivalent of all income annually, which means that the minimum required distribution to a surviving spouse who is over age 45 will satisfy these requirements for marital deduction purposes with no special drafting concerns. This is because a surviving spouse who is at least age 46 has a life expectancy of slightly less than 33 years, which would require slightly more than 3% of the value of the account to be distributed annually as the minimum required distribution. Because a minimum of 3% is regarded as all income annually under the unitrust equivalence regime, no special drafting about distribution of the greater of all income or the minimum required distribution would be needed. Nevertheless, many cautious drafters will state the annual distribution as the Ruling encourages, just as a reminder to the fiduciaries involved and a salve to any government watchdog. Even without such, however, qualification should not be a problem.

Note in this regard that the all-income-annually requirement is a "real income" fiduciary accounting notion. In this respect the ruling clarifies that a state law that resembles the Uniform Principle and Income Act §409(c) allocation regime[3] will *not* suffice to meet the marital deduction requirement. A wise drafter might simply disable that statutory provision to the extent it is inconsistent with the all-income-annually requirement. Indeed, some marital deduction saving clauses do just this, specifying that no law or provision that would interfere with qualification shall apply.

Also remember that the government thinks of the account and the QTIP trust named as its beneficiary as two separate QTIPs, each requiring its own separate QTIP election. Further, the drafter should address the unproductive property rules for all-income-annually purposes and select between the two alternatives in Treas. Reg. §20.2056(b)-5(f)(4) (trustee must obtain consent of the spouse to hold unproductive property, or the spouse can compel its conversion) or -5(f)(5) (trustee must distribute or spouse may withdraw corpus equal to any deficiency in income). If (as the facts of the ruling state) the IRA or qualified plan document does not prohibit withdrawal of a greater amount than the minimum required distribution, then reliance on the Treas. Reg. §20.2056(b)-5(f)(5) right of withdrawal alternative probably is the easier approach to comply with the unproductive property issue. Although the Ruling makes no mention of this alternative, the right to withdraw corpus equal to any deficiency in income is an authorized option and it would be uncommon to find an IRA or qualified plan document

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3. §409(c) specifies that

> If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

No mention is made in the ruling of §409(d), which provides: "If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction."

that prohibits withdrawal of a larger amount than the minimum required distribution. Notice, however, that this unproductive property issue is in addition to the primary focus of the Ruling, which is on the right to an amount equal the "greater of" all income or the minimum required distribution. (§§9.4 n.10; 13.5.6.7 and nn.258, 259, 263; 13.5.7.2 n.310 (6th ed.))

Sheltering a Spouse's Unified Credit. In the context of planning for spouses who together have more wealth than the estate tax applicable exclusion amount ($2 million through 2008, $3.5 million in 2009) but less than double that amount the hard issue for an estate planner is how to avoid wasting any of the unified credit of the first of them to die. If events presented the proper opportunity the expected survivor could make a transfer of assets to the spouse whose death is impending, but reliance on death bed planning to "fill up" the decedent spouse's estate with enough wealth to maximize the shelter benefits of the unified credit is not very efficient. As one alternative the joint settlor revocable trust that is familiar in community property states is a well considered option that works in noncommunity property states as well. It allows the couple to mimic the effect of the survivor giving the soon-to-be decedent enough wealth to run through the first estate and maximize the tax sheltering benefits of the decedent's unified credit (or generation-skipping transfer exemption). The government previously has ruled on the effect of this planning, with every aspect of their position being favorable to taxpayers except to the extent the taxpayer wanted to avert §1014(e) and generate a new basis in both spouses' assets on the death of the first to die. See Private Letter Rulings 200210051 and 200101021 for confirmation that the government is doing right by taxpayers in this.

A refinement in **Private Letter Rulings 200604028 and 200403094** may be attractive to many clients because it does not entail a joint trust and the control granted to the first spouse to die is limited to a formula driven general power to appoint (inter vivos likely being a "better" power than a testamentary version) the amount of the decedent spouse's "remaining applicable exclusion amount." Otherwise the same regime is employed, with the formula general power over just the limited amount being used to soak up any unused part of the deceased spouse's unified credit, with the full applicable exclusion amount passing into a nonmarital trust for the survivor for life, with no subsequent inclusion in the survivor's gross estate on the second death. One refinement that has not been addressed but that seems reasonable (as a means of minimizing the need to trust the holder of this general power) is to make the power exercisable one time only, and for the powerholder to make a formula election *or release* of just the amount (if any) needed to soak up any unused applicable exclusion amount, and guaranteeing that no later (unexpected or unwelcome) exercise can occur. Make the exercise or release effective upon the death of the powerholder so as to avoid any possible gift during the powerholder's life, or retain a narrow nongeneral power of appointment over the amount that otherwise would constitute a gift, all to avoid §2514 gift tax liability.

Other alternatives are available, such as the related alternative addressed in **Private Letter Ruling 200413011**, which was in the form of an inter vivos QTIPable trust created by a wealthy spouse for a poor spouse, with the following refinements:

- The trust was fully revocable (through a retained power of appointment) on creation, so the donor made no taxable gift at creation.
- If the donor released the power to revoke during the donor's life the trust could be made to qualify as QTIP by making the requisite election inter vivos.
- If the donee spouse then died first the property would be includible in the donee's gross

estate under §2044 and would be divided between marital and nonmarital trusts as in traditional planning, to shelter the unified credit of the donee spouse, with the nonmarital trust not being includible in the donor's gross estate at the second death.

This plan was desirable because it was undoable (for example, in the case of divorce) and did not give the donee spouse control. Nevertheless it satisfied the need to shelter the donee spouse's unified credit. It was, however, subject to a risk that the donor would not release the power to revoke in a timely manner and make the QTIP election before the donee spouse died.

The government has been most consistent in holding that there is no §2036 problem for the surviving spouse in this planning. The surviving spouse is beneficiary of a nonmarital trust created by the first spouse to die, or of a trust of the survivor's own creation in default of exercise of the deceased spouse's general power. But in either case there is no potential estate tax consequence to the surviving spouse to the extent any of the survivor's property is includible in the estate of the first deceased spouse. The government consistently has ruled that inclusion to the deceased spouse cleanses the wealth and eliminates the concern of the survivor having made a transfer with a retained secondary life estate. See Treas. Reg. §25.2523(f)-1(f) Example 11. No untoward §2041 inclusion should arise if any powers granted to either spouse are properly circumscribed, and exercise of powers is not actually required by the first deceased spouse if the default provision properly sends any amount includible in the estate of the deceased spouse into a bypass style trust for the survivor's benefit. So, in a nutshell, it is easy to embrace planning that avoids loss of any part of the unified credit of the deceased spouse. (§§4.1.14; 7.3.2; 10.7; 13.2.5; 13.3.2; 13.5.6; 13.5.6.5; 15.8.2 (6th ed.))

Equitable Recoupment. Estate of Buder v. United States, 372 F. Supp. 2d 1145 (E.D. Mo. 2005), aff'd, 436 F.3d 936 (8th Cir. 2006), involved the estates of Decedent (D) and Surviving Spouse (S) and prior litigation found at 7 F.3d 1382 (8th Cir. 1993). D's estate claimed and was allowed a §2056(b)(7) marital deduction for a trust, notwithstanding that "the parties agree that the QTIP election made by [D's] estate was improper. They further agree that the [trust] therefore should not have been included in [S's] estate." S's estate included the value of that trust under §2044 and paid estate tax and, because that was improper, S's estate subsequently sued for a refund, which was at the core of the current case. The government asserted that it could reduce the refund that it clearly owed to S's estate by the amount that it should have collected from D's estate had the marital deduction properly been disallowed.

Normally the government would have been barred from collecting that tax liability by the estate tax statute of limitation. But the concept of equitable recoupment permitted the government to use D's estate tax liability as an offset against the refund owing to S's estate because three requirements were met: (1) there was a single transaction subject to two taxes on inconsistent legal theories, (2) the statute of limitation for asserting the liability in D's estate had expired, and (3) there was a sufficient identity of interest between the various taxpaying parties. The court found that the single question common to both taxpayers was the appropriate estate in which D's trust should be included for estate taxation, and it regarded the erroneous marital deduction and the erroneous inclusion in S's estate as constituting the single transaction subject to two taxes on inconsistent legal theories.

Because it was clear that the statute of limitation in D's estate had long since expired, the only question of any significance was whether there was a sufficient identity of interest between the two estates to properly apply the doctrine of equitable recoupment. Citing O'Brien

v. United States, 766 F.2d 1038, 1050 (7th Cir. 1985), as "gathering numerous cases and stating that courts have found sufficient identity of interest between sole beneficiary of estate and trustees of estate, husband's estate and surviving spouse, husband's estate and wife's estate, decedent and his estate, and estate and all beneficiaries of the estate," the court concluded that D's estate and S's estate were sufficiently connected.

Subject to one caveat: Several charities and various other preresiduary beneficiaries would have borne some of the tax that would have been generated if D's estate had been properly taxed by denial of the marital deduction. That reality produced a problem "given that third parties not currently before this Court derived a substantial benefit from the [improper] deduction, and these third parties cannot be made to share in the detriment of the recoupment of the tax." On the basis of that holding the court prorated the tax liability that would have been generated in D's estate and used only S's proportionate share of the total benefit to D's estate as an offset against the refund sought by S's estate.

And then, addressing a question on which the court found no direct authority in the Code, it concluded that the government should pay interest on the refund owed to S's estate but that it could not collect interest on the equitable recoupment amount. The net result was that D's trust, worth $45.57 million at S's death, generated $5.22 million of offset tax liability, out of a tax that would have been $9.42 million at D's death. A nice result, if only taxpayers could *plan* for it! The important point to remember is that suing for a refund in such a case allows the government to reopen the connected prior matter. With different figures and facts it could have been that S's estate would incur costs to litigate and end up collecting little or nothing in return.

A similar equitable recoupment holding was rendered in **Warner v. United States**, 2006 U.S. Dist. LEXIS 61290 (C.D. Cal. 2006), without the special tax allocation and reduction in liability element in *Buder*. Here the simple situation was QTIP trust qualification in the estate of D, followed by a claim by the estate of S that the QTIP election was improper and that the trust therefore was *not* a QTIP marital deduction trust and could not be subjected to §2044 inclusion in the estate of S. The factual dispute centered around the all-income-annually requirement, the facts probably supported a conclusion that the requirement was met and the QTIP election was proper, but in any event the court concluded that deduction in D's estate just plain made the trust includible in S's estate.

Meanwhile, under a different equitable heading — the duty of consistency — **Janis v. Commissioner**, 87 T.C.M. (CCH) 1322 (2004), aff'd, 461 F.3d 1080 (9th Cir. 2006), and 469 F.3d 256 (2d Cir. 2006) (two different appeals, involving the two different sons who inherited from the decedent), involves one direct and one not-so-direct application of a simple equitable proposition that should apply if (a) a taxpayer made a representation, return position, or report, (b) on which the government relied, (c) that the taxpayer later repudiates or seeks to change after the statute of limitation has run, (d) to the government's disadvantage. The *Janis* appeal to the Second Circuit Court of Appeals involved the most obvious application of this principle in the wealth transfer arena — which entails a taxpayer who asserts a low asset value for estate tax inclusion purposes (to reduce estate tax liability) but later asserts a higher value for income tax basis purposes (to reduce gain or increase loss on a subsequent sale). The position in the case appealed to the Ninth Circuit Court of Appeals involved inconsistent positions taken by the taxpayer designed to generate a higher income tax net operating loss for the art gallery business that was included in the decedent's gross estate, but the notion is equally applicable. Each court on appeal affirmed the Tax Court's rejection of the taxpayer's

"flip-flop in position" or form of shell game (as in: then you saw the discount, now you don't).

Janis involved a decedent's sons who, as executors of the estate, were allowed a blockage discount in determining the inclusion value of an art gallery that owned many works of a select number of artists. As beneficiaries the court held that those sons were later required to use the same discount in determining the income tax basis of the collection as an asset of the gallery. That basis could have been relevant when they subsequently sold the art piecemeal or when they continued to hold the art and generated net operating losses in the gallery. Having served as executors they were not allowed to articulate inconsistent positions for income tax basis purposes. The Tax Court recognized that Treas. Reg. §1.1014-3(a) only presumptively regards the estate tax value as binding to determine the income tax new basis at death. Nevertheless, the court also regarded the ability to prove that the estate tax value is erroneous would not apply in such a case as this, in which the sons were claiming that the discount only applied to the gallery as a whole and not to individual art work held by the sons or by the gallery after death.

On appeal, several aspects of the courts' opinions might be regarded by some as potentially troubling for the government. For example, it is not clear in *Janis* whether the courts would have applied the doctrine if a third party had been the personal representative who claimed the discount. Although it was central to the holding that the same parties were both executors and later the income tax payers involved, other cases cited make it clear that an identity in interest (rather than an overlapping role in each determination) should suffice. In addition, the Ninth Circuit Court of Appeals rejected the taxpayer's assertion that the blockage discount should not apply for income tax purposes, because in this case the gallery remained intact and still held the collection. The same result ought to obtain if the art had been distributed to various estate beneficiaries, even if no one beneficiary going forward held sufficient items to make a blockage discount relevant.

Finally, the taxpayer in that same appeal argued that the duty of consistency is only available as an affirmative defense to the government, conceivably meaning that it is applicable only in a refund case and not in the Tax Court if the government affirmatively asserts a deficiency. Rather than state simply that the duty applies in all forms of litigation, the court just rejected the taxpayer's objection because the taxpayer "implicitly consented to consideration of . . . the doctrine" when the taxpayer failed to timely object to the government's advocacy of it.

In a more expansive application, the duty of consistency should be applied whenever a taxpayer seeks to propound inconsistent positions. For example, presumably the government should allege that discounts allowed (or that should be allowed) to value fractional interests in realty included in a decedent's gross estate must inform the income tax basis, even if the decedent's estate was not interested in taking that discount (because the property passed to the decedent's surviving spouse and whatever value was included in the estate would be matched with a marital deduction, or because the estate was not large enough to be taxable, in either case making the estate tax value irrelevant for estate tax purposes). There is no evidence that the government is making a concerted effort to enforce income tax basis results that reflect the estate tax valuation issue, nor does there appear to be any coordinated enforcement of any form of the duty of consistency. (§§3.3.6; 13.5.6; 15.3 n.13 (6th ed.))

8. Gift Tax

All Hat and No Cattle. Texans have crafted some wonderful expressions and, reading the opinion in **McCord v. Commissioner**, 461 F.3d 614 (5th Cir. 2006), rev'g and rem'g 120 T.C. 358 (2003), brings to mind the expression about a blowhard who is trying to make a big impression. Seldom is there an opinion that is so lacking in judicial comportment, or one that was more eagerly awaited but that fails to address so many important issues.

McCord probably was anticipated most for what it might say about defined valuation clauses — sometimes vilified as "saving clauses" or, more objectively, called "formula" provisions. The Tax Court opinion was issued almost exactly two years after the case was argued, and the appellate court opinion was delayed 27 months after the argument on appeal — each significant delay fueling hope that either court might address the saving/formula clause issue and was wrestling with the difficulties that question has posed over the years. Based on a plan that was pretty clearly designed to make it nearly worthless for the government to challenge a gift tax valuation, the Tax Court made quick work of the defined valuation issue in a single footnote 47, half way through its monster 9-4 majority reviewed decision, and it did so by relying on a disingenuous reading of the taxpayer's documents that dodged the question. On appeal the court gave even less attention to the issue, saying that the Commissioner had waived it, along with several other theories that the government advanced in the Tax Court below but that it did not advocate on appeal. In a subsequent Tax Court opinion written by Chief Judge Colvin, **Dallas v. Commissioner**, 92 T.C.M. (CCH) 313 (2006), totally disregarded another formula defined valuation provision (in this case in a sale agreement, but similarly designed to avoid any gift tax liability), the court's final footnote summarily dismissing any consideration of the issue because the taxpayer failed to respond to the government's allegation of invalidity. *Dallas* is otherwise unremarkable, save for its almost exact "split-the-baby" result, which *McCord* and *Kohler* (see page 4) both suggested that the courts are moving away from, and for the court's citation of *Thompson* (see page 8) for the notion that lack of negotiation among parties is relevant to the bona fides of a transaction for tax purposes. *Huber* (see page 34) suggested the exact opposite.

Instead of tackling this important drafting and planning question, the appellate court opinion is a fairly straightforward reversal of the Tax Court's "split the baby" result, and it addresses just two basic issues, only one of which being difficult. First, the court held, consistent with oodles of authority, that the wealth transfer tax employs a "snapshot" principle that requires valuation as of the date of a transfer (gift or death — the latter of which may be deemed to be the alternate valuation date if §2032 properly is elected), without consideration of facts that develop thereafter. In this case that meant the Tax Court erred when it considered a post-gift "confirmation agreement" among parties other than the donor. Rarely is a court as direct or as forceful in holding that post-transfer occurrences or facts may not be considered in the valuation process. That *is* a traditional and correct result.

Second, the court found valid the taxpayer's net gift argument based on the donees' agreement to pay (1) any gift tax incurred on the transfer, *plus* (2) any §2035(b) gross-up rule estate tax attributable to that gift tax, applicable only if the donor died within three years of the gift. The only challenge to this gross-up rule issue was valuation of the possibility that the

donees would be required to pay, but the court determined that it is easy enough to discount to present value the possibility of death within the three year window and, based on the law as we know it (which the court assumed a willing buyer would consider) the estate tax that therefore might be incurred. The court simply rejected the Tax Court's holding that this determination was *too* speculative to be reflected in the gift tax valuation of the interests that originally were gifted (notwithstanding that the court listed seven factors that might be relevant).

The balance of the opinion essentially spanked both the government (which is not so unusual in the Fifth Circuit) and the Tax Court (in a surprising shower of invective), ending with a final slap that assessed the government with all costs, "without limitation." The net result was an uninformative finding that the government had failed to carry its burden of proof (resulting in a 100% embrace of the taxpayer's gift tax valuation), a sharp critique of the Tax Court's valuation methodology, a vindication of Tax Court Judge Foley (who was unceremoniously displaced by order of the Chief Judge of the Tax Court when the court's reviewed opinion was issued), and a funny criticism of the government's "disturbingly increased" habit of asserting "a grossly exaggerated amount . . . in a notice of deficiency" that typically is issued long before the government incurs the expense of hiring its own expert. (§7.2.5 nn.303, 306.3 (6th ed.)).

Ed/Med Exclusion Allowed for Prepaid Tuition. In addition to the §2503(b) annual exclusion, §2503(e) allows an unlimited gift tax exclusion for amounts properly paid for the education or medical expenses of any person (which also may be shielded from generation-skipping transfer taxation by §2642(c)(3)(B)). Qualified transfers include amounts paid for tuition of full or part time students, but only if payments are made directly to the education service provider.

In that vein, Rev. Rul. 82-143, 1982-2 C.B. 221, held that tuition paid directly to a §170(b)(1)(A)(ii) foreign educational institution was exempt from gift tax under §2503(e), but Treas. Reg. §25.2503-6(c) Example (2) establishes that a transfer to a trust for the ultimate payment of tuition charges to an educational organization does not qualify tuition payments that would be excluded from the gift tax under §2503(e), because the transfer was not made directly to a qualifying educational organization as required. In a similar context, **Private Letter Ruling 200602002**, like Technical Advice Memorandum 199941013 before it, authorized payments to an educational institution that essentially constituted nonrefundable prepayment of tuition that might be incurred in the future, with respect to students who currently were enrolled but who had no guarantee of continued enrollment, nor any assurance that tuition would not increase (in which case added monies would be needed to cover any deficiency in the fund set aside). Because the school was the payee and not a trust, the government determined that these prepayments were within the letter of the law and permitted total exclusion of the one time transfers, notwithstanding that they were well in excess of the donor's annual exclusion for the respective students involved and potentially in excess of all tuition that ultimately would be assessed against any particular intended object of the donor's educational support or bounty.

Donors who do not want to transfer funds directly to an educational institution but who are considering a gift designed to further the education of a donee may consider §§529 and 530, which provide income tax exemptions for qualified state tuition programs. For gift tax purposes, §§529(c)(2), 529(c)(4), and 529(c)(5) provide that contributions to these programs

are completed gifts for gift tax purposes, with present interest §2503(b) gift tax and §2642(c) generation-skipping transfer tax annual exclusion (but not §2503(e) ed/med exclusion) qualification (and a special five year ratable carry forward provision if the contribution exceeds the donor's annual exclusion limitation for the year of contribution). In exchange for immediate gift tax exposure to the donor, however, the only estate tax inclusion to the donor is under §529(c)(4)(C) for any outstanding carry forward amount if death occurs within the five year carry forward period. Most importantly, distributions from the plan may be used for more than just the §2503(e)(2)(A) limited tuition and fees; under §529(e)(3)(A) qualified higher education expenses include such items as room, board, books, and other required expenses. Other options include gift to minors act accounts, §530 Coverdell Education Savings Accounts (a form of tax benefited saving account with much smaller contribution limitations but similar permitted uses and taxation), and prepaid tuition plans.

This topic entails a moving target of available options and advisors can only help to evaluate various criteria that may be useful or important to a family, including questions of age limitations for contributions and withdrawals, maximum contributions, qualified expenditures, client control over account investments and distributions, spendthrift protections, and both state and federal income, estate, gift, and generation-skipping taxation (especially conversion of investment gain into ordinary income as the price paid for tax free internal build up in the account prior to withdrawals, and any penalties that might apply). (§7.1.1.11 (6th ed.))

Uneasy Application of the Reciprocal Trust Doctrine. There are several issues of potential interest to estate planners in **Private Letter Ruling 200612002** (the primary gist of which was planning designed to shift the state income tax liability of a trust), but only one that has the potential to be controversial. The simple (but hardly common) situation is that a trust settlor retained the right to receive discretionary distributions of income or principal as appointed by either the settlor acting with consent, or by a committee of others, in each case with the other parties involved having adverse interests to making distributions (because they were beneficiaries, including after the settlor's death). The adverse interest element protected the settlor from grantor trust exposure, and the ability to receive distributions back protected the settlor from completed gift treatment. The fact that others might receive distributions through actions of the settlor also meant that the settlor did not make a completed gift and retained sufficient control to trigger §2036(a)(2) inclusion at death (joint powers, even with an adverse party, are sufficient retention of control in either context). Those holdings are not very significant, or controversial, for federal tax purposes and, upon information and belief, the whole construct was designed to shift income taxation at the state level from the grantor's home state to a jurisdiction (perhaps a zero-tax state) regarded as more income tax favorable.

What *does* catch the eye for federal wealth transfer tax purposes is the treatment of the two members of the committee who must give approval to distributions, each of whom is a beneficiary in their own right. Said the Ruling:

> Y and Z as members of the Power of Appointment Committee have the power to distribute Trust income and corpus to themselves. However, Y's power can only be exercised with the consent of Z, and Z's power can only be exercised with the consent of Y. . . . Therefore, Y and Z will not have a general power of appointment by reason of the joint distribution power.

A similar statement is found in **Private Letter Rulings 200647001** and **200637025** (involving different cases, however). The element in this conclusion (which is not reliable in the earlier Ruling because it was not one of the questions the government was asked in the request for that Ruling, making it a form of dicta in a resource that itself cannot be relied upon for authority) that seems questionable is whether the government should have applied the reciprocal trust doctrine in the context here of bestowed (§§2041 and 2514) powers. There is very little law on the application of reciprocity in the wealth transfer taxes outside the §2036 arena in which the doctrine was born. There are, however, totally predictable applications in which the doctrine uncrossed reciprocal annual exclusion gifts. For example, A makes annual exclusion gifts to all of A's children and all of B's children, and B does the same thing. Courts have had no trouble treating A as having made gifts (in excess of the annual exclusion) just to A's children, and B the same for B's children. See, e.g., Estate of Schuler v. Commissioner, 80 T.C.M. (CCH) 934 (2000), aff'd (8th Cir. 2002), which followed Sather v. Commissioner, 251 F.3d 1168 (8th Cir. 2001).

Rather, the interesting application of reciprocity here is reminiscent of the situation in Technical Advice Memorandum 8029001, in which the same settlor created two trusts, one for each of children A and B. In each case presumably the settlor was concerned about general power of appointment exposure if a child was trustee of the child's own trust, so in one trust child B was named as trustee for the benefit of child A, and in the other trust child A was named as trustee for the benefit of child B. Applying the interrelation test of the traditional §2036 reciprocal trust doctrine the government ruled that the doctrine ought to apply under the gift tax, but departed from the historical pattern of that doctrine in one respect.

Normally trusts are "uncrossed" at the "settlor" level: if A created a trust for B and B created a trust for A, they would be treated as if A created the trust for A and B created the trust for B. Because that approach would work no difference in a case in which the same settlor created both trusts, the government uncrossed the trusts at the trustee level. Thus, A was treated as trustee of the trust created for A, and B as trustee of the trust for B. In two similar cases involving multiple trusts for a group of children, however, the reciprocal trust doctrine was not applied in a seriatim or circular reciprocity context in which child A eventually would succeed the original trustee to act as trustee of a trust for child B, child B would become trustee for child C, who would become trustee for D, who would become trustee for child A. In both cases the government concluding that the trusts were not reciprocal on creation or that there was no intent at the time of creation to cross the trusts and trustees. See Private Letter Rulings 9804012 and 9735025 (trusts created by siblings, as to which successor trustee provisions were involved).

In a case like Private Letter Ruling 9235025 and perhaps most like the case under scrutiny now, application of the reciprocal trust doctrine could have a slightly different result. In that 1992 case the decedent (D) and D's sibling were cotrustees of identical trusts, one for each sibling. Each trust authorized the cotrustees to make discretionary distributions that constituted a general power of appointment, but state law precluded the powerholder from participating in any exercise of that power for the powerholder's own benefit. In essence that meant that each sibling acted as sole trustee with discretion over distributions to the other sibling from that sibling's trust. In that context, if the reciprocal trust doctrine then were applied the result would be that each sibling would be regarded as trustee of the trust for the sibling's own benefit, in which case the state statute still would apply to preclude exercise of discretion for their own benefit. That would have precluded general power of appointment treatment. So the

government articulated a theory based on the reciprocal trust doctrine to conclude that these reciprocal trustee arrangements meant only that each sibling *controlled* distributions to themselves in a "you scratch my back, I'll scratch yours" sort of arrangement.

The government thus opined that D could ensure receipt of desired distributions from D's trust because "it can be objectively inferred that [D] and [the sibling] would exercise their respective distributive powers on a reciprocal basis. That is, because of the reciprocal nature of the parties' distributive powers." On that basis the government then concluded that each sibling's control over the other should be regarded as tantamount to holding a general power of appointment. A similar argument could be applied in the 2006 Ruling, in which Y would make distributions that Z wanted because Z could be expected to reciprocate for Y.

The 2006 Rulings and Private Letter Ruling 9451049 together may indicate that the government has cooled to this notion. The 1994 Ruling involving two trusts created, one for each of two children, in which each child had a nongeneral inter vivos power to appoint the trust to their sibling, which each proposed to exercise in the other's favor. Although the government concluded that each child would make a gift of their respective income interests, it declined to apply the reciprocal trust doctrine. Quaere whether the gift of each child's remaining interest in that child's trust would be offset by the benefit received by that child from the sibling's trust by virtue of the sibling's exercise of the nongeneral power, or whether lack of reciprocity would cause this net gift analysis also to be inapplicable. The planning point is that the uncertain application of the reciprocal trust doctrine makes planning involving such crossed or symbiotic powers troublesome and therefore dangerous (a good but different illustration of that concern currently surrounds the use of so-called "Parallel GRATs"). Better avenues exist to preclude untoward inclusion of trusts in the estates of beneficiaries due to unconstrained powers to appoint, including powers to make distributions. Most predictably successful in this context is use of properly drafted ascertainable standards to limit a trustee's discretion such that attribution of powers to that person will be harmless.

In that regard, **Private Letter Ruling 200647022** is interesting and potentially useful because it concluded that use of the term "care" is synonymous with "support" and "maintenance." This meant that the government regarded "care" as an ascertainable standard. Because it is not one of the terms expressly blessed by Treas. Reg. §20.2041-1(c)(2), however, and because this is only a private letter ruling, this conclusion is less reliable than were this one of the more familiar "HEMS" standards. Nevertheless, this Ruling is not the only authority holding that the term is properly constrained to qualify. See, e.g., Private Letter Rulings 200028008 ("proper care, support and maintenance"), 9713008 ("support, care, maintenance, and education"), and 9148036 ("maintenance, care, and support"), all of which held "care" to be ascertainable. Like this latest Ruling, the logic expressed typically relies on the fact that Rev. Rul. 76-547, 1976-2 C.B. 302, involved both "care" and "enjoyment" as arguably not ascertainable and singled out and based its holding entirely on "enjoyment," leading to a positive implication that "care" was not improper. Rev. Rul. 78-398, 1978-2 C.B. 237, found "maintenance and medical care" to be ascertainable (but clearly because "care" was tied to medical needs and to maintenance, both of which are ascertainable). And Estate of Strauss v. Commissioner, 69 T.C.M. (CCH) 2825 (1995), and First Virginia Bank v. United States, 490 F.2d 532 (4th Cir. 1974) ("care and comfort"), involved attacks specifically directed at the term "comfort" standing alone, again presumably indicating that "care" was regarded as acceptable. Cf. Private Letter Ruling 9523030 (for §2055(e)(3) reformation purposes a standard of "maintenance, support, and care" was deemed ascertainable under state

law and therefore the beneficiary's entitlement under it was measurable). (§§12.1; 12.3.2.4 n.55 (6th ed.))

Application of Debt Forgiveness Rules. It has been almost 50 years since the famous litigation in Deal v. Commissioner, 29 T.C. 730 (1958) (not the first case of its ilk, but the one folks seem to remember, maybe only because the taxpayer was Minnie Deal and her name is memorable), but cases continue to raise the same issue. In one way or another, these cases involve a purported sale for a note in one year, followed by forgiveness of the note installments in subsequent years, typically orchestrated so that forgiveness is in an amount sheltered from gift tax by the annual exclusion. Given the fact that a taxpayer typically could make fractional interest gifts of the underlying asset that is the subject of a purported sale, each with a value less than the annual exclusion, in most cases the subterfuge is not about maximizing the exclusion but, rather, it is an effort to accomplish something different. In a very unusual aspect of **Private Letter Ruling 200603002** the government undertook on its own motion to rule on an element of a transaction that was not part of the ruling request put to the government, which they issued anyway "for purposes of sound tax administration."

The Ruling itself was generous enough, dealing with the so-called "intent facts" versus "policy facts" issue that can arise in a life insurance context if an insurance agent causes a policy to be issued in a manner different than that intended by the parties. In this case, for example, the parties anticipated that an exchange of two existing policies on two different lives would result in the issuance of a new survivor life policy, and that the new policy would be issued in the name of a trust that previously had acquired the two policies (for the notes, which we'll discuss shortly). Instead the new policy was issued to the two individuals, purportedly because the insurance agent (now deceased) made a mistake. The government accepted the taxpayer's explanation and regarded the policy as if originally issued properly to the trust as owner. That treatment was important because it meant the new policy was owned by the trust from the date of the exchange, rather than treating replacement of the new policy with another new policy issued correctly being a new transfer that would expose the parties to the three year rule under §2035(a).

The issue addressed by the Ruling on the government's own motion involved the transfer of the original policies into the trust, which purported to be a sale in exchange for a note from the trust, which was cancelled on January 1 of the very next year, no payments having been made on the note in the interim and forgiveness being regarded by the taxpayers as a gift that qualified for the annual exclusion in that new year. In the year of original transfer the taxpayers claimed the annual exclusion for the value of the policies transferred in excess of the amount of the note, so the net result was that the taxpayers were seeking to transfer the policies at no gift tax cost, notwithstanding that they had more value than one year's worth of annual exclusions would shelter. Moreover, presumably transfer in the first year began the period of the three year rule sooner, to the extent sale of the policies did not fully qualify for the §2035(d) full and adequate consideration exception (which likely did not shelter the transfer, because of the principle of United States v. Allen, 293 F.2d 916 (10th Cir. 1961), that full and adequate consideration is measured against the amount that would be included in the transferor's estate at death, not against the value of the transfer itself). According to the government,

> [w]e view the initial transfer of the policies, made subject to a deferred debt

> obligation, and the subsequent forgiveness of such debt obligation a few months later, in a different tax year, without any payments having been made on such debt obligation, as part of a prearranged plan to avoid owing gift tax with respect to the transfers of the policies. Accordingly . . . [t]he note given . . . by the Trust is not considered adequate and full consideration in money or money's worth for the transfers of the life insurance policies

and the taxpayers were deemed subject to gift tax on the full value of the note. Notice that the Ruling did not address the *Allen* issue and probably should not be regarded as if that element of the transaction would be resolved favorably to the taxpayer. Instead, by implication it appeared that more than three years had expired since the original transfer of the two policies. Indeed, treating all transfers as if they occurred in the year of the initial transfer would work against any potential application of the three year rule, and in another case the government might be expected *not* to make the *Deal* prearrangement argument for just that reason. (§6.5.2 nn.32, 38; 7.3.1 n.19 (6th ed.))

Gift Tax Stock Valuation Using Annual Appraisal. It is somewhat remarkable that the government lost at every possible turn in challenging a gift tax valuation based on the independent appraisal of a private company's stock by national accounting firm Ernst & Young — not because there is anything questionable about the firm but only because the government brought the case with so little to successfully support its position. But therein lies the significance of the opinion in **Huber v. Commissioner**, 91 T.C.M. (CCH) 1132 (2006): this was an unusual case because not *any* of the government's slings found their target. In that regard, other taxpayers need to appreciate that the circumstance in which this valuation was upheld was very unusual.

Among the exceptional factors were that (1) there were about 250 shareholders of this nonpublic corporation, not all by any means were family members; (2) the appraisal was performed annually, (3) by a firm that did not perform any other auditing functions for the company, (4) for a variety of purposes, some of which informing a low desired valuation and others a high value, including to value charitable gifts of stock, to value stock options given to corporate executives, to fix compensation of board members, and to value shares redeemed by the corporation. Further, (5) in a six year period there had been approximately 90 transactions that relied on the appraisal, among shareholders who were not obliged in any way to use that valuation, including nonprofit organizations that had received gifts of stock and were selling the shares back to the corporation or sales by "well informed" parties "who had no reason to accept a price that was artificially low," including many who "were hardly related or unrelated and who had fiduciary obligations to obtain the best price." All of which probably distinguishes a typical family corporation's effort to evaluate its own stock. Also of interest was the court's rejection of the government's argument "that the lack of negotiation in the transactions at issue connotes the lack of an intent to realize the best price for the value of the shares. [The government] fails to cite any caselaw that holds that negotiation is a necessary element of an arm's-length transaction. In fact, the weight of authority is to the contrary." Citing *Kimbell v. United States*, the family limited partnership case discussed at page 8. The same issue involving negotiation has arisen this year in *Dallas* (discussed at 28), *Stone* and *Schutt* (discussed at 18), *Amlie* (discussed at 41), and Melnik (discussed at 45). (§7.2.4 (6th ed.))

A Jury Trial, on Value? In Smith v. United States, 2004-2 U.S. Tax Cas. (CCH) ¶60,488 (W.D. Pa. 2004), and an order accepting a Magistrate's report at 2004-2 U.S. Tax Cas. (CCH) ¶60,490 (W.D. Pa. 2004), the government previously successfully asserted that §2703(a) is applicable to value interests in a family limited partnership or limited liability company. Now comes a report on the actual determination of value for gift tax purposes following fractional interest gifts of partnership interests. Tried to a jury, the government asserted that the proper value was about $800,000 higher than reported by the taxpayer and therefore a deficiency was owed of about $360,000. The taxpayer paid and sued for a refund, which the jury found should be nearly $650,000 (which includes interest). To which the government screamed that the taxpayer cannot recover more than it sought on refund (including interest, which would have increased that amount to about $440,000) and should be required to pay tax on no less than the value it originally reported. **Smith v. United States**, 2006 U.S. Dist. LEXIS 47620 (W.D. Pa. 2006), rejected a novel government argument that the taxpayer's original claim for refund was timely but that the "excess" amount awarded by the jury was tantamount to an independent claim for a refund of the added amount, which was barred by the statute of limitation. The court also allowed valuation testimony by a family member involved in the corporation, notwithstanding that this person was no expert, citing Committee Reports to Fed. R. Evid. 701 that "[s]uch opinion testimony is admitted . . . because of the particularized knowledge that the witness has by virtue of his or her position in the business" and concluding that "[w]hether . . . his opinion is accurate goes to the weight of the testimony and not its admissibility." (§§15.3.1.2.2, 15.3.1.4 (6th ed.))

9. Generation-Skipping Transfer Tax

Trust Severance. Under §2642(a)(3) it may be useful to regard a single trust as being two separate trusts for GST exemption allocation purposes, such as to create one subtrust that is totally exempt and a second that is totally taxable. Replacing existing Treas. Reg. §26.2654-1(b), **Prop. Treas. Reg. §26.2642-6** establishes essentially six rules for making a qualified severance. As a predicate, none of this is applicable unless severance is authorized by local statute or the governing instrument. Quaere the result if severance is by court order: would that constitute a reformation of the trust and essentially constitute a division that is authorized by the trust instrument? That question is not resolved.

Among the requirements that *are* established, the first is that any qualified severance of a trust that has an inclusion ratio of less than one but greater than zero (meaning that it is "partially" taxable) must produce two trusts, of which one is totally taxable (inclusion ratio of one) and one is totally exempt (inclusion ratio of zero). A second is that added severances then may be made of either or both of those two trusts, to produce separate trusts (e.g., for different blood lines in a family). But first the trust must be severed to produce totally exempt and taxable trusts. Third, any severance must be made on a fractional/percentage basis, rather than on a pecuniary basis, meaning that leveraging appreciation into one subtrust or another is prohibited. In this regard a *formula* fractional division is expressly authorized.

Fourth, severance need not be on a pro rata basis with respect to each and every asset in the trust. Rather, the regulation essentially embraces a form of division that mimics the marital deduction funding known as a "pick-and-choose" fractional, by which division is made on a

fractional basis (reflecting total appreciation/depreciation in the fund) of the *value* of the trust but the respective portions are funded by selection of assets at their value on the date(s) of distribution, with full trustee discretion to allocate some, all, or none of any particular asset in distributing assets with a date of funding value equal to the value of the respective subtrusts. As an ancillary to this, **Prop. Treas. Reg. §1.1001-1(h)** also provides that severance according to these rules is *not* regarded as an income tax gain/loss realization event. *And* there is no requirement that the selection of assets in the pick-and-choose non-pro-rata funding of the severed trusts must comply with the kind of dictate found in Rev. Proc. 64-19. Pro rata allocation of value but not of built-in capital gain/loss is the only requisite.

Fifth, any severance along different beneficiary lines must provide that, *in the aggregate*, each trust provides for the same succession of beneficial interest as the original trust. This does *not* require, however, that every beneficiary of the original trust must be a beneficiary of each severed trust, provided that there is no shift of beneficial interest to a beneficiary in a lower generation than the original trust. Further, the new trusts must not extend the vesting duration of the original trust. Finally, severance may be made at *any* time, specifically before or after any exemption allocation, before or after a taxable transfer has occurred, or before or after any addition has been made to the trust. With the reservation that no severance can alter the tax consequence of a *previously* complete taxable event.

This regulation again provides that it is a reasonable interpretation of the statute and may be relied upon before it becomes final, at which point it applies to any subsequent severance. (§§11.4.3.2, 11.4.8)

Generation-Skipping Transfer Tax Chronological Exemption. Special interpretations of the generation-skipping transfer tax effective date rules relate to powers of appointment. See, e.g., Treas. Reg. §26.2601-1(b)(1)(v). Property subject to a power of appointment that is taxable in the powerholder's estate for estate tax purposes is treated as an addition to the trust if the power lapses, is exercised, or is released, with the powerholder being treated as the transferor with respect thereto as if the property subject to the taxable event had been withdrawn and recontributed by the powerholder to the trust (as reduced by any tax paid from that appointive property). Thus, for example, Private Letter Ruling 9324014 held that the chronological exemption for a trust is lost to the extent an unexercised five or five withdrawal power causes §2041(a)(2) inclusion in the powerholder's estate at death. The powerholder becomes the transferor with respect to a separate share deemed to exist under §2654(b)(1), and the trustee may divide the trust to segregate this separate portion, with no additional taint of the trust and with no gain or loss consequences. Private Letter Rulings 200541031 and 200540004 (seemingly the same situation notwithstanding that the Rulings came out in separate weeks) involved lapsing general powers of appointment in the form of withdrawal powers and a correct statement that the powerholder would become the transferor to the trust of the lapse amounts. The Rulings did not articulate (or even mention) the §2654 result.

The constructive addition rule is applicable regardless of when the power or the trust was created. Thus, for example, in a marital deduction trust of the all income, general power of appointment variety that is exempt because it was irrevocable before September 26, 1985, if the surviving spouse dies after that date and allows the general power to lapse, that portion of the trust as to which the general power exists will be tainted, the spouse will be treated as the

transferor thereof, and the spouse may allocate his or her generation-skipping transfer exemption to that deemed addition or transfer to the trust. See Treas. Reg. §26.2601-1(b)(1)(v)(D) Example 1; Rev. Rul. 82-36, 1982-1 C.B. 146; Technical Advice Memorandum 9630003 (exercise of general power to grandchildren deemed a direct skip by surviving spouse), and Private Letter Rulings 9644055 (inclusion of general power of appointment marital deduction trust in estate of surviving spouse caused loss of chronological exemption, new transferor and separate share treatment, and allowed exemption allocation to make a portion of that separate share exempt), and 9302019 (under §2654(b)(1), deemed addition by spouse upon exercise of general power of appointment treated as a separate share, allowing exemption allocation to make separate share totally exempt and to avoid tainting original chronologically exempt portion of trust).

Notwithstanding its seeming logic, this general power of appointment, constructive addition rule has not been without controversy. For example, it was deemed not to apply in Simpson v. United States, 183 F.3d 812 (8th Cir. 1999), rev'g 17 F. Supp. 2d 972 (W.D. Mo. 1998), nonacq., AOD 2000-003, 2001-1 C.B. ix, in the context of a surviving spouse who exercised a general power of appointment in a §2056(b)(5) marital deduction trust that was chronologically exempt from the generation-skipping transfer tax. Distinguishing (on questionable grounds) the result in Peterson Marital Trust v. Commissioner, 102 T.C. 790 (1994), aff'd, 78 F.3d 795 (2d Cir. 1996), the *Simpson* court held that exercise of the power by appointment to grandchildren *free of trust* did not lose the chronological exemption and, therefore, the generation-skipping transfer tax did not apply. That conclusion turned on the court's reading of the constructive addition provision in then Treas. Reg. §26.2601-1(b)(1)(v)(A), which treated "any portion of a trust [that] *remains* in the trust after the release, exercise, or lapse of a [general] power" of appointment as a nonexempt constructive addition to the trust (emphasis added). According to the court, because the surviving spouse in *Simpson* exercised the power outright and free of trust:

> There was no portion of the trust remaining after the exercise. Nor did the power lapse to any extent. There is therefore no way to argue, and the government in fact does not argue, that the transfer at issue here is subject to the GST tax because it was made out of corpus added to the trust. . . . Nor is there any regulation . . . that applies to the particular sort of transfer made here — a transfer of the entire corpus of the trust remaining at the time of the exercise of the power.

In effect, allowing the power to lapse, or exercise of it in further trust, would have caused loss of the chronological exemption — as it should — but the exemption was preserved by exercise of the power free of trust. That result was wrong minded in policy, it was rejected by Bachler v. United States, 126 F. Supp. 2d 1279 (N.D. Cal. 2000), which itself was reversed and remanded, 281 F.3d 1078 (9th Cir. 2002), but the problem presumably was cured prospectively when Treasury promulgated regulations that add meaning to the §2601 effective date rules with respect to trust modifications, amending Treas. Reg. §26.2601-1(b)(1)(i) to provide that the chronological exemption "does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under" either the estate or gift tax. The transfer subject to the tax is deemed to be made by the powerholder when the exercise becomes effective "and is not considered a transfer under a trust that was irrevocable on September 25, 1985" — meaning that it is no longer chronologically exempt.

The presumption — that the problem was cured by amendment to the regulation — is belied by the latest iteration of this issue, found in **Estate of Gerson v. Commissioner**, 127 T.C. 139 (2006), a fully reviewed opinion producing an 11-to-5 victory for the government and an unbelievable six opinions, two in dissent. In a nutshell this old-style all-income, general-power-of-appointment marital deduction trust was deemed subject to the constructive addition result following exercise of the power by the surviving spouse in favor of grandchildren. Fortunately no distinction was made between the 40% of the trust exercised directly in favor of grandchildren and the balance exercised in further trust, and the court's logic was simply that *Simpson* and *Bachler* are whacked (yes, that's the technical legal term). Finding the regulation to be a uniform and consistent application of the general wealth transfer tax policy that property subject to a general power of appointment is the functional equivalent of owned assets, the court found that treating the powerholder as a transferor and the exercise here as a transfer made constructive addition treatment logical. And it tainted the trust's prior chronological exemption. In addition, the court noted that "we fail to see any meaningful difference . . . whether . . . there is a lapse, exercise, or released of the power."

Note that inclusion in the surviving spouse's gross estate under §2044 will not taint a chronologically exempt generation-skipping trust as to which an effective QTIP election was made for marital deduction purposes. Treas. Reg. §26.2601-1(b)(1)(iii). Peterson Marital Trust v. Commissioner, 102 T.C. 790 (1994), aff'd, 78 F.3d 795 (2d Cir. 1996), rejected an equal protection challenge based on the difference in result following §2041 inclusion of a chronologically exempt §2056(b)(5) general-power-of-appointment marital deduction trust as compared to §2044 inclusion of a chronologically exempt QTIP marital trust in the estate of a surviving spouse. The court's rationale was that the spouse's ability to change the generation-skipping remainder by exercise of the power of appointment in a §2056(b)(5) trust provides a rational justification for imposing the generation-skipping transfer tax that is lacking in the case of a QTIP marital deduction trust in which the surviving spouse need not be given control of any dimension. (§11.4.16.2 (6th ed.))

10. Special Valuation Rules

Spousal Annuities under §2702. Treas. Reg. §25.2702-3(d)(4) (this was §25.2702-3(d)(3) prior to promulgation of the *Walton* regulation revisions described below), provides that a GRAT annuity must be fixed and ascertainable upon creation of the trust and may be payable for the life of the term interest holder or for a term specified in years, or for the *shorter* of the two, but may not run for the full term if that is the *longer* of the two. A term annuity payable to the holder or the holder's estate is permissible if death occurs prior to expiration of the term, but payment to the holder's surviving spouse will fail to qualify — as recently held in **Estate of Focardi v. Commissioner**, 91 T.C.M. (CCH) 936 (2006).

Technical Advice Memorandum 9707001 illustrated the prohibition against running for the longer of the two periods in the context of a term annuity that was payable for the entire term by continuing after the term interest holder's death. Involved was a five year GRAT with payment either to the holder's spouse or, if the holder revoked that interest or the spouse also died before expiration of the five year term, to the holder's estate, in either case contingent on the holder's death within the five year term. Notwithstanding that a spouse may be a qualified

interest term holder and that for many purposes a decedent's estate is regarded as the same jural entity as the decedent, the government held that neither contingent interest could be considered in determining the value of the gift represented by creation of the trust and that only the holder's own term interest for the lesser of life or the term would be considered.

Today the continuation to the holder's estate would be permitted, but the spouse's interest still would be a problem. At the time the 1997 Memorandum concluded that each term interest following the holder's death, contingent upon that death within the five year term, was not fixed and ascertainable in value at inception of the GRAT. We now know that this is because, although the end point is known, the time when they might begin is not known (said the Tax Court in *Focardi*, "the spousal annuity . . . is dependent on when the grantor dies and, in particular, on how much of the term remains at the grantor's death"). Treas. Reg. §25.2702-3(d)(4) now expressly states that rationale, which is affirmed by *Focardi*. As a result, the government opined in the 1997 Memorandum that the gift tax would be imposed on the full value transferred to the trust, less only the value of the holder's annuity interest. See also Technical Advice Memoranda 9741001 and 9848004. Today the holder's annuity would be qualified if the continuation to the spouse was eliminated and payment was to the holder or the holder's estate only, because these results were altered by the developments noted next.

The government's position was dealt a blow by Walton v. Commissioner, 115 T.C. 589, 603-604 (2000), acq., Notice 2003-72, 2003-2 C.B. 964 (a unanimous reviewed opinion involving a taxpayer who created two "substantially identical" two year grantor retained annuity trusts with the annuity payable to the holder's estate if death occurred before the term annuity ended). See McCaffrey, Plaine, & Schneider, The Aftermath of *Walton*: The Rehabilitiation of the Fixed-Term, Zeroed-Out GRAT, 95 J. Tax'n 325 (2001), regarding ancillary planning implications of *Walton*. In *Walton* the government argued that (then) Treas. Reg. §25.2702-3(d)(3) (now -3(d)(4)) limited an annuity for the holder's life or a two year term to the shorter of those periods for valuation purposes. As a consequence the government regarded the gifted remainder following the retained annuity as larger than the taxpayer reported, as illustrated in Treas. Reg. §25.2702-3(e) Example 5 as it then existed.

The *Walton* court's forceful reply was that the then existing Example 5 was "an invalid and unreasonable interpretation" of §2702. Given the "historical unity between a taxpayer and the taxpayer's estate," the court held that designating the estate as the alternative payee in the event of death before expiration of the term was the same as if the document were silent about the consequence of death before expiration of the retained annuity term. Furthermore, this term annuity payable to the estate was regarded "as creating a single, noncontingent annuity interest payable for a specified term of years[,] Congress meant to allow individuals to retain qualified annuity interests for a specified term of years, and . . . the proper method for doing so is to make the balance of any payments due after the grantor's death payable to the grantor's estate." The court stressed that, although Example 5 was cited with approval in Cook v. Commissioner, 115 T.C. 15 (2000), the result in *Cook* would be obtained without Example 5 because "the spousal interests at issue there were in fact contingent in a sense violative of the policy behind" §2702 and never would take effect if the spouse predeceased the holder. As a result, invalidity of Example 5 was regarded as not affecting the consequences in *Cook*. See McCaffrey & Schneider, The Flaw in Example 5: Did the 2702 Regs. Try to Extend the Repeal of the Doctrine of Worthier Title?, 93 J. Tax'n 219 (2000), regarding *Cook* and the history of Example 5. In the wake of its loss in *Walton* the government revised Example 5 to permit the entire term interest to qualify. But none of that altered the effect of a surviving

spouse's contingent annuity, as involved in *Cook* and now in *Focardi*, which involved essentially a two year and a four year GRAT with payments to the holder's surviving spouse if he died within the original term.

The simple change made by addition of a new Treas. Reg. §25.2702-2(a)(5) was to regard a person and that person's estate as a single qualified recipient. And the revised Example 5 merely illustrates that change. In addition, in a new Example 8 the regulation provides that a following annuity in the holder's surviving spouse can be a qualified spousal interest and will be considered in valuing the remainder following both, but only if the spouse's interest is for a fixed term or until the prior death of the spouse. And, by a new Example 9, the government adheres to its position that an annuity payable to the holder's surviving spouse (rather than to the holder's estate) for only the remaining term of the holder's primary annuity (if the holder dies within the term) cannot qualify because there is no way to know, at inception of the trust, when the spouse's annuity will begin and therefore how long it will last. The Tax Court again confirmed that result in *Focardi*. In the process, it also continued to distinguish Schott v. Commissioner, 319 F.3d 1203 (9th Cir. 2003), as it did in *Cook*.

It would appear that the requirements of the revised regulations are met if an annuity is payable to the holder's estate if the holder dies early, and that annuity is then payable by the estate to the holder's surviving spouse. Why it should matter if the annuity is payable directly to the spouse is not made clear (the Tax Court in *Focardi* said that "[t]he possibility of . . . an abuse is present where, as here, it is not certain at the outset of the trusts that payments will ever be made under a survivorship annuity," but it did not explain why that was so). Nevertheless, it is not necessary to take advantage of the qualified spousal annuity because presumably planning the *Walton* way will be acceptable. As a result, the holding in *Focardi* is nearly irrelevant for planning purposes today; these cases may continue to be litigated for circumstances and planning that predated the amendment to the regulations following *Walton*, but they should not be problematic going forward.

One added element in *Focardi* may be important to taxpayers. The taxpayer argued that a saving clause in that case salvaged the situation because it provided that "[n]o . . . right . . . under the agreement will be effective . . . to the extent that it would cause [the] retained annuity interest . . . to fail to qualify as a 'qualified annuity interest' under I.R.C. §2702(b)(1)." To this the court responded simply that the saving clause was violative of public policy, citing Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944); Ward v. Commissioner, 87 T.C. 78 (1986); Harwood v. Commissioner, 82 T.C. 239 (1984). We had hoped that the decision of the Fifth Circuit Court of Appeals on the issue of saving clauses in McCord v. Commissioner, 120 T.C. 358 (2003), rev'd and rem'd, 461 F.3d 614 (5th Cir. 2006), might yield a different interpretation than the Tax Court. That long delayed decision is totally devoid of any guidance on the issue, which some regard as an affirmation of the planning involved. It certainly is ***not*** a government victory, but the court's total avoidance of the issue can be regarded in two ways — one being that this court, widely regarded as the most taxpayer friendly in the land, did not bless the formula provision involved and, if it would not, is it likely that any other will? On the other hand, the court did not seize the opportunity to vilify such planning or to remand for a determination on the question of validity. To an objective observer, it appears that this decision is a total cipher on the issue and, read in the light of its precedential value, it will be regarded as insignificant or totally nonrelevant to the question. See page 28. (§7.2.2.2.2 (6th ed.))

Buy-Sell Agreement Found Effective. There is little to be learned from **Estate of Amlie v. Commissioner**, 91 T.C.M. (CCH) 1017 (2006), a totally fact specific determination that the value of a decedent's bank stock was properly pegged to the striking price in a buy-sell agreement. In a nutshell, one child was involved in a bank operation and was permitted to purchase for roughly 45% less than the amount he received on a sale approximately two years later. Based on the hindsight comparison of the price he paid and what he received, the government asserted that the striking price was not binding for federal estate tax valuation purposes. The opinion reveals that the striking price was determined by arm's length negotiations between the one child and the decedent's other heirs, there was a history of acrimony among those parties that belied any sense of a sweetheart deal, the decedent was represented by a conservator who obtained court approval for the agreement, several rounds of negotiations that led up to the particular agreement had involved outside parties, and legitimate nontestamentary transfer reasons justified the undertaking (including to provide liquidity and to relieve the taxpayer from having too substantial a portion of the estate locked into a minority position in a closely held bank).

The opinion is noteworthy because it confirms that a buy-sell agreement must meet *both* the pre-§2703 requirements of (a) setting a fixed and determinable price, (b) binding both during life and postmortem, (c) entered into for a bona fide business reason, and (d) not a substitute for a testamentary disposition, and must fall within the §2703(b) safe harbor by being (1) a bona fide business arrangement, (2) not a testamentary device, and (3) comparable to similar arrangements entered into at arm's length. The court confirmed that there is overlap among these requirements (compare items c with 1, and d with 2). According to the opinion, "an agreement that represents a fiduciary's efforts to hedge the risk of a ward's holdings may serve a business purpose . . . [as does] planning for future liquidity needs of decedent's estate . . . ." Further, "[w]hether a restrictive agreement constitutes a testamentary device depends in important respects on the fairness of the consideration received by the transferor, judged at the time the agreement is entered."

In this case evidence showed that the striking price was based on a survey of comparables, and testimony from "an attorney with extensive experience in the purchase and sale of closely held equity interests" satisfied the court that the agreement met the §2703(b)(3) comparability requirement. That the agreement was reached by a conservator with a fiduciary duty and involved negotiations with prospective beneficiaries who had an acrimonious relation and adverse interests with the child who was entitled to purchase confirmed for the court that what it regarded for the estate as "a bad bargain in hindsight" was made at arm's length and was not a testamentary device. Finally, the differential between striking price and the amount for which the child sold two years later was attributable, "at least in part, to the passage of time and the apparent appreciation of the . . . stock . . . and not to any deliberate undervaluing of the stock in the [agreement]." (§15.3.1.2 (6th ed.))

11. Tax Payment

§6166 Passive Activity Safe Harbor Rules. The quantitative tests for §6166 installment payment of estate tax qualification are coupled with a qualitative requisite that the interest be engaged in an *active* "trade or business," rather than some passive investment or

enterprise. The trade or business requirement is articulated in §6166(b)(1) for proprietorships, partnerships, and corporations; the passive asset aspect is added by §6166(b)(9) (along with a special provision for "qualifying lending and finance" businesses under §6166(b)(10)). Probably the most prevalent and illustrative example of the active trade or business issue involves rental real estate properties owned by a decedent directly (or sometimes by an entity, such as a corporation, partnership, LLC, or trust in which the decedent owned a substantial interest). This form of activity often is regarded as lacking in the business operations needed to qualify as an active trade or business, if all the decedent did was passively invest in the property and then merely collect the rents.

In this regard, Rev. Rul. 75-365, 1975-2 C.B. 471, 471 (the decedent maintained a business office to collect rental payments on commercial and farm properties and other investment assets, negotiate leases, make occasional loans, and direct maintenance of the rental properties), was the most often cited (among a trio of rulings all issued at the same time) when denying active trade or business status, and for three decades it illustrated the government's starting point in this analysis. Now it has been revoked and the guidance updated by **Rev. Rul. 2006-34**, 2006-1 C.B. 1171, which embraces the notion that activities of employees and agents, along with those activities performed by owned entities like partnerships, corporations, and LLCs (trusts are not mentioned), will be considered work performed by the decedent to measure active management for qualification purposes. Further, work performed by independent contractors will not preclude qualification if their activities do not reduce the decedent (and any employees, agents, and other owned entities) to the mere passive holding of investment property.

According to Rev. Rul. 75-365, "the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute." Similarly, under Situation 2 of Rev. Rul. 2006-34 the mere holding of property managed by an unrelated property management company was regarded as inadequate. But in a somewhat surprising liberalization, ownership of just 20% of that management entity in Situation 3 of Rev. Rul. 2006-26 was sufficient to reverse that conclusion and give active management treatment. With respect to properties leased to an active business owned by the decedent, compare Lane v. United States, 82-2 U.S. Tax Cas. (CCH) ¶13,473 (D. Mass. 1982); Parrish v. Loeb, 558 F. Supp. 921 (C.D. Ill. 1982); Technical Advice Memoranda 8451014, 8140020, and 7917006 (involving land and buildings net leased to corporations owned by the decedents such that the decedents were not responsible for maintenance, repairs, taxes, insurance premium payment, and the like; the corporation might qualify as an active trade or business, but not the separate properties leased to the corporation), and Private Letter Ruling 9621007 (in large part because tenants did most of the day-to-day work and in part because the decedent's health precluded more active participation for the last seven years of the decedent's life), with Situation 5 in Rev. Rul. 2006-34, which concluded that activities of the owned corporation would be imputed to the decedent and allow the property leased to that entity to qualify, all consistent with Gettysburg National Bank v. United States, 92-2 U.S. Tax. Cas. (CCH) ¶60,108 (M.D. Pa. 1992), which regarded the government's attempt to exclude orchards that were cash-leased to the decedent's active operating corporation as an improper exaltation of form over substance, because the decedent was active in operating the corporation. Also see Private Letter Ruling 200339047 with Private

Letter Ruling 200339043, both involving the same taxpayer but with respect to different corporations, one of which was a passive investor and the others active.

Rev. Rul. 2006-34 is consistent with numerous authorities that detail ownership activity that goes "beyond merely collecting rents, making mortgage payments and making necessary repairs (considered management of investments)," as to which §6166(b)(1) active trade or business status is recognized. See Rev. Rul. 75-367, 1975-2 C.B. 472 (the decedent's S Corporation built homes, some of which decedent rented and maintained), which also was updated (and that portion dealing with rental homes revoked) by Rev. Rul. 2006-34, all making qualification today more likely. See also Technical Advice Memoranda 8601005 (decedent was a partner in a partnership that owned ranch lands), 8240055 (decedent was sole proprietor of over 300 rental units), 8145008 (decedent was primary operator of a 36 unit apartment house), 8136022 (decedent's corporation owned and leased five warehouses that was deemed an active business), 8130057 (decedent was a sole proprietor, building or rehabilitating rental properties that the decedent maintained), 8050002 (decedent was a partner in a partnership that owned and operated a multistory office building), and Private Letter Rulings 200518047 (involving a nice dichotomy between passive and active parcels, a property management company, and a "spousal unity" rule that assets included and qualified in the decedent's estate would retain their qualified character when distributed to the decedent's surviving spouse if there was no material change in the form or operation of them), 200340012, 200339043, 200114005, 200006034, 199929025, 9832009, 9801009, 9634006, 9602017, 9517006, 9422052, 9311031, 9309015, 9250022, and 9128024. The deciding factor among these situations is that decedents who engaged directly in the day-to-day operation of the properties in ways that entail much more active routine involvement are deemed to be engaged in the active trade or business of operating the properties, rather than passive investment in rental realty. Rev. Rul. 2006-34 lists a variety of factors that the government will consider, including the amount of time devoted, whether an office was maintained to conduct active management, leasing and negotiation activities, care of exterior areas, making or supervision of repairs and maintenance, handling tenant requests and complaints, and the like.

Other factors harvested from prior authorities include such things as interviewing prospective tenants and preparing apartments for new leaseholds, maintaining and repairing common areas, disposing of garbage and satisfying recycling requirements, maintaining financial records, paying bills, obtaining and reviewing insurance, inspecting buildings, filing various governmental regulation reports (such as rent control), mediating tenant disputes, hiring and supervising employee staffs, and providing general tenant relations and emergency services. Some cases entail even more activity but, in essence, the decedents' activities must be in the nature of hands'-on property management rather than the mere management of investments in property.

An interesting dichotomy that may help to illustrate the difference in these kinds of situations involves farm or ranch operations, similar to the material participation requirements of §2032A(e)(6). Decedents who actively operate property, as well as those who participate in the operation through a crop share rental agreement, are deemed to qualify as active in the trade or business of farming or ranching:

> An individual is engaged in the business of farming if he cultivates, operates or manages a farm for gain or profit, either as owner or tenant, and if he receives a

> rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.

Rev. Rul. 75-366, 1975-2 C.B. 472, 472, not addressed or altered by Rev. Rul. 2006-34 but potentially clarified in the sense that Situation 2 of that Ruling would indicate that financial risk alone will not likely suffice without active participation in management. Both elements appear to be required, and decedents who merely lease farm or ranch property on straight cash rents in which they bear none of the financial risk and do not participate in management or operation decisions typically are denied active trade or business status. See Schindler v. United States, 87-2 U.S. Tax Cas. (CCH) ¶13,735 (N.D. Ohio 1987); cf. Smith v. Booth, 86-2 U.S. Tax Cas. (CCH) ¶13,686 (W.D. Tex. 1986), (the decedent's cash leases of all but one of five parcels of farmland were for a fixed amount and not different from a landlord's passive rental to "an unrelated tenant"; only the one crop share rental was deemed to qualify). And decedents whose activity terminated before death, usually due to failing health, also have been denied active trade or business status, although the activities of an agent may be imputed to the decedent for qualification. Compare Technical Advice Memorandum 8446009 (the decedent's active cattle raising and farming operation was deemed passive when, two years before death, the decedent sold the herd and ceased generating income other than from the sale of fruits and nuts); Private Letter Ruling 8020101 (the decedent's children operated the property but paid no rent and the decedent was no longer active), with Technical Advice Memoranda 8327009 (a farm and cattle raising operation conducted for a physically and mentally incapacitated decedent by an attorney in fact and two relatives qualified), 8244003 (crop sharing orchestrated by an elderly decedent's child and child-in-law as an agent on the decedent's behalf were qualified), 8144012 (farm operated principally by the decedent's child who lived with the decedent, acting on behalf of the decedent, was qualified), and 8133015 (management consisted of crop share rentals by the decedent and, after a stroke, the decedent's spouse, again with qualified status); Private Letter Rulings 9015003 (timber property held in a grantor trust was deemed to qualify due to activity of the decedent's sibling individually and on behalf of the trustee, who was treated as the decedent's agent), and 8524037 (rental property held in a land trust was actively managed by the decedent and several employees; §6166(b)(2)(C) entity attribution was not mentioned). (§15.2.2 (6th ed.))

§6166 Security and Lien Rules. **Field Attorney Advice 20070801F** and **ILMs 200645027** and **200627023** address aspects of the §6166 installment payment rules dealing with the §6166(k)(1) security, §6165 surety bond, and §6324A installment lien provisions. In a nutshell, the government concludes that its ability to demand security for unpaid installments is separable from its ability to assess a tax and the normal statute of limitation rules applicable to an assessment. Further, the government holds that it may demand a surety bond under §6165 or a special lien under §6324A at any time until a tax deferred under §6166 is fully paid. And recording a §6324A lien divests a §6324(a) lien only with respect to the particular property designated on the §6324A lien agreement and not with respect to other estate properties.

More specifically, the earlier ILM states that there is no statute of limitation on the government's rights to obtain security, nor will issuance of a closing letter affect the government's right to seek or to increase its security. Indeed, the position stated is that the government may terminate a §6166 election at any time it is unable to obtain proper security in either form, and that until such suspension occurs the taxpayer has no §7479 declaratory

judgment right of appeal to the Tax Court (and even then §7479(b)(2) requires the taxpayer to exhaust all administrative remedies within the Internal Revenue Service). Perhaps most interesting about all three pronouncements is that they follow closely a critical report of the GAO to the effect that hundreds-of-millions of §6166 deferred payments are not being collected by the government and that follow-up enforcement must improve. (§§15.2, 15.2.4 (6th ed.))

12. Subchapter J and Other Income Tax Developments

Private Annuity Trusts. A transaction that generates substantial, passionate, and negative government reaction is a taxpayer's sale of an appreciated asset to an intentionally defective grantor trust, in exchange for a private annuity payable by that trust, and the trust's turnaround sale of that asset to an intended (arguably prenegotiated) third party buyer. There are so many ways that such a transaction can be challenged, not the least of which being the fundamental taxpayer assumption that sale by the grantor to a properly structured defective grantor trust can never be a gain or loss realization event. **Melnik v. Commissioner**, 91 T.C.M. (CCH) 741 (2006), and **Field Attorney Advice 20062701F** (which cited and relied on *Melnik* in stating that "there is no reason to believe that the annuity is valid and that taxpayer expects to receive any payments from the annuity" but otherwise is not relevant to this discussion), do not resolve those kinds of questions, but they remind planners that attention to detail and proper appearances are critical.

No one would structure a deal today as was done in *Melnik*, because §679 (relating to the foreign trusts involved there) has changed. But there were many badges of impropriety in the case, including (1) absence of proof by the taxpayer (who bore the burden) regarding critical dates such as when the ultimate buyer engaged in purchase negotiations and with whom, making it impossible for the court to determine a time line or to reject the government's assertion that the ultimate sale was prearranged, (2) use of offshore entities (a corporation that never conducted business operations, and several trusts) for no apparent nontax purpose, (3) absence of negotiations by those offshore entities in the ultimate sale of the asset they ostensibly acquired in the private annuity purchase, (4) no independent appraisals or other objective determination of the appropriate private annuity purchase price, (5) admitted backdating of documents, (6) failure to admit that tax planning played *any* role in the transaction, (7) sale to an unfunded foreign entity without security or any of "the kind of restraint that one would expect to see from participants in a legitimate annuity transaction," and (8) the existence of annuities and trusts that "are easily susceptible of manipulation so as to create illusion."

According to the court, the evidence "reeks of self-interest and is riddled with imprecision and inconsistencies, . . . is lacking in credible evidence that the annuity transactions had economic substance independent of tax considerations, and . . . is not worthy of belief . . . ." The ultimate holding that the transaction was a sham or lacked economic substance and therefore was disregarded flowed from the court finding that there was neither "a business purpose [nor] a reasonable possibility of generating a profit independent of tax considerations." In some ways the court's analysis is reminiscent of the failed family limited

partnership or LLC discount cases, and provides good reading before undertaking transactions designed to alter the look or feel of a transaction.

Issued separately but also of interest to taxpayers engaged in sales in exchange for private annuities are proposed changes to **Treas. Reg. §§1.72-6(e)** and **1.1001-1(j)** intended to reverse the so-called "open transaction" doctrine of Rev. Rul. 69-74, 1969-1 C.B. 43, and carrying an effective date of October 18, 2006 — as if already effective. Excepted only from the effective date are annuity contracts received before April 19, 2007 if:

> (A) The issuer of the annuity contract is an individual;
>
> (B) The obligations under the annuity contract are not secured, either directly or indirectly; and
>
> (C) The property transferred in exchange for the annuity is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

Altogether the clear implication of all these developments is that the government understands that, in the income tax arena, it is being abused by certain forms of transaction, most aggressively involving private annuities. One interesting question is why the government has not already retracted the position it staked out in Rev. Rul. 85-13, 1985-1 C.B. 184, that now provides for planning involving defective grantor trusts that is every bit as disadvantageous to the government. (§5.11.9 (6th ed.))

Changing IRA Designated Beneficiary. Treas. Reg. §1.401(a)(9)-4 now allows determination of the designated beneficiary of a qualified plan or IRA as of September 30 of the calendar year following the calendar year of the participant or account owner's death. Making a change in the designated beneficiary before that date can significantly alter the life expectancy and therefore the minimum required distributions and, thereby, the amount of income tax deferral available.

In that context, **Private Letter Rulings 200616041** and **200616039** involved a surviving spouse as the designated beneficiary who died shortly after the decedent, under a beneficiary designation that at one time named two children as contingent beneficiaries but, when a change in the IRA was made, the contingent beneficiary designation was omitted. Nevertheless, as personal representatives of the surviving spouse, the children made a qualified disclaimer of all interests of the surviving spouse in the IRA, and obtained a state court order reforming the beneficiary designation and splitting the IRA into two sub-IRAs. The court order also restored the children as contingent beneficiaries and gave them each a separate account, such that by the September 30 deadline the government agreed that each child would be regarded as the designated beneficiary of half and their life expectancies could each be used to determine the income tax deferral available. Rather than regard this as an inherited IRA that could not be rolled over (because only a surviving spouse could do so at that time), the government regarded it as a trustee-to-trustee transfer that did not accelerate or cause a taxable distribution to the two children. (§9.3.3 (6th ed.))

Funding Residuary Charitable Share Does Not Accelerate IRD. The context in which **Private Letter Rulings 200652028, 200633009, 200618023, 200617020, 200526010** and **200520004** arise is a decedent's executor making an assignment of IRAs payable to the estate, in partial satisfaction of a residuary charitable bequest under a document that authorized pick-and-choose fractional funding. The government confirms that assignment of the decedent's IRA is not an event that will cause §691(a)(2) acceleration of the built-in income tax liability in that income in respect of the decedent. Care is required here to distinguish these fractional division situations from a pecuniary bequest funded in kind. As shown by **ILM 200644020**, that situation *does* cause acceleration of the IRD, which is a very bad result. Particularly in the context of marital deduction funding, all this informs reconsideration of the choice between fractional and pecuniary bequests and favors the fractional version in estates that promise to hold substantial rights to receive income in respect of the decedent. (§§5.10.5; 13.7.8.1.3; 13.7.9.1.3; 13.7.9.2.2 (6th ed.))

§664 Charitable Split Interest Trusts and Spousal Elective Shares. Every now and again the government issues a pronouncement that appears to be without precedent. And the reason why an issue became a concern is unknown, which was the case with **Rev. Proc. 2005-24**, 2005-1 C.B. 909. This is not to say that the issue was wrong, but it certainly was unexpected. That pronouncement raised all form of rancor, and **Notice 2006-15**, 2006-8 I.R.B. 1, has effectively put the controversy on hold as the government reconsiders its position and whether other avenues for addressing the perceived abuse may exist. So for the moment this is a tempest pushed back into the teapot; Pandora's box has been re-closed for the time being. (§§14.3.2 n.40 (6th ed.))

Transfer for Value Rule. Confirming a position that by now is well known and understood, **Rev. Rul. 2007-13**, 2007-1 C.B. 684, upgrades and makes reliable a position that has been consistent and long standing, as shown just in the last two years by **Private Letter Rulings 200636086, 200606027, 200518061, 200514002,** and **200514001**. In all of these the government concludes that transfers for value of insurance policies are benign for income tax purposes because they are between the grantor and his or her grantor trust, or between one grantor trust and another grantor trust (both with the same grantor), or constitute a transfer from a third party into a grantor trust (which is treated as a transfer to the grantor). It was not stated in every case (but it is specified in the Revenue Ruling) that the grantor was the insured under the policies involved, but in each case the theory upon which the government relies is classic grantor trust dogma: that the grantor is deemed for income tax purposes to own the assets held by a grantor trust. As said in the Revenue Ruling:

> Because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes. In addition, because the grantor is therefore considered to own the purported consideration both before and after the transaction, the exchange . . . is not recognized as a [transfer for value] for federal income tax purposes.

Thus, either of two results is applicable. Either §101(a)(2) (the transfer for value rule) does not apply — the transfer cannot be recognized as a §101 transfer, for value or otherwise — because the grantor is deemed the owner both before and after the transfer [Situation 1 in the

Revenue Ruling]. Or the transfer qualifies as a §101(a)(2)(B) transfer to the insured [Situation 2 in the Revenue Ruling], which is an exception to the transfer for value rule. See Rev. Rul. 85-13, 1981-1 C.B. 184, cited by the Rulings, and Swanson v. Commissioner, 518 F.2d 59 (8th Cir. 1975), which is the leading case but was not cited. (Note that the Rulings did not establish that the trusts *were* effectively defective grantor trusts but instead relied on that representation.)

Be careful, however, to consider that the Rev. Rul. 2007-13 does not articulate the "street lingo" theory of grantor trusts, which is that they are "ignored" for federal income tax purposes. The nuance is that a grantor is treated by the Code and Regulations as owning the assets of the trust. That position is strained when various authorities say that, as a result, "the exchange . . . is not recognized as a sale." This extrapolation *is* a stretch, in terms of what the Code and Regulations say is the real application of the grantor trust rules. To wit:

Every grantor trust rule (§§673-677) begins by saying "The grantor shall be treated as the owner of any portion of a trust . . . ." The significance of this is found in §671:

> Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.

This does not say that an exchange with a grantor trust is not to be recognized, *or* that the trust is to be ignored. Elaborating on this are the regulations, which add only:

> *Treas. Reg. §1.671-2(a).* . . . [A] grantor . . . includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner.
>
> *Treas. Reg. §1.671-3(a).* When a grantor . . . is treated . . . as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example —
>
> (1) If a grantor . . . is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's gain and loss, income, deductions, and credits belonged to the grantor. The conclusion, articulated by these Rulings, is not what either the Code and Regulations themselves actually specify. Yet Rev. Rul. 85-13 has been interpreted by taxpayers in a vast number of different situations to restate its conclusion by asserting that a grantor trust is treated as if it did not exist, most particularly involving transfers by a grantor *into* a defective grantor trust (the exact opposite of the situation involved in Rev. Rul. 85-13, which was a transfer by the trust back to the grantor). That articulation is based on the government's Ruling position, there in 1985 and repeated here in 2007 as well, that the grantor can have no gain or loss on a transfer involving the trust — that an exchange between the grantor and the trust "is not recognized as a sale." That result is taxpayer favorable in this

§101(a)(2) context, but it was disfavorable to the taxpayer in Rev. Rul. 85-13, and in each case it is not quite what the law provides, making it slightly unreliable. Not that anyone should worry in the §101((a)(2) context — the government is being consistently generous in this application. But perhaps in other areas of defective grantor trust planning in which taxpayers are engaged in affirmative planning that gets over on the government in ways that are not so likely to be regarded by the government as benign. (§§5.11.9 n.219; 8.4.1 n.32 (6th ed.))

Application of §67(e) Exception to 2% Haircut Rule. Regulations have not yet given guidance to the meaning of §67(e)(1), which provides that items of deduction are not subject to the 2% threshold rule to the extent they are "paid or incurred in connection with the administration of the . . . trust and . . . would not have been incurred if the property were not held in such trust . . . ." O'Neill Irrevocable Trust v. Commissioner, 98 T.C. 227, 230 (1992), rev'd, 994 F.2d 302 (6th Cir. 1993), nonacq. (investment counseling fees paid by individual trustees to an outside advisor), restated the rule as "only those costs which are *unique* to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor . . . " (emphasis in original). Examples given of unique items in trust administration were "the fees paid to a trustee and trust accounting fees mandated by law or the trust agreement." In finding that the 2% rule was applicable, the Tax Court focused on the fact that applicable law regarding permissible trust investments was the antiquated "legal list" approach, stating that this provided the trustees with a list of preapproved investments that obviated the need to incur investment advice fees altogether. Thus, it reasoned that the costs involved could not be unique to the fiduciary administration.

If that position was correct, it might indicate that no deduction should be allowed at all, because the expense would not be necessary, as required by §212(2). In reversing, the Sixth Circuit Court of Appeals held that the 2% limitation did not apply at all, because mere selection of an approved investment from the statutory list does not automatically meet the prudent investor standard and investment advice might be necessary to help the trustee diversify or choose among other prudent investments. Because the fiduciary is liable for negligence in these activities, unlike individual investors, the appellate court agreed with the taxpayer that these fees were unique to fiduciary administration for §67(e)(1) purposes and that the 2% haircut did not apply.

In a substantially similar case on the facts, however, the Virginia legal list statute was deemed to be substantially different in law, providing "absolute immunity" to a fiduciary who selects from the legal list, meaning that no investment advice was required by fiduciary principles whatsoever. Scott v. United States, 186 F. Supp. 2d 664 (E.D. Va. 2002), aff'd, 328 F.2d 132 (4th Cir. 2003). Thus, the court held that a trustee's election to hire a financial consultant is no different than what an individual investor might do, and therefore caused the fee to be subject to §67 without protection by the §67(e) exception. At the same time, however, the court also found that costs incurred for investment advice properly were deductible, presumably as they would be for an individual notwithstanding that no advice was needed to avoid fiduciary liability.

Different from *Scott*, which merely found the laws of Virginia and Ohio different and therefore the application of §67 differed also, the fundamental position in *O'Neill* was called into question in Mellon Bank v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶50,642 (Ct. Fed. Cl. 2000), aff'd, 265 F.3d 1275 (Fed. Cir. 2001). Fees were incurred for investment

strategy advice, along with accounting, tax preparation, and management services. The opinion below was a rejection of cross motions for summary judgment, causing the case to continue essentially to determine which expenses should be subject to the §67 haircut. The taxpayer subsequently stipulated that it would not present evidence regarding whether any of the costs at issue would not have been incurred if the property were not held in trust, basically choosing to proceed with the case and challenge the lower court's interpretation of the law, which discredited the opinion in the Sixth Circuit on appeal in *O'Neill* and effectively restored the sense of the Tax Court opinion in that case. On appeal of the lower court's subsequent grant of the government's motion for summary judgment, the Federal Circuit Court of Appeals basically reviewed whether the lower court's interpretation of §67(e)(1) is correct in requiring the taxpayer to prove that the deductible expenses were not routinely incurred by individuals and therefore met the test that they be unique to fiduciary administration.

According to the Claims Court in *Mellon*, it is not enough to determine that the expenses were incurred properly in a fiduciary context, nor that they were necessitated by the fiduciary duties involved. Instead, the first of two tests under §67(e)(1) is that the expenses were incurred in the proper administration of the fiduciary entity. Mellon Bank wanted only this requirement to govern. The second test, with which these cases have wrestled, is that they would not have been incurred but for the existence of that fiduciary entity. According to the *Mellon* court, this requires a determination on a case by case basis whether the particular costs would have been incurred even if no trust had been involved. "[T]he fact that costs can be characterized as trustee fees in a trust context says nothing about whether those costs would not have been incurred in a nontrust context."

In *Mellon* in particular, state law imposed a prudent investor standard that the fiduciary act as would prudent individuals in their own investment activities. This made the lower court believe that it is not reasonable to suggest that fees paid for investment advice rendered to the trustee are necessarily any different than fees that would be incurred by individuals in their personal investment activities. And, according to the lower court, "[t]he same reasoning applies to the fees paid . . . for accounting, tax preparation, and management services. Certain types of such services would be employed whether or not the property were held in trust." Those that would be incurred regardless of the existence of the fiduciary relation are subject to the 2% haircut. Finally, to the suggestion made by the American Bankers Association in an amicus brief that this interpretation will require a costly individuated inquiry into the facts and circumstances of each and every fiduciary administration, the lower court replied that only Congress can provide relief from the difficult burden of the exception in §67(e)(1).

The upshot, it originally seemed, of the lower court opinion in *Mellon* appeared to be that fiduciaries would be encouraged to "unbundle" their fees, establishing those amounts that are incurred solely because of the existence of the fiduciary engagement. Unbundling would entail some extra investigation, because it seems likely that the *Mellon* court would say that, if the taxpayer was paying for investment advice before the trust was created, and pays for investment advice after the trust is created, then the investment element of the fiduciary's fee would be subject to the 2% threshold. Conversely, if the taxpayer was not incurring that cost prior to creation of the trust but the trustees did provide an element of investment services for which a portion of their fee is incurred, that portion might qualify for the exception to the 2% loss of deductions.

On appeal these notions seem almost to have been reversed, because the court stated that it was "undisputed that trustee fees are fully deductible," without more. Which may suggest that

trustees should hire the advisors and service providers they need and wrap the fees paid for those services into a single trustee fee, as if the trustee provided all those services itself without the need for outside help. Would this make the single undifferentiated fee totally deductible without restriction by the §67 haircut?

This essentially was the position argued by the Mellon Bank, which maintained that trustee fees are "merely a label for fiduciary services performed by the trustee" and that "there are really no unique 'trustee' services — all remain subject to fiduciary standards and are fiduciary services under governing law. Therefore, payments for outside fiduciary services are in fact trustee fees, and should be fully deductible." With this the court of appeal did not agree, stating that the taxpayer's interpretation would conflate the two requirements of §67(e)(1) into one: that they were incurred in the administration of the fiduciary entity is not enough; the Code also requires that they would not have been incurred had there been no trust. It is the second of these requirements that creates the controversy and uncertainty, and without question more guidance will be needed into the practical application of such a rule.

The court of appeal stated, for example, that investment advice and management fees commonly are incurred outside of fiduciary administration and thus the costs for those items are not exempt from the 2% haircut. Said the court, "Mellon Bank chose to hire outside consultants to satisfy their fiduciary duty as trustees. The plain meaning of §67(e)(1) prevents the deduction of fees thus incurred unless they satisfy the general requirements of §67(a)." This would appear to say that, even if the trustee incurred those fees out of its own pocket and then charged a trustee fee large enough to cover all its costs, the very act of hiring outside consultants would preclude qualification for the exception to §67(a). Yet it hardly makes sense to require every trustee to provide all the services it needs from within — that would not be the most prudent course for all trustees, and it would not be the most reasonable in cost.

At this juncture, then, along came **Rudkin Testamentary Trust v. Commissioner**, 467 F.3d 149 (2d Cir. 2006), aff'g 124 T.C. 304 (2005) (a unanimous reviewed opinion), that makes no mention of unbundling, involves a picayune $4,448 tax deficiency, and in no uncertain terms stated below the Tax Court's belief that it's original position in *O'Neill* and the results in *Scott* and *Mellon Bank* are correct, making it reasonably certain that a blanket position that all fiduciary fees are free from the 2% rule will attract government challenge and (at a minimum) Tax Court disapproval. On appeal the court rejected smart original arguments about both legislative history and statutory construction of §67(e) and crafted a refinement of — perhaps a deviation from — the positions in both *Scott* and *Mellon Bank*, leaving what the court called the "clear and unambiguous" statutory text now subject to several not totally clear or consistent interpretations (and, in the process, rejecting the need to consider the legislative history because "the statutory language is clear"). Said the court on appeal:

> . . . Mellon Bank . . . held that the second clause of section 67(e)(1) . . . "treats as fully deductible only those trust-related administrative expenses that are . . . not customarily incurred outside of trusts."
>
> . . . Scott . . . stated that "trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers."
>
> . . . [We hold that] the plain meaning of section 67(e)(1) . . . excludes from full deduction those costs of a type that could be incurred if the property were held individually rather than in trust.

> . . . [T]he statute demands . . . an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are incapable of incurring. . . . [C]osts that individual taxpayers are capable of incurring are . . . not fully deductible . . . when incurred by a trust. By contrast, costs that individuals are incapable of incurring, like "fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns" are fully deductible. [citing *Scott*]
>
> . . . [I]nquiry into whether a given cost is "customarily" or "commonly" incurred by individuals is unnecessary . . . . We believe the plain text of section 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual . . . [and] permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner.

Notice the court's change of the statute's "would not have been incurred if the property were not held in such trust or estate" to "could not have been incurred by an individual." Gad!

Notwithstanding the lack of consistency among the various opinions granting governmental victories, it is clear that the government and the majority of the courts find 100% deduction of all fiduciary expenses to be unacceptable. And the government now seems to be well positioned to promulgate regulations that will restrict deductions under §67(e)(1). In particular, as noted by the *Rudkin* appellate court, Temp. Treas. Reg. §1.67-1T(a)(1)(ii) stating that investment advisory fees are subject to the 2% floor almost surely will be extended to trusts and estates.

The hard question for fiduciaries is whether the government will be paying attention to fiduciary income tax returns, until or even after such guidance is made available. The interesting question is whether Form 1041 returns are being audited, and how did Mellon Bank or the Rudkin Trust get targeted for this litigation? The answer in *Mellon* was that the fiduciary filed a return that respected the 2% limitation and then, on the strength of *O'Neill*, filed a claim for refund, which put the case on the government's radar. *Scott* indicated that the government simply audited the trust's return. There is no indication in *Rudkin*, which is remarkable for how little we are told other than that the Tax Court and the Second Circuit Court of Appeals are firmly on the government's side in this battle. (§5.3.1 (6th ed.))

Is It IRD, and Why Should You Care? The issue in **Eberly v. Commissioner**, T.C. Summ. Op. 2006-45 (a summary opinion that may not be cited or relied upon), is far more revealing than the court's holding, because it reminds us of the relative value of a finding that an item is income in respect of a decedent (IRD). The particular situation was a taxpayer's lump-sum withdrawal from a qualified plan, which provided that any "election or change . . . will take effect as of the date it was signed, whether or not the signer is living at the time we receive it. Any other notice will take effect as of the date it is received." The taxpayer executed a request for withdrawal a week before death but that document was not received by the plan until the very day of the taxpayer's death. The first significance of that timing was whether the amount the taxpayer attempted to withdraw passed under the taxpayer's will to three children, or under the plan beneficiary designation that directed to each of them and the last 25% to several charities. One unexpected aspect of the case was that the charities were not contesting whether the withdrawal was effective, and it was the children who asserted that the withdrawal was too late and that the distribution constituted §691(a) IRD when received.

The helpful reminder is that, in many cases there are only three potential results: an item is income of the decedent before death (the conclusion of the court here, holding that withdrawal was effective before death), it is IRD, or it is income to the recipients. In a case such as this, a fourth option — that it is not income to anyone — was not viable. So, which position is preferable? Of the three taxable income alternatives, the worst is that it is income to the recipients, because that conclusion denies them the §691(c) deduction for estate tax attributable to the income item. As between the other two positions, these days the better option is income to the decedent before death, because the decedent's income tax liability constitutes a §2053(a)(3) deduction that reduces the estate for estate tax purposes, which has the same effect as the §691(c) deduction, *plus* it has the same tax saving impact for state death tax purposes, as to which there is no §691(c) counterpart. There may be timing issues, and acceleration of the time to pay income tax should be considered as between these two options, but the important point is that either position is likely better than suggesting that the item is neither IRD nor income of the decedent received during life, which may be counterintuitive to many taxpayers at first blush. (§5.10.3 (6th ed.))

Kiddie Tax Age Changed to 18. Presumably to raise revenue and not just to make the lives of taxpayers with young rich children crazy, Congress in the Tax Increase Prevention and Reconciliation Act of 2005 (**TIPRA**), which was enacted in 2006 but is applicable to tax years beginning after 2005, changed the **Kiddie tax** §1(g) age from 14 to 18. Which, among other things, means that income set to mature just after a child turns 14 (and that therefore would have avoided the tax) now will be subject to the Kiddie tax unless that income can be further deferred until the age of majority. (§6.3.2 (6th ed.))

Be Careful in Claiming Deductions. The simple message in **Brownstone v. United States**, 465 F.3d 525 (2d Cir. 2006), is that the proper fiduciary income tax entity needs to claim the deduction for charitable contributions. Another ancillary lesson is that the estate tax and estate income tax rules need not be in pari materia. In a nutshell, the trustee of a trust for the benefit of the settlor's surviving spouse belatedly amended its income tax return to claim a §642(c) deduction for amounts distributed by the trust to the estate of the surviving spouse, who had exercised the power in favor of that estate and, through it, in favor of several charities. Notwithstanding inclusion of the appointive property in the spouse's estate under §2041 (because of the spouse's general power of appointment), the taxpayers did not regard the distribution as (1) a trust distribution carrying out trust DNI to the estate, followed by (2) an estate distribution to charity generating a §642(c) income tax charitable deduction to the spouse's estate. It is anyone's guess why these missteps occurred, or whether amended returns that regarded the distributions in a more appropriate manner were possible, given the various tax years and statutes of limitation that applied to each of the trust and the estate. The end result was denial of the charitable deduction to the trust, which made no provision in favor of the charities that received the ultimate distributions (thus violating the §642(c)(1) requirement that the distribution be pursuant to the governing instrument). (§5.9 n.11 et seq. and accompanying text (6th ed.))

13. Notable State Law Developments

Insurable Interest. It is rare that lack of an insurable interest arises as an estate planning issue. On occasion the question has beclouded planning such as charitable split dollar life insurance, but even then it typically is a side show, ancillary to a real question of a different nature, such as creative financing or fraud on the tax system. **Chawla v. Transamerica Occidental Life Insurance Company**, 440 F.3d 639 (4th Cir. 2006), aff'g in part and vacating in part 2005 U.S. Dist. LEXIS 3473 (E.D. Va. 2005), is no exception, in the sense that the insurable interest issue was ancillary to a more direct (and successful) challenge to a claim to insurance proceeds that was rejected in large part based on a material misrepresentation in the application for the insurance coverage. Indeed, as a second theory for rejecting the insurance beneficiary's claim, the court on appeal vacated as "unnecessary" the lower court's conclusion that "even absent a material misrepresentation, Plaintiff's claim necessarily fails as a matter of law because the Trust maintained no insurable interest in the life of the decedent, thus rendering the policy void."

As a matter of freestanding jurisprudence, that insurable interest issue was "novel" under the applicable state law, and it would throw the world of life insurance trust planning into a tailspin if there was currency to the court's conclusion that a trust owning a policy of life insurance makes the coverage invalid because the trust can have no insurable interest in the insured. Furthermore, the lower court's interpretation of insurable interest law might be error (because normally the proceeds are simply payable by constructive trust to someone who *does* have an insurable interest, or to the insured's estate). See, generally, Swisher, The Insurable Interest Requirement for Life Insurance: A Critical Reassessment, 53 Drake L. Rev. 477 (2005), citing 4 Russ & Segalla, Couch on Insurance 62:5 (3d ed. 1997 & Supp. 2004). Swisher describes as "controversial" a rule that the insurer would pay *anyone* if there was no insurable interest, but he points out that this rule may not apply if there was fraud with respect to acquisition of the insurance, which actually was the case in *Chawla* and makes the end result proper. Payment is barred in the case of fraud. Swisher also opines that it largely is unquestioned that the insurable interest rule is available only as an insurer's defense to payment and is not available to the real parties in interest who suffer a loss attributable to any wrongdoing prompted by the owner of a policy not having an insurable interest.

Notice that the insurable interest rule could be a major issue if coverage were sought by unmarried cohabitants, by a paramour, or a nonmarital and non-filiated child, and perhaps even if the insured is a business partner or "low level" employee. So, it is critical to keep in perspective the particular facts and primary holding of the case on appeal. *Chawla* involved a decedent who had undergone brain surgery, suffered a series of what the court called "residual neurological afflictions," and had been hospitalized for alcohol abuse. None of which was disclosed in the insurance policy application, which specifically asked whether in the past five years the insured had observation or treatment at a clinic, hospital, or sanitarium, or had consulted, been examined by, or been treated by any physician. The only affirmative answer to these questions was revelation of a physical exam and a visit to a urologist for an elevated PSA. The application later was supported by a letter from the plaintiff's husband, a medical doctor. "Ah-ha," you say, "and what exactly was the insured-decedent's relation to the doctor, or to the plaintiff"? As near as the lower court opinion revealed, the answer was "none." On

appeal it turns out that the doctor and the plaintiff were personal friends and co-investors in various real estate ventures with the decedent, who also lived with them intermittently.

The decedent originally applied for a policy in which the doctor's wife (the plaintiff) was named as owner and beneficiary. The insurer refused to issue that policy because she lacked an insurable interest. The decedent then created a trust of which the decedent and the plaintiff were cotrustees, the decedent was beneficiary during his life, and the plaintiff was the sole remainder beneficiary. The policy was issued in that case but the insurer refused to pay after learning the totality of the facts. Instead, it refunded all premiums and was upheld in its renunciation of the insurance contract. This postmortem treatment and the court's determination on appeal confirms that *Chawla* is not really an insurable interest decision; it is really just an insurance fraud case. And again it reminds us to keep all this in perspective. Indeed, as so viewed, the case is hardly a surprise, and probably says next to nothing about legitimate estate planning uses of insurance trusts. Except, perhaps, in one respect.

Local law contained an insurable interest requirement referencing "a person with an insurable interest" and further defined "person" as "an individual, . . . trustee, guardian, personal representative, fiduciary, representative of any kind, partnership, firm, association, corporation, or entity." *Chawla* held that the person involved (the trust) did not have an insurable interest in the life of the decedent because it viewed the statute as requiring that "the benefits be made payable to . . . a person with an insurable interest in the decedent." Which the court apparently read to mean not that the trust must have the insurable interest but that the trust itself be payable to a trust beneficiary who is a person with an insurable interest. Normally this would mean that we would look through the trust to its beneficiaries to make the insurable interest determination. In that regard, it may be fair to say that the lower court's decision in *Chawla* was a tad unexpected (the higher court said it failed to reflect "judicial restraint") and that it was flawed. But the final result still makes good sense, under the relatively unique facts of the case. Further, as so viewed the decision is not controversial in the least, because seldom in garden variety insurance trust planning is there no trust beneficiary with an insurable interest in the insured.

The final chapter in the *Chawla* story (one may hope) is that the Maryland legislature amended its insurable interest law (Md. Code Ann., Insurance §12-201(b)(6) (2006), effective June 1, 2006), to provide that a trustee has an insurable interest if the insured is the grantor, an individual related by blood or law to the grantor, or an individual in whose life the grantor has an insurable interest, *and* the trust beneficiaries have an insurable interest in the insured. Presumably that definition would preclude the trust for the doctor's wife in *Chawla*, even if the decedent created the trust. It looks like it might also preclude a trust for a grantor's paramour, of either the same or the opposite sex. Wrong result? (§8.2 n.1 (6th ed.))

Fiduciary Duty to Diversify. In a spate of state cases the question of investment prudence and diversification has been evaluated, all in the context of document authority that purported to authorize a trustee to retain original investments left by the settlor. Especially significant about these decisions is the differing interpretations that have been given to language that likely had similar intent. For example, **Wood v. U.S. Bank**, 828 N.E.2d 1072 (Oh. Ct. App. 2005) (trust holding stock in the corporate fiduciary, as to which the sale of other assets actually reverse diversified an 80% holding to 86%, followed by a decline of over half its value), held that authority "[t]o retain any securities in the same form as when

received, including shares of a corporate Trustee . . . even though all of such securities are not of the class of investments a trustee may be permitted by law to make" was adequate to overcome the fiduciary's duty of loyalty, which would have precluded the fiduciary from holding its own stock, but did not supersede the duty to diversify the large block of that stock received from the decedent. Six months later **National City Bank v. Noble**, 2005 WL 3315034 (Oh. Ct. App. 2005) (trust holding stock in the family business decreased its shareholding from 87% to 25% but still lost 52% of the trust's value), held that authority "to retain . . . any part or all of my securities . . . even though its retention may result in a large part or all of the trust property's being invested in assets of the same character or securities of a single corporation . . . the Trustees are expressly empowered to retain . . . all securities issued by [the family corporation] . . . irrespective of any limitation prescribed by law" was sufficiently specific to overcome the duty to diversify. Similarly, **In re Chase Manhattan Bank**, 809 N.Y.S.2d 360 (Sup. Ct. App. Div. 2006) (a/k/a *Dumont*, involving a 95% concentration in Kodak stock), found that the trustee properly held pursuant to language expressing "my desire and hope that said stock will be held by my [fiduciaries] to be distributed to the ultimate beneficiaries and neither [fiduciary] shall dispose of such stock for the purpose of diversification . . . [unless] there shall be some compelling reason other than diversification of investment to do so." For a much more expansive collection of recent cases dealing with diversification see Cline, Do Trustees Have an Absolute Duty to Diversify?, 31 Tax Mgmt. Est., Gifts & Trusts J 140 (2006).

The broader message for estate planners and the drafters of documents is that it may be wise to consider changes that have been made to state law that ought to generate revisions to provisions in documents, such as the trustee powers. State law, more quietly than tax law, has been changing nationwide at a pace that may be surprising — just consider revisions or adoptions, either in whole or in part or just spawned by such laws as the Uniform Prudent Investor Act, the Uniform Principal and Income Act, the Uniform Trust Code, the Uniform Probate Code, and the Revised Uniform Estate Tax Apportionment Act. Quaere whether your "boilerplate" provisions have kept pace with these state law developments.

Apportionment of Death Tax. There is no planning and drafting issue that is more likely to produce litigation than apportionment of a tax payment obligation. On an annual basis more cases raise tax apportionment issues than any other litigated matter, and the one consistent root of problems is a tax payment direction — provided under a badly drafted document or (rarely) under state law in the absence of an applicable direction — calling for payment from the residue of an estate, typically waiving all rights of reimbursement. On a recurring basis in this space recent examples of these train wrecks are reported, in the hope that some readers will reassess the wisdom of unthinking boilerplate inclusion of the few short paragraphs found in many estate planning documents, directing payment of all taxes caused by a client's death from the residue of the client's estate and, applicable in all but four American jurisdictions, overriding the more sensible state law equitable apportionment that usually would avert the particular problem raised. To illustrate:

In re Estate of Williams, 853 N.E.2d 79 (Ill. App. Ct. 2006), held that the court "reject[s the] claim that the will's language, 'pay [all estate, inheritance, transfer, and succession taxes] from the residue of my estate . . . without apportionment or reimbursement,' somehow clarifies any ambiguity concerning [the decedent's] intent." The question was whether an old-

style §2056(b)(5) all-income, general power of appointment marital deduction trust should pay the estate tax caused by its §2041 inclusion in the estate of the surviving spouse, or whether the residue of the spouse's estate should pay, which would adeem a charitable residuary bequest. The majority concluded that the pay-all-taxes provision in the surviving spouse's will "merely shows an intent to prohibit the beneficiary of the residue from seeking apportionment from the beneficiaries of the probate and nonprobate assets," but that it did not address the question of what would happen if the residue of the surviving spouse's estate was insufficient to pay all taxes. Illinois lacks a tax apportionment statute but Illinois case law has "consistently applied the doctrine of equitable apportionment . . . among recipients of probate and nonprobate assets," unless "the testator has expressed a clear intention to the contrary." Here the court concluded that the pay-all-taxes and waive-all-reimbursement provision was insufficient to alter that apportionment result.

In **Estate of Malik v. Lashkariya**, 861 N.E.2d 272 (Ill. App. Ct. 2006), the will directed "all taxes shall be paid by my estate" and this *was* deemed adequate to alter apportionment and place the full burden on the residue of the probate estate — in that case involving over $500,000 of life insurance (includible under §2042), another $230,000 of joint tenancy property (includible under §2040), and undisclosed value in a retail business and other probate assets that were substantially reduced by the tax burden.

This may have been the right result in *Williams* — that the power of appointment trust pay the taxes caused by its inclusion — but it generated a strong dissent based on an accurate assessment that "the majority manufactures testamentary ambiguity out of dislike for . . . the results." Oddly, neither opinion addressed the existence of the federal §2207 right of reimbursement, much less the more targeted question whether the will provision was sufficient to waive its application in this case. In *Malik* no mention was even made of §2206, the federal right of reimbursement for taxes attributable to §2042, which appeared to be over 50% of the taxable estate. Leaving the reader to wonder whether the litigants in both cases did not brief the issue of tax apportionment versus reimbursement. Unresolved in *Williams* was the fact that the marital trust default beneficiaries were a charity and private individuals and the issue whether taxes apportioned to the trust would be equitably apportioned so as to impose the total burden on the noncharitable beneficiaries (equitable because their entitlements generated all the tax). A well drafted tax payment regime will address all of these questions.

Equitable apportionment was involved in both **In re Probate of the Will of Lee**, 2006 N.J. Super. LEXIS 322 (2006), and **Shriners Hospital for Children v. Schaper**, 2006 Mo. App. LEXIS 1824 (2006), in each case involving preresiduary bequests to individuals and residuary bequests to charity. In each case the question was whether taxes — which were entirely attributable to the noncharitable bequests — should burden the bequests that generated the tax. Essentially that result would allow each charity to take more because (1) the preresiduary bequests would each abate to pay the taxes attributable to them, leaving more in the residue (because taxes would not be a burden on the residue), and (2) the estate being larger because the charitable deduction would not be reduced by the imposition of taxes on the residue. As decided by these courts, however, the unmentioned result will be a circular whirlpool tax calculation involving a determination of the residue based on the amount remaining after payment of all taxes, paying the taxes from that residue, then reducing the residue for deduction purposes, recalculating the now higher tax and causing that added tax to be paid from the residue, again further reducing the residue and the deduction and increasing the tax, ad nauseam. In each case the courts determined that the decedent intended the

individuals to receive particular amounts or property unreduced by any impost such as debts, expenses, or taxes — and in each case that might have been the right judgment of the decedent's intent — but in each case litigation was generated by the drafter's failure to clearly articulate that the charities were meant to receive only what remained after these preresiduary gifts took precedence and the charities paid all the tax. The *Schaper* court actually stated that the drafter "did not draft specific terms . . . concerning where the burden of the estate tax would fall," partly because the estate was expected to be too small to be taxable and partly because the decedent's "plan was to leave payment of expenses up to [the trustee] because [the decedent] trusted [the trustee] to 'take care of things' and 'she did not see any need to worry about it in detail at that point.'" Oh my! No indication is given whether this delegation of authority caused the government to deny the charitable deduction in its entirety, nor whether the cost of resolving these disputes will be borne by the drafter who failed to anticipate the controversy. Quaere the result of a community standard defense to a malpractice case.

A far less intuitive (because it is a much less common) drafting issue arose in **Estate of Dehgani-Fard**, 46 Cal. Rptr. 3d 289 (Cal. Ct. App. 2006), involving income tax attributable to substantial income items discovered 11 years postmortem. Charity was one of several residuary beneficiaries and the question was whether its share of the residue should be calculated before or after payment of income tax on those items. This is a different equitable apportionment concept than typically is encountered, but the common notion is that a charity's portion of *any* estate should be calculated pre-tax (income *or* the more common wealth transfer tax) to properly apportion the benefit of any charitable deduction to the charity. It is not necessarily the decedent's intent to allocate the benefit of a charitable deduction entirely to the charity, which is why litigation is required if the document is silent. The way to maximize any charitable benefit and reflect the charity's tax exempt status is to divide before tax and subject only the portion passing to noncharitable beneficiaries to the tax, with all the tax being paid from that nondeductible portion. That was the result reached in *Dehgani-Fard*, but again it required litigation and reversal here of a lower court determination that violated "the equitable principle requiring that 'the burden of the tax accompanies the income and should be borne by the account into which the taxed item goes.'" Quaere whether the typical tax apportionment provision even *mentions* the proper allocation of *income* tax liabilities (including the Canadian capital gain at death tax) incurred during estate administration.

In re Estate of Eriksen, 716 N.W.2d 105 (Neb. 2006), raised a different form of equitable apportionment, involving a noncharitable beneficiary but the same essential equities. To wit: who should get the benefit of any tax saving attributable to special use valuation under §2032A (or, in an old-facts situation such as this, the now-defunct §2057 QFOBI deduction)? Particularly in a case (such as this) in which the tax benefit generated by a bequest (such as qualified real property or stock in a family business) ultimately may be recaptured if certain material participation qualification rules are not met postmortem, the hard question is whether the beneficiary who receives the qualified property, and who may be burdened later with any recapture tax, should receive the tax benefit generated by that special property. The issue in *Eriksen*, to be resolved on remand, was whether the decedent's tax payment provision directed against statutory equitable apportionment, which the court apparently thought would apportion the tax savings attributable to either special use valuation or any deduction (only the latter of which was expressly mentioned in the statute).

A similar item that might be relevant (but under most statutes or tax payment provisions it is not) includes the benefit of credits or exclusions. One increasingly common illustration of

this is illustrated by **Pfeufer v. Cyphers**, *** A.2d *** [2007 Md. LEXIS 111] (Md. 2007), involving the benefit of a state inheritance tax exemption for relatives of the decedent as opposed to "strangers." In a larger setting, state death tax may contain tax rate differentials for beneficiaries in varying degrees of relation. In *Pfeufer* four residuary beneficiaries were required to split the estate remaining *after* payment of all state death tax, notwithstanding that all of that tax was incurred by the share of just one of them, who was not a relative and therefore not entitled to exempt beneficiary status. Based on what the court regarded as "boilerplate language" in the decedent's will to pay all taxes from the residue of the estate without apportionment, it is not inconceivable that the decedent thoughtfully intended to treat all four beneficiaries (two children, a sibling, and the nonrelative) as if they were similarly situated. The fact that this litigation reached the highest state court, however, tends to put the lie to the court's expressed notion that the will provision was "clear." Given the animosity created by that lack of equity, and the deviation from the state law default rule, a more affirmative articulation of intent would have been useful to better avoid the controversy. (§3.3 (6th ed.))