THE YEAR IN REVIEW:
AN ESTATE PLANNING PERSPECTIVE
ON RECENT TAX DEVELOPMENTS

by

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INTRODUCTION

The past twelve months have witnessed substantial changes in the estate, gift and generation-skipping transfer taxes and in the income tax laws relating to estate planning.

This outline summarizes the legislation, regulations, revenue rulings and procedures, regular decisions of the Tax Court, the Claims Court and the courts of appeals, as well as selected district court and Tax Court memorandum decisions, private rulings, notices, announcements and other IRS and Treasury documents from the past year. Because of publication deadlines, this outline includes only those developments reported publicly from April 1, 2007 through April 1, 2008.

The tax developments in this outline are divided into 5 categories:

(I) Estate taxes,
(II) Gift taxes,
(III) Generation-Skipping Transfer Taxes
(IV) Special Valuation Rules, and
(V) Income Taxes.

Each category is divided generally by Internal Revenue Code section, except that special consolidated discussion examine the various developments relating to the taxation of family holding companies (corporations, limited partnerships, and limited liability companies), and charitable remainder trusts.

There is also an additional section, "Selected Attachments," that includes sample forms illustrating some of the planning techniques discussed in this outline.

I ESTATE TAXES

A Code § 2001. Estate Tax Repeal and Rates

Estate Tax Repeal Effort Restarts. H.R. 3170, 110th Cong., 1st Sess. (July 25, 2007), H.R. 4172, 110th Cong., 1st Sess. (Nov. 14, 2007), H.R. 4235, 110th Cong., 1st Sess. (Nov. 15, 2007), H.R. 4242, 110th Cong., 1st Sess. (Nov. 15, 2007); Senate Finance Committee Hearings, 110th Cong., 2nd Sess. (November 14, 2007; March 12, 2008); S. Con. Res. 70, 110th Cong., 2nd Sess. (March 20, 2008)

- **H.R. 3170 (July 25, 2007).** Rep. Harry E. Mitchell, D-Ariz., introduced H.R. 3170, which would permanently reform the estate tax and fix the capital gains tax rate at 15 percent. H.R. 3170 includes the following proposed changes, which are effective January 1, 2010, except as noted:

  - Increasing the unified credit to the equivalent of a $5 million exclusion, phased in as follows:
    - $3.75 million in 2010;
    - $4 million in 2011;
    - $4.25 million in 2012;
    - $4.5 million in 2013;
    - $4.75 million in 2014; and
    - $5 million after 2014;
  - Reunifying the estate and gift tax exemptions, so that increased unified credit applies to the estate, gift and GST taxes;
  - Indexing the unified credit and GST exemption for inflation after 2015;
  - Reducing the estate and gift tax rates to the top capital gains tax rate (currently 15 percent; increasing to 20 percent January 1, 2010) on estates between $5 million and $25 million, and twice that rate on estates above $25 million
  - Indexing the $5 million definition of the top rate bracket for inflation after 2014;
  - Reducing the GST tax rate to the same as the top estate tax rate, as phased-in;
  - Permitting the executor of the estate of a deceased spouse to elect to give any unused applicable exclusion amount to the surviving spouse (usable for gift and estate tax purposes, but not for GST tax purposes);
  - Repealing the state death tax deduction in 2010;
  - Eliminating the schedule repeal of the estate and GST taxes; and
  - Retaining the present basis step-up rules.

Note. It should be noted that the spouse-to-spouse portable unused applicable exclusion amount was not indexed and that the surviving spouse could take advantage of a carryover of unused applicable exclusion amounts from more than one predeceasing spouse, but not more than a total of $5 million. Also, the carried-over exemption was not available for GST exemption purposes.

_ **H.R. 4172 (Nov. 14, 2007).** Rep. Dennis Moore, D-Kan., introduced H.R. 4172, which would permanently reform the estate tax. H.R. 4172 includes the following proposed changes, which are effective for transfers after December 31, 2007:

_ Increasing the unified credit to the equivalent of a $3.5 million exclusion;
_ Indexing the unified credit and GST exemption for inflation after 2007;
_ Eliminating the schedule repeal of the estate and GST taxes; and
_ Retaining the present basis step-up rules.

_ **H.R. 4235 (Nov. 15, 2007).** Rep. Nita M. Lowey, D-N.Y., introduced H.R. 4235, which would permanently reform the estate tax. H.R. 4235 includes the following proposed changes, which are effective from the date of enactment:

_ Increasing the unified credit to the equivalent of a $3 million exclusion for estate and GST tax purposes;
_ Indexing the unified credit and GST exemption for inflation after 2006;
_ Reducing the estate and gift tax rates to 39.2 percent on estates over $2 million;
_ Eliminating the schedule repeal of the estate and GST taxes; and
_ Retaining the present basis step-up rules.

_ **H.R. 4242 (Nov. 15, 2007).** Rep. Earl Pomeroy, D-N.D., introduced H.R. 4242, which would permanently reform the estate tax. H.R. 4242 includes the following proposed changes, which are effective after the date of enactment:

_ Increasing the unified credit to the equivalent of a $3.5 million exclusion for estate and GST tax purposes;
_ Indexing the unified credit and GST exemption for inflation after 2006;
_ Reducing the estate and gift tax rates to 47 percent on estates over $2 million;
_ Restoring the five percent surtax on estates over $10 million;
_ Limiting the discount for partial interests in a closely-held business to the extent attributable to non-business assets;
_ Eliminating the schedule repeal of the estate and GST taxes; and
_ Retaining the present basis step-up rules.

_ **Senate Finance Committee Hearings.** The Senate Finance Committee has completed a three-part series of hearings on wealth transfer taxes. The first hearing was held November 14, 2007, and was entitled "Federal Estate Tax: Uncertainty in Planning Under the Current Law." The speakers at that hearing included Warren Buffett, Chairman and Chief Executive Officer of Berkshire Hathaway, and the richest man in the world, two other business owners and one noted estate tax attorney.

The second set of hearings was held on March 12, 2008, and was entitled "Alternatives to the Current Estate Tax System." This hearing considered the possibility of replacing our current system with other forms of taxes, such as an accessions tax (similar to a national inheritance tax) or an income inclusion system. It also examined how other countries have approached the taxation of wealth transfer at death. The speakers at that hearing were three law professors. See Staff of the Joint Committee on Taxation, 111th Cong., 1st Sess., "Description and Analysis of Alternative Wealth Transfer Tax Systems" (March 10, 2008) (Committee Print).

The third hearing was held April 3, 2008, and was entitled "Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning." The speakers at this hearing included a mixture of practitioners, a law school professor and a representative of an organization that represents charities. In preparation for these hearings, the Staff of the Joint Committee of Taxation published a committee print discussing possible reforms in the estate tax. The Joint Committee notes the following possible reforms:

- Completely unifying the unified credit for gift and estate taxes;
- Making the unified credit portable;
- Enhancing the special rules for farms and small businesses held in an estate;
- Limiting perpetual dynasty trusts by making the GST exemption shelter only one generation of skips;
- Eliminating the use of valuation discount planning for investment assets; and
- Eliminating or dramatically limiting the use of *Crummey* withdrawal powers to qualify gifts for the annual exclusion.

Staff of the Joint Committee on Taxation, 110th Cong., 2nd Sess. "Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform" (April 2, 2008) (Committee Print).

_ **S. Con. Res. 70.** The Senate Finance Committee Chairman Baucus added amendment 4160 to the Senate Budget resolution. This was the *only* estate tax amendment to pass. It would make the 2009 law permanent, with a $3.5 million exemption and a 45% rate. It was approved 99-1. There were several amendments that were rejected, however, including:

- Graham amendment 4170, which would have raised the exemption to $7.5 million and a 35 percent rate;
- Kyl amendments 4191 and 4372, which would have raised the exemption to $5 million and imposed rates starting at 15% and with a top rate of 35 percent;
- Salazar amendment 4196, which would have raised the exemption to $5 million and imposed a 35 percent rate;
- Landrieu amendment 4378, which would have raised the exemption to $5 million and imposed a 35 percent rate, with a small surcharge for large estates and several special tax breaks for small businesses and family farms.

B Code §§ 2031, 2032, 2032A and 7520. Valuation

1 Fifth Circuit Affirms Use of IRS Tables to Value Non-transferable Commercial Annuities. *Anthony v. United States*, ___ F3d ___, 2008 WL 570811 (5th Cir. March 4, 2008)

James settled a lawsuit over serious injuries he sustained in an automobile accident by agreeing to receive three annuities issued by three different insurance companies. Each annuity guaranteed monthly or annual payments for a period of at least fifteen years, and precluded transfer of the right to the annuities. When James died, he was scheduled to receive ten more years' of payments. His estate valued the guaranteed payments at $2,371,409, using the IRS actuarial tables prescribed in Section 7520. Thereafter, the estate filed a claim for refund stating that the "fair market value" of the annuity contracts should be determined without regard to the actuarial tables, because the annuities were nontransferable. The IRS denied the claim, and a U.S. District Court granted summary judgment to the IRS, finding that nontransferability does not render the valuation provided by the actuarial tables unreasonable or unrealistic.

On appeal, the Fifth Circuit affirmed, finding that the annuities must be valued under the actuarial tables, notwithstanding their nontransferability. The court noted that the fair market value of an annuity for estate and gift tax purposes is generally determined by resort to the Section 7520 annuity tables, which admittedly prize certainty over accuracy. The values determined by application of the annuity tables need not be used, however, when the tables result in a value that is unrealistic and unreasonable, other valuation methods should be employed. *Cook v. Comm'r*, 349 F.3d 850, 854 (5th Cir. 2003) (citing *O'Reilly v. Comm'r*, 973 F.2d 1403, 1407 (8th Cir. 1992)). The regulations provide explicit exceptions to the tables for "restricted beneficial interests," which they define as "an annuity, income remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances." Treas. Reg. § 20.7520-3(b)(ii). A restricted beneficial interest is assigned its fair market value without regard to the annuity tables. Treas. Reg. §§ 20.7520-3(b)(ii), 20.7520-3(b)(iii). *Cook* addressed the proper method for valuing an estate's interest in non-transferable lottery payments, before the current regulations. The court noted that the language of Treas. Regs. § 20.7520-3(b)(1)(ii) broadly states that "[a] restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances." The estate focused on the phrase "any . . . other restriction," but the court stated that the regulations must be read as a whole, and that the "other restriction" must be read in light of the two examples that precede it – "a contingency" and "a power" that might undermine the fundamental assumptions supporting the valuation of an "ordinary beneficial interest." For example, a right to receive annuity payments that is contingent on the survival of a person who is terminally ill cannot be valued under the actuarial tables. *See* Treas. Reg. § 20.7520-3(b)(4) (Example 1). Similarly, a right to payments that can be thwarted by a trustee who has a power to invade the corpus and, thereby, exhaust or diminish the income stream, cannot be valued under these tables. *See* Treas. Reg. § 20.7520-3(b)(2)(v) (Example 4). These types of restrictions are different in character and effect from mere nonassignability, which reduces the marketability of the annuity. Furthermore, the structure of the regulation suggests a narrow definition of "other restriction," Treas. Regs. § 20.7520-3(b)(1)(ii) defines "restricted beneficial interest," but Treas. Regs. § 20.7520-3(b)(1)(iii) does not refer to a "restricted beneficial interest," but rather instructs the taxpayer that "[i]f, under the provisions of this paragraph (b), the *interest rate and mortality components* prescribed under section 7520 are not applicable in determining the value of any annuity . . . the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances. . . ." Treas. Reg. § 20.7520-3(b)(1)(iii) (emphasis added). The estate further argued that even if the "restricted beneficial interest" exception does not encompass a non-marketability exception to valuation under the tables, the result of the tables in this case produces an "unreasonable and unrealistic" result. The district court held that use of the annuity tables did not create an "unrealistic or unreasonable" result, even though the table valuation was approximately double the estate's purported free market valuation. The court noted that the disparity in *Cook v. Comm'r* was as great, and that the size of the disparity is not alone enough to render the tables inapplicable, when the disparity is attributable solely to reduced marketability.

2 Valuation Offset for C Corporation Unrecognized Capital Gains Not Reduced Despite Unlikelihood of Actual Liquidation. *Estate of Jelke v. Comm'r*, 507 F.3d 1317, 2007 WL 3378539 (11th Cir. Nov. 16, 2007), *rev'g*, T.C. Memo. 2005-131

Frazier Jelke, III=s gross estate included a 6.44-percent interest in a company substantially all of the assets of which were marketable securities. The company had been in existence for many years, was well managed and had a relatively high rate of return in the form of annual dividends coupled with capital appreciation of approximately 23 percent annually for the five-year period before the decedent's death, and during this same period there was no action taken to liquidate the company. The company's securities turnover averaged only six percent per year. On the date of death, the company's net asset value was approximately $178 million and it had a built-in capital gain tax liability of approximately $51 million. The estate valued the decedent's interest by reducing the company's net asset value by the entire $51 million potential capital gain, and then applying discounts for lack of control and marketability.

The Tax Court held that the built-in capital gain tax liability must be discounted to reflect the fact that the company was unlikely to be liquidated for many years after the decedent's death. The court noted that, while the liquidation value of a C corporation should include an offset for the capital gains tax that would be due when the company is liquidated, several courts had disagreed regarding whether a discount was appropriate when the estate could not establish a likelihood of prompt liquidation or sale. *Estate of Davis v. Comm'r*, 110 T.C. 530, 552-554 (1998); *Estate of Welch v. Comm'r*, T.C. Memo. 1998-167, *rev'd without published opinion* 208 F. 3d 213 (6th Cir. 2000); *Eisenberg v. Comm'r*, T.C. Memo. 1997-483, *rev=d* 155 F. 3d 50 (2d Cir. 1998), *acq*. 1999-1 C.B. xix; *Gray v. Comm'r*, T.C. Memo. 1997-67; *Estate of Dunn v. Comm'r,* T.C. Memo. 2000-12, *rev'd* 301 F. 3d 339 (5th Cir. 2002); *Estate of Jameson v. Comm'r*, T.C. Memo. 1999-43, *rev'd* 267 F. 3d 366 (5th Cir. 2001). This case was appealable to the 11th Circuit, which not already addressed this issue. The Tax Court held that the company=s profitability suggested that it would not be liquidated or sold quickly, and reduced the capital gains tax offset for the 16 years it estimated would be required to sell all of the company's securities, at the present turnover rate. This reduced the capital gains tax offset from $51 million to $21 million for the entire company, and the decedent's share of that discount from $3,284,400 to $1,352,400. The court also rejected the 25-percent minority discount and 35-percent marketability discount, and allowed a ten percent minority discount and a 15-percent marketability discount (23.5 percent aggregate discount.)

The Eleventh Circuit reversed, finding that the entire tax offset was an appropriate adjustment, though it upheld the Tax Court's adjustments to the discounts for lack of control and lack of marketability. The court reviewed the entire history of the deduction for the capital gains inherent in a C corporation that was being valued at net asset values. The Eleventh Circuit agreed with the Fifth Circuit, that the value of the corporation must be reduced by 100 percent of the estimated capital gains taxes, regardless of when the liquidation was likely to occur. The court stated:

> The Tax Court chose a sixteen-year period to reflect when the corporation would reasonably incur the tax. This distinction is not persuasive to us. We are dealing with hypothetical, not strategic, willing buyers and willing sellers. As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place on the date of death. Assets and liabilities are deemed frozen in value on the date of death and a "snap shot" of value taken. Whether or not a majority or a minority interest is present is of no moment in an assumption of liquidation setting.

3 Two More Courts Split on Valuation of Right to Receive Nonassignable Lottery Winnings Under Section 7520. *Negron v. U.S.*, 2007 WL 1662767, 99 A.F.T.R.2d 2007-3127 (N.D. Ohio, June 4, 2007) (slip opinion); *Davis v. U.S.*, 491 F.Supp.2d 192, 2007 WL 1697104 (June 13, 2007), 2005 WL 3464384, 97 A.F.T.R.2d 2006-332 (D.N.H. 2005), and 2006 WL 213761, 97 A.F.T.R.2d 2006-824 (D.N.H. 2006)

– ***Negron.*** Mary Susteric and Mildred Lopatkovich and others won the Ohio Super Lotto jackpot price, and received a right to 26 annual payments of $256,410.26 from the state. The remaining payments could not be assigned or used as collateral. Mary and Mildred each died after receiving one payment. Both were residents of Lorain, Ohio, and had the same executor. The executor valued each right to receive 15 future payments based on various factors. The valuation of Mary's rights was based on the nine percent discount rate applied by the State of Ohio in valuing lump sum payments to the winners, because Mary had elected (under then-existing Ohio rules) to receive the rest of her payments as a lump sum. The IRS valued both sets of rights to lottery payments under the relevant actuarial tables under Section 7520. Both parties moved for summary judgment.

The District Court held that a non-marketable, nonassignable right to a series of lottery payments should not be valued under the Section 7520 actuarial tables, because the result would be unreasonable. It granted in part the taxpayer's motion for summary judgment. The court reviewed the present split in the circuits, and noted that the

Seventh Circuit, to which this case would be appealed, had not yet opined on this issue. The court rejected the view of the Tax Court and the Fifth Circuit, that the annuity should be valued strictly under the Section 7520 actuarial tables. *Gribauskas v. Comm'r*, 116 T.C. 142 (2001); *Estate of Cook v. Comm'r*, 349 F.3rd 850 (5th Cir. 2003), *aff'g* T.C. Memo. 2001-170. The court was more convinced by the reasoning of the Second and Ninth Circuits, than by that of the Tax Court and the Fifth Circuit, and stated that "it makes fundamental economic sense that the transferability of an annuity would affect its fair market value." *Estate of Gribauskas v. Comm'r,* 342 F.3rd 85 (2nd Cir. 2003), *rev'g* 116 T.C. 142 (2001); *Estate of Shackleford v. U.S.*, 262 F.3rd 1028 (9th Cir. 2001), *aff'g*, 84 AFTR2nd 99-5902, 1999 WL 744121 (E.D. Cal. 1999). The court held that the Section 7520 value of the lottery payments was "unrealistic and unreasonable" and that the parties would be required to hold a hearing to determine the value of the annuity.

Davis. Kenneth Freeman won the Massachusetts lottery and received the first of 20 annual payments of $209,220 before his death. At his death, Kenneth was entitled to receive ten more annual payments. Kenneth's estate valued the remaining ten payments under the Section 7520 actuarial tables, though they erred slightly and undervalued them at $1,584,690, rather than the $1,607,164 that the IRS determined was the correct value. The estate sued for a refund, claiming that the value of the lottery annuity should be reduced to $800,000, to reflect the lack of marketability, because the annuity cannot be assigned, sold, transferred or pledged as collateral. Both sides moved for summary judgment.

In 2005, the District Court denied summary judgment to both sides. The court denied the IRS partial summary judgment because it could not conclude, as a matter of law, that it is either appropriate or inappropriate to use the annuity tables to determine an approximate measure of the fair market value of the annuity in question. It denied the estate its partial summary judgment because the fair market value of the annuity would be a question of fact that was inappropriate for summary judgment.

Ultimately, the district court held that the estate had not proven that the figures reached by the actuarial tables under Section 7520 were unreasonable. The estate's appraiser claimed a 50 percent discount for lack of marketability, but the court rejected the theory that the estate tax value should assume that the hypothetical buyer would have to rely on the estate to continue receiving the payments and remitting them to the buyer. Rather, the court stated, the estate tax determination of fair market value requires the assumption that the contract is assigned to a hypothetical buyer, who then cannot re-assign it. Thus, the hypothetical buyer has a highly-secure annuity right that cannot be reassigned. The court held that the greatest discount that would be justified was five percent, which did not render the actuarial valuation unreasonable.

Points of Note. If *Donovan*, *Estate of Cook*, and the Tax Court view in *Gribauskas* are wrong, and *Davis*, *Shackleford* and the Second Circuit view in *Gribauskas* are correct, does this preclude the use of the Section 7520 tables to value a private annuity that prohibits assignment, or an interest in a GRAT the spendthrift clause of which prohibits assignment? If so, there may be a substantially increased gift tax associated with both of these transactions.

Also, the district court in Davis stated that the valuation of the annuity was not affected by the lack of transferability, because the tax law should look at what a willing buyer would pay to have all of the rights that the seller holds, rather than just those rights that the seller legally can convey. This analysis would be contrary to all other case law on the willing buyer, willing seller standard.

4 **Partial Interest in Artwork is Eligible for Marketability Discount Based on Cost of Partition. *Stone v. U.S.*, 2007 WL 1544786, 99 A.F.T.R.2d 2007-2992 (N.D. Ca. May 25, 2007) (slip opinion), *final opinion* 2007 WL 2318974, 2007 TNT 158-15 (N.D. Ca. Aug. 10, 2007) (slip opinion)**

Lois's estate included her one-half interest in 16 valuable paintings. (The other one-half interest was held by the nonmarital trust under the will of Lois's late husband.) The IRS valued the decedent's one-half interest at 50 percent of the value of the entire collection. The estate had valued the artwork at $1,420,000, after a 44 percent discount for lack of marketability and control. The IRS valued the artwork at $2,766,250 – $1,346,250 more than the value claimed by the estate. This difference reflected both the IRS's determination that two paintings by Camille Pissarro were undervalued by the estate and the IRS refusal to allow a fractional interest discount. The estate argued that the correct value should reflect a 44 percent discount for lack of marketability of a partial interest. The estate also contended that appraisals it had obtained from Sotheby's should set the value of the artwork, rather than the valuation proposed by the IRS Art Advisory Panel.

The district court held that a discount was allowed, but that it should be less than the 44 percent claimed, and that the valuation prepared by the

IRS Art Advisory Panel was the more persuasive determination of value. On the basic valuation, the court appeared to be very impressed with the IRS Art Advisory Panel valuation, noting that the panel was a collection of experts who are not paid (except for cost reimbursements), and who are not told whether an item is being valued for a charitable contribution deduction, estate tax valuation, or gift tax valuation. The Art Advisory Panel also does not know the identity of the taxpayer. The panel based its valuation on comparable sales of similar paintings near the date of valuation. The estate, on the other hand, relied on an appraisal by Sotheby's, that contained no description of how the valuations were determined. The estate failed to introduce any expert testimony to support the Sotheby's valuations, and the court sustained the government's objection to the estate's attempt to introduce the Sotheby's appraisal into evidence based on lack of foundation. Nonetheless, the court noted, even if the court had considered the Sotheby's appraisal, it would find it unpersuasive, because of the lack of any basis for its valuations in this particular case. The court also rejected as relevant the values received when one of the two works of art was sold, because the sale occurred six years after the decedent's death, and because the estate declined to rely on the sales price for the other painting when it was sold at the same time. The IRS had allowed a two percent discount for cost of partitioning the property, but the estate had claimed a 44 percent fractional interest discount. The court held that a hypothetical seller under no compulsion to sell would not accept the 44 percent discount proposed by the estate, but would instead demand a greater discount than the two percent proposed by the IRS. The government's experts testified that, while they were aware of sales of undivided interests in art occurring, none of these had ever occurred at a discount. The estate's expert testified that he could find no data regarding sales of undivided interests in art, and so based his valuation in part on data respecting sales of undivided interests in real estate and limited partnerships holding real property. The court rejected the analogy, noting that the art market differs from the real estate or business market, and that the nature of each piece of art means that an investor may not prefer to own 100 percent of a painting of lesser value than a 50 percent interest in another painting of greater value. The court stated that a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work of art and split the proceeds, rather than seeking to sell his or her fractional interest at a discount. The court further stated that, because an undivided interest holder has the right to partition, a hypothetical seller would not likely accept any less for his or her undivided interest than could be obtained by splitting proceeds in this manner. The court noted that the IRS agreed that the estate was entitled to a discount based on the costs to partition and sell the collection. The estate's expert estimated the cost of partitioning to be 51 percent of the value of the artwork, while the IRS estimated it at two percent of the value. The court rejected both that the estate provided a cost of partitioning analysis and that the IRS had not, but the court rejected both the notion of a 51 percent cost of partition and that of a two percent discount. The court stated:

> In sum, the Court finds that a hypothetical willing seller who is under no compulsion to sell would seek to gain consent from other co-owners to sell the collection and divide the proceeds or, barring such consent, would bring a legal action to partition. At the very least, a hypothetical seller would consider the potential proceeds from the partition process before agreeing to accept any fractional interest discount when selling his or her partial interest. Because the Court cannot consider whether other co-owners would consent to a sale, a small discount is appropriate to account for legal fees required to enforce the hypothetical seller's right to partition. No discount is required to account for appraisal fees, but the government's expert agrees that a 2% discount is appropriate to account for the actual costs of selling the art by an auction house. Finally, some discount is appropriate to account for the uncertainties involved in waiting to sell the art until after the partition action is resolved.

The court directed that the parties meet further and attempt to settle on the amount of the discount.

In a final order issued August 10, 2007, the court noted that the parties were unable to agree on a discount, and it allowed a five percent discount for lack of marketability.

Note. This case is extraordinary because it upholds the IRS attempt to limit the discount for lack of marketability on a partial interest in tangible assets to the costs of partition. The court did not, however, consider the major cases that have denied the legitimacy of this limitation on the discount for lack of marketability. See, e.g., *Estate of Baird v. Comm'r*, 416 F.3d 442 (5th Cir. 2005), *rev'g and rem'g in part, aff'g in part,* T.C. Memo. 2002-299; and *Williams v. Comm'r*, T.C. Memo. 1998-59. nonetheless, it appears that the IRS is willing to continue to assert this limitation on the discount for lack of marketability with respect to tenancy-in-common interests, at least with respect to artwork and, presumably, such similar assets as antiques and other collectibles.

5 IRS Non-Acquiescence in *Kohler v. Comm'r* Stock Valuation Ruling. AOD-2008-01, 2008 WL 577006 (March 5, 2008)

In *Kohler, Jr. v. Comm'r*, T.C. Memo. 2006–152, the decedent's estate elected to use the alternate valuation date under Section 2032. After the date of death, and before the alternate valuation date, the estate entered into a reorganization of the family business pursuant to Section 368(a). As part of the reorganization, transfer restrictions and a purchase option were imposed upon the shares, which reduced their market value. The IRS assessed a deficiency of nearly $100 million, claiming that the effects of the reorganization cannot be taken into account in establishing the alternate valuation. The IRS stated that Treas. Reg. § 20.2032-1(d) requires that the value be measured according to stock's pre- reorganization value. The court rejected the IRS position, noting that neither the Code nor the regulations contained a valuation restriction that would require disregard of tax-free reorganization.

The IRS now declared that it does not acquiesce in *Kohler, Jr.*, relating to whether the alternate valuation date allows a discount for transfer restrictions and a purchase option imposed on closely-held corporate stock pursuant to a post-death tax-free reorganization in determining the fair market value of the decedent's stock on the alternate valuation date. The IRS stated in its action on decision that the Tax Court erred in focusing on whether a disposition had occurred, rather than whether it should take into account a change in the character of the property that had occurred during the alternative valuation period, and that the Tax Court should have ignored changes in the character of the stock due to the post-death restrictions in determining the value of the stock on the alternate valuation date.

6 Section 2032A Limitation Adjusted for Inflation. Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (Nov. 5, 2007)

An estate can reduce the estate tax value of qualifying real property used in a farm or business and valued under Section 2032A, by up to $960,000 for estates of decedents dying in 2008.

C Family Holding Companies (Code §§ 2031, 2036-2038, 2512, *et al.*)

Section 2036(a) and Family Limited Partnerships and LLCs. *Estate of Bigelow v. Comm'r*, 503 F.3d 955, 2007 WL 2684526 (9th Cir. Sept. 14, 2007), aff'g, T.C. Memo. 2005-65; *Estate of Mirowski v. Comm'r*, T.C. Memo. T.C. Memo. 2008-74 (March 26, 2008); *Estate of Rector v. Comm'r*, T.C. Memo. 2007-367 (Dec. 13, 2007)

Estate of Bigelow. Virginia had created a revocable trust to hold certain real property, naming herself and her son as co-trustees. Two years later, when Virginia was about 85 years of age and in poor health (having suffered a stroke and moved into an assisted-living facility), the trust and her children together created a family limited partnership. The trust transferred to the partnership real property it held, but agreed to hold the partnership harmless on $450,000 of debt for a loan and line of credit, that were secured by the transferred property. The trust was both the sole general partner and a limited partner, and Virginia's three children were limited partners. The partnership then actively leased and sold the real estate. The transfer left Virginia without sufficient income to meet her living expenses or satisfy her liability on the debt. The reasons for creating the partnership were to facilitate gift giving and to reduce Virginia's estate tax liability. The partnership directly paid part of the debts of Virginia's trust and it did not adjust the trust's capital account for those payments, as required by the partnership agreement. There were also numerous transfers of funds between the partnership and Virginia, and she owed the partnership $3,500 at her death. The decedent made various gifts of limited partnership interests to her children and grandchildren, often through her son, as attorney-in-fact. The partnership did not make any distributions to its partners with respect to their interests in the partnership before Virginia died, and during the year after her death, her trust continued to act as the general partner until the partnership was terminated. The partnership made over 40 transfers to Virginia's estate, characterized by the estate as loans. Virginia's estate claimed a 37 percent discount for lack of marketability and control with respect to the partnership interests still owned by her estate at her death.

The Tax Court (Judge Colvin) held that the value of the property transferred by the decedent to the partnership was includible in her gross estate under Section 2036(a)(1), because she had retained a life estate in the transferred assets. The court found an implied agreement for Virginia to retain the beneficial enjoyment of the partnership assets, based on the fact that the partnership did not follow the terms of its agreement with respect to paying Virginia's debts, and that she had transferred so much of her property to the partnership as to render her unable to support herself. The court also found that there was no non-tax purpose for creating the partnership, noting that the trust gained no creditor protection because it was the sole general partner.

The Ninth Circuit affirmed, rejecting the estate argument that no "cognizable economic benefit" was retained in the properties transferred to the partnership under Section 2036(a)(1). The court inferred an agreement to retain economic benefit of the partnership property from the partnership payments of a debt on which the decedent was personally liable. The failure to transfer the liability for the underlying debt when real property was transferred to the partnership created a retained economic interest, as the partnership paid off the debt. The court stated that the partnership may have had a "practical liability" to pay off the debt and avoid losing the property, but it still created a reserved economic benefit. The court also upheld the Tax Court finding that the other facts disclosed a retained economic benefit, including the fact that the transfers left the decedent with insufficient income to meet her living expenses, frequent partnership "loans" to the decedent, the payment of decedent's funeral expenses from the partnership, and the failure to follow the partnership formalities, including inconsistent partnership capital account debiting. Citing *Estate of Thompson v. Comm'r*, 382 F.3d 367 (3d Cir. 2004); and *Estate of Korby v. Comm'r*, 471 F.3d 848 (8th Cir. 2006). The court also rejected the argument that the transfer of property to the partnership in exchange for partnership interests was a "*bona fide* sale for an adequate and full consideration." The court agreed with *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004), that looks at whether (a) the interests credited to each partner was proportionate to the fair market value of the partner's contributed, (b) each partner's contributed assets were properly credited to their respective capital accounts, and (c) each partner is, on termination or dissolution, entitled to distributions equal to their respective capital accounts. The court stated, however, that the estate must also show a genuine pooling of assets and a potential for intangibles stemming from this pooling to offset the discounts for lack of control. That requires that there be an arm's-length transaction with legitimate and significant nontax reasons. The Ninth Circuit agreed with the Tax Court that this was not a *bona fide sale* for adequate and full consideration, because the transfers impoverished the decedent, the partnership ignored formalities in its operation and the transfer had no nontax benefit to the decedent.

– ***Estate of Mirowski.*** Anna Mirowski was married to Dr. Michael Mirowski when he invented the automatic implantable cardioverter defibrillator (ICD), which monitored and corrected abnormal heart rhythms. Dr. Mirowski licensed the device and, during his lifetime, received modest royalties. The Mirowski family held annual family meetings during their vacations, and invited their accountants or attorneys to attend and assist in their discussions of family business and investment matters. Dr. Mirowski died in 1990, leaving the bulk of his assets, including the ICD patents and interests in the licenses, to his wife. Ms. Mirowski maintained a long and continuous history of making charitable gifts and gifts to her daughters, her grandchildren, and six other family members and friends. Ms. Mirowski created an irrevocable spendthrift trust for each of her three daughters and their respective issue in order to provide for each daughter during the daughter's life and each daughter's children after the daughter died. Ms. Mirowski named all three of her daughters as cotrustees of each of the daughters' trusts, because she wanted her daughters to work together and have a close working relationship. Ms. Mirowski funded each trust with part of her interest in the ICD patents licensing agreement. Sales of ICDs increased significantly after Dr. Mirowski died and the royalties received under the license agreement increased from thousands of dollars a year to millions of dollars a year. Before Dr. Mirowski died, he was primarily responsible for managing the financial affairs of Ms. Mirowski and himself. After Dr. Mirowski's death, Ms. Mirowski became primarily responsible for managing her own financial affairs. When Ms. Mirowski first started investing, she was a highly conservative investor, and her daughters Ariella Rosengard and Ginat Mirowski began to act as bookkeepers for her, but neither of them made financial decisions for Ms. Mirowski. Ms. Mirowski hired Goldman, Sachs & Co. to assist in managing some of her investments, and ultimately brought all of her investments under Goldman, Sachs management. In May 2000, Ms. Mirowski met with representatives of U.S. Trust, who introduced her to the concept of a limited liability company (LLC). Ms. Mirowski then discussed creating an LLC with her attorney, who then drafted articles of organization and a draft operating agreement for an LLC to be named Mirowski Family Ventures, L.L.C. (MFV). Copies were sent to the daughters for their review and comments. In mid-August 2001, Ms. Mirowski's daughters and their families took their annual vacation and held their previously planned family annual meeting to which they had invited Ms. Mirowski's lawyer. At that meeting, they discussed Ms. Mirowski's plans to form MFV, her plans to make respective gifts of interests in MFV to her daughters' trusts, the manner in which MFV was to function, and the responsibilities of her daughters with respect to MFV. Ms. Mirowski did not attend this meeting, because she was receiving medical treatment for a nonterminal problem. After the family annual meeting, Ms. Mirowski's attorney finalized the documents required to form MFV. Between September 1 and September 7, 2001, Ms. Mirowski made several bona fide, arm's-length transfers of ICD patents and the licensing agreement, and over $62 million in cash and securities in her Goldman Sachs account, to MFV. After each transfer, Ms. Mirowski was the only member of MFV. Ms. Mirowski always planned on making a gift of an interest in MFV to each of her daughters' trusts, and she did so later in September, 2001. Ms. Mirowski's daughters were not aware of specifically how Ms. Mirowski planned to pay the gift tax on those gifts, but they knew that she had retained substantial personal assets outside MFV, including over $3 million in cash and cash equivalents and another $4.5 million in various assets. Ms. Mirowski had retained enough assets to support her lifestyle, but not enough to pay the gift taxes. Ms. Mirowski could pay those taxes by (1) using part of the over $7.5 million of personal assets that she retained and did not transfer to MFV, including cash and cash equivalents of over $3.3 million, (2) using part or all of the distributions that she expected to receive as an interest holder in MFV of the millions of dollars of royalty payments under the ICD patents license agreement that she expected MFV to receive, and (3) borrowing against her retained personal assets and her 52-percent interest in MFV. The operating agreement of MFV stated that Ms. Mirowski's capital account would be credited with her contributions to MFV and properly maintained thereafter. A share of Ms. Mirowski's capital account was allocated to each daughter's trust to which she made gifts of LLC interests. MFV was to be managed by a general manager who could be, but did not have to be, a member of the LLC. Ms. Mirowski was the initial general manager. Although Ms. Mirowski held a 52-percent interest in MFV and was its general manager, she could not sell or otherwise dispose of any of the assets of MFV, other than in the ordinary course of MFV's operations, without the approval of all the members of MFV. Mirowski also could not liquidate and dissolve or admit additional members without the approval of all the members of MFV. All profit or loss (other than profit or loss derived from a capital transaction) for any taxable year was to be allocated to the interest holders in proportion to their respective percentage interests in MFV, and cash flow was to be distributed annually, within 75 days after the end of each taxable year. Ms. Mirowski died from unexpected complications from treatment for a foot ulcer on September 11, 2001. The IRS contended that the assets of the LLC should be included in Ms. Mirowski's gross estate under Section 2036(a), assessing a

$14,243,208.37 deficiency.

The Tax Court (Judge Chiechi) held for the estate, that the transfers to MFV were bona fide transfers for full and adequate consideration, not subject to Section 2036(a), 2038(a), or 2035(a), applying the principles set out in *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). The court stated that, while Ms. Mirowski understood that certain tax benefits could result from forming MFV, they were not the most significant factor in her decision to form MFV. Ms. Mirowski formed the LLC (a) to provide joint management of the family's assets by her daughters and eventually her grandchildren, (b) to maintain the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or their trusts, and (c) to provide for each of her daughters and eventually each of her grandchildren on an equal basis. Based on her experiences with a family business when she was younger and living in Lyons, France, Ms. Mirowski valued the family cohesiveness that joint management of a family business can foster. She wanted her daughters, and eventually her grandchildren, to work together, remain closely knit, and be jointly involved in managing the investments derived from the royalties received from the ICD and the business matters relating to the ICD patents and the ICD patents license agreement, including the litigation arising with respect to those patents and that license agreement. As Ms. Mirowski had hoped, her daughters, in their capacities as officers of MFV and as trustees of MFV's members, have actively worked together to manage MFV's assets. Ms. Mirowski's daughters have held meetings with representatives of Goldman Sachs approximately three to four times a year in order to review MFV's Goldman Sachs' account performance and asset allocation and to determine what, if any, changes should be made in the future. For at least one of those meetings each year, all of Ms. Mirowski's daughters were present in person. For the several other meetings each year, the daughters met together in person or participated by teleconference. All of Ms. Mirowski's daughters jointly made investment decisions for MFV and planned to have each of their respective children also become involved in such decisionmaking when they reach the appropriate age. In addition, Ms. Mirowski's daughters have worked together on matters concerning the business of managing the ICD patents, the ICD patents license agreement, and related litigation. At the time of the trial in this case, there was substantial ongoing litigation relating to those patents and that license agreement with respect to which Ms. Mirowski's daughters communicated several times a week with MFV's attorney Mr. Silver. With respect to Ms. Mirowski's intent to maintain in a single pool the bulk of the family's assets, certain specific investment opportunities at Goldman Sachs would not have been available if Ms. Mirowski had separated her assets among her daughters or her daughters' trusts by giving a portion of those assets to each daughter or each trust. At all relevant times, including after Ms. Mirowski's death, MFV has been a valid functioning investment operation and has been managing business matters relating to the ICD patents and the ICD patents license agreement, including related litigation. The IRS also argued that Ms. Mirowski failed to retain sufficient assets outside of MFV for her anticipated financial obligations, that MFV lacked any valid functioning business operation, and that Ms. Mirowski delayed forming and funding MFV until shortly before her death and her health had begun to fail. The court rejected all three contentions as not supported by the facts. The IRS also argued that Ms. Mirowski sat on both sides of her transfers to MFV, but the court held that the Section 2036(a) and 2038(a) exception for bona fide sales for adequate and full consideration applied notwithstanding that the transferee was a single-member LLC. The IRS further argued that MFV should be ignored because, soon after Ms. Mirowski's death, it distributed to her estate over $36 million, which was used to pay estate taxes and expenses. The court rejected this because Ms. Mirowski's death was unexpected, depriving her of time to plan for the liquidity of her estate. The court also rejected the IRS contention that, because Ms. Mirowski did not at any time contemplate forming and funding MFV without making respective gifts of 16-percent interests in MFV to her daughters' trusts, she actually received only a 52 percent MFV interest in exchange for Ms. Mirowski's transfers to MFV of 100 percent of its assets. The court stated that Ms. Mirowski made two separate, albeit integrally related, transfers of property and that the transfer of the property to the LLC were made in exchange for 100 percent of the LLC. With respect to the gifts of interests in MFV, the court noted that there was no understanding, express or implied, that decedent retained any interest in the MFV interests given away, and that this case did not involve the kinds of facts that have led courts to find implied agreements that a decedent has retained an interest in the decedent-transferred property. The court also rejected the argument that the authority Ms. Mirowski held as general manager of the LLC constituted a right to control the beneficial enjoyment of the transferred assets, noting that the operating agreement did not give Ms. Mirowski as MFV's general manager the authority to determine the timing and the amount of all distributions from MFV. Any authority that she had under the agreement was in her capacity as the member who owned a majority of the outstanding percentage interests, and that her majority owner authority did not include the authority to determine the timing and the amount of distributions from MFV. The court also rejected the IRS argument that, with the approval of the daughters, Ms. Mirowski had the authority to dispose of assets in other than the ordinary course of business, because she held a majority of the interests of MFV. First, the court noted that Ms. Mirowski's daughters were not members of MFV after Ms. Mirowski's gifts; the daughters' trusts were the members. SSecond, the court rejected the contention that at the time of Ms. Mirowski's gifts and at the time of her death she retained, either alone or in conjunction with any person, the right to designate the persons who shall possess or enjoy the respective 16-percent interests in MFV that she gave to her daughters' trusts or the income from such interests within the meaning of Section 2036(a)(2).

Note. This case is noteworthy for several reasons.

First, the facts of this case appear to be more favorable than those of most of the cases in which taxpayers were unsuccessful, but it more likely reflects a judge with a more favorable eye. It may be noteworthy that Judge Chiechi was also the judge in *Estate of Stone v. Comm'r,* T.C. Memo. 2003-309, in which a similar favorable estate tax result was achieved.

Second, Judge Chiechi found three significant nontax reasons for creating the family LLC in this case, one or more of which exists in a great many family situations. This suggests that a family limited partnership or LLC may be more useful than other decisions have suggested.

Third, while Judge Chiechi noted that business activities were conducted by the LLC, she rejected the IRS argument that "the activities of MFV had to rise to the level of a 'business' under the Federal income tax laws in order for the exception under section 2036(a)…to apply." This should be contrasted with Judge Laro's stringent requirement that there be an active business conducted by the entity in *Estate of Rosen v. Comm'r*, T.C. Memo. 2006-115 and *Estate of Rector*, below.

Fourth, Judge Chiechi's rejection of the IRS argument that the LLC had been used to pay the decedent's estate taxes and, therefore, was serving both personal and business purposes, seems in conflict with the analysis of Judge Kroupa in *Estate of Erickson v. Comm'r*, T.C. Memo. 2007-107. Judge Chiechi agreed with the taxpayer that an obligation that only arises when the decedent dies cannot be deemed a personal obligation of the decedent.

Fifth, Judge Chiechi rejected the IRS argument that the creation and funding of the LLC ought to be combined with the subsequent gifts, and the combination be treated as a constructive gift of the underlying assets. Judge Chiechi explained that the contributions to the LLC and the subsequent gifts were "separate, albeit integrally related." The IRS argument is a substantial extension of its winning arguments in *Senda v. Comm'r,* T.C. Memo. 2004-160, *aff'd* 433 F.3d 1044 (8th Cir. 2006). See Gans & Blattmachr, "Partnership Formation: Dueling Dicta," 35 Capital Univ. L. Rev. 1 (Fall, 2006).

_ ***Estate of Rector.*** Concetta (the decedent) and her two sons, John and Frederic, created the family limited partnership, each communicating with the same attorney who proposed the partnership and drafted the agreement. Concetta transferred to the partnership all of her investment assets, leaving her only a $2.5 million nonmarital trust, from which she received income. Concetta would receive principal from the nonmarital trust only if she first exhausted all of her other assets, including those now held in the partnership. Concetta and her revocable trust were the initial partners, with Concetta holding a two percent general partnership interest and her trust holding a 98 percent limited partnership interest. Concetta later transferred limited partnership interests to her sons. The partnership made distributions to all of the partners, but the distributions to Concetta were disproportionately large. Concetta's executors claimed a 19 percent discount for lack of marketability and control for her interests in the partnership.

The Tax Court (Judge Laro) held that the value of the assets that Concetta transferred to the partnership was includible in her gross estate under Section 2036(a)(1), because Concetta had made an inter *vivos* transfer of the property for less than adequate and full consideration and retained the possession or enjoyment of, or the right to the income from, the transferred property. Judge Laro found that Concetta had retained the possession or enjoyment of the partnership income by an understanding or agreement with her sons. The court cited, as evidence of this agreement, the facts that Concetta was the general partner, either directly or through her revocable trust, and she transferred to the partnership so much of her assets that she could not meet her living expenses without partnership distributions, which were in fact made to her in amounts sufficient to meet those expenses. The court held that the transfer of Concetta's assets to the partnership in exchange for partnership interests was not a bona fide sale for adequate and full consideration, as demonstrated by the facts that: (a) the sons contributed no assets to the partnership, so that the formation of the partnership entailed no change in the underlying pool of assets or the likelihood of profit; (b) the transaction was not conducted in a manner similar to that of unrelated parties dealing at arm's length, in that the sons did not have separate counsel, the partnership did not hold regular meetings and the partnership did not issue regular reports of its activities; and (c) there was no legitimate nontax business purpose for forming the partnership.

Planning Points. The IRS often has a strong case under the Tax Court's interpretation of the *bona fide* sale rule in *Estate of Bongard*, and despite the broader interpretation of that rule in *Kimbell v. U.S.* Yet, there are some taxpayer victories that suggest a divided Tax Court and the possibility of substantial tax advantages in appropriate cases. See Abbin, "A Practical Checklist for Planning with Family Limited Partnerships," 33 Est. Plan. 10 (Oct. 2006); Bogdanski, "Bye Bye *Byrum*, Bonjour *Bongard*," 32 Est. Plan. 47 (June, 2005); Korpics, "How Estate Planners Can Use *Bongard* to Their Advantage," 32 Est. Plan. 32 (July 2005); Korpics, "Qualifying New Flps for the *Bona Fide* Sale Exception: Managing *Thompson*, *Kimbell*, *Harper*, and *Stone*,"102 J. Tax'n 111 (Feb. 2005).

Practical estate planners should consider the following steps to minimize or avoid the application of Section 2036(a) to their own family limited partnerships:

Section 2036(a)(1)

- **Recordkeeping.** The general partners should keep detailed contemporaneous records of their activities, and send copies to the limited partners (for information purposes, only).

- **Stationery.** The partnership should have stationery that identifies precisely who the general partners are, to assure that the general partner never acts in a different capacity.

- **Commingling.** Never, never, never commingle partnership and personal assets.

- **Personal Expenses.** Never, never, never pay personal expenses from the partnership assets, even if capital account adjustments are made;

- **Personal Use Assets**. Do not transfer personal use assets to the partnership, even if the donor then leases them from the partnership.

- **Reserve Adequate Assets.** Never put too much of the donor's wealth in the partnerships; the donors should retain enough assets on which to live comfortably.

- **Active Management Assets.** Try to fund the partnership with assets that require active management, though favorable cases do exist regarding partnerships that hold solely passive assets.

- **Independent Payment for Limited Partnership Interests.** Limited partners should pay for their partnership interests with their own assets. If they do not have assets, the donors should make gifts and let the gifts gather some age, before creating the partnership.

- **The General Partner.** Donors should not be the general partners, if possible. Rather, family members or trusts to whom the client wishes to pass the bulk of the partnership assets should themselves be general partners and participate in the operations of the enterprises.

- **Separate Representation.** All partners should be represented by counsel and consulted in the preparation of the governing instruments.

- **Powers of Attorney.** Consider a provision, like one used in the *Stone* documents, that precludes anyone voting for a general partner through a power of attorney (Contrast the emphasis in *Strangi* that the general partner's son-in-law ran the partnership under a power of attorney).

- **Avoid Immediate Pre-Mortem Funding.** Create and fund the partnership as early as possible, to minimize any appearance that it is testamentary in nature.

- **Significant Interests Held by Others.** Give or sell significant limited partnership interests to others, particularly including trusts with independent trustees.

Section 2036(a)(2)

- **No Discretionary Distributions.** Eliminate discretion regarding distributions -- either preclude distributions during the donor's lifetime (preferred), or require distribution of all income.

- **Multiple Classes of General Partnership Interests.** Create two classes of general partnership interests, one of which has control over distributions, and the other which manages the partnership assets. The donor can then transfer the former, retaining the latter. See Gans & Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*," 100 Tax Notes 1153 (Sept. 1, 2003). See also sample partnership form in Selected Attachments.

D Code § 2053. Expenses, Indebtedness and Taxes

1 Loan from Disabled Child's Trust Fund was a *Bona Fide* Debt for Estate Tax Purposes. *Estate of Hicks v. Comm'r*, T.C. Memo. 2007-182 (July 10, 2007)

Kimberly, while still a toddler, was severely disabled in a collision among a locomotive, another car and a minivan driven by Kimberly=s mother. Litigation resulted in a substantial lump sum payment to Kimberly and a $1.4 million payment to her father, with the expectation that he would immediately lend $1 million to a special trust for Kimberly's benefit. The loan was made but Kimberly died before she needed the money. The executors of Kimberly's estate deducted the $1 million debt to Kimberly's father, and the IRS disallowed the deduction, arguing that the debt was not a *bona fide* loan.

The Tax Court (Judge Holmes) held that Kimberly's estate could deduct the amount owed to her father and that the loan was contracted *bona fide* and for full and adequate consideration. Int. Rev. Code § 2053(c)(1)(A). The IRS argued that there never was a loan because the $1 million was never under the father's control, and that the probate judge's allocation of damages effectively transferred the $1 million straight from the guardian's interim holding account to the trust. The court held, however, that the court's order decided to whom the award belonged, and that the $1 million belonged initially to the father. The IRS then argued that the allocation was a sham, but the court stated that the question was really whether the parties intended that there be a loan and a right of repayment. Citing *Estate of Ribblesdale v. Comm'r*, T.C. Memo. 1964-177. The court emphasized that the note was executed and admitted into the record, and the father was paid interest every month on the principal amount of the loan. The IRS noted that the parents themselves proposed the allocations, and that Kimberly and her father did not have adverse interests in how the settlement proceeds were distributed. The court disagreed, stating that the $1 million right to repayment would have been included in the father's gross estate had he predeceased his daughter, which was actuarially likely. This, furthermore, suggested that there was real economic substance to the transaction.

2 **Crime Doesn't Pay, and if it Does, It's Taxable. *Estate of Hester v. U.S.*, 2007 WL 703170, 99 A.F.T.R.2d 2007-1288 (W.D. Va. March 2, 2007) (slip copy)**

Wendell Hester was the sole current beneficiary and trustee of a trust created at her death by his wife, Dorothy, which held substantial assets. On February 25, 1998, Wendell transferred all of the trust assets to himself individually, in breach of his fiduciary duties. Wendell then commingled the trust's cash with his own assets and set out upon several months of "day trading," that resulted in over $2 million in net losses. Wendell also pledged the distributed trust assets as security for margin loans, withdrew over $450,000 in cash and collected approximately $280,000 of principal and interest from a promissory note held by his late wife's estate. The commingling was so complete and complicated that it was, at his death, impossible for anyone to determine which interests in the combined whole belonged to the decedent and which belonged to the remainder beneficiaries of the trust. At Wendell's death on October 12, 1998, his estate was subjected to standard probate pursuant to applicable state law (Virginia), including a "Debt and Demands" hearing in which all persons who had legal claims against Wendell's estate were required to present them. No one appeared in opposition to the plan of distribution, and the court entered an order of distribution of the estate assets of Wendell's estate, according to his will. The estate tax return for Wendell's estate reported as belonging to Wendell the remaining misappropriated assets, and claimed no deduction for the hypothetical claims of the remainder beneficiaries. The estate paid over $2,727,000 in estate taxes. Sometime later, the estate filed a claim for refund, seeking to exclude from Wendell's gross estate the value of the assets misappropriated by him from his late wife's trust, or in the alternative, to deduct those amounts as a debt of the estate or a claim against the estate. Wendell's estate claimed a refund of more than $2.8 million. The IRS denied the claim for refund, and the estate brought suit.

The District Court for the Western District of Virginia held both that the misappropriated funds were properly included in Wendell's gross estate and that there was no offsetting deduction. The court noted that Wendell had exercised dominion and control over the assets of his wife's trust as though they were his own, without recognizing any obligation to repay those amounts. The court also rejected the estate's alternate argument that the estate should be allowed an offsetting deduction of equal value under Section 2053(a)(3), either as a claim against the estate, or under Section 2053(a)(4) as a debt of the decedent. The court noted that the trust's beneficiaries never made a claim against Wendell or his estate, and that no claim was ever reasonably expected. Thus, the amount could not be a deductible claim. The court also noted that any claim that might now arise would be barred by the two-year state statute of limitations on actions against a fiduciary. The court rejected the estate's argument that the running of the statute of limitations after the death of the decedent could not be taken into account in valuing the claim, relying on the Supreme Court's opinion in *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929). The court also denied a deduction for the other beneficiaries' possible claims as indebtedness of Wendell's estate, noting that "neither Wendell nor the estate had an unconditional and legally enforceable obligation for the payment of money."

Note. The decision of the district court in *Estate of Hester* is reasonable, but not unassailable. The court stated that Dorothy Hester's trust was a "qualifying income interest for life," which suggests that it was a deducted QTIP marital trust. If the trust was a QTIP marital trust, then the trust assets would have been includible in Wendell's gross estate under Section 2044, and allowing any type of exclusion or offsetting deduction would yield Wendell a better estate tax result than would have existed had he not misappropriated the assets. This result would be untenable. If the assets of Dorothy Hester's trust were not deducted under Section 2056(b)(7), the certainty of the district court's analysis becomes clear. It is reasonable to hold that the decedent's gross estate should include the misappropriated funds, but courts are divided regarding whether the IRS may consider *post mortem* events in determining the deductibility and amount of a claim against the decedent's estate.

E Code § 2055. Charitable Distributions

1 **Tax Technical Corrections Act Repeals Estate Tax Limit on Charitable Gifts of Partial Interests in Tangible Personal Property. Pub. L. 110-172, 110th Cong., 1st Sess. (12/2007)**

The Tax Technical Corrections Act of 2007 eliminates the estate tax restriction on charitable bequests of partial interests in tangible personal property. The Pension Protection Act of 2006 provides limits the estate tax charitable contributions for a taxpayer who, after having made an initial fractional contribution, thereafter makes an additional testamentary or inter vivos charitable gift of an interest in that same property (an Aadditional contribution@). Int. Rev. Code §§170(o), 2055(g), 2522(e). The PPA stated that the income, estate and/or gift tax deduction for a testamentary transfer of such an additional contribution was limited to the appropriate fractional share of (a) the fair market value of the property at the time of the initial fractional contribution, or if less, (b) the fair market value of the property at the time of the additional contribution. Thus, no income, gift or estate tax deduction would be allowed for any share of the appreciation in the value of the tangible personal property that occurred after the initial fractional contribution.

2 **Charitable Deduction Denied Noncomplying Remainder Trust; Doctrine of Substantial Compliance Does Not Apply to Trust Reformation. *Estate of Tamulis v. Comm'r*, 509 F.3d 343, 2007 WL 4191981 (7th Cir. Nov. 29, 2007)**

Father Tamulis, a Catholic priest, died in 2000, leaving an estate of $3.4 million. His will left the bulk of his estate to his revocable living trust, which provided that the trust would continue for the longer of 10 years or the joint lives of Tamulis's brother and the brother's wife. During their lives, the brother and sister-in-law would have the right to live in a house owned by the trust and the trust would pay real estate taxes on the house. The remainder of the trust's net income would be distributed to two of the brother and sister-in-law's granddaughters, less $10,000 per year, which would be paid to their third child until she graduated medical school. After the 10-year period (or the shorter lifetimes of the brother and sister-in-law), the remaining trust assets would pass to a Catholic diocese. The estate filed a timely estate tax return, claiming a $1.5 million charitable deduction -- the present value of a charitable remainder following a 10 year term certain charitable remainder unitrust at five percent quarterly payments to two grand nieces. The trustee administered the trust from 2001 through 2004, as if it required distribution of a five percent unitrust amount to the grandnieces and the payment of the real estate taxes on the residence. A petition for state court reformation was drafted but never filed. Thereafter, a proposed nonjudicial reformation was circulated among the beneficiaries, but one of the noncharitable beneficiaries refused to sign, and the trust was not reformed.

The Tax Court (Judge Gale) denied the charitable deduction, noting that the trust was not a charitable remainder unitrust, that the interest left to the various beneficiaries was not a "reformable interest" because certain noncharitable payments (the use of the residence) were are not expressed as either a specified dollar amount or a fixed percentage of the fair market value of the trust property, and that no state court reformation was undertaken within 90 days of the date the estate tax return was filed. The Tax Court rejected the trustee's argument that the administration of the trust as a charitable remainder unitrust should alone satisfy Section 2055(e)(3) under the doctrine of substantial compliance. The Tax Court stated that the doctrine of substantial compliance applies to procedural, rather than substantive requirements, and the rules on reformation of a charitable remainder trust are substantive.

The Seventh Circuit affirmed, applying an even more restricted reading of the doctrine of substantial compliance than that applied by the Tax Court, stating that the doctrine should apply only in cases in which a taxpayer had a good excuse for failing to comply with either an unimportant or unclear requirement of the statute or regulations. In this case, the executor-trustee was represented by counsel and knew that substantial deductions depended upon reforming the trust within the required time. The failure to do so may have been caused by an intransigent beneficiary, but that did not itself constitute cause to apply the doctrine of substantial compliance.

3 IRS Publishes Sample Testamentary Charitable Lead Trust. Rev. Proc. 2007-45, 2007-29 IRB 89 (July 16, 2007)

The IRS published sample testamentary charitable lead trust forms and guidance. Among the more interesting aspects of this very useful procedure are the following:

- **Defining the Annuity.** The sample trusts define the annuity interest as a percentage of the initial value of the trust funds, but provide alternate language to specify the dollar amount in the governing instrument.

- **Measuring the Annuity Term.** The sample trust forms permit measurement of the annuity period by a fixed number of years or one or more measuring lives. The IRS states, however, that one can use a measuring life, rather than a term of years, only if the measuring life is the donor or certain related persons.

- **Increasing Annuity.** The annotations permit the creation of an annuity interest with increasing annual payments, as long as the annuity has an ascertainable value. This authorizes the use of lower annuity payments in early years, which may be very useful particularly if the measuring life is in poor health (though having a life expectancy of more than 18 months when the trust is created.)

- **Commutation Prohibited.** The trustee may not have the right to commute the charitable annuity interest and prepay the charitable distribution. Rev. Rul. 88-27, 1988-1 C.B. 331.

- **Excess Business Holdings.** If the charitable interest exceeds 60 percent of the value of the trust fund, the trust instrument must prohibit acquisition and retention of assets that would give rise to a tax on excess business holdings under Sections 4943 or 4944.

- **Distribution of Appreciated Assets.** A distribution of appreciated property in satisfaction of the annuity amount produces both a recognized gain and a charitable deduction. Rev. Rul. 83-75, 1983-1 C.B. 114.

- **Rule Against Perpetuities.** Any rule against perpetuities savings clause must be based on the common law life in being plus 21 years approach, rather than the Uniform Act's alternate 90 years approach. Treas. Regs. § 20.2055-2(e)(2)(vi)(a).

- **GST Planning.** No GST planning is included. As these are CLATs, rather than unitrusts, the inclusion ratio is calculated under a special set of rules included in Section 2642(e).

- **Alternate Charitable Beneficiaries.** The trust may designate an alternate charitable beneficiary or permit the trustee to select one, as long as the trustee's powers are limited selecting organizations described in both Sections 170(c) and 2055(a).

Note. The annotations are particularly useful, highlighting most of the serious issues raised by the use of a charitable lead trust. They may themselves be the most important part of the sample forms. The drafting style is typical IRS, which means that the language is relatively clear, but the organization can stand some improvement. The practitioner should consider reorganizing the forms to improve readability.

4 **Estate Tax Deduction Denied for Nonqualified Split-Interest Trust Disguised as Share of Residue.** ***Galloway v. U.S.*****, 492F.3rd 219, 2007 WL 1775006 (3rd Cir. June 21, 2007),** ***aff'g*****, 2006 WL 1233683, 97 AFTR 2d 2006-2458 (W.D. Pa., 2006)**

James= revocable trust provided that the residue would pass in four equal shares, with two shares passing to specified individuals and two shares to named charities. The four shares would each be paid out in two installments, with one share being distributed on January 1, 2006, and the other on January 1, 2016, when the trust would terminate. The instrument stated that the share for any individual beneficiary who was not alive on the date of a distribution would lapse and be reallocated among the other surviving beneficiaries. Following James= death, his executors asked the Pennsylvania tax authorities to calculate the value of the residuary interest, which they set at $690,475, of which $399,079 would be distributed to the charitable entities. The executors deducted $399,079 on the Federal estate tax return. The IRS calculated an estate tax of $168,637, denying the deduction for the charitable remainder. The Estate paid the tax in three installments, and sued for a refund.

The U.S. District Court for the Western District of Pennsylvania held for the IRS, finding that the residuary disposition was a non-qualifying charitable split-interest trust, under Section 2055(e)(2), which denies an estate tax deduction for a charitable split-interest charitable trust, other than a charitable remainder or lead annuity trust or a unitrust, a pooled income fund, and certain other interests. The court stressed that the trust fund was created under one document from one set of property.

The Third Circuit affirmed. The court examined the legislative history of the split-interest rule, noting that the Tax Reform Act of 1969 eliminated the rule by which any charitable remainder interest of ascertainable value was deductible. Now, a deduction is allowed a split-interest in trust only if the trust meets certain specific requirements, which the trust in this case did not meet. The question, therefore, was whether this trust was a split-interest charitable trust at all. The court defined a Asplit interest charitable trust@ using the ordinary natural meaning of the terms, as one in which property passes from a decedent both to a charity and a non-charity. This was true in this case, and the court refused to consider the legislative history, finding the Code itself unambiguous.

Note. This disposition looked at first glance like a simple quartile division of the residuary share of the trust, which would have permitted a charitable deduction for the charitable share. In this case, however, the amount that the charities would receive depended upon the survival of the individual beneficiaries, and so was part of a true split-interest arrangement. Sadly, in this situation, no deduction is allowed even for the one-half of the residuary estate that the charities would be assured of receiving. Citing *Estate of Johnson v. U.S.*, 941 F.2d 1318, 1321 (5th Cir. 1991) (no deduction for charitable share of trust to support decedent=s three sisters, to maintain the graves of his family members, and to create a charitable trust to pay for religious education in certain Catholic parishes); *Zabel v. U.S.,* 995 F.Supp. 1036 (D. Neb. 1998) (no deduction for trust whose income was to be split between charitable and individual beneficiaries for 21 years, with the remaining corpus to be distributed to the charitable beneficiaries at that time); *Estate of Edgar v. Comm'r,* 74 T.C. 983 (1980), *aff'd,* 676 F.2d 685 (3rd Cir. 1982) (no deduction for assets added to trust created by the decedent=s sister, providing for regular payments from income to non-charitable individuals, with the remainder passing to various charities upon the death of the non-charitable beneficiaries, even though the income from the trust to which the estate poured-over would be sufficient to pay all noncharitable amounts.)

F Code §§ 2056, 2044, 2519, 2523, 2207A. Marital Deduction

1 Ninth Circuit Affirms Application of Marital Deduction Based on Finding of Decedent's Intent. *Estate of Sowder v. U.S.*, 2007 WL 3046287, 100 A.F.T.R.2d 2007-6379 (9th Cir. Oct. 18, 2007) (slip opinion), *aff'g per curiam (without opinion)* 407 F.Supp. 2d 1230 (E.D. Wash. 2005)

Tony's will bequeathed $600,000 to persons other than his widow, Marie, and the residue of his estate to his widow, "if she survives me, and if she does not survive me, or dies before my estate is distributed to her. . ." The IRS disallowed the estate tax marital deduction, claiming that the condition of survivorship rendered the residuary gift a nondeductible terminable interest. Int. Rev. Code § 2056(b)(3).

The District Court initially held for the estate, applying a state law that requires construction of a bequest that was intended to qualify for the marital deduction in such a manner as to make it so qualify. Rev. Code of Wash. §11.108.020(1). After procedural issues were resolved by an appeal to the Ninth Circuit, the district court heard evidence and concluded that the decedent's intent was for his residuary gift to qualify for the marital deduction. The court cited the facts that: (a) the decedent was a tax-wise businessman and individual who did not want to pay any more tax than necessary; (b) the decedent died possessed of an article that explained the 1981 enactment of the unlimited marital deduction and state law presupposes a decedent to have known the law on the date of death; (c) the decedent created an irrevocable life insurance trust holding a last-to-die life insurance policy, suggesting that he intended to defer estate taxes until both spouses had died.

The Ninth Circuit affirmed per curiam, in an unpublished opinion.

Points of Note. The same analysis could have been required (and the same result obtained) in a state that lacks such a generous statute, if the decedent=s testamentary instruments contain a statement of the tax objectives, and a requirement that they be construed in such a manner as to achieve those goals. For example, the following language might be included in a conventional marital deduction will or revocable trust:

> **Tax Objectives.** I intend that: (a) the Marital Share qualify for the Federal estate tax marital deduction [OPTIONAL FOR QTIP:, except to the extent that my personal representative does not elect for it to be deductible]; (b) the Family Share shall not be includible in the gross estate of my *husband/wife*, if *he/she* survives me. In all matters involving my estate, my will [OPTIONAL FOR REV. TRUST: and revocable trust] shall be construed in such a manner as to effectuate these tax objectives, and my personal representative [OPTIONAL FOR MARITAL TRUST: and trustees] shall exercise no power in a manner that would be inconsistent with these tax objectives.

2 **Marital Deduction Not Allowed for Bequest to Spouse Presumed to Have Survived Decedent.** ***Estate of Lee v. Comm'r*, T.C. Memo. 2007-371 (Dec. 20, 2007)**

Kwang Lee died 46 days after his wife, Kyong. Kwang's estate claimed a marital deduction for property that was transferred to Kyong, as if she had survived him. Kyong's will stated that Kwang would be deemed to have predeceased Kyong for purposes of her will if he died within six months after Kyong's death. Kwang's will was silent, but it was shown that he intended, for purposes of his will, that Kyong be deemed to have survived him if he died within six months after her death. Both spouses were suffering from a serious disease when their planning was done, and they both died from that disease. Most of the couple's assets were titled in Kwang's name. The IRS disallowed the estate tax marital deduction for the bequest to Kyang.

The Tax Court (Judge Laro) granted summary judgment to the IRS and held that the marital deduction cannot be allowed for a bequest to a spouse who does not actually survive the deceased spouse. The court stated that the decedent's intent that he be deemed to have predeceased his wife would not be recognized as qualifying the estate for the marital deduction.

3 IRS Explains Tax Consequences of Nonqualified Disclaimer of QTIP Income Interest. PLR 200801009 (Jan. 4, 2008)

A QTIP trust was created under a revocable trust that became irrevocable on the grantor's death. The revocable trust created a nonmarital trust (Trust B) for the grantor's children and more remote descendants, in an amount equal to the grantor's applicable exemption amount. The residue of the revocable trust assets would be held as a QTIP marital trust (Trust A), giving the surviving spouse all of the net income, payable at least annually and allowing the trustees to distribute principal for the spouse's support, maintenance and medical care. The revocable trust instrument also authorized the spouse to disclaim her interest in the QTIP trust, in whole or in part, and directed that any disclaimed property would be added to Trust B. The spouse proposed to disclaim her interest in the QTIP trust, and a state court confirmed that any disclaimed portion of the QTIP trust would be added to Trust B as if it were part of that trust's initial funding. The spouse agreed to pay any gift taxes arising from her disclaimer of the income interest in the QTIP trust, but stated that she would exercise her right of recovery for gift tax relating to the transfer of the remainder interest pursuant to Section 2207A(b). The assets of the QTIP marital trust have fair market values that are less than the trust's basis in those assets. The ruling does not so state, but based on the tax consequences, the disclaimer was not a qualified disclaimer under Section 2518.

The IRS ruled that the spouse's disclaimer, when effective, would constitute a completed net gift of the remainder interest in the QTIP trust for federal gift tax purposes, if she exercised her right of recovery under Section 2207A, and that the disclaimer would also constitute a completed gift of the spouse's income interest in the QTIP trust under for federal gift tax purposes, with the values of the income and remainder interests determined under the actuarial tables promulgated under Section 7520. The IRS further stated that the disclaimed interests in the QTIP would not be includable in the spouse's gross estate at her death for federal estate tax purposes, that spouse would not recognize gain or loss on the disclaimer, and that the adjusted basis of the marital trust assets, for the purpose of determining gain, in the hands of the persons receiving the property, will be the same as the basis of those assets in the QTIP trust at the time of transfer. For purposes of determining loss, the basis of the QTIP assets would be limited to their fair market value at the time of the disclaimer.

G Code § 2057. Qualified Family Owned Business Interest

Loans Are Not Interests in Family Owned Business. *Estate of Farnam v. Comm'r*, 130 T.C. ___ (No. 2) (Feb. 4, 2008)

Duane and Lois owned and (with other family members) managed a corporation that operated retail and wholesale stores in Minnesota and the Dakotas, selling automobile parts, retail and wholesale. The family members all lent money to the corporation for use in its business operations. The loans were unsecured and subordinated to claims of outside creditors, and substantiated by written promissory notes. The corporation made repayments of both principal and interest on the loans after 1984, and before that made repayments of principal, but not of interest. The decedents died owning each 50 percent of the voting shares of the corporation, and substantial majority interests in two family partnerships that held two buildings and the decedents' promissory notes. The executors claimed the estate tax deduction under Section 2057 for the qualified family-owned business interests (QFOBI). The common stock and the notes held by the partnerships were included in the respective decedents' gross estates and in the calculation of whether more than 50 percent of each adjusted gross estate consisted of QFOBI (the QFOBI 50-percent liquidity test). Int. Rev. Code §2057(b)(1)(C). The IRS disallowed the QFOBI deductions, finding that the promissory notes were not business interests and, therefore, did not qualify for the QFOBI deduction.

The Tax Court (Judge Swift) held for the government, noting that an "interest" in a family business, for purposes of the 50-percent liquidity test includes only equity interests. The court stated that the close proximity of the language "interest in an entity" in section 2057(e)(1)(B) to the explicit equity ownership language of Section 2057(e)(1)(B)(i) and (ii) rendered it illogical to divorce the equity ownership requirements of Section 2057(e)(1)(B)(i) and (ii) from the immediately preceding language.

H Estate Tax Procedures

1 Supplemental Appropriations Act (The U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007) Extends Return Preparer to Estate and Gift Tax Returns, Tightens Rules. Pub. L. 110-28, § 8246(a)(2), 110th Cong., 1st Sess. (May 25, 2007)

Under revised section 6694, a penalty is imposed on the person who prepares a tax return for another or advises in the preparation of the return, for an incorrect position, if the preparer did not have a reasonable basis to conclude the position was more likely than not correct. Disclosure on the return (or, in the case of a non-signing practitioner, advice about a given disclosure), limits the penalty to situations in which there is a reasonable basis for the position (the one-in-three formulation under prior law). This rule applies to all tax returns, including estate and gift tax returns. The penalty for preparing or assisting in preparing such returns is $1,000, or if greater, one –half of the income derived (or to be derived) by the tax return preparer with respect to the return. No penalty is imposed if it is shown that there is a reasonable cause for the understatement and the tax return preparer acted in good faith. This change applies to returns prepared after May 25, 2007 (the date of enactment).

Note. A practitioner who gives a legal opinion about a substantial issue on the return will be deemed to be a non-signing preparer, and the fees upon which the penalty is based could be those involved in a larger transaction of which the return is only a modest part. Therefore, these penalties can be a significant issue for even those practitioners who do not prepare returns generally.

See also Notice 2007-54, discussed below, which postpones until January 1, 2008, the application of the new penalty rules for tax return prepares and advisors, continuing to apply the reasonable basis standard (one out of three) instead of the more-likely-than-not standard.

2 **IRS and Treasury Issue Final Regulations on Material Advisors. 72 Fed. Reg. 43146 (Aug. 3, 2007), 72 Fed. Reg. 43154 (Aug.3, 2007), 72 Fed. Reg. 43157 (Aug. 3, 2007)**

The IRS and Treasury issued final regulations that impose substantial reporting and record-keeping requirements on professionals who advise relating to the filing of estate and gift tax returns. The final regulations largely follow the proposed and temporary regulations. The following are the key points of these regulations.

- **Transactions of Interest.** The final regulations under Section 6011, like the proposed regulations, create a new category of reportable transactions for which the taxpayer or material advisor must file a specific disclosure form and maintain records. A transaction of interest is one that is the same as or substantially similar to a transaction identified in published guidance, that the IRS believes to have a potential for tax avoidance or evasion, but for which the IRS currently lacks adequate data from which to determine whether the transaction should be promoted to a listed tax-avoidance transaction. The IRS publication that identifies a transaction of interest will also identify the classes of persons who are participants required to file a disclosure statement. Treas. Regs. §§ 1.6011-4(b)(6), 1.6011-4(c)(3)(e); 20.6011-4(a), 25.6011-4(a).

_ **Material Advisor.** The regulations impose disclosure and record-keeping requirements on "material advisors." A material advisor is a person who provides any "material aid, assistance, or advice" regarding the organization, management, promotion, sale, implementation, insurance, or conduct of any reportable transaction, and derives substantial income from that aid, assistance, or advice. Treas. Regs. § 301.6111-3(b)(1). Material aid, assistance or advice is provided by a person who provides or makes a tax statement for the benefit of a taxpayer who is or whom the material advisor knows (or reasonable expects) to be required to disclose the transaction, or another material advisor who is or whom the material advisor knows (or reasonably expects) to be required to disclose the transaction. Treas. Regs. § 301.6111-1(b)(2).

_ **Furnishing Lists.** The regulations state that each material advisor must prepare and maintain a list for each reportable transaction, including an itemized statement of the name and identifying data for each person required to be included in the list, the dates on which the persons entered into the transaction, the amount invested in each transaction, a summary or schedule of the tax treatment of each person participating in the transaction, and the name of each other material advisor known to the advisor filing the statement. The material advisor must also file a description of the transaction and copies of the supporting documents. The list must be furnished to the IRS upon its written request. Treas. Regs. § 301.6112-1.

3 IRS and Treasury Re-Propose Regulations on Installment Payment Arrangements. 72 Fed. Reg. 9712 (March 5, 2007)

The Treasury and the IRS re-proposed regulations under Section 6159, explaining how installment payment arrangements are requested, accepted, and administered, and when the IRS can terminate an installment payment agreement and recommence collection proceedings.

- **Requesting an Agreement to Pay Tax in Installments.** Section 6159(a) authorizes written agreements under which a taxpayer may "make payment on any tax in installment payments if the Secretary determines that such agreement will facilitate full or partial collection of such liability." Prop. Treas. Regs. § 301.6159-1(a). The regulations state that a request to pay taxes in installments must be follow the procedures, and be in the form and manner, prescribed by the IRS, but do not include specific procedures for requesting an installment agreement. The regulations preclude the IRS from accepting a proposed installment agreement for processing after the matter has been referred to the Justice Department. Prop. Treas. Regs. §§ 301.6159-1(b)(1), 301.6159-1(b)(2). A proposed installment agreement remains pending until the IRS accepts it or notifies the taxpayer that it has been rejected or until the taxpayer withdraws it. The IRS will ask the taxpayer for additional information, if a proposed installment agreement accepted for processing lacks sufficient information to enable the IRS to decide whether to accept it. The IRS can reject an agreement if the taxpayer fails to submit the requested additional data within "a reasonable time." Prop. Treas. Regs. § 301.6159-1(b)(2).

- **Acceptance of a Proposed Installment Agreement.** An installment agreement is "accepted" when the IRS notifies the taxpayer or the taxpayer's representative of its acceptance. Acceptance of an installment agreement does not alter the amount of a taxpayer's liability for tax, interest or penalties; penalties may continue to accrue at a reduced rate in some cases. Prop. Treas. Regs. §§ 301.6159-1(c)(1)(i), 301.6159-1(c)(1)(ii). The IRS is not required to accept installment agreements for estate or gift tax, or for fiduciary income taxes; they are required to accept certain agreements relating to individual income taxes. Prop. Treas. Regs. § 301.6159-1(c)(1)(iii).

- **Form and Terms of Installment Agreements.** An installment agreement must be in writing, and it may either be signed by both the IRS and the taxpayer, or sent or delivered by the IRS to the taxpayer as confirmation of an agreement reached by them. Prop. Treas. Regs. § 301.6159-1(c)(2). An installment agreement must include an expiration date, which cannot be later than the statute of limitations period. Prop. Treas. Regs. § 301.6159-1(c)(3)(ii). The IRS may require that the taxpayer agree to a reasonable extension of the statute of limitations, as well as to any other terms that protect the interests of the government. Prop. Treas. Regs. § 301.6159-1(c)(3)(iii). The IRS may request an update on the taxpayer's financial condition at any time while the agreement is in effect. Prop. Treas. Regs. § 301.6159-1(c)(3)(iv).

- **Rejecting Proposed Agreements.** The IRS may reject an installment agreement by notifying the taxpayer or the taxpayer's representative of the fact of and reasons for the rejection and the taxpayer's right to appeal. Prop. Treas. Regs. § 301.6159-1(d)(1). The taxpayer has 30 days from the date of the notice of rejection in which to appeal to the IRS Office of Appeals. The taxpayer must indicate an intention to appeal in the manner that the IRS provides. Prop. Treas. Regs. § 301.6159-1(d)(2).

- **Terminating and Modifying Installment Agreements.** Generally, the IRS may terminate an installment agreement if: (a) the taxpayer has provided inaccurate or incomplete information, (b) collection of any tax to which the agreement relates is in jeopardy, (c) the taxpayer fails to pay any required installment when due, (d) the taxpayer's financial condition changes significantly, (e) the taxpayer fails to provide a requested financial condition update, or (f) the taxpayer fails to pay any other Federal tax liability when due. Int. Rev. Code § 6159(b); Prop. Treas. Regs. §§ 301.6159-1(e)(1), 301.6159-1(e)(2). The Secretary must give the taxpayer 30-days written notice of an intention to terminate an installment agreement, explaining why the agreement will be terminated, unless the collection of the tax to which the agreement relates is in jeopardy. Prop. Treas. Regs. § 301.6159-1(e)(4).

- **Effect of the Agreement on Collection Activity.** An installment agreement suspends the IRS' right to levy on the assets of the taxpayer in order to collect the tax to which the agreement relates, or to turn the matter over to the Department of Justice for collection. Suspension begins when the agreement is accepted for processing and ends 30 days after the agreement terminates. Collection is also suspended during appeal of a termination notice, if the taxpayer files a timely request for appeal. Prop. Treas. Regs. §§ 301.6159-1(f)(1), 301.6159-1(f)(3)(ii). The IRS can levy on the taxpayer's assets during this suspension period, if the taxpayer waives the restriction on levy, the proposed installment agreement was submitted merely to delay collection or collection of the tax is in jeopardy by delay. Prop. Treas. Regs. § 301.6159-1(f)(2).

- **Suspension of the Statute of Limitations.** The statute of limitations for collection of a tax liability is suspended during the period that a proposed installment agreement is pending with the IRS (before it is accepted or rejected), for 30 days following rejection of the proposed agreement, and for 30 days following termination of an installment agreement. The statute of limitations is also suspended during a taxpayer's timely appeal from a notice of termination. Prop. Treas. Regs. §301.6159-1(g).

- **Annual Statements and Biannual Review.** The IRS is required to give each taxpayer who has a currently valid installment agreement an annual statement that includes the initial balance on the first day of the year, the payments made during the year, and the remaining balance at the end of the year. Prop. Treas. Regs. §301.6159-1(h). The IRS is required to review the taxpayer's financial condition every two years in the case of a partial payment installment agreement, to determine whether the taxpayer's financial condition has changed so significantly that the value of the payments being made should be changed or the agreement entirely terminated. Prop. Treas. Regs. § 301.6159-1(i).

- **Effective Date.** These new rules will apply when final regulations are published in the Federal Register.

Note. The IRS is far from powerless during the suspension of its right to levy pending the consideration or operation of an installment agreement. The IRS can still take other actions to improve its position with respect to collection. For example, the IRS could credit an overpayment by the taxpayer against the liability in question, file or refile notices of Federal tax liens, and bring collections proceedings against people who are not named in the installment agreement but who may share the liability. The IRS could also authorize the Department of Justice to file a counterclaim or third-party complaint in a refund suit, or to join the taxpayer in any other proceeding in which the ultimate liability of the taxpayer for the tax may be determined. The government could also file a claim in a bankruptcy proceeding in which the taxpayer in the bankrupt. Prop. Treas. Regs. § 301.6159-1(f)(3).

4 **Title Company Cannot Sue to Contest Estate Tax Assessment. *First American Title Ins. Co. v. U.S.*, ___ F.3d ___, 2008 WL 795356 (9th Cir. March 27, 2008)**

The decedent named her daughter Penny the personal representative of the decedent's estate, which consisted of three houses and the stock of a corporation that owned a hamburger drive-in (Frisko Freeze, Inc.). The estate filed its federal estate tax return and elected to pay the $144,323 estate tax in installments under Section 6166. Penny then conveyed the three houses to herself and her husband and over the next two years, sold the houses to three different buyers, all of whom were *bona fide* purchasers for value, and each of whom obtained title insurance from the plaintiffs in this case. Despite their title searches, none of the title insurers discovered that the houses were encumbered by tax liens. On audit, the IRS and the estate agreed that the Frisko Freeze stock was worth more than the estate had claimed. Penny signed an IRS Form 890, waiving restrictions on assessment and collection and agreeing that no Tax Court petition would be filed. Not long after agreeing to the higher assessment, Penny quit paying the estate taxes, and both she and Frisko Freeze eventually filed for bankruptcy. The estate owed $189,372 in estate taxes and the IRS sought to foreclose its liens on the three houses. The buyers made claims on their title insurers, and the title insurers paid off the tax liens under protest and brought this case, challenging the IRS's high valuation of the company. The title companies sued for a refund of the taxes under 28 U.S.C. § 1346, contending that the taxes were "erroneously or illegally assessed and collected." The district court concluded that the court lacked jurisdiction to decide the title insurers' claims under 28 U.S.C. § 1346.

The Ninth Circuit affirmed, based on *EC Term of Years Trust v. U.S.,* 549 U.S. ___ , 127 S. Ct. 1763, 167 L.Ed.2d 729 (2007), holding that 28 U.S.C. § 1346 does not allow the title insurers to contest the estate tax liability. Section 7426(a) conclusively presumes the assessment of tax upon which a tax lien is based to be valid, making it impossible for the insurers to sue to contest the assessment. Thus, the insurers sued for a refund of the taxes, under 28 U.S.C. § 1346. In *EC Term of Years Trust,* the Supreme Court held that a third party cannot sue under 28 U.S.C. § 1346 because that would be irreconcilable with the general principle that a "detailed statute [Section 7426] pre-empts more general remedies [28 U.S.C. § 1348]." *EC Term of Years Trust* involved a challenge to a tax levy, but the Ninth Circuit held that it applies equally well to a challenge to an assessment.

5 Tax Court Properly Rejected both Taxpayer's and Government's Appraisals, but Erred in Holding that Sufficient Reasonable Cause Existed Not to Impose Underpayment Penalty. *Estate of Thompson v. Comm'r*, 499 F.3d 129, 2007 WL 2404434 (2nd Cir. Aug. 23, 2007), *vac'g* T.C. Memo. 2004-174

The decedent, Josephine, owned a 20.57 percent block of the stock of Thomas Publishing Co., Inc. (TPC), a closely-held corporation formed in 1898. The decedent's block was the largest block of TPC's common stock held by any one shareholder. Capital Cities/ABC, Inc. owned a 12.656-percent block of the stock, and the rest was owned by various members of Josephine's extended family. TPC's primary business is the production and sale of industrial and manufacturing business guides and directories, though it also published and sold a variety of news magazines, software comparison guides, and a magazine relating to factory automation, and it owned a product information exchange service and a custom publishing group. TPC also maintained a leading business-to-business website. TPC had a long history of paying annual cash dividends. The decedent's estate valued the decedent's block of stock at $1.75 million, based on an appraisal prepared by an attorney and an accountant, which capitalized TPC's earnings at a 30.5-percent capitalization rate and claimed a 40-percent minority interest discount and a 45-percent lack of marketability discount. A professional appraiser employed by the IRS valued the decedent's stock at $35.273 million, using the comparable public company method and the discounted cash flow method, and applying a 30-percent discount for lack of marketability, and no discount for lack of control.

The Tax Court (Judge Swift) valued the block of stock at $13.525 million, and refused to impose a penalty for undervaluation. The court found both parties' valuations to be "deficient and unpersuasive," noting that the estate's appraisers had relatively little valuation experience, that they valued the interest aggressively and overstated the risks associated with the Internet and technology and by applying excessive discounts. The IRS expert, the court noted, used a "sterile approach" that was concerned only with numbers, and that did not value TPC as a real company. The companies selected by the IRS expert as comparable were not, the court stated, very similar to TPC. The court valued TPC by capitalizing its earnings at an 18.5-percent rate, and allowing a 15-percent minority interest discount and a 30-percent lack of marketability discount. The court refused to apply a penalty for substantial valuation understatement, finding that the taxpayer's valuation was based on reasonable cause and the taxpayer had acted in good faith. The court noted that the valuation of the stock of TPC was particularly difficult, comparable companies did not exist, and capitalization of income and the discounted cash flow methods involved a number of difficult judgment calls.

The Second Circuit agreed that the Tax Court could reasonably adopt its own valuation and deferred to its criticisms of the methodology of both the taxpayer and the government, though it noted a conceded math error that required remand to the Tax Court for correction. The court vacated the Tax Court's conclusion that the taxpayer had reasonable cause for its understatement. The penalty applies automatically, in case of a substantial underpayment, unless it is shown that there was a reasonable cause and that the taxpayer acted in good faith. Int. Rev. Code § 6664(c)(1). Reliance on an appraiser does not necessarily demonstrate reasonable cause, unless reliance was reasonable. The Second Circuit held that the Tax Court's findings were insufficient to support a determination of reasonable cause, because they included no finding regarding the good faith of the taxpayer-either in assessing its own liability or in relying on an expert to do so. The court must make a finding as to whether the estate's reliance on its experts was reasonable and in good faith, or whether the estate knew or should have known that they lacked the expertise necessary to value the company.

6 **IRS Will Not Require Bond, Lien For All Estates Seeking Payment Extension. Notice 2007-90, 2007-46 I.R.B. 1003 (Nov. 13, 2007)**

This Notice provides interim guidance for estates electing to defer payment of the estate tax attributable to a closely held business under Section 6166, in light of *Estate of Roski v. Comm'r*, 128 T.C. 113 (2007). The IRS will determine on *a* case-by-case basis whether security will be required to protect the government's interest in obtaining full payment of the estate tax and interest when that liability is deferred under Section 6166. The IRS plans ultimately to propose regulations detailing the factors that will enter into its decisions and it requests comments on the relevant factors. A primary factor will be the nature of the business generating the income on which estate taxes are owed, and other considerations will include the company's assets, relevant market factors affecting the success and survival of the business, recent financial history and the experience of the company's management. The IRS also expects to consider information about outstanding liens, judgments, pending or anticipated lawsuits, or other claims against the business, as well as all facts tending to show the business's ability to pay the taxes, including cash flow, assets and liabilities. Compliance history also will play a big part in determining whether IRS will require the outstanding taxes to be secured, the agency said. The notice said the government will look at compliance with federal tax payment and filing requirements by both the business and the estate.

This notice applies to estates that timely elect to pay taxes in installments and timely file returns after November 17, 2007 or that had returns being classified, surveyed or audited as of April 12, 2007. The notice also applies to estates that are currently paying taxes under Section 6166 but that have not yet provided bond or lien, if (1) the general federal estate tax lien will expire within two years from November 13, or (2) the IRS reasonably believes there is sufficient risk to justify requiring the tax payments to be secured.

7 **Estate Liable for Addition to Tax for Late Filing Despite Reliance on Counsel. *Estate of Zlotowski v. Comm'r*, T.C. Memo. 2007-203 (July 24, 2007)**

Gertrude, a U.S. citizen domiciled in Germany, died with two wills -- a U.S. will and a later German will, which revoked the U.S. will. Not knowing of the German will, Jacques and Henry qualified as executors of her estate in Surrogate's Court in New York. They retained an attorney recommended by Gertrude's former lawyer. The executors received an extension of the filing date that would permit them to file by December 10, 2000, but the return was not actually filed until September, 2001. In 2003, the heirs under the German will hired an American attorney to help with ancillary proceedings in the Surrogate's Court, and ancillary administrators C.T.A. were appointed in 2004, and the preliminary letters testamentary issued to Jacques and Henry were revoked. Jacques testified that he is 85 years of age, owns real estate and is the head of his own diamond firm, and he agreed to serve because the decedent's husband was a close business associate. He testified that he knew nothing about the estate and relied fully on the attorneys, who were in charge of the estate. He did not participate in the preparation of the estate tax return and instead relied fully on his counsel. The attorney testified that he did not file in a timely manner because he had learned of the German will and was concerned about meddling in the e state when his clients were not legally personal representatives.

The Tax Court (Judge Halpern) held that the taxpayers were liable for penalties for late filing of the estate tax return, under Section 6651(a)(1). That penalty is imposed unless it is shown that the failure to file a timely return was due to reasonable cause and not due to willful neglect. The court agreed with the IRS assertion that Henry and Jacques failed to establish reasonable cause, and that they failed to show that the attorney gave them any advice upon which they could rely to file a late return.

> They have failed to show that he advised them that, as a matter of law, it was not necessary to file timely the estate tax return. Moreover, their reliance on him to file the estate tax return was an impermissible delegation of their responsibility as executors. Respondent adds: "If the executor is unable to obtain complete information about the decedent['s] assets, he must still file a timely tax return based on the information available at that time."

The court noted that Henry had died, and Jacques was "almost completely disengaged" from the estate administration.

8 IRS Provides Transition Relief for New Tougher Preparer Penalties. Notice 2007-54, 2007-27 I.R.B. 12 (July 2, 2007)

The IRS stated that, until 2008, preparers and advisors can avoid the new tightened penalties under Section 6694, if the preparer/advisor concludes there is a reasonable basis for the treatment reported on the return or claim, even if the preparer makes no disclosure or the advisor does not advise of opportunities to avoid penalties by disclosure.

Note. See discussion of the new penalties above.

9 Two Percent Interest Rate on Deferred Estate Taxes on Closely-Held Business Adjusted for Inflation. Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (Nov. 5, 2007)

The value of a closely-held business interest, the deferred estate taxes on which bear interest at a two percent rate, is increased to $1,280,000 with respect to estates of decedents dying in 2008.

10 IRS Considers When to Accept Alternate Collateral Under Section 6324A. C.C.M. 2008030126 (Jan. 18, 2008)

The decedent's executor elected to pay the taxes on the decedent's interest in an LLC over ten years, under Section 6166. Seventy-five percent of the assets of the LLC were a shopping center. The LLC had 15 or fewer members. The executors consented to the creation of the 15-year estate tax lien under Section 6324A and submitted a proposed Pledge and Escrow Agreement noting that the LLC interest of the decedent is "not registered and readily saleable on the open market and which constitutes an interest in a closely held business as defined by Section 6166. . . ." The estate asked the IRS to accept a pledge of the membership interest in lieu of bond. The agreements of the parties include the following provisions (in part): (1) the estate will hold the LLC interest and assigns its interest to Law-Firm as escrow agent; (2) the estate will provide annual reports or certified financial statements to the IRS on or before April 15 of each year during the term of the agreement; (3) the estate will remain the owner of the LLC interest and will be entitled to income from the LLC interest and to vote the interest; the IRS will not exercise incidents of ownership except after default and delivery of the escrow property to the IRS.

The IRS stated that it can accept the decedent's LLC interest as collateral for the tax deferred pursuant to a Section 6166 election, if it meets three statutory requirements. First, the collateral must be expected to survive the deferral period, determined after valuing the business and then judging whether the LLC can be expected to survive the deferral period. Second, the LLC interest must be identified in a binding written agreement filed by the executor, showing that all of the persons having an interest in the collateral, i.e., the LLC interest, agree to the creation of the special lien. Third, the value of the LLC interest as of the agreement date must be sufficient to pay the deferred taxes plus the required interest, considering all available financial data, as well as all relevant factors affecting the fair market value. Assuming that the IRS's analysis of the LLC involved a determination that the interest was expected to survive the deferral period and a determination that the value of the interest was sufficient to pay the deferred taxes plus the required interest, then the statutory requirements under Section 6324A have been met, the special estate tax lien arises, and the IRS must accept the LLC interest as collateral.

The IRS also stated that, if it accepts the LLC interest as collateral, it might choose not to enter into the Pledge and Escrow Agreement. Section 6324A(c) requires a written agreement protecting the IRS interest in the collateral securing Section 6324A special lien, signed by all persons having any interest in the collateral securing the lien. The Code does not either require the IRS from entering into or forbid it from entering into any additional agreements, such as a Pledge or Escrow Agreement. The IRS should determine whether the Pledge or Escrow Agreement will provide any additional security. The Chief Counsel's Office noted that the Pledge and Escrow Agreement reiterated the features of the required Section 6324A written agreement, but also required that the estate provide annual reports or certified financial statements, which would assist the IRS in monitoring whether the LLC interest has maintained its value. The IRS prefers to take possession of stock certificates for shares held as security, but as LLC membership certificates do not exist for the IRS to retain possession, the IRS could request that the estate to assign the LLC interest to the IRS in lieu of the Law-Firm acting as escrow agent. Assignment of the LLC interest to the IRS would provide additional security for the government because it would not need to go through a third party in the event that the estate fails to comply with the terms and conditions of Section 6324A.

The IRS also stated that the IRS should perfect its security interest in the LLC by filing a Notice of Federal Tax Lien (NFTL), Form 668-J, for the special estate tax lien in the LLC interest. As the LLC interest is personal property, the NFTL must be filed in the offices based both on the residence of the executor at the time the NFTL is filed, and based on the residence of the decedent at time of death.

11 When Stock or Other Business Interests Can be Used as Collateral for Special Estate Tax Lien. Chief Counsel's Memo. 200747019 (Nov. 23, 2007)

The IRS Chief Counsel's Office addressed several issues regarding when the IRS will accept closely-held stock as collateral for a Section 6324A lien to secure the payment of estate taxes deferred under Section 6166. The IRS stated that, while it was discussing the treatment of closely-held stock, the same rules applied to partnership interests and membership interests in an LLC. The IRS explained that the special section 6324A tax lien comes into existence only if the IRS is satisfied that:

(A) the collateral is expected to survive the deferral period;

(B) the collateral is identified in the special lien agreement; and

(C) the value of the collateral is sufficient to pay the estate tax liability plus the aggregate amount of interest payable over the first four years of the deferral period.

_ **When Stock Can be Pledged for a Special Lien.** The first issue addressed in the Memorandum was whether, and under what circumstances, closely-held stock is property that can be pledged in support of the election to defer estate taxes. The Office of Chief Counsel noted that although closely held stock may be offered as collateral to secure the Section 6324A lien, the IRS may accept it only when all three of these statutory requirements are met. Thus, both the stock and the corporation must be expected to survive the deferral period and to retain its value during that period.

First, to determine whether a corporation will survive the deferral period, the IRS must value the business, based on all relevant financial information provided by the estate, including appraisals, annual reports, and any other relevant financial document. The IRS must then judge whether the business can be expected to survive the deferral period. The IRS bears whatever risk exists that it will err in its conclusion.

Second, the stock must be identified in the written lien agreement, which must show that all persons having an interest in the stock agree to creating the special lien. The agreement must be binding on all parties that have any interest on the stock.

Third, the value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest.

If all three Section 6324A requirements are met, the special lien arises and the IRS must accept the collateral. The IRS cannot reject collateral proffered by the estate on the grounds that it would be burdensome for the IRS to make the economic or business calculations to determine the value, or on the grounds that the IRS would prefer other collateral. The Chief Counsel's Office recognized that taking such business interests as collateral may be risky, but that Congress left that risk with the IRS, rather than the taxpayer.

- **Criteria Used to Determine the Adequacy of Stock as Collateral.** Section 6324A(b)(1)(A) requires that the IRS determine whether the collateral can be expected to survive the deferral period, based on any accepted business criteria. The viability and net worth of the company is reflected in the value of the stock, and whether the stock will retain its value is a factor to be considered in determining whether the company will survive the deferral period. The IRS will not assume that a stock's failure to retain its value automatically means that a company will not survive the deferral period, however. If stock accepted as collateral decreases in value, the IRS may request additional collateral under Section 6324A(d)(5).

- **Requirements the IRS May Impose on an Estate that Pledges Stock as Collateral for a Special Lien.** The IRS may determine whether there has been a disposition of interest or withdrawal of funds from the company that would trigger the acceleration of payment under Section 6166(g)(1). The IRS may, in so doing, require all relevant financial information from the estate to continue to monitor the value of the accepted stock as collateral during the deferral period. Int. Rev. Code § 6324A(d)(5). The IRS can require that the estate provide annual reports or certified financial statements on or before April 15 of each year during the deferral period, and may require additional collateral if the estate refuses to provide the requested information. If the estate fails to provide the required additional collateral, the IRS can declare an acceleration of all deferred payments under Section 6166(g).

- **Securing the IRS Interest in the Pledged Stock.** Section 6324A(d)(1) provides that the special estate tax lien "shall not be valid as against any purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor until notice thereof which meets the requirements of Section 6323(f) has been filled by the Secretary." Thus, the IRS should first file a Notice of Federal Tax Lien (NFTL), Form 668-J, for the special estate tax lien on the stock. Int. Rev. Code § 6324A(d)(1). The lien arises when the executor is discharged from personal liability under Section 2204 and continues until the liability for the deferred amount is satisfied or becomes unenforceable by reason of lapse of time. Int. Rev. Code § 6324A(d)(2).

Section 6323(f) states that a NFTL must be filed in the office mandated by applicable state law for the state in which the property subject to the lien is situated. Int. Rev. Code § 6323(f)(1)(A)(ii). Stock is personal property, and thus is situated at the residence of the taxpayer at the time the NFTL is filed. Int. Rev. Code § 6323(f)(2).

In addition, if stock certificates exist, the IRS should request that the certificates be given to the IRS, to prevent the sale of the stock to third parties, who might incorrectly believe that they have a right in the certificates superior to that of the IRS. See Int. Rev. Code § 6323(b)(1)(A). The IRS explained that Section 6324A(d)(3) provides that only three of the superpriorities listed in Section 6324(b) qualify as a superpriority against the special estate tax liens, and that there is no superpriority for purchasers of stock encumbered by a Section 6324A special estate tax lien.

_ **Recording the Section 6324A Lien.** Recording the Section 6324A lien divests the regular general estate tax lien with respect to the property designated in the special lien agreement. The general estate tax lien expires 10 years from the date of death and cannot be extended. See Int. Rev. Code § 6324(a). The special estate tax lien expires when the deferred estate taxes are paid or the obligation to pay them otherwise is satisfied. Section 6324(d)(1) requires that the Service file a NFTL for the special estate tax lien to give the IRS priority over a purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor. To protect its interest in the remainder assets of the gross estate more than 10 years after decedent's death, therefore, the IRS should file a NFTL under Section 6321 (the general estate tax lien), assuming proper procedures for assessment, demand, and refusal or neglect to pay have been met. Whether the IRS should file a NFTL in a particular situation is a business decision to be made by the IRS.

_ **Full Audit Need Not be Required Just Because an Estate Tax Return Proposes Using Closely Held Stock as Security under Section 6324A.** The Memorandum states simply that there is no legal requirement to conduct full audits just because an estate proposes to use closely-held stock to secure a special lien under Section 6324A. The decision regarding a full audit is a business decision to be made by the IRS on a case-by-case basis, considering all relevant factors.

- **The Proper Procedure to Determine Whether the Stock Adequately Secures the Deferred Taxes and Interest.** The Chief Counsel's Office stated merely that the IRS should value the closely held business and the business interest based on the relevant financial information provided by the estate. It should also consider all other relevant facts and circumstances of each particular case. If the IRS ultimately decides to reject the stock or the entity interest proffered as collateral, it should detail, in writing, the basis for the rejection.

- **The Proper Procedure for Denying or Terminating a Section 6166 Election Because the Property Initially Proffered Ceases to be Sufficient Collateral.** If the value of the property provided to secure the lien for unpaid estate taxes on a business interest, together with required interest, the IRS may require that the estate provide additional security either in the form of assets to secure the lien or a surety bond. If within 90 days after notice and demand the estate does not provide the additional security requested, the estate's refusal will be treated as an act accelerating payment of the installments under Section 6166(g). Int. Rev. Code § 6324A(d)(5).

  Acceleration of the payments under Section 6166(g) is treated as a termination of the Section 6166 election. Section 7479 provides the Tax Court with declaratory judgment jurisdiction with respect to Section 6166, including determinations "whether the extension of time for payment of tax provided in section 6166(a) has ceased to apply" with respect to an estate. The estate may seek relief in the Tax Court by filing a timely petition and must exhaust administrative remedies. Int. Rev. Code § 7479(b). See Rev. Proc. 2005-33, 2005-24 I.R.B. 1231 (administrative procedures when the IRS terminates a Section 6166 election because it is unsecured for a portion of the tax and the executor or a representative of the estate refuses to provide additional security).

- **IRS Review of the Continuing Sufficiency of Collateral Securing a Section 6324A Lien that Already is in Place.** Section 6324A(d)(5) permits the IRS to review the continuing sufficiency of collateral securing a Section 6324A lien agreement, giving it the implicit right to monitor the value of the collateral to determine whether the value has become less than the amount of the unpaid portion of the deferred amount and the required interest amount. Int. Rev. Code § 6324A(d)(5). The Chief Counsel's Office strongly recommended that the IRS monitor the sufficiency of the collateral securing a Section 6324A tax lien agreement during the deferral period. The IRS could, for example, require that the estate provide annual reports or certified financial statements each year during the deferral period, to assist the IRS in determining that the stock has maintained its value.

12 Gross Valuation Misstatement Penalty Applied to Estate and Gift Tax Appraisals. AM 2007-0017 (Oct. 31, 2007)

In generic legal advice, the Service stated that it may assess a gross valuation misstatement penalty against an appraiser for post-May 25, 2007, estate and gift tax appraisals and that these penalties should generally be assessed within three years after the filing of the estate or gift tax return or refund claim. The IRS discussed the new penalty under Section 6695A, as adopted by the Pension Protection Act of 2006. Pub. L. No. 109-280, 109th Cong., 2nd Sess. (2006), 120 Stat. 780. The Small Business and Work Opportunity Tax Act of 2007, Public Law 110-28, 110th Cong., 1st Sess. (2007), 121 Stat. 190, extended the income tax return preparer penalties to all tax return preparers, and defines "return" for purposes of Section 6695A as "any return of any tax imposed by this title," which clearly includes estate and gift taxes.

Note. The penalty is the greater of $1,000 or 10% of the amount of the underpayment attributable to the misstatement (but in no event more than 125% of the gross income received by the appraiser for preparing the appraisal). Int. Rev. Code § 6695A(b). The penalty does not apply if the appraiser establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value. Int. Rev. Code § 6695A(c). Section 6695A is generally effective for appraisals prepared with respect to returns or submissions filed after August 17, 2006.

13 Section 9100 Relief Not Available for Late Section 6166 Election. PLR 200721006 (May 25, 2007)

The decedent=s executor filed a timely Form 4768 to request an extension of time to file the Federal estate tax return, and thereafter filed the return with a request to pay the estate taxes in installments under Section 6166. The ruling is redacted, but apparently the return was filed after the date permitted in according to the Form 4768 request for late filing.

The IRS denied relief under Section 9100 relief, noting that the Section 9100 regulations apply only to extension of deadlines that are dictated by regulations and rulings, rather than statutory deadlines. Section 301.9100-1(b) of the regulations defines a "statutory election" as one whose due date is prescribed by statute, while a "regulatory election" is one "whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice or announcement published in the

Internal Revenue Bulletin." Section 6166(d) states that the elective deferral of estate taxes attributable to the value of an interest in a closely held business must be made no later than the time prescribed by Section 6075(a) for filing the estate tax return. This is a statutory requirement, and there are no regulations that can or do vary this statutory requirement. The timeliness requirement is not statutory merely because the regulations refer to the statute. Section 9100 relief is not, therefore, available for an untimely election to defer estate tax payments under Section 6166. The IRS also declined to apply the doctrine of substantial compliance, because Section 6166 contains no "reasonable cause" exception to the requirements for a timely election. See *Estate of Boyd v. Comm'r*, T.C. Memo 1983-316; and *Estate of Gardner v. Comm'r*, 82 T.C. 989 (both denying application of the substantial compliance doctrine to elections to value certain farm or small business real estate at its present use, under election rules that are virtually identical to those of Section 6166).

II GIFT TAXES

A Code § 2503. Gift Tax Annual Exclusion

Annual Exclusion Adjusted for Inflation. Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (Nov. 5, 2007)

The gift tax annual exclusion is increased to $12,000 per donee per year for transfers made in 2008. The annual exclusion for gifts to a non-U.S. citizen spouse is raised to $128,000 for transfers made in 2008.

B Code § 2511. Transfers in General

IRS Reconsidering Whether Reserved Right to Change Beneficiaries Creates Incomplete Gift to Trust That Shifts Taxable Income. Inf. Rel. 2007-127 (July 9, 2007)

In PLRs 200502014, 200612002, 200637025, and 200647001, the IRS stated that a reserved right to change beneficiaries created an incomplete gift in trust, but that the trusts were completed transfers for income tax purposes. In PLR 200647001, for example, the grantor created a trust with a corporate trustee, and directed that the trust income and principal would be distributed during the grantor's lifetime to and among a class that includes the grantor, the grantor's spouse (if and when the grantor marries), the grantor's parents, the grantor's brother and his wife, the grantor's own descendants, and any "qualified charity" (defined as one to which contributions are deductible for income, gift and estate tax purposes.) The distributions will be made in such proportions as directed by either the unanimous decision of the distributions committee (the "Committee"), or by the decision of the grantor and one or more members of the Committee. At the grantor's death, the remaining trust principal (including any undistributed income) will be distributed to the persons that the grantor names in the grantor's last will. The grantor may exercise this power of appointment in favor of anyone other than the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate. The trust included an alternate disposition in default of the valid exercise of this power of appointment, in favor of the grantor's siblings and their descendants, with a contingent remainder in certain private foundations. The Committee initially consists of the grantor's brother and sister, but at all times it must include at least two adult members of the class of potential beneficiaries. Neither the grantor nor the grantor's spouse may be a member of the Committee. The IRS ruled that The IRS stated that the trust was not a grantor trust for income tax purposes, apparently because any distribution of income or principal to the grantor or the grantor's spouse could be made only with the consent of an adverse party. Int. Rev. Code §§ 672(a), 674(b)(3), 677(a). The IRS also stated that the grantor's limited power of appointment gave the grantor the power to change the trust beneficiaries, and caused any gifts to the trust to be incomplete for gift tax purposes. Treas. Regs. § 25.2511-2; *Estate of Stanford v. Comm'r*, 308 U.S. 39 (1939). Trust distributions are not taxable gifts from the distribution committee, because their power to distribute trust funds to themselves is exercisable only with the consent of an adverse party. Distributions of trust property to a beneficiary other than the grantor, however, or the grantor's lifetime release of the testamentary power of appointment, would constitute completed gifts by the grantor. The IRS also ruled that distribution of property from trust to the taxpayer by distribution committee would not be a taxable gift by the members of the committee.

In Inf. Rel. 2007-127 (July 9, 2007), the IRS Office of Associate Chief Counsel, Passthroughs & Special Industries, stated that it is considering withdrawing these rulings, because of inconsistency with Rev. Rul. 76-503, 1976-2 C.B. 275 and Rev. Rul. 77-158, 1977-1 C.B. 285. The IRS sought public comments on the subject. Both rulings involved a trust created by three siblings, each of whom named an adult child as one of the three trustees who had complete discretionary power over the assets of the trust and individually had the right to name a relative as successor. In Rev. Rul. 76-503, the trustees acted unanimously; in Rev. Rul. 77-158, by majority vote. The IRS in both rulings stated that the surviving trustees were in no better position to exercise the power after a decedent-trustee's death than before the death, so the IRS stated that the interests of the co-trustees were not adverse to exercise of the power in favor of the decedent-trustee. Thus, in both rulings, one-third of the trust fund was includible in a decedent-trustee's estate as property subject to a general power of appointment under Section 2041. These rulings suggest that the distributions of property from the trusts in the PLRs would be taxable gifts by the trustees. The IRS noted that in the PLRs, the grantor's gift to the trust was incomplete, because the grantor retains a testamentary special power of appointment. The IRS noted, however, that this might not preclude the application of the two revenue rulings. Citing Treas. Regs. § 25.2514-1(e), Ex. 1 and Rev. Rul. 67-370, 1967-2 C.B. 324.

Note. One may question the IRS interpretation of the incomplete gift rules. The IRS accurately quotes the gift tax regulations, but the donor in the various private rulings gave the trustees the power to distribute principal without the donor's consent. The IRS could have stated that this deprived the donor of the power to control beneficial enjoyment over the trust assets during the donor's lifetime. The IRS reliance on *Estate of Sanford* may be misplaced, because the taxpayer in that case created a trust for the benefit of named beneficiaries and reserved the power to revoke the trust in whole or in part, and to designate new beneficiaries other than him. The taxpayer relinquished the power to revoke the trust six years after creating it, but retained the right to change the beneficiaries. Later, the taxpayer relinquished the right to change the beneficiaries. The Supreme Court held that the taxpayer's gift was not complete, for purposes of the gift tax, when the taxpayer reserved the power to determine those others who would ultimately receive the property. The Court stated that the taxpayer's gift was complete only when the taxpayer relinquished his right to change the beneficiaries of the trust. The facts of *Estate of Sanford* are distinguishable from those in the rulings, because the donor in *Estate of Sanford* retained the power to change the beneficiaries of the trust during his lifetime, while the donor in the rulings held only a testamentary power to change the trust beneficiaries. The trustees in the rulings could divert the trust funds to the beneficiaries, even over the donor's objections.

C Code § 2518. Disclaimers

Disqualified Formula Disclaimer Failed Despite Savings Clause, Resulting in Loss of Estate Tax Charitable Deduction. *Estate of Christiansen v. Comm'r*, 130 T.C. ___ (No. 1) (Jan. 24, 2008)

Helen's last will left all of her estate to her daughter, Christine, after payments of any debts and funeral expenses. The will stated that 25 percent of any disclaimed assets would pass to a charitable foundation and 75 percent to a 20-year charitable lead annuity trust. Christine disclaimed a fractional share of the estate, equal to the excess of the estate over $6,350,000 (an amount she and her advisers determined would allow the family business to continue, as well as to provide for her and her own family's future.) Christine did not disclaim her contingent remainder in the charitable lead trust; she remained a potential beneficiary of the trust funds remaining after the 20-year annuity term. The disclaimer also contained a savings clause that stated "the extent that the disclaimer set forth above . . . is not effective to make it a qualified disclaimer, Christine . . . hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code." The estate deducted the amount passing outright to the Foundation as a result of the foundation, and the present value of the annuity in the charitable lead trust. The IRS disallowed both deductions.

The Tax Court (Judge Holmes for a ten-judge majority), held that the disclaimer of the portion of the estate passing to the lead trust was not a qualified disclaimer, and denied the estate tax charitable deduction for that portion of the estate. The estate argued that Christine's remainder interest in the charitable lead trust was either "severable property" or "an undivided portion of the property," and that the disclaimer was qualified. The Tax Court majority disagreed. The disclaimer regulations define "severable property" as property that can be divided into separate parts each of which, after severance, maintains a complete and independent existence. Treas. Regs. § 25.25183(a)(1)(ii). The regulations define "an undivided portion of the property" as a fractional or percentile share of each and every substantial interest or right owned by the decedent in the property. Treas. Regs.§ 25.2518-3(b). The majority stated that neither definition fit the interests in the charitable lead trust. The estate argued that the savings clause automatically disclaimed a fractional share of the remainder interest in the trust, and that the disclaimant intended to do whatever was required to have a qualified disclaimer. The IRS argued that the savings clause was invalid as a matter of public policy. The majority declined to address the public policy issue, finding that the clause itself would not save the disclaimer from disqualification. The clause might be read in two ways. First, it could be read as a promise that, once the court disqualified the disclaimer, Christine will *then* disclaim her contingent remainder interest in the charitable lead trust. This analysis, the majority stated, would yield a disqualified disclaimer because the disclaimer would not be timely. Second, the savings clause could be read as meaning that Christine automatically disclaimed the contingent remainder when she signed the disclaimer. Such a disclaimer also would be disqualified because it would not identify the property being disclaimed and would not be unqualified. The majority stated that such clauses that depend for their effectiveness on a condition subsequent are ineffective for disclaimers, as they are for revocable spousal interests and gift adjustment agreements. See *Estate of Focardi v. Comm'r*, T.C. Memo. 2006-56 (spousal interests); and *Ward v. Comm'r*, 87 T.C. 78, 11011 (1986) (gift adjustment agreements).

The majority also held that the disclaimer of the portion of the estate passing outright to the foundation was a qualified disclaimer for which an estate tax charitable deduction was allowed. The IRS argued that the use of a formula clause to increase the charitable deduction when the valuation of the assets increased was invalid. The majority rejected this notion, because it would have the "remarkable" effect of increasing the estate tax because more property passed to the charity. The IRS argued that any increase in that amount was contingent on a condition subsequent-- the IRS challenge to the value of the gross estate—and that the formula adjustment (valuing the disclaimed property "as such value is finally determined for federal estate tax purposes") was contrary to the requirement that the amount the charity will receive be ascertainable at death. Treas. Regs. § 20.2055-2(b)(1). The majority noted that this was a transfer by disclaimer--not a "testamentary charitable contribution"-- and that the disclaimer relates back to the date of death. The IRS also argued that the increased charitable deduction on account of the revaluation of the assets was contingent, both because it depended on a disclaimer and because it occurred only because the IRS examined the estate tax return and challenged the fair market value of its assets. The majority disagreed, noting that the transfer of property to the foundation was not contingent on any event that occurred after the decedent's death, other than the execution of the disclaimer which related back to the date of death. The Tax Court also rejected the IRS argument that the disclaimer's adjustment clause was void on public policy grounds, because it would, at the margins, discourage the IRS from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction. The court stressed the narrowness of the public policy rule -- the public policy being frustrated must be shown by a governmental declaration, and the frustration that would be caused by allowing the contested deduction must be severe and immediate.

Eight judges agreed to a separate concurring opinion written by Judges Haines and Goeke, which expanded on why Christine's remainder interest in the charitable lead trust and the foundation's 20-year annuity interest were not severable for purposes of the disclaimer. This opinion expressly agreed with the majority's analysis of the validity of the formula clause and the invalidity of the savings clause. On the disqualification of the disclaimer in favor of the charitable lead trust, the Haines-Goeke opinion explained that Christine did not disclaim her right to receive the remainder of the charitable lead trust and that her disclaimer was not one of an undivided portion of Christine's entire interest. Treas. Regs. § 25.2518-2(e)(3). Thus, this disclaimer was qualified only if the remainder interest was a severable property interest. In order to be treated as severable property, the foundation's guaranteed annuity and Christine's remainder, after severance, must maintain "a complete and independent existence." Treas. Regs. § 25.2518-3(a)(1)(ii). The Haines-Goeke opinion noted that an example in the disclaimer regulations specifically stated that a person who is left a fee simple interest could not disclaim the remainder interest and keep the life estate. This, the opinion continued, is directly on point.

Judges Swift and Kroupa each wrote a separate opinion, concurring in part and dissenting in part; and each signed the others opinion. Judge Swift agreed with the majority on the question of the application of the public policy doctrine to the savings clause in the disclaimer, but stated that she believed that the disclaimer in favor of the charitable lead trust was a qualified disclaimer.

Judge Swift believed that the annuity and remainder interests maintained "a complete and independent existence," primarily because each had an independent ascertainable value. The Haines-Goeke concurring opinion, however, disputed this analysis, because the ascertainable value analysis was based on the charitable deduction regulations, which state that a charitable deduction is allowed for the value of a charitable beneficial interest in a trust "only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest." Treas. Regs. § 20.2055-2(a). The concurring opinion stated that whether an interest has an ascertainable value is not the proper standard to apply in determining whether that interest is severable for purposes of making qualified disclaimers. The charitable deduction regulations, the concurring judges note, state that a remainder following a life estate or a term of years is ascertainable and thus "severable" for charitable deduction purposes, but the disclaimer regulations state that remainder following a life estate or a term of years or an annuity is not severable for purposes of determining whether a disclaimer is a qualified disclaimer. Treas. Regs. § 25.2518-3(d), Ex. 2.

Judge Kroupa, in his separate opinion, noted that he had been the trial judge, and that he found the decedent's and Christine's charitable intent compelling. Judge Kroupa agreed with the majority that the disclaimer in favor of the foundation was qualified, but stated that the estate was entitled to deduct the amounts passing to the charitable lead trust to the extent of the annuity portion. Judge Kroupa argued that the majority's interpretation of the severability rules were unduly restrictive and that the majority erred when it relied heavily on the statement in the disclaimer regulations that "if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which Christine has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed." Treas. Regs. § 25.2518-2(e)(3)(Ex) Judge Kroupa stated that reliance on this sentence ignores the regulations focus on whether the property is severable. Judge Kroupa stressed that the other examples in the gift tax regulations more clearly distinguish between severable and nonseverable property. The annuity and remainder interest in the charitable lead trust are distinctly separate interests, both of which were created by the decedent. The disclaimer renounced a fractional portion of the property passing to Christine under the decedent's will–it did not create or carve out a particular interest for Christine and renounce the rest.

Note. This opinion is useful for its illustration of the problems that may arise in partial disclaimers, but more importantly, for its approval of the formula disclaimer that automatically adjusted for audit changes in the valuation of the estate assets. A fractional disclaimer of an interest in an estate can, the court says, be safely tied to the valuation of the assets as finally determined for Federal estate tax purposes.

Additionally, the dissent may be correct in its assertion that the partial disclaimer in favor of the charitable lead trust was a qualified disclaimer. The fact that the decedent, rather than the disclaimant, created the two distinct interests in the charitable lead trust should have been enough to render the two interests severable for disclaimer purposes. Nonetheless, the majority still refused to distinguish between situations in which the decedent creates the two interests and those in which the disclaimer creates two interests.

D Code § 2522. Charitable Deduction

1 Tax Technical Corrections Act Eases Gift Tax Limit on Charitable Gifts of Partial Interests in Tangible Personal Property. Pub. L. 110-172, 110th Cong., 1st Sess. (12/2007)

The Tax Technical Corrections Act of 2007 eliminates the estate tax restriction on charitable bequests of partial interests in tangible personal property. The Pension Protection Act of 2006 provides limits the gift tax charitable contributions for a taxpayer who, after having made an initial fractional contribution, thereafter makes an additional testamentary or inter vivos charitable gift of an interest in that same property (an "additional contribution"@). Int. Rev. Code §§ 170(o), 2055(g), 2522(e). The PPA stated that the gift tax deduction for a testamentary transfer of such an additional contribution was limited to the appropriate fractional share of (a) the fair market value of the property at the time of the initial fractional contribution, or if less, (b) the fair market value of the property at the time of the additional contribution. Thus, no gift tax deduction would be allowed for any share of the appreciation in the value of the tangible personal property that occurred after the initial fractional contribution. The new law does not eliminate the recapture provisions that recover the gift tax charitable deduction if the donor does not transfer the rest of the tangible personal property to the same charity within ten years or, if earlier, before his or her death.

2 IRS Publishes Sample *Inter Vivos* Charitable Lead Annuity Trusts. Rev. Proc. 2007-46, 2007-29 IRB 102 (July 16, 2007)

The IRS published a set of sample inter vivos charitable lead trust forms and guidance, including both grantor and nongrantor charitable lead trusts. Among the more interesting aspects of this very useful procedure are the following:

- **Defining the Annuity.** The sample trusts define the annuity interest as a percentage of the initial value of the trust funds, but provide alternate language to specify the dollar amount in the governing instrument.

- **Measuring the Annuity Term.** The sample trust forms permit measurement of the annuity period by a fixed number of years or one or more measuring lives. The IRS states, however, that one can use a measuring life, rather than a term of years, only if the measuring life is the donor or certain related persons.

- **Increasing Annuity Payments.** The annotations permit the creation of an annuity interest with increasing annual payments, as long as the annuity has an ascertainable value. This authorizes the use of lower annuity payments in early years, which may be very useful particularly if the measuring life is in poor health (though having a life expectancy of more than 18 months when the trust is created.)

- **Grantor Trust Power.** The grantor trust power selected by the IRS is the right to substitute assets. The IRS sample language requires that the person granted the power not be the grantor, the trustee, or a disqualified person as defined in Section 4946(a)(1). Excluding the grantor avoids any questions about the gift being incomplete or includible in the grantor's gross estate, though such results seem strained and unreasonable. Excluding the trustee may be intended to eliminate the question (at least in a model form) of whether the power is actually held in a nonfiduciary capacity. Eliminating disqualified persons addresses the fact that exercise of the power by a disqualified person can be an act of self-dealing.

- **Commutation Prohibited.** The trustee may not have the right to commute the charitable annuity interest and prepay the charitable distribution. Rev. Rul. 88-27, 1988-1 C.B. 331.

- **Excess Business Holdings.** If the charitable interest exceeds 60 percent of the value of the trust fund, the trust instrument must prohibit acquisition and retention of assets that would give rise to a tax on excess business holdings under Sections 4943 or 4944.

- **Distributing Appreciated Assets.** A distribution of appreciated property in satisfaction of the annuity amount produces both a recognized gain and a charitable deduction. Rev. Rul. 83-75, 1983-1 C.B. 114.

- **Rule Against Perpetuities.** Any rule against perpetuities savings clause must be based on the common law life in being plus 21 years approach, rather than the Uniform Act's alternate 90 years approach. Treas. Regs. § 20.2055-2(e)(2)(vi)(a).

- **GST Planning.** No GST planning is included. As these are CLATs, rather than unitrusts, the inclusion ratio is calculated under a special set of rules included in Section 2642(e).

- **Alternate Charities.** The trust may designate an alternate charitable beneficiary or permit the trustee to select one, as long as the trustee's powers are limited selecting organizations described in both Sections 170(c) and 2055(a).

Note. The annotations are particularly useful, highlighting most of the serious issues raised by the use of a charitable lead trust. They may themselves be the most important part of the sample forms. The drafting style is typical IRS, which means that the language is relatively clear, but the organization can stand some improvement. The practitioner should consider reorganizing the forms to improve readability.

E Gift Tax Procedures

A Long and Winding Road: *Res Judicata* Applied to Gift Tax Cases. *U.S. v. Davenport*, 484 F.3d 321 (5th Cir. April 9, 2007), *revised opinion* (5th Cir. July 2, 2007), *petition for cert. filed* 76 U.S.L.W. 3066 (Aug 13, 2007)

Birnie and Elizabeth, two sisters who lived together much of their adult lives, commingled all of their earnings and assets, pursuant to a long-standing oral agreement., Elizabeth held legal title to the assets but the sisters shared equally in the profits and losses. Each sister filed a separate income tax return reporting her earnings from her job and an equal share of profits and losses from the joint investments. The IRS accepted this split of investment income and expenses throughout numerous audits. Birnie died in 1991, having outlived her sister by eleven years. After Elizabeth's death, Birnie had given and sold some of these shares to the sisters' nephews, Gordon and Botefuhr, and niece, Vestal. The gift portion had been a net gift, but the donee, Botefuhr, failed to pay the gift taxes, after which the corporation redeemed his shares for $2,190 per share. When Vestal and Gordon filed Birnie's estate tax return, they also filed a gift tax return reporting the earlier gift to Botefuhr, which they valued at $804 per share. Botefuhr signed neither the gift tax return nor the estate tax return. On audit of Birnie's estate, the IRS valued Birnie's gift of Hondo stock to Botefuhr at $2730 per share rather than $804 per share. They imposed a gift tax deficiency, which was contested unsuccessfully in *Estate of Davenport v. Comm'r,* T.C. Memo. 1997-390, *aff'd*, 1814 F.3d 1176 (10th Cir. 1999).

The Tax Court held, in part, that Birnie made a completed gift to Gordon Davenport, Vestal and Botefuhr, when she made sales and gifts, and that although Birnie lacked legal title to the assets she had equitable title and could convey the stock. The Tax Court also valued the Hondo stock at $2,000 per share, at the time of the gifts. Birnie's executors still declined to pay the taxes, stating that the tax court lacked the authority to enforce its judgments.

The government brought an action in district court to reduce impose transferee liability on the nephews and niece, as executors. The estate conceded the liability, but the court dismissed the claim for individual liability against the executors personally for having made prior distributions. On appeal, the Tenth Circuit held that the Oklahoma district court did not have jurisdiction over Botefuhr and Gordon after dismissing the claim for personal liability. *U.S. v. Botefuhr,* 309 F.3d 1263, 1274 (10th Cir.2002), *rev'g*, 159 F.Supp.2d 1330 (N.D. Ok. 2001). The case was remanded to the Oklahoma district court, which transferred Botefuhr's case to the Western District of Texas and Gordon's case to the Southern District of Texas.

The Southern District of Texas ruled on multiple motions for summary judgment by Gordon and the government. It held that the statute of limitations barred assessment of the gift tax on the imputed gift arising from the July 1980 installment sale, but that the statute of limitations did not bar assessment of the gift to Botefuhr. It also held that although *res judicata* and collateral estoppel bound Gordon to the Tax Court's finding that he was a donee neither doctrine established the value of the gift to him (the Hondo stock) or the amount of his liability. The district court also held that the government failed to provide any evidence on damages, an essential element of its claim, and it granted summary judgment against the government.

On appeal, the Tenth Circuit held that held that Tax Court's findings of the estate's tax liability, concerning value of conveyed stock, and concerning limitations period, were *res judicata* in instant action. The court distinguished res judicata, in which final judgment on the merits bars further claims by parties or their privies based on same cause of action, from collateral estoppel, where second action is upon different cause of action and judgment in prior suit precludes relitigation of issues actually litigated and necessary to outcome of first action. The court stated that res judicata applied in this case because the parties were either identical or in privity, judgment in prior action was rendered by court of competent jurisdiction, the prior action was concluded to final judgment on merits, and the same claim or cause of action was involved in both actions.

Note. See also Gerzog, "*Davenport*: Res Judicata Applied," 115 Tax Notes 1199 (June 18, 2007).

III GENERATION-SKIPPING TRANSFER TAXES

A Code § 2601. Effective Date Provisions

Divided Tax Court Sustains Validity Of GST Effective Date Regulations. *Estate of Gerson v. Comm'r*, 127 T.C. 139 (2006), *aff'd* 507 F.3d 435, 2007 WL 3307024 (6th Cir. Nov. 9, 2007)

Eleanor died on October 20, 2000, leaving a will that, in applicable part, exercised a broad general power of appointment contained in the marital trust created by her late husband, Benjamin, who died in 1973. No additions were made to the corpus of the marital trust after September 25, 1985. Eleanor appointed the marital trust to a trust for the benefit of her grandchildren and more remote descendants.

The Tax Court (Judge Haines) held that the regulations that treat the exercise of a general power of appointment as a separate constructive addition to the pre-September 25, 1985 trust were a reasonable interpretation of the statutory effective date rules. The majority relied on its earlier holding in *Peterson Marital Trust v. Comm'r,* 102 T.C. 790 (1994), *aff'd* 78 F.3d 795 (2nd Cir. 1996), which involved a lapse of a general power of appointment and an interpretation of the temporary regulations. The court noted that the effective date provisions sought to protect the "reliance interests" of settlors who established trusts before the new GST tax regime was introduced. The majority also noted that the Second Circuit, in affirming the Tax Court, had stressed the fact that a general power of appointment is generally treated like outright ownership, and that one holding such a power had no reliance interest in the earlier trust terms, because the power-holder could vary them in the exercise of the power. The Eighth and Ninth Circuits, however, had disagreed in *Simpson v. U.S.*, 183 F.3d 812 (8th Cir. 1999), *rev'g and rem'g,* 17 F. Supp. 2d 972 (W.D. Mo. 1998), and *Bachler v. U.S.*, 281 F.3d 1078 (9th Cir. 2002), *rev'g and rem'g* 126 F. Supp. 2d 1279 (N.D. Cal. 2000), both of which involved the exercise of general powers of appointments under facts very like those in *Gerson*. The Eighth and Ninth Circuits had held that the plain language of the statute rendered the entire pre-September 25, 1985 trust exempt from the GST tax, including the exercise of powers of appointment created under that trust. The majority noted that these contrary holdings predated the final regulations, which, though only interpretative regulations, have the force of law and are valid reasonable. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). The court rejected the views of the Eighth and Ninth Circuits in *Simpson* and *Bachler,* and sustained the regulations as harmonious with the statutory effective date rules.

There were three concurring opinions and two dissenting opinions. Judge Swift wrote a three-judge concurring opinion that stated that the decisions of the Eighth and Ninth circuits in *Simpson* and *Bachler* had confused which transfers were protected by the effective date rules and had improperly distinguished the opinions in *Peterson Marital Trust.* Judge Swift stated that the pre-September 25, 1985 creation of the trusts in each case that included powers of appointment made the later exercise of those powers possible, but the "possibility" of a later transfer that was created before the effective date was different from the actual transfer that occurred after that date. The relevant transfer of property that occurred "under" the trust was the one made to the surviving spouse, and not the one that she made when she exercised or permitted to lapse her general power of appointment.

Judge Thornton wrote a separate concurrence with which seven judges agreed (including four judges who signed the majority opinion). Judge Thornton stressed the need to "give effect, if possible, to every clause and word of" the statute, and criticized the Eighth and Ninth Circuits for failing to give effect to the phrase "generation-skipping" that immediately precedes "transfer under a trust." The *Simpson* analysis rendered the phrase "generation-skipping" irrelevant, because neither the GST tax nor the effective date rule apply to any type of transfer other than a generation-skipping transfer. Judge Thornton stated that the only way that the phrase "generation-skipping" used before the phrase "transfer under a trust" can have purpose and effect, is by limiting the effective date protection to a generation-skipping transfer that occurs pursuant to the terms of the trust instrument. A generation-skipping transfer resulting from the exercise of a general power of appointment is not, therefore, a "generation-skipping transfer under a trust."

Judge Holmes wrote a third concurring opinion (in which Judge Swift joined), focusing on whether the effective date regulations are a reasonable interpretation of the statute. Judge Holmes noted that the intent of Congress on this issue is not clear, leaving the Treasury to construe it. The variation in views in this case alone, Judge Holmes stated, shows that the statute is ambiguous. The only thing required of the regulations is reasonableness, and the regulations are reasonable because they merely extend the long-standing rule that a general power of appointment is taxed as the equivalent of ownership.

Judge Laro and Judge Vasquez both wrote separate dissenting opinions, though Judge Vasquez also joined on Judge Laro's dissent (together with three other judges.) Judge Laro deemed the regulation not to be "a reasonable and valid interpretation of the plain language" of the effective date rules. The Sixth Circuit, Judge Laro noted, stated that "[w]here the statute is clear, the agency has nothing to interpret and the court has no agency interpretation to which it may be required to defer." *Dixie Fuel Co. v. Comm'r of Soc. Sec.*, 171 F.3d 1052, 1064 (6th Cir. 1999), abrogated on other grounds by *Barnhart v. Peabody Coal Co.,* 537 U.S. 149 (2003). Judge Laro noted that *Peterson Marital Trust* was concerned only with the portion of the statute that follows the comma--the exception that provides "only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985." The instant case, as well as the opinions of the Eighth and Ninth Circuits concerned the part of TRA 1986 section 1433(b)(2)(A) preceding the comma; i.e., the general rule that provides "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985."

Judge Vasquez wrote a separate dissent to address the issue of the proper deference the Court should give to interpretive regulations. Judge Vasquez did not believe that interpretive regulations are subject to the deference described by the Supreme Court in *Natl. Muffler Dealers* Association, in light of the opinion of the Court in *U.S. v. Mead Corp.,* 533 U.S. 218 (2001). In *Mead*, the Supreme Court clarified the limits of *Chevron* deference owed to an agency's interpretation of a statute it administers. The Court held that an agency's interpretation of a particular statutory provision qualifies for *Chevron* deference when Congress delegated authority to the agency to make rules or regulations carrying the force of law and the agency interpretation claiming deference was promulgated in the exercise of that authority. An agency's interpretation that does not qualify for *Chevron* deference is "accorded respect proportional to its 'power to persuade'" *Skidmore v. Swift & Co.,* 323 U.S. 134 (1944). Judge Vasquez stated that regulations promulgated under Section 7805 do not have the force of law, because to hold otherwise would recognize no distinction between such regulations and those issued pursuant to an express grant of quasi-legislative authority. Interpretative regulations are owed less deference than legislative regulations. Under *Mead*, the first question is whether Congress delegated authority to the agency to make rules or regulations carrying the force and effect of law. The second question is whether the agency invoked that authority. By promulgating a regulation pursuant to section 7805, the regulation was not issued pursuant to a delegation of authority by Congress to make rules or regulations carrying the force and effect of law. Therefore, Judge Vasquez stated that, under *Mead,* the regulations under the grantor trust effective date rules would not need merely to be a reasonable interpretation; they would need to be persuasive.

The Sixth Circuit affirmed the decision of the Tax Court, giving the regulations special deference under Chevron, rejecting the argument that interpretative regulations were not entitled to such great deference. The court held that any regulation promulgated after notice and comment is issued with the force of law, and that it must be sustained unless its position is clearly unreasonable, unless Congress has directly spoken to the precise question at issue. The GST tax effective date provisions do not apply, the court emphasized, to transfers made out of corpus added, directly or constructively, after September 25, 1985. The court reviewed the split among the circuits, and sided with the Second Circuit that either a lapse or an exercise of a general power of appointment should be treated as a constructive addition to an effective date-protected trust. The court stated that when a general power of appointment is exercised, two transfers occur; the holder of the power becomes the owner of the trust assets for tax purposes, and then transfers them to the appointee. When a power of appointment lapses, the holder of the power becomes the owner of the trust assets for tax purposes, and then they are retransferred to the original transferor, who then transfers them to the ultimate takers. In either case, if the last transfer occurs after the effective date of the GST tax, there is no effective date protection available.

Note. See also Nenno, *"Gerson v. Comr.:* Donees of General Powers of Appointment Over Grandfathered Trusts Unite!" 32 Estates, Gifts & Tr. J. 131 (March-April, 2007).

B Code § 2642. Inclusion Ratio

Final and Proposed Regulations on Division of Trusts Facilitate GST Tax Planning. 72 Fed. Reg. 42291 and 72 Fed Reg. 42340 (Aug. 2, 2007)

The IRS and the Treasury Department published final regulations detailing how one can effect a qualified severance of a trust for GST tax purposes, and proposed regulations regarding both certain qualified severances and non-qualified severances that are effective for GST tax purposes. The following are the key provisions of these regulations.

- **The Effects of a Qualified Severance**. A qualified severance of a trust into two or more separate trusts will be treated as creating two independent GST trusts from the date of the severance. Most actions taken with respect to each result trust will have no effect on the other resulting trust or trusts. The qualified severance rules apply for GST tax purposes, and do not determine other income and transfer tax results from the trust. A qualified severance is effective as of the date of the severance, and the resulting trusts are treated as separate trusts for GST tax purposes as of that date. The date of severance is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding (if the severance is effected pursuant to an order of the local court.) Treas. Regs. §§ 26.2642-6(a), 26.2642-6(c), 26.2642-6(d)(3).

- **Qualified Severance and the Seven-Part Test**. A qualified severance means a trust division that creates two or more separate trusts, that satisfies seven specific requirements.

  - First, the severance must occur pursuant to the terms of the governing instrument, or pursuant to applicable local law. Treas. Regs. § 26.2642-6(d)(1).

  - Second, the severance must be effective under local law. Treas. Regs. § 26.2642-6(d)(2). It is noteworthy that these first two requirements refer to the application of "applicable local law," rather than to state statutory law. Thus, a judicial order of severance can create a qualified severance even if there is no authority for the severance under state statutory law or the governing instrument.

_ Third, the funding of the trust must commence immediately upon, and must occur within a reasonable time (never more than 90 days) after, the selected valuation date. The actual selection of the particular assets to be distributed to each resulting trust, may either consist of the appropriate fraction or percentage (pro rata portion) of each asset held by the original trust, or the assets may be divided among the resulting trusts on a non pro rata basis, based on the fair market value of the assets on the date of severance. Resulting trusts that are funded on a non-pro rata basis must apply the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance. Treas. Regs. § 26.2642-6(d)(3). The new proposed regulations would prohibit in a non-pro rata funding any discount or other reduction in the value of the assets held by the original trust in determining the relative shares of the two resulting trusts. Each resulting trust's interest in stock, partnership interests, LLC interests, or other assets, would be valued as a pro rata share of the value of the interest held by the original trust before severance. This proposed rule would be effective for qualified severances occurring on or after the date that the final regulations are published in the Federal Register. Prop. Treas. Regs. §§ 26.2642-6(d)(4), 26.2642-6(k)(1).

_ Fourth, the original trust must be severed on a fractional basis, such that each resulting trust is funded with a fraction or percentage of the original trust. The total of all fractions or percentages must be one or one hundred percent. The regulations permit the use of a formula to determine the respective fractions or percentages. For example, one resulting trust could be a fraction of the original trust, "the numerator of which is equal to the transferor's unused GST tax exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance." Such a severance would create one trust with a GST inclusion ratio of zero and another trust with a GST inclusion ratio of 1. The original trust may not be severed based on a pecuniary amount. Thus, for example, a resulting trust could not be created in the amount of $2 million, and the rest of the trust assets allocated to the other resulting trust. Presumably, a trust could not be created in an amount equal to the transferor's unused GST tax exemption, either. Treas. Regs. § 26.2642-6(d)(4).

- Fifth, the terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement is met if the beneficiaries of and interests in the separate resulting trusts, viewed collectively, are the same as the beneficiaries and interests with respect to the original trust. This succession-of-interests test is satisfied with respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non-pro rata basis, if: (i) the terms of each resulting trust are the same as the terms of the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting trusts); and (ii) each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, on a per-capita basis. The succession-of-interests-testalso requires that the severance not shift a beneficial interest in the trust to any beneficiary assigned to a lower generation than the person or persons who held the beneficial interest in the original trust, and that it not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust. Treas. Regs. § 26.2642-6(d)(5).

- Sixth, a qualified severance of a trust with an inclusion ratio of either one or zero must create resulting trusts with the same inclusion ratio as the original trust. Treas. Regs. § 26.2642-6(d)(6).

- Seventh, a qualified severance of a trust with an inclusion ratio of neither one nor zero, that occurs after GST exemption has been allocated to the trust, must initially create two trusts, one of which will have an inclusion ratio of zero and the other of which will have an inclusion ratio of one. This means that one resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the severance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction will have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal resulting trusts, the trustee has the option of designating which resulting trust will have an inclusion ratio of zero and which will have an inclusion ratio of one. The division of the trust based on the inclusion ratios will often not be the only required division; additional divisions may be desirable to segregate the assets being held for component groups of family members. The final regulations state that each separate resulting trust may be further divided "in accordance with the rules of this section." Treas. Regs. §26.2642-6(d)(7). The new proposed regulations would permit the qualified severance of a trust into more than two separate trusts, in order to expedite the multi-step process contemplated by the final regulations. Under the proposed regulations, a trust could be initially severed into more than two resulting trusts, as long as one or more of the resulting trusts, in the aggregate, have a GST inclusion ratio of zero and the other resulting trust or trusts have a GST inclusion ratio of one. Prop. Treas. Regs. § 26.2642-6(d)(7)(ii).

_ **Reporting a Qualified Severance.** One reports a qualified severance on Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations," writing at the top of the form the words "Qualified Severance." One attaches a Notice of Qualified Severance (Notice) to the return, and files it by April 15th of the year immediately following the year during which the severance occurred, or by the last day of the period covered by an extension of time, if an extension of time is granted, to file such form. Treas. Regs. § 26.2642-6(e)(1). The final regulations deleted the requirement that the words "Qualified Severance" appear in red ink.

_ The Notice should provide the following information regarding the original trust: (i) the name of the transferor; (ii) the name and date of creation of the original trust; (iii) the tax identification number of the original trust; and (iv) the inclusion ratio before the severance. Treas. Regs. § 26.2642-6(e)(2).

- The Notice should also provide the following information regarding each resulting: (i) the name and tax identification number of the trust; (ii) the date of severance; (iii) the fraction of the total assets of the original trust received by the resulting trust; (iv) other details explaining the basis for the funding of the resulting trust (a fraction of the total fair market value of the assets on the date of severance, or a fraction of each asset); and (v) the inclusion ratio. Treas. Regs. § 26.2642-6(e)(3).

- **Timing and Prospective Operation of a Qualified Severance.** A qualified severance may occur at any time before the trust terminates, either before or after the allocation of GST exemption to the trust, the occurrence of a taxable event with respect to the trust, or an addition to the trust fund. Treas. Regs. §26.2642-6(f)(1). A qualified severance is effective as of the date of severance, and thus has no effect on a taxable termination or a taxable distribution that occurred before the date of severance. A qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance. Treas. Regs. §26.2642-6(f)(2), 26.2642-6(j), Ex. 8.

- **Severance of an Effective Date-Protected Trust.** Severing a trust that was created before September 25, 1985, and that is thus protected from the GST tax by the effective date rules, need not be done in accordance with the qualified severance rules but must instead comply with the separate rules of Treas. Regs. § 26.2601-1(b)(1)(iv)(A). An effective date-protected trust to which a post-September 25, 1985 addition has been made, however, is treated for this purpose as two separate trusts, one of which is entirely protected from the GST tax by the effective date rules and that is treated as having an inclusion ratio of zero, and one of which is not effective date-protected and that has an inclusion ratio of one. Treas. Regs. § 26.2642-6(g). Such a trust may be severed into two trusts in accordance with the rules for nonqualified severances, into one trust with an inclusion ratio of one and another with an inclusion ratio of zero. See Treas. Regs. § 26.2654- 1(a)(3), and discussion of proposed amendments to those regulations, below.

- **Income Taxation of Qualified Severances.** The exchange of a beneficiary's interest in one trust for an interest in one or more new trusts created by a qualified severance could be deemed a taxable exchange of assets by a broad reading of Section 1001. The income tax treatment of a trust severance is not determined by whether or not it is a qualified severance. Nonetheless, the same regulations project amends the regulations under Section 1001, to explain when a trust severance will result in a realization of gain. Treas. Regs. §§ 1.1001-1(h), 26.2642-6(a). New Treas. Regs. § 1.1001-1(h) states that no severance of a trust is a taxable exchange of property for other property differing materially either in kind or in extent if--(i) state statutes or the governing instrument authorizes or directs the trustee to sever the trust; and (ii) mandatory or discretionary non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding permitted under the GST regulations), is authorized by an applicable state statute or the governing instrument. Treas. Regs. § 1.1001-1(h)(1). This new rule applies to severances occurring on or after August 2, 2007. Taxpayers may apply this new rule to prior severances that occurred after August 24, 2004, at their own option.

- **Non-Qualified Severances.** The 2004 proposed regulations substituted the qualified severance rules for the severance rules already contained in the regulations, but many commentators noted that the qualified severance rules addressed situations quite distinct from those affected by the existing severance rules and were intended to be supplementary. The commentators noted that qualified severances are effective prospectively from the date of severance, while the existing severance rules for trusts includible in the grantor's gross estate are effective retroactively from the date of death. Therefore, the final regulations are supplementary to the existing regulations regarding severances of trusts that are effective under state law. See Treas. Regs. § 26.2654-1(b). The IRS and Treasury did, however, propose a set of amendments to the pre-existing regulations, to amend the rules for mandatory and discretionary severances of trusts includible in the transferor's gross estate, effective retroactively to the transferor's date of death. The new proposed regulations also state that trusts resulting from a non-qualified severance will still be treated as separate trusts for GST tax purposes, if the resulting trusts are recognized as separate trusts under applicable state law. Each such resulting trust will have the same inclusion ratio immediately after the severance as the original trust immediately before the severance. Nevertheless, the GST exemption allocated after the severance may be allocated separately to one or more of the resulting trusts, taxable events with respect to one or more of the resulting trusts will not affect the other resulting trusts, and the resulting trusts will otherwise be treated as separate trusts for GST tax purposes. Prop. Treas. Regs. §§ 26.2642-6(h); 26.2654-1(a)(1)(i), 26.2654-1(a)(1)(iii), 26.2654-1(a)(5), Ex. 8.

Note. The qualified severance rules apply to downstream severances. The existing rules under Section 2654 apply to severances involving trusts includible in a decedent's gross estate, and severances that are effective on the date of death. The qualified severance rules apply where you discover that you did not allocate enough exemption to an existing trust, and want to sever going forward. These rules creates two or more new resulting trusts that are treated as separate beginning on the designated severance date. This can utilize GST exemption more effectively because the GST-exempt trust can be invested and administered in a manner that minimizes current distributions to non-skip person beneficiaries and that maximizes distributions to skip-persons. The non-exempt trust can be invested and administered to maximize current distributions to non-skip persons. The preservation of the existing rules for non-qualified severances removes a serious question that had been raised by the 2004 proposed regulations regarding the use of a revocable trust, rather than a testamentary trust, to create generation-skipping transfers. The final regulations make it clear that a revocable trust may be severed in the same manner as a testamentary trust for GST purposes. Practitioners should carefully study these regulations, as they will quickly become a fundamental element in planning and administering generation-skipping trusts.

See also Zaritsky, "Final and Proposed Regs on Division of Trusts Facilitate GST Tax Planning," 19 Prob. Pract. Rptr. 1 (Sept. 2007).

IV CHAPTER 14. SPECIAL VALUATION RULES

Code § 2702. Trusts with Reserved Interests

1 Proposed Regulations on How Much Is Included in Grantor's Gross Estate for Retained Annuity or Unitrust Interest. 72 Fed. Reg. 31487 (June 7, 2007)

The Treasury, however, has now proposed regulations that would cause the principal of a GRAT, QPRT, or other retained annuity, income or unitrust interest to be included in the gross estate of a grantor who died during the term of the reserved income, annuity or unitrust interest, under Section

2036(a), rather than under Section 2039, in most cases. The regulations generally follow the rules first established for charitable remainder trusts, and concluded that where Sections 2039 and 2036(a) both apply to a trust, other than certain employment-related trusts, Section 2036(a) should be applied. The proposed regulations provide that, if a decedent transfers property during life to a trust and retains the right to an annuity, unitrust, or other income payment from, or retains the use of an asset in, the trust for the decedent's life, for a period that does not in fact end before the decedent's death, or for a period not ascertainable without reference to the decedent's death, the decedent has retained the right to income from all or a specific portion of the property transferred as described in section 2036. The decedent's gross estate in such cases will include that portion of the trust corpus, valued as of the decedent's death (or the alternate valuation date, if applicable) required to yield that annual payment (or use) using the appropriate section 7520 interest rate. For example, a 6-year $10 million GRAT created in July, 2007 (six percent Section 7520 rate) would create a zero gift if the annuity (payable annually) were 20.33636% of the initial value of the trust fund. If the grantor dies after five years and the interest rate under Section 7520 is then nine percent, the grantor's gross estate will include the lesser of the trust fund at that time or $25,595,729.59 (the principal that would pay a nine percent income interest equal to $2,033,636 per year). The proposed regulations illustrate these principles with several examples, involving a charitable remainder annuity trust, a grantor retained annuity trust, a charitable remainder unitrust, a grantor retained income trust, and a qualified personal residence trust. Prop. Treas. Regs. §20.2036-1(c)(2)(ii). The substantive proposed regulations will apply to the estates of decedents for which the valuation date of the gross estate is on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. Prop. Treas. Regs. § 20.2036-1(c)(3).

Note. The IRS rejected the application of Section 2039 in such cases for several reasons. First, Section 2039 appears to have been intended to address annuities purchased by or on behalf of the decedent and annuities provided by the decedent's employer. Second, the interests retained by grantors in the types of trusts described in this guidance are more similar in most relevant respects to the interests addressed under Section 2036 than those most clearly addressed under Section 2039.

This resolves one of the few uncertainties in using GRATs has been the estate tax treatment of the trust if the grantor dies during the reserved annuity term. It is important because the section under which the inclusion in the grantor's gross estate is determined may directly affect the basis of the trust assets in the grantor's gross estate. Section 2036 requires inclusion of the underlying trust assets, giving a basis step-up directly to the assets that require them. Section 2039 may only provide a basis increase for the annuity itself, rather than the underlying assets, and it is unclear whether a basis step-up is available for annuity interests at all, as they are arguably items of income in respect of a decedent. See Int. Rev. Code §1014(c).

Many practitioners believed that the GRAT should be treated like a charitable remainder annuity trust, which include in the grantor's gross estate that a portion of the trust assets (up to 100 percent) that would be required to produce an income interest equal to the annuity interest, determined under the Section 7520 actuarial tables. Rev. Rul. 82-105, 1982-1 C.B. 133; see also Rev. Rul. 76-273, 1976-2 C.B. 268. The IRS, however, had issued several private letter rulings that included the value of the entire trust fund in the grantor's gross estate, under Section 2039(a). See, *e.g.*, PLR 9345035, 9451056, 9448018, and Field Serv. Advs. 200036012 and 200210009. These proposed regulations demonstrate, once again, that private rulings are not necessarily the best evidence of serious IRS positions.

Also, the proposed regulations fail to address at least two important issues. First, is the analysis different for a Walton-GRAT, in which the annuity is continued to the grantor's estate, if the grantor dies during the annuity term? Could the remaining payments be included separately under Section 2033, while the value of the trust corpus is included under Section 2036(a)(1). This produces an unreasonable result, but the IRS does occasionally take unreasonable positions.

Second, how does one value a GRAT with increasing payments? Do you calculate the amount includible based on the annuity due on the date of death, or do you use the greater payments that would have been made had the grantor lived the entire annuity period?

See also Gans & Blattmachr, "Treatment of GRATs Under the Section 2036 Proposed Regulations – Questions Remain," 107 J. Tax'n 143 (Sept. 2007); Rap kin, "How Will the New Prop. Regs. Affect Grantor Retained Trusts?" 34 Est. Plan. 25 (Oct. 2007).

2 IRS Applies QPRT Rules to Sale of Remainder Interest. PLR 200728018 (July 13, 2007)

The grantors were a married couple, Husband and Wife, who held certain real estate as tenants by the entireties. The property was subdivided into two parcels, one of which constituted a second residence of the couple. No structures on the property were used for commercial purposes. The couple proposed to execute Trust, which was a qualified personal residence trust under the regulations, which would hold the property for their lifetime use of the residence. The QPRT provided that, upon the death of the survivor of Husband and Wife, the trustees will distribute the property to the trustees of

APurchasing Trust,@ which was previously established by Husband and Wife for the benefit of their descendants and certain charities. After executing the QPRT, Husband and Wife will transfer the property to the QPRT in exchange for the transfer by Purchasing Trust to Husband and Wife of cash and marketable securities that have an aggregate fair market value on the date of transfer equal to the value of the remainder interest in the QPRT based on the fair market value of the property on the date of transfer (as determined by an expert appraiser) and the actuarial principles of Section 7520.

The IRS stated that the trust was a QPRT and that the valuation rules for such trusts applied to the sale of the remainder interest to Purchasing Trust. Therefore, the transfer of the remainder interest in the QPRT to Purchasing Trust in exchange for cash and marketable securities would not constitute a taxable gift by Husband and Wife to Purchasing Trust.

Note. This ruling is interesting, but not very useful, because the IRS expressly expressed no opinion on whether the trust funds would be included in the gross estate of Husband or Wife under Section 2036, or whether the appraiser correctly determined the fair market value of the parcel of property. The IRS views on those issues are the real open issue in a sale of a remainder interest.

V INCOME TAXES

A Code § 1. Income Tax Rates

1 U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act Expands Kiddie Tax. Pub. L. 110-28, 110th Cong., 1st Sess. (May 25, 2007)

The kiddie tax applies to all unearned income of a person who is under the age of 19 (24, in the case of a student), and whose earned income does not exceed one-half of the amount of his or her support. This provision applies to taxable years beginning after May 25, 2007.

2 Income Tax Rates Adjusted for Inflation. Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (Nov. 5, 2007)

The 2008 income tax rates for trusts and estates are:

Income	Rate
Not over $2,200	15%
Over $2,200 but not over $5,150	$330 + 25% on excess over $2,200

Over \$5,150 but not over \$7,850	\$1,067.50 + 28% on excess over \$5,150
Over \$7,850 but not over \$10,700	\$1,823.50 + 33% on excess over \$7,850
Over \$10,700	\$2,765 plus 35% on excess over \$10,700

Int. Rev. Code § 1(e). Also, the kiddie tax applies to income over \$900 (standard deduction for a dependent under Int. Rev. Code § 63(c)(5)), and a parent may elect to include in gross income up to \$9,000 of a child's income. Int. Rev. Code § 1(g)(4)(A).

B Code § 67. Miscellaneous Itemized Deductions

Supreme Court, Treasury and IRS Weigh in on Whether Trust or Estate Investment Expenses Are Subject to the Two Percent Floor on Miscellaneous Itemized Deductions. Prop. Treas. Regs. § 1.67-4, 72 Fed. Reg. 41243 (July 27, 2007); *Knight v. United States*, 552 U.S. ___, 128 S.Ct. 782, 76 USLW 4048 (Jan. 16, 2008), *aff'g, Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149 (2nd Cir. Oct. 19, 2006), *rehearing en banc denied* (2007); Notice 2008-32, 2008-14 I.R.B. 593, 2008 WL 510055 (Feb. 27, 2008)

- **Proposed Regulations**. The Treasury has proposed regulations dealing with what expenses of a trust or estate are subject to the two percent floor on miscellaneous itemized deductions. The regulations exempt from the two percent floor those costs that could not have been incurred by an individual in connection with property not held in a trust or estate, based on the type of product or service in question, rather than how it is characterized. Prop. Treas. Regs. § 1.67-4(b). For example, the two percent floor does not apply to costs in connection with fiduciary accountings, judicial or quasi-judicial filings required as part of the trust or estate administration, fiduciary income tax returns, the division or distribution of income or principal among beneficiaries, trust or will contests or constructions, fiduciary bond premiums, and communications with beneficiaries regarding trust or estate matters. The expenses that are subject to the two percent floor include such items as costs associated with the custody or management of property, advice on investing for total return, gift tax returns, the defense of claims by creditors of the decedent or grantor, and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property. *Id.* A single fee that covers both costs that are and are not unique to a trust or estate must be allocated between the two categories, using some reasonable method. Prop. Treas. Regs. § 1.67-4(c). The regulations will apply to payments made after the date the final regulations are published in the Federal Register. Prop. Treas. Regs. § 1.67-4(d).

  Note. The general rule of the proposed regulations comes as no surprise, as it is consistent with the position espoused by the IRS in a long line of cases. It is, however, incorrect, under the Supreme Court's decision in *Knight v. Comm'r*, discussed below, and likely will be changed in the final regulations to the "not commonly incurred by individuals" test preferred by the Court. Also, note that the requirement that a bundled fee be allocated, however, is new and will require fiduciaries to keep detailed records of the types of activities on which time is expended.

Knight v. Comm'r. William Rudkin created an irrevocable trust for the benefit of his family and funded it with the proceeds of the sale of his interest in Pepperidge Farm Corporation to Campbell Soup Company. Michael J. Knight, the trustee, was expressly authorized by the trust instrument to invest in any type of investment that was suitable for fiduciary investment, and to employ such advisors as the trustee deemed appropriate. Applicable state (Connecticut) law imposed the prudent investor standard on the trustees who were not themselves skilled investors. The trustee then hired an investment advisor to manage the trust assets. The trustee paid the advisor more than $28,000, and deducted the payments as miscellaneous itemized deductions. The IRS stated that the deductions were subject to the two percent floor.

The Tax Court (Judge Wherry), in a reviewed opinion, held for the government. The court stated that the investment expenses paid by the trust were clearly paid or incurred in connection with the administration of a trust or estate, but that they were not incurred because the taxpayer was a trust. The court stated that Section 67(e) is designed to permit the trust to deduct without regard to the two-percent floor, only "those costs which are *unique* to the administration of an estate or trust" and that individual investors routinely incur costs for investment advice as an part of their investment activities. Therefore, the court stated, such expenses could never be deemed unique to the administration of an estate or trust, even if the fiduciary feels compelled to incur such expenses in order to meet the prudent person standards imposed by state law.

The Second Circuit affirmed, stating that Congress could clearly have created a "but for" causal test, but that the language of the Code does not do so. The court stated that "the plain meaning of § 67(e)(1)'s second clause" applies the two-percent floor to any expenses of at type that could be incurred if the property were held individually. The statute, the court stated, demands an objective determination of whether the particular cost is one that is peculiar to trusts and one that individuals are "incapable of incurring." The court expressly rejected the focus by the Federal and Fourth Circuits on whether the costs were "not customarily incurred outside of trusts." The Second Circuit refused a request for rehearing.

A unanimous Supreme Court (C.J. Roberts) affirmed the decision of the Second Circuit, though it rejected the test applied by that court and adopted, instead, the test applied by the Federal and Fourth Circuits. The Court stated that the question raised is whether a particular type of cost incurred by a trust (in this case, investment advice) "would not have been incurred" but for the fact that the taxpayer is a trust or estate. This determination amounts to predicting what would happen if the trust's property were held by an individual. In making a prediction, the word "would" is best read to express concepts such as custom, habit, natural disposition or probability. This is the direct import of the statutory language, even if it is not clearly stated. The Court rejected the Second Circuit's approach, which asked whether the cost at issue could have been incurred by an individual, because the words "would" and "could" do not mean the same thing. Further, the Second Circuit's approach would render meaningless the requirement of Section 67(e) that the expense be incurred in connection with the administration of the trust or estate. The Court rejected the trustee's argument that the proper inquiry is whether a particular expense of a particular trust was caused by the fact that the property was held in trust, because the statute does not adopt a causation test, but rather looks to the whether an individual would have incurred such costs in the absence of a trust. Also, the trustee's approach would render virtually all trust-related expenses fully deductible, which is inconsistent with the purpose of the 2% floor. The Court then stated that the trustee had failed to establish that it is uncommon or unusual for individuals to hire an investment adviser. The trustee tried to distinguish trust investment advisory fees from those incurred by individuals, because the trustee hired an investment adviser in effectuation of his state law fiduciary duty to manage trust investments "as a prudent investor would." The Court noted that the prudent investor rule looks to what an individual investor would do, rather to what a prudent trustee would do. Further, the Court noted, nearly all of a trust's expenses are incurred because the trustee has a fiduciary duty to incur them; otherwise, there would be no reason for the trust to incur the expense in the first place. The Court ultimately agreed with the view adopted by the Fourth and Federal Circuits, that costs incurred by trusts escape the 2% floor if they would not "commonly" or "customarily" be incurred by individuals. *Scott v. U.S.*, 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. U.S.*, 265 F.3d 1275 (Fed. Cir. 2001).

_ **Notice 2008-32.** The IRS provided guidance on the treatment of bundled investment advisory costs and other expenses subject to the two percent floor under Section 67, effective until final regulations are released. The notice states that, for tax years beginning before January 1, 2008, taxpayers need not separate bundled fiduciary fees between those that are and those that are not subject to the two percent floor under Section 67; bundled fiduciary fees can be deducted in full without regard to the Section 67 floor. The notice extends the comment period on the proposed regulations until May 27, after which the IRS stated that it would publish final regulations "without delay." The IRS stated that the final regulations will include safe harbors for allocating some portion of bundled fees to investment advice, and asked for specific comments on what would be a reasonable percentage. The notice also stated that, while bundled fees are fully deductible for taxable year 2007, it adds that two percent floor expenses that are "readily identifiable" must be treated separately from the otherwise bundled fee.

C Code § 101. Taxation of Life Insurance Proceeds

1 Sale of Life Insurance Policy to Grantor Trust is Not a Transfer for Value. Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (March 12, 2007)

The ruling posed two situations. In Situation 1, the grantor created two trusts, TR1 and TR2, each of which was a wholly-owned grantor trust under Section 671. (The IRS did not state the reason for grantor trust status, nor was the basis of this status relevant in the ruling.) The trustee of TR2 transferred a life insurance policy on the life of the grantor's to the trustee of TR1, in exchange for a payment of cash held by TR1. In Situation 2, the facts were the same as those in Situation 1, except that only TR1 was a grantor trust; TR2 was not a grantor trust.

The IRS ruled that in neither case was the transfer of the life insurance policy by the trustee of TR1 to the trustee of TR2 a transfer-for-value, under Section 101, and the proceeds of the transferred policy remained excludible from the beneficiary's gross income. The IRS explained that life insurance proceeds are usually excludible from the beneficiary's gross income under Section 101(a)(1), but that they are fully taxable if the policy is acquired in a transfer for valuable consideration. Int. Rev. Code § 101(a)(2). The proceeds of a policy acquired in a transfer for value are includible in the beneficiary's gross income, to the extent that the proceeds exceed the consideration paid for the policy and the premiums and other amounts thereafter paid by the transferee. The transfer for value rule, however, does not apply to a transfer of a life insurance policy to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. The IRS reviewed Rev. Rul. 85-13, in which a grantor bought assets from a grantor trust in exchange for the grantor's unsecured promissory note. Rev. Rul. 85-13, 1985-1 C.B. 184. The IRS in that ruling treated the grantor as the deemed owner of the trust under Section 675(3), because the grantor borrowed the corpus of the trust without adequate security. The IRS then explained that, the grantor was also treated as the owner of the trust assets for federal income tax purposes. The grantor, therefore, would be deemed to own the consideration both before and after the transaction, so that the exchange of a promissory note for the trust assets could not be taxed as a sale for Federal income tax purposes. The IRS then applied this rule to the two situations in the ruling. In Situation 1, the grantor would be treated as the owner of the assets of both trusts before and after the transaction. Therefore, there could be no transfer for income tax purposes, and the transfer for value rule of Section 101(a)(2) would not apply. In Situation 2, there was a transfer, because the grantor was deemed to own only the assets of TR1, and not those of TR2. The grantor was deemed to own deemed to own the cash held by TR1 before the exchange, and to own the insurance policy held by TR1 after the exchange. In this situation, there was a transfer of a life insurance policy for a valuable consideration, but the transfer was deemed made to the insured personally. Therefore, the transfer for value rule did not apply.

Note. Rev. Rul. 2007-13 may make it easier to solve at least two of the annoying tax and nontax problems that are often raised by the use of irrevocable life insurance trusts. First, such trusts must be irrevocable, but the facts and circumstances of the grantor's family are constantly changing. This lack of flexibility in an irrevocable trust instrument can be addressed at least partially by naming a trusted and trustworthy person to serve as trustee, and then giving the trustee broad authority to determine when distributions should be made, to whom they should be made and how large they should be. Even such flexibility, however, does not necessarily address all types of changes in circumstances. One technique sometimes used to change the terms under which a life insurance policy is held in trust is to create and fund a second trust, and then to have the trustee of the second trust buy the insurance policy from the trustee of the first trust. Thus, the second trust now would hold the policy on those terms and for those persons that the grantor deems most appropriate. The first trust would hold a cash sum equal to the fair market value of the policy purchased by the second trust.

Rev. Rul. 2007-13 helps assure that such a transaction is not likely to constitute a transfer for value, under Section 101(a)(2), as long as the new trust is a grantor trust for Federal income tax purposes. On the other hand, the trustee of the first trust must be careful to assure that the purchase price paid for the policy constitutes full and adequate consideration for the policy being transferred, in order to avoid a fiduciary liability to the beneficiaries for having wasted trust assets. Full and adequate consideration is the fair market value of the policy. This is not necessarily the gift tax value of the policy under the applicable regulations, but rather the amount that the trustee could obtain from an independent third-party upon a sale of the policy. See Treas. Regs. § 25.2512-6(a). A strong secondary market for life insurance policies has grown in the past few years, and trustees should determine the price that can readily be obtained for a policy, before setting the price at which that policy will be sold to another trust. Also, the trustee must act independently and carefully in evaluating, contracting for and effecting this transfer; any suggestion that the grantor actually controlled the trustee's actions could impute the trustee's incidents of ownership over the policy to the grantor, creating a risk of estate taxation under Section 2042.

A second problem often raised by irrevocable life insurance trusts is avoiding the estate taxation on the proceeds of a life insurance policy the incidents of ownership over which are transferred within three years of the grantor's death. Int. Rev. Code § 2035(a)(2). Some practitioners have tried to avoid this limitation by having the grantor sell the policy to the trustee for its fair market value; Section 2035(a)(2) does not apply to a transfer for full and adequate consideration in money or money's worth. Rev. Rul. 2007-13 helps minimize the risk that such a sale would be a transfer for value for income tax purposes. Practitioners must, however, remember that this sale will remove the proceeds from the grantor's gross estate only if the selling grantor receives full and adequate consideration in money or money's worth. This, again, may be more than the gift tax value of the policy, and may require that the trustee make diligent inquiries into the value of the policy if sold in the secondary market for insurance policies. Also, even if the policy is sold for its full and adequate consideration, the IRS has previously claimed that the appropriate measurement of full and adequate consideration is the amount that would be included in the grantor's gross estate if the transaction did not occur. This would be the full amount of the proceeds, rather than the fair market value of the policy itself. *Compare* IRS arguments in *U.S. v. Allen*, 293 F.2d 916 (10th Cir. 1961) and *U.S. v. Past*, 347 F.2d 7 (9th Cir. 1965); with IRS approval of sales for the policies' gift tax value in PLRs 9413045 and 200606027. Therefore, practitioners should take comfort in Rev. Rul. 2007-13, as creating a comfortable way to avoid the transfer for value rule when assigning life insurance policies to a life insurance trust, but should not overlook the estate tax issues that can be at least as challenging as the income tax issues, in such transactions.

2 **Modification of Split-Dollar Agreement Does Not Subject Pre-August 18, 2006 Plan to Newer Rules of Sections 101(j) or 264(f). Notice 2008-42, 2008-15 IRB ___ (April 14, 2008)**

The Pension Protection Act of 2006 adopted two new sets of income tax rules on employer-owned life insurance. Section 101(j) treats certain death benefits under such arrangements as taxable income, and Section 264(f) requires pro rata allocation of interest expense to policy cash values for purposes of the income tax deduction for interest paid on loans on such policies. Both rules apply to plans made or substantially modified after August 17, 2008. The IRS now stated that a modification of a split-dollar life insurance arrangement that does not entail any change to the life insurance contract underlying the arrangement, will not be treated as a material change in the life insurance contract for purposes of the employer-owned life insurance rules of Section 101(j). Thus, if the parties to a split-dollar life insurance arrangement may modify the terms of the arrangement without modifying the terms of the life insurance contract underlying the arrangement, the modification will not be treated as a material change in the life insurance contract for purposes of Sections 101(j) and 264(f), even if the modification *is* treated as a material modification of the split-dollar arrangement for purposes of the split-dollar regulations effective date.

D **Code §§ 170, 642, 4940-4947. Charitable Gifts and Distributions**

1 **Attorney Denied Charitable Contribution Deduction for Donating Items from Client's Case File. *Jones v. Comm'r*, 129 T.C. 299 (Nov. 1, 2007)**

Jones was lead counsel in the defense of Timothy McVeigh against charges that he participated in the bombing of the Alfred P. Murrah Federal Building in Oklahoma City. During the course of his defense of McVeigh, Jones accumulated a file that included copies of extensive materials received from the Government and delivered them Jones, including statements of FBI interviews with witnesses, documentary evidence, medical examiner's reports, color and black and white photographs, audio and video cassettes, a copy of a text of the Declaration of Independence containing notes made by McVeigh, copies of investigative materials compiled by the Government in its prior investigation of David Koresh, and copies of Government expert summary reports. None of the materials were originals, and none were prepared personally by the taxpayer or for him by anyone under his direction. These materials were always provided to the taxpayer by the Government, and copies were also held by several other parties. Jones always permitted his client to see the materials upon request, but McVeigh never held any part of the files for more than 72 hours. Jones contributed the documents and materials to the University of Texas at Austin, subject to certain restrictions on the disclosure of certain parts of the collection. Jones obtained an independent professional appraisal valuing the documents at $294,877. The appraiser spent one day reviewing some of the documents, and he discounted the preliminary evaluation by 50 percent because none of the materials were originals. The appraiser did not take into consideration that multiple copies of the materials had been distributed to various attorneys during the course of the trial. Jones deducted $294,877, and the IRS disallowed the deduction.

The Tax Court (Judge Cohen) held for the IRS, finding that Jones did not have a property right in the contents of McVeigh's file, and thus could not deduct the value of that file given to charity. The court noted that this was a case of first impression, and that no prior court had ever directly ruled on the property rights of an attorney in files related to the representation of the attorney's client, in this context. The court rejected Jones's contention that he owned the files because he had possession of the files and he had never allowed his client to possess the files for any extended period. The court noted that, while such possession may be prima facie evidence of ownership in general personal property matters, it did not apply to attorney's files because of the fiduciary relationship between an attorney and his or her client. The IRS argued that Jones had received the materials as an agent of McVeigh during the course the trial bombing and that the materials belonged to McVeigh, rather than Jones. The Tax Court agreed, notwithstanding the argument by taxpayer that a client may possess a right of access to information in a case file, but the attorney is the rightful owner of the case files and, in any event, may keep copies of the materials in the files. Citing *Swift, Currie, McGhee & Hiers v. Henry*, 581 S.E.2d 37, 39 (Ga. 2003) (citing *Resolution Trust Corp. v. H---, P.C.*, 128 F.R.D. 647 (N.D. Tex. 1989); *In re Kaleidoscope, Inc.*, 15 Bankr. 232, 241 (Bankr. N.D. Ga. 1981), *rev'd on other grounds* 25 Bankr. 729 (N.D. Ga. 1982); *In re Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn L.L.P.*, 689 N.E.2d 879, 882-883 (N.Y. App. Div. 1997)). The Tax Court did note, however, that some courts have held that ownership of a case file is divided between attorney and client, and that an attorney's work product, including internal legal memoranda and preliminary drafts of documents, remains the property of the attorney; though McVeigh has superior property rights in the end product of the attorney's representation, which includes finalized legal documents, pleadings filed, correspondence among parties, and other papers "'exposed to public light by the attorney to further [the] client's interests'". See *In re Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn L.L.P.*, 689 N.E.2d at 881-882 (quoting

Fed. Land Bank v. Fed. Intermediate Credit Bank, 127 F.R.D. 473, 479 (S.D. Miss. 1989), *modified* 128 F.R.D. 182 (S.D. Miss. 1989)); *Apa v. Qwest Corp*., 402 F. Supp. 2d 1247, 1250 (D. Colo. 2005); *Loeffler v. Lanser (In re ANR Advance Transp. Co.)*, 302 Bankr. 607, 614 (E.D. Wis. 2003); *Womack Newspapers, Inc. v. Town of Kitty Hawk*, 639 S.E.2d 96, 104 (N.C. Ct. App. 2007). Jones also argued that the attorney's right to retain copies of McVeigh's case files means that copies belong to the attorney. The court denied that an attorney's right to maintain a copy of his client's file after termination of representation includes "a right to publicize, sell, or otherwise dispose of the case file to the attorney's benefit."

2 IRS Adds Charitable Contributions of Limited Partnership Interests to No-Rule List. Rev. Proc. 2008-3, §§ 3.01(22), 3.01(62), 3.01(64), 2008-1 IRB 110 (Jan. 7, 2008)

The IRS added to its list of areas in which it will not issue private rulings, the income, gift and estate tax treatment of a charitable contribution of a limited partnership interest or interest in a limited liability company.

3 First "Transaction of Interest" Involves Charitable Gifts. Notice 2007-72, 2007-36 IRB, 544 (Sept. 4, 2007)

On August 14, 2007, the IRS released notices identifying two "transactions of interest" the involvement in which trigger disclosure rules, list maintenance requirements and possible penalties under Sections 6011, 6111 and 6112. The first, Notice 2007-72, involves situations in which a taxpayer=s advisor owns all of the membership interests in an LLC that holds real property that may be subject to a long-term lease, and sells the taxpayer a right to become successor member after a number of years. The taxpayer holds the successor rights for more than a year, and then transfers them to a charity, claiming an income tax deduction substantially higher than the amount that the taxpayer paid for the rights, based on an appraisal based on the value of the underlying real property. The IRS explained that its concerns are based on the large discrepancy between the amount paid by the taxpayer and the amount claimed as a charitable deduction, the possible mischaracterization of the different ownership interests in the LLC, the charity=s agreement to retain the membership interests for a specific period of time, and whether the charity later sells the interests to a party selected by the taxpayer or the taxpayer=s advisor. The charitable contribution arrangement was identified as transactions of interest effective August 14, but the IRS stated that disclosures of these deals or substantially similar deals must be made by taxpayers entering into the transactions on or after November 2, 2006.

4 **IRS Outlines Added Tax Benefits for Donating Conservation Contributions Under Pension Law. Notice 2007-50, 2007-25 IRB 1430 (June 18, 2007)**

The IRS has provided guidance regarding the Pension Protection Act of 2006 rules that accelerates and increases the tax benefits of contributions of qualified conservation contributions in calendar years 2006 and 2007. The amount of charitable contributions that individual taxpayers can deduct in a taxable year was increased from 30 percent of the contribution base (modified adjusted gross income) to 50 percent (100 percent for contributors who are farmers or ranchers). The new law also extends the carryover period for unused deductions for such contributions from five years to 15 years. The 100 percent limitation applies to contributions made after August 17, 2006, only if the property is required to remain available for agriculture or livestock production; the 50 percent limitation applies otherwise. Int. Rev. Code § 170(b)(1)(E); Pub. L. No. 109-280, 109th Cong., 2nd Sess., 120 Stat. 780 (2006). The Notice contains a series of questions and answers, the key points of which include the following:

- **Applying the Percentage Limitations if Other Charitable Gifts Made in the Same Year.** The notice explains that a qualified conservation contribution may be taken into account under the percentage limitations and the carryover rules in a taxable year in which an individual has made a qualified conservation contribution, only after taking into account contributions subject to the limitations in Section 170(b)(1)(A), (B), (C), and (D). Thus, for example, an individual who has a $100x contribution base and who makes $60x in cash contributions to 50 percent organizations and a qualified conservation contribution of capital gain property worth $80x, may, if not a qualified farmer or rancher, deduct $50x of the cash contributions and none of the conservation easement. That taxpayer could carryforward $10x of cash contributions (for up to five years), and $80x of qualified conservation contribution (for up to 15 years). A taxpayer who was a qualified farmer or rancher could deduct both $50x of cash and $50x of the conservation easement in the year of the gift, carrying forward $30 of the conservation easement.

- **Qualified Contribution.** The 50 percent and 100 percent special limitations apply only to qualified conservation contributions of a qualified real property interest to a qualified organization, exclusively for conservation purposes. A qualified real property interest is the taxpayer's entire interest subject to a qualified mineral interest, a remainder interest or a perpetual restriction on the use which may be made of the real property. A gift of the taxpayer's entire interest in the property without a reservation of a qualified mineral interest does not qualify for the special limitations.

- **Qualified Farmer or Rancher.** The 100 percent limitation applies only to gifts by an individual who is a qualified farmer or rancher, which is defined as an individual whose gross income from the trade or business of farming (See Section 2032A(e)(5)) in the taxable year of the contribution is more than 50 percent of his or her total gross income. Income from a sale (including a bargain sale) of a conservation easement is not gross income from the trade or business of farming, because selling easements is not the trade or business of farming. Income from the sale of timber is farming income, however. Income from fees to permit hunting or fishing on the property is not gross income from farming.

- **Pass-Through Entities.** A qualified conservation contribution made by a pass-through entity such as a partnership or S corporation, looks to the partners, shareholders or other members to determine whether it is a gift made by a qualified farmer or rancher.

- **Qualifying for the 100 Percent Limit.** A qualified conservation contribution need not be of property used or available for use in agriculture or livestock production in order for a qualified farmer or rancher to qualify for the 100 percent limitation. Section 170(b)(1)(E)(iv)(I) requires that an individual be a qualified farmer or rancher to qualify for the 100 percent limitation, but it does not require that the qualified conservation contribution be of property used or available for use in agriculture or livestock production. If the property is used or available for use in agriculture or livestock production, the restriction described in § 170(b)(1)(E)(iv)(II) may apply.

- **Property Used or Available for Agriculture.** Property used or available for use in agriculture or livestock production includes the portions of the property upon which are located any of the following: dwellings used for family living by the farmer or rancher, a lessee that operates the property, or their employees; other types of buildings used for agriculture or livestock purposes; and roads throughout the property. A qualified farmer or rancher can comply with the requirement that a qualified conservation contribution of property used or available for use in agriculture or livestock production be subject to a restriction that the property remain available for such production, by including in the document of conveyance prohibitions against construction or placement of buildings (except those used for agriculture or livestock production purposes, or dwellings used for family living by the qualified farmer or rancher, a lessee that operates the property, or their employees), removal of mineral substances in any manner that adversely affects the property's agriculture or livestock production potential, and other uses detrimental to retention of the property for use in agriculture or livestock production. See, e.g., Treas. Regs. § 1.170A-14(f), Ex. 5.

5 Facade Easement Cannot be Valued by Applying a Percentage to the Value of Underlying Property Before Contribution under Section 170(h). CCA 200738013 (Sept. 21, 2007).

Donors attempted to substantiate their deduction under Section 170(h) for charitable contributions of facade easements, by using appraisals that applied a percentage to the value of the property before the contribution. The appraisers relied on a statement that it is "generally recognized" that facade easement contributions result in a loss of value of between 10 percent and 20 percent of the underlying property.

The IRS Office of Chief Counsel stated that Treas. Regs. § 1.170A-14(h)(3)(i) require that the value of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. The fair market value of the easement is based on the sales price of comparable easements, if there is a substantial record of sales of comparable easements. Otherwise, the fair market value of a perpetual conservation restriction is generally equal to the difference between the fair market value of the property before the granting of the restriction and the fair market value of the property after the granting of the restriction. This is generally referred to as the "before and after" approach. See *Hilborn v. Comm'r*, 85 T.C. 677 (1985); and Rev. Rul. 73-339, 1973-2 C.B. 68, clarified in Rev. Rul. 76-376, 1976-2 C.B. 53. An appraisal of a facade easement that values the easement as a percentage of the value of the underlying fee before grant of the easement, without reference to the actual value of the underlying fee after the grant, cannot be used to substantiate the easement's fair market value under tax code Section 170(h). The IRS explained that certain tax advisers and charitable organizations are misinforming the public about the valuation of contributed facade easements by indicating that the service allows tax deductions of approximately 10 percent to 15 percent of the fair market value of the underlying property. The IRS added that there does not exist a "generally recognized" percentage by which an easement reduces the value of property. The value of a donated facade easement must be individually substantiated with a full appraisal of the value of the easement, and this is generally obtained by determining the values of the underlying fee both before and after the contribution. See *Nicoladis v. Comm'r*, T.C. Memo. 1988-163 (adopting a 10% discount proposed by both parties, but adding that there is no general ten-percent discount for facade easements.)

E Code § 529. Education Savings Accounts

IRS Issues Advance Notice of Proposed Regulations on Abuse of Section 529 Education Savings Accounts. 73 Fed. Reg. 3441 (Jan. 18, 2008)

The IRS issued advance notice of its intention to propose regulations curtailing possible abuses of the special rules for Section 529 education savings accounts. The advance notice states that the IRS will address in these proposed regulations such issues as:

- using the ability to change the beneficiary of a Section 529 account to establish multiple accounts for the same designated beneficiary;
- using a Section 529 account as a retirement savings account;
- contributing to a Section 529 account for the contributor's benefit and then changing the beneficiary to someone assigned to the same or a higher generation without a taxable gift;
- treating contributions to a Section 529 account as completed gifts even when the contributor retains the power to withdraw the contributed money.

The IRS also stated that it will issue general anti-abuse rules that will apply whenever a taxpayer creates or uses a Section 529 account for transfer tax avoidance.

F Code § 664. Charitable Remainder Trusts

1 Proposed Regulations Detail 100 Percent Excise Tax on UBTI of a Charitable Remainder Trust. 73 Fed. Reg. 12313 (March 7, 2008)

The proposed regulations provide that charitable remainder trusts with UBTI in taxable years beginning after December 31, 2006, are exempt from Federal income tax, but are subject to a 100-percent excise tax on the UBTI of the charitable remainder trust. Prop. Regs. § 1.664-1(c)(1). The excise tax is reportable on Form 4720, "Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code." The proposed regulations clarify that the excise tax imposed upon a charitable remainder trust with UBTI is treated as paid from corpus and the trust income that is UBTI is income of the trust for purposes of determining the character of the distribution made to the beneficiary. Prop. Regs. § 1.664-1(c)(1). The proposed regulations provide examples illustrating the tax effects of UBTI on a charitable remainder trust for taxable years beginning after December 31, 2006. In one example, a charitable remainder annuity trust has $60,000 of ordinary income, including $10,000 of income from a partnership that constitutes unrelated business taxable income to the trust. The trust has no deductions that are directly connected with that income, but it has $16,000 of deductible administration expenses. The trust's net ordinary income is $44,000 ($60,000 - $16,000). The trust's UBTI is $9,000 ($10,000 – the $1,000 deduction under Section 512(b)(12)). Undistributed ordinary income from prior years is $12,000 and undistributed capital gains from prior years are $50,000. The noncharitable annuity is $100,000 for the taxable year. The trust is liable for a $9,000 excise tax on its UBTI, and the $100,000 distribution to the noncharitable beneficiary is deemed to consist of: $56,000 of ordinary income ($44,000 from current year plus $12,000 from prior years), and $44,000 of capital gains. The $9,000 excise tax is allocated to corpus. Prop. Regs. § 1.664-1(c)(1)(Ex. 1). The second example involves a charitable remainder trust that sells real estate generating gain of $40,000. Because the trust had obtained a loan to finance part price of the real estate, some of the income from the sale is treated as debt-financed income under Section 514 and thus is UBTI. The UBTI under Section 514 is $30,000. The trust has UBTI of $29,000 for the taxable year ($30,000 minus the $1,000 deduction under Section 512(b)(12)). The trust is subject to a $29,000 excise tax under Section 664(c), and the $29,000 of UBTI is allocated to corpus, and does not reduce the amount in any of the categories of income. The entire $40,000 is capital gain for purposes of Section 664 and is allocated accordingly. The proposed regulations will be effective for taxable years beginning after December 31, 2006.

2 IRS Adds Early Termination of Charitable Remainder Trusts to No-Rule List Rev. Proc. 2008-3, §§ 4.01(40), 5.10, 2008-1 IRB 110 (Jan. 7, 2008)

The IRS added to its list of areas in which it will not issue private rulings, whether the early termination of a charitable remainder trust by the commutation of the interests of the parties is properly taxed as a sale or exchange and whether it causes the trust to cease to be a qualified charitable remainder trust.

3 Early Termination of CRUT by Commutation is not Self-Dealing. PLR 200739004 (Sept. 28, 2007)

D created a charitable remainder unitrust to pay the unitrust amount to individual beneficiaries for life. Upon the death of a beneficiary, the associated subshare was to be terminated and the remainder transferred to Charity, a public charity. In a private ruling request, the beneficiaries and Charity stated that administrative expenses and reduced investment performance led them to desire that the trust be terminated early. They proposed that, upon approval by a state court, the trust would be commuted, and each of the non-charitable beneficiaries would receive an actuarially-determined share of the trust's assets, as would Charity. The actuarial shares would be determined based on the IRS actuarial tables for the month in which the commutation occurred, and none of the individual beneficiaries had any known medical condition which would render the tables inapplicable.

The IRS stated that the transaction takes the form of a distribution of present values of respective interests of each beneficiary and the charity, but that it is also in substance a sale of each unitrust interest to the charity. The disposition of each beneficiary's interest is not part of a transaction in which the entire interest in the trust is transferred to a third party, so the adjusted basis in each interest is disregarded under Section 1001(e)(1) in determining the gain realized by each beneficiary. Therefore, each beneficiary will realize and recognize capital gain equal to the entire amount received for his or her interest. Payments to beneficiaries by a charitable remainder trust are usually an act of self-dealing, but because the distributions in this ruling are really an acceleration of the unitrust interests, the exception for distributions of the unitrust amount applies and the distributions are not an act of self-dealing.

Note. See also, *e.g.*, similar results in PLRs 200441024, 200323035, 200314031 and 200252092.

4 Termination of Charitable Remainder Trust by Sale of Unitrust Interest to Charity is not Self-Dealing, But Gain Recognized. PLR 200733014 (Aug. 17, 2007)

H and W, a married couple created a net income charitable remainder unitrust with a make-up provision. The unitrust amount would be paid to the couple or the survivor, at which time the entire trust fund would be paid to Charity, a public charity. The trustee proposed to terminate the trust by the grantors transfer of their unitrust/income interest to the charity, in exchange for a distribution from the trust equal to the actuarial fair market value of their reserved unitrust/income interest. All computations would be based on the actuarial tables under Sections 664 and 7520, using the interest rate assumptions effective on the date of the commuting distributions. Assets distributed in-kind would be distributed on a pro-rata basis. Neither grantor was aware of any physical condition that would decrease the grantor's normal life expectancy, confirmed by a statement from their personal physician.

The IRS concluded that the early termination of the trust would not disqualify it under Section 664, and that the distribution to the grantors would not be subject to the excise tax on self-dealing, because the charity is a public charity and the amount of the distributions is equal to the actuarial fair market value of the reserved unitrust/income interest. The IRS stated that the value of the reserved unitrust/income interest could be calculated by (i) finding the special factor indicated in Treas. Regs. § 1.7520-3(b)(1)(ii); and (ii) using the methodology stated in Treas. Reg. § 1.664-4 for computing the factor for a remainder interest in a unitrust, except that where Treas. Regs. § 1.664-4(a)(3) requires an assumption that the trust's stated payout percentage is to be paid out each year, the grantors should instead assume a payout of a fixed percentage equal to the lesser of the trust's stated payout percentage or the Section § 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor. The IRS also stated that the transfer of the grantors' unitrust/income interest to the charity, together with the trust distribution to the grantors, constituted a sale of the grantors' interest in the trust (rather than a return of the grantor's extant interest.) Thus, gain would be realized and recognized under Section 1001. Furthermore, the grantors' basis would be zero, under Section 1015. The grantors had held their interest for more than one year, and the gain would be a long-term capital gain.

Note. The IRS stressed that state law allows for early termination under the facts presented pursuant to the Court order, and that those requirements would be met. Also, it is odd that the IRS required that the value of the unitrust interest take into account the net income limitation, as it is ignored in computing the deduction for the charitable contribution on the funding of the trust.

See also similar conclusions in PLRs 200725044, 200616035, 200614032, 200525014, 200314021.

G Code § 671-679. Grantor Trusts

Second "Transaction of Interest" Involves "Toggled" Grantor Trusts. Notice 2007-73, 2007-36 IRB 545 (Sept. 4, 2007)

On August 14, 2007, the IRS released notices identifying two "transactions of interest" the involvement in which trigger disclosure rules, list maintenance requirements and possible penalties under Sections 6011, 6111 and 6112. The second, Notice 2007-73, involves two tax shelters in which taxpayers "toggle" on and off the grantor trust status of a trust, in order to avoid recognizing gain, or to claim a tax loss greater than actual economic loss. In one variation, the taxpayer buys four options, consisting of two sets of paired options that are expected to change in valuation in direct opposition to each other, such that when two options have gains, the other two will have offsetting losses. The taxpayer funds a grantor trust with the four options and a small amount of cash, giving a unitrust interest to a family member but retaining a remainder interest in the trust after a fixed relatively short term of years. The grantor retains the nonfiduciary right to reacquire trust assets by substituting assets of equivalent value, to become effective at a fixed future date. Shortly before the substitution power is to become effective, the grantor then sells the remainder interest to an unrelated buyer for its fair market value, which is equal to that of the options (the unitrust interest apparently being equal to the value of the cash contributed to the trust). No gain is reported, because the grantor allocates to the remainder interest an amount of the basis in the underlying assets equal to the sales price. The grantor claims that the sale terminates the grantor trust status under Section 673. The substitution power then becomes effective and restarts grantor trust status, and the grantor closes the loss options, recognizing and deducting the losses. The grantor again uses the same portion of the basis in the options that is attributable to the grantor=s interest, ignoring the fact that this basis has been used once already to offset the gain on the sale of that interest. The third-party then buys the unitrust interest from the grantor's family member for an amount equal to the actuarial value of that interest, which is approximately equal to the remaining cash. The trust is then terminated and the assets distributed to the buyer, who claims a basis in them equal to the amount paid, thereby recognizing little or no gain on the exercise of the gain options. Thus, the grantor has sold the options for approximately what they cost the grantor, and claimed a significant deductible loss. In the second variation, the grantor contributes marketable securities, rather than options, to the trust. The grantor then substitutes appreciated assets for the marketable securities after the sale of the remainder interest but before the effective date of the power of substitution. Both of these trust deals were identified as transactions of interest effective August 14, but the IRS said that disclosures of these deals or substantially similar deals must be made by taxpayers entering into the transactions on or after November 2, 2006.

H Code § 685. Funeral Trusts

Contributions to Qualified Funeral Trusts Adjusted for Inflation. Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (Nov. 5, 2007)

A qualified funeral trust can accept no more than $9,000 in contributions by or for the benefit of an individual, if the contract is entered into during 2008.

I Code § 691. Income in Respect of a Decedent

Gain From Sale of Property Is Not Income in Respect of Decedent. PLR 200744001 (Nov. 2, 2007)

The decedent's revocable trust entered into a contract to sell a plot of real property during the decedent's life, with an intended closing date of X. Before X, however, a gas pipeline was discovered underneath the property, causing the parties to delay the sale until the parties could resolve a number of issues, such as providing for an easement for the pipeline company to enter onto the property and for the pipeline company to provide restitution for any damage to the property. Before the parties could resolve these issues, the decedent died. The sale actually closed after the date of death.

The IRS explained that the gain was taxable to the trustee, rather than to the decedent's estate as IRD. IRD is generally defined as those amounts to which a decedent was entitled as gross income but which were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of the decedent's death under the method of accounting employed by the decedent. Treas. Regs. § 1.691-1(b). The IRS explained that entering into a binding contract to sell real estate prior to the date of death typically converts the gain into IRD, even if the sale closes after the date of death, because all of the substantive prerequisites to the realization of the gain have been completed before death. Rev. Rul. 78-32, 1978-1 C.B. 198. In the ruling, there remained several important issues that had to be addressed before the sale of the property could be closed. Therefore, the gain was not IRD.

J Code § 1035. Tax-Free Exchange of Life Insurance Policies

Reinvestment in Second Annuity Contract of Cash Distributed with Regard to First Annuity Contract is a Taxable Event. Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (May 21, 2007); Rev. Proc. 2008-24, 2008-13 IRB 684 (March 31, 2008)

- **Rev. Rul. 2007-24.** A, an individual, wished to do a tax-free exchange of a non-qualified annuity contract issued by Insurer X for a desired annuity contract issued by Insurer Y. In 2007, A requested that Insurer X issue directly to Insurer Y a check as consideration for a new annuity contract, but Insurer X refused to do so and, instead, issued a check to A. A endorsed the check directly to Insurer Y as consideration for a new annuity contract.

  The IRS stated that the transaction did not constitute an exchange and was not, therefore, a tax-free transaction. In this case, there was no actual exchange of annuity contracts, no assignment of the Insurer X contract to Insurer Y, and no direct transfer from Insurer X to Insurer Y of the cash value of the old contract. Section 1035 does not apply to "roll-overs" of nonqualified annuities; it applies to exchanges in which cash is not made available to the taxpayer. Thus, the amount that A received from Insurer X under the first annuity contract is taxable in the year in which it is distributed, under the rules of Section 72(e). See exchange treatment allowed in Rev. Rul. 72-358, 1972-2 C.B. 473 (taxpayer assigned unmatured life insurance contract issued by one insurance company to a second insurance company in exchange for a variable annuity contract issued by the second company); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned contract into a pre-existing annuity contract owned by the same taxpayer). See also legislative history of Section 1035, explaining that it applies to taxpayers who have "merely exchanged an [annuity contract] for another better suited to their needs and who have not actually realized gain." H. Rep. 1337, 83d Cong., 2d Sess. 81 (1954).

- **Rev. Proc. 2008-24.** The IRS issued further guidance on the treatment of partial exchanges of annuity contracts under Sections 1035 and 72(e), modifying and superseding the interim guidance issued in 2003. The procedure states that a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies, will be treated as a tax-free exchange under ' 1035 if either --

(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or

(b) the taxpayer demonstrates that, between the date of the transfer and the date of the withdrawal or surrender, one of the following conditions occurred:

- the taxpayer attains the age 59 2;
- the taxpayer died;
- the transfer occurred from a qualified plan, contract, account, trust or annuity (described in Section 72(e)(5)(D));
- the transfer is allocable to investment in the contract before August 14, 1982;
- the transfer is under a qualified funding asset (described in Section 130(d), but without regard to whether there is a qualified assignment);
- the transfer is one on which the ten percent excise on early distributions from qualified retirement plans would not be imposed (Section 72(t)).
- the annuity is purchased by an employer on the termination of a qualified retirement plan (under Sections 401(a) or 403(a)) and held by the employer until such time as the employee separates from service;
- or any similar life event (such as divorce or loss of employment).

A direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies, that does not meet these requirements will be treated as an annuity distribution (taxable under Section 72(e)), followed by a payment for the second contract. The IRS states that it will not require aggregation under Section 72(e)(12), or otherwise, of two annuity contracts that are the subject of a tax-free exchange under Section 1035 and the tax-free rules of this revenue procedure, even if both contracts are issued by the same insurance company. Both contracts will be treated as separate annuity contracts. This revenue procedure is effective for transfers described in section 3 of this revenue procedure that are completed on or after June 30, 2008.

K Code §§ 1361-1367. S Corporations and S Corporation Trusts

1 Supplemental Appropriations Act (The U.S. Troop Readiness, Veterans' Care, Katrina Recovery and Iraq Accountability Appropriations Act, 2007) Permits ESBT to Deduct Certain Interest on Debt to Acquire S Corporation Shares. Pub. L. 110-28, 110th Cong., 1st Sess. (May 25, 2007)

The act enables an ESBT to deduct interest expense it incurs when it borrows to buy S corporation stock. This change treats ESBTs the same as the law already treats other taxpayers and qualified S corporation trusts. This provision applies to taxable years beginning after December 31, 2006.

2 Proposed Regs. Detail New Rules for Some S Corporation Trusts. REG-143326-05, 72 Fed. Reg. 55132 (Sept. 28, 2007)

The IRS proposed regulations providing guidance regarding the changes made to the rules governing Electing Small Business Trusts (ESBTs) by the American Jobs Creation Act of 2004, Pub. L. (Public Law 108-357, 108th Cong., 2nd Sess. (2004), 118 Stat. 1418, and the Gulf Opportunity Zone Act of 2005, Pub. L. 109-135, 109th Cong., 1st Sess. (2005). The proposed regulations would replace obsolete references in the current regulations and allow taxpayers to make proper use of the provisions that made changes to prior law. In particular, the proposed regulations provide guidance on the following areas.

$ **Six Generation Test.** The regulations adopt a "six-generation test" for determining whether individuals who share a common ancestor are members of a family for S corporation purposes. Section 1361(c)(1)(B)(ii) treats as members of a family persons with a common ancestor, as long as the common ancestor is not more than six generations removed from the youngest generation of the people being included in the family. The applicable date in Section 1361(c)(1)(B)(iii) on which a person will be tested for qualification as a "common ancestor" shall be the latest of (1) the date the S election is made, (2) the earliest date an individual who is a "member of the family" holds stock in the S corporation, or (3) October 22, 2004. The regulation would clarify that the "six generation" test is applied only at the date specified in Section 1361(c)(1)(B)(iii) for determining whether an individual meets the definition of "common ancestor," and has no continuing significance in limiting the number of generations of a family that may hold stock and be treated as a single shareholder. There is no adverse consequence to a person being a member of two families.

- **Defining "Powers of Appointment" and "Potential Current Beneficiaries."** The regulations define "powers of appointment" and "potential current beneficiaries" (PCBs) with regard to ESBTs. Potential current beneficiaries (PCBs) are treated as shareholders of an S corporation for purposes of the number of and identity of permitted shareholders. The new laws state that in determining the PCB's of an ESBT, powers of appointment will be disregarded to the extent not exercised by the end of the relevant period. The amended section also increases the period from 60 days to one year during which an ESBT may safely dispose of S corporation stock after an ineligible shareholder becomes a PCB. These amendments apply to taxable years beginning after December 31, 2004. The amendment overrides a current regulation and example, under which a broad power of appointment commonly included in many trusts would preclude those trusts from qualifying as ESBTs, because that power would cause the S corporation to have an excessive number of deemed shareholders or to have as deemed shareholders persons ineligible to hold S corporation stock. The proposed regulations remove and replace the sections of the regulation inconsistent with current law. The preamble to the proposed regulations states that the powers to add persons to the class of current beneficiaries or to select from an unlimited class of charitable beneficiaries will, regardless of the identity of the holder, not result in the termination of the S corporation election even if the class of charities that could currently receive distributions or the class of persons who could be added as beneficiaries is sufficiently large to cause the corporation to have more than the number of shareholders allowed by Section 1361(b)(1)(A). Generally, the regulations state that powers held by fiduciaries who are not also beneficiaries of the trust are not "powers of appointment." The proposed regulations also amend the definition of "potential current beneficiary" to provide that all members of a class of unnamed charities permitted to receive distributions under a discretionary distribution power held by a fiduciary that is not a power of appointment, will be considered, collectively, to be a single PCB for purposes of determining the number of permissible shareholders under Section 1361(b)(1)(A) unless the power is actually exercised, in which case each charity that actually receives distributions will also be a PCB. The ESBT election requirements under Treas. Regs. § 1.1361-1(m)(2)(ii)(A) would be amended to require a trust containing such a power to indicate the presence of the power in the election statement. This amended PCB definition applies only to powers to distribute to one or more members of a class of unnamed charities which is unlimited in number. The amended PCB definition would not apply to a power to make distributions to or among particular named charities. Furthermore, the power to add beneficiaries, whether or not charitable, to a class of current permissible beneficiaries is generally a power of appointment and thus will be disregarded to the extent it is not exercised. If the power is exercised and an unlimited class of charitable beneficiaries is added to the class of current permissible beneficiaries, however, that class will count as a single PCB under the amended definition of PCB, and, to the extent distributions are actually made to one or more charities, those charities will each count as PCBs.

$ **Suspended Losses**. The regulations explain the allowance of suspended losses to the spouse or former spouse of an S corporation shareholder. Section 235 of the 2004 Act amended Section 1366(d)(2) to provide that if the stock of an S corporation is transferred between spouses or incident to divorce under Section 1041(a), any loss or deduction with respect to the transferred stock which cannot be taken into account by the transferring shareholder in the year of the transfer because of the basis limitation in Section 1366(d)(1) shall be treated as incurred by the corporation in the succeeding taxable year with regard to the transferee. Before this amendment, any losses or deductions disallowed under Section 1366(d) were personal to the shareholder and did not transfer upon the transfer of the S corporation stock to another person. Section 1366(d)(2) is effective for transfers after December 31, 2004. The proposed regulations also amend Treas. Regs. §1.1366-2(a)(5) to include this exception to the general rule of nontransferability of losses and deductions. Losses and deductions carried over to the year of transfer that are not used by the transferor spouse in such year will be prorated between the transferor spouse and the transferee spouse based on their stock ownership at the beginning of the succeeding taxable year. The proposed regulations include examples illustrating these rules. The Treasury Department and IRS request comments on the best methods to ensure that losses are properly allocated between the transferor and transferee spouses, including whether a notification requirement should be imposed on the transferor spouse.

$ **At Risk Limitations**. The regulations detail the application of Sections 465 and 469 (at risk limitations) to beneficiaries of a qualified subchapter S trust (QSST). The 2004 Act amends Section 1361(d)(1) to provide that, for purposes of applying Sections 465 and 469 to the beneficiary of a qualified QSST with respect to which the beneficiary has made an election under Section 1361(d)(2), the disposition of S corporation stock by the QSST shall be treated as a disposition by the beneficiary. This creates an exception to the general rule that the trust, rather than the beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of a disposition of the stock. The proposed regulations add conforming language to the regulations.

$ **Conforming to S Corporation Rules.** The regulations conform the regulations (a) to the increase in the number of permissible S corporation shareholders from 75 to 100 (for taxable years beginning after December 31, 2004), (b) the treatment of spouses and their estates and all members of a family and their estates as a single shareholder for the 100 shareholder limitation (also for taxable years beginning after December 31, 2004), and (c) the elimination of the election to treat family members as a single shareholder (effective for taxable years beginning after December 31, 2004).

3 **IRS Explains Tax Consequences of 2006 or 2007 Charitable Gift by S Corporation. Rev. Rul. 2008-16, 2008-11 I.R.B. 585 (March 17, 2008)**

Individual A is the sole shareholder of S Corporation, X, which makes a 2007 charitable gift of unencumbered property in which the corporation has a basis of $100x. The property has a fair market value of $190x. A's adjusted basis in the X stock is $50x. In 2007, X has ordinary taxable income of $30x and a long-term capital loss of $25x.

The IRS explained that the Pension Protection Act of 2006, §1203(a), Pub. Law 109-280, 109th Cong., 2nd Sess., 120 Stat. 780 (2006), amended Section 1367(a)(2) to provide that the decrease in an S corporation shareholder basis by reason of a corporate charitable contribution of property is equal to the shareholder's *pro rata* share of the corporation's adjusted basis of the property. The Tax Technical Corrections Act of 2007, § 3(b), Pub. Law 172, 110th Cong., 1st Sess., 121 Stat. 2473 (2007), added Section 1366(d)(4), which does not apply the general loss limitation to the extent of the excess (if any) of (A) the shareholder's *pro rata* share of such contribution, over (B) the shareholder's *pro rata* share of the adjusted basis of such property. Thus, in this ruling, X's charitable contribution is treated as a separately stated item of deduction that passes through to A and is deductible in computing A's individual tax liability. A's $50x basis in the X stock is first increased by $30x to reflect A's share of X's taxable income. Treas. Regs. § 1.1367-1(f). A's basis in the X stock is then decreased (but not below zero) by A's *pro rata* share of the $100 adjusted basis of the contributed property ($100x). Int. Rev. Code § 1367(a)(2). A's basis is also reduced by A's pro rata share of X's long-term capital loss ($25x). Int. Rev. Code § 1367(a)(2)(B). A's pro rata share of the aggregate amount of losses and deductions ($100x + $25x) exceeds A's basis in the X stock of $80x ($50x + $30x). The basis limitation rule does not apply to A's *pro rata* share of the amount of deductible appreciation in the contributed property ($90x). The amount of the limitation allocable to a charitable contribution deduction is an amount that bears the same ratio to the Section 1366(d) limitation as the shareholder's *pro rata* share of the contributed property's adjusted basis bears to the total of the shareholder's *pro rata* share of the corporation's losses and deductions (excluding the charitable contribution deduction attributable to the shareholder's *pro rata* share of the fair market value of the contributed property over the contributed property's tax basis). Treas. Regs. § 1.1366-2(a)(4). Accordingly, the amount of the limitation allocable to A's share of X's charitable contribution deduction is determined by multiplying A's basis in the X stock ($80x) by a fraction, the numerator of which is $100x (the contributed property's adjusted basis) and the denominator of which is $125x (the total of the capital loss and the contributed property's adjusted basis). $64x is allocated to the charitable contribution deduction. The remaining $16x is allocated to the capital loss. Accordingly, in 2007, the amount of the charitable contribution deduction that A may claim is $154x. This amount is comprised of A's *pro rata* share of the property's appreciation ($90x) plus the amount of the loss limitation allocated to A's *pro rata* share of the contributed property's adjusted basis ($64x). A's basis in the X stock is reduced to 0 to reflect the $16x reduction in basis attributable to the capital loss and the $64x reduction in basis attributable to the charitable contribution deduction. Treas. Regs. § 1367(a)(2)(B). The disallowed portion of the charitable contribution deduction ($36x) and the capital loss ($9x) shall be treated as incurred by X in the succeeding taxable year with respect to A. Int. Rev. Code § 1367(a)(2)(B).

4 Trust Cannot Deduct Net Operating Loss Carryover from S Portion of ESBT. CCM 200734019 (Aug. 24, 2007)

A residuary testamentary trust held assets that included S corporation stock, and it succeeded to a net operating loss that the testator's estate could not use at its termination. Int. Rev. Code § 642(h)(1). The trustee elected ESBT status during the two years following the testator's death.

The IRS discussed the bifurcated nature of ESBT taxation, in which the S corporation portion of the trust is taxed on those items of income, loss, deduction, or credit required to be taken into account by the trust under Section 1366, any gain or loss from the disposition of the S corporation shares, and any State or local income taxes or administration expenses allocable to the aforementioned items of income. The non-S corporation portion of the trust is taxed on the other items. Treas. Regs. § 1.641(c)-1(a). The IRS stated that Section 641(c)(2)(C) provides a complete list of the items of income, loss, deduction, or credit allocable to the S corporation portion of the ESBT, and that the NOL carryover cannot be used by that portion of the trust.

L Income Tax Procedures

Mortgage Forgiveness Debt Relief Act Limits Disclosure of Tax Return Information to Trust and Estate Beneficiaries. Pub. L. 110-142, § 8(c), 110th Cong., 1st Sess. (Dec. 29, 2007)

The Mortgage Forgiveness Debt Relief Act of 2007 reduces the ability of trust and estate beneficiaries to obtain copies of tax returns filed by the entity. Section 6103(e) already states that a fiduciary, heir at law, next of kin, or beneficiary under a will can obtain information from a tax return filed by a decedent's estate, upon showing that the individual has a material interest that will be affected by the return information, and the trustee or trustees and any beneficiary of a trust can obtain information from a trust tax return upon a similar showing. Under the new rules, a beneficiary who is otherwise entitled to examine the tax return of a trust or estate cannot obtain any supporting schedule, attachment or list that includes the taxpayer identity information of a person other than the trust or estate or the beneficiary seeking such disclosure.

VI SELECTED ATTACHMENTS

PLEASE NOTE

THESE ARE NOT THE ACTUAL DOCUMENTS ON WHICH THE IRS OR COURT OPINED. THEY ARE AN INTERPRETATION BY THE AUTHOR OF THE RULINGS OR CASES CITED, OR OF TECHNIQUES THAT MAY ADDRESS PROBLEMS RAISED BY THESE CASES OR RULINGS.

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USE YOUR INDEPENDENT JUDGMENT -- NEITHER THE AUTHOR NOR THE CONFERENCE SPONSOR CAN TAKE ANY RESPONSIBILITY WHATSOEVER FOR THE INDIVIDUAL USE OF THESE SAMPLE DOCUMENTS.

A Family Limited Partnership Agreement and Certificate Two Class General Partnership Interests (Managing and Administrative) to Avoid Issuess Under Section 2036(a)(2) -- Corporate Managing General Partner Limits Lapse of Liquidation Rights under Section 2704 – Formed Under the (2001) Revised Uniform Limited Partnership Act – Requires Substantial Non-tax Business Purpose to Avoid Section 2036(a)(1)[1]

Limited Partnership Agreement

On [*date*], *ManagingGeneralPartner*, of [*locality, state*] (the managing general partner, defined below), *AdministrativeGeneralPartner*, of [*locality, state*] (the administrative general partner, defined below), *LimitedPartner1*, of [*locality, state*], and *LimitedPartner2*, of [*locality, state*] (together the limited partners and individually a limited partner, defined below), agreed to form this limited partnership (the partnership, defined below).

RECITALS

A. The partners (defined below) desire to enter into this partnership agreement (the agreement, defined below) to establish a limited partnership to own certain property and transact certain business;

B. The partners desire to share in the risks, benefits, profits and losses of the partnership's activities;

C. The partners desire that *ManagingGeneralPartner* be the sole managing general partner, that *AdministrativeGeneralPartner* be the sole administrative general partner, and that all the other partners be limited partners.

AGREEMENTS

Section 1. Name

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[1] **KEY:**

ManagingGeneralPartner	-	Full name of the managing general partner
AdministrativeGeneralPartner	-	Full name of the administrative general partner
LimitedPartner1	-	Full name of the first limited partner
LimitedPartner2	-	Full name of the second limited partner
Name	-	Full name of the partnership
Agent	-	Full name of the registered agent
State	-	State in which the partnership is formed

The partnership's name is *Name*.

Section 2. Place of Business and Agent

2.1 Place of Business. The partnership's principal place of business is at [full street address], but the administrative general partner may change the partnership's principal place of business to another location and add additional places of business.

2.2 Agent. The partnership's agent for service of process shall be *Agent*, of [address]. All records that the partnership is required to keep at a specified office shall be kept at its principal place of business.

Section 3. Business

The partnership is formed to own and manage certain real and personal property as the administrative general partner may buy for the partnership, and to conduct any other legal business.

Section 4. Term

4.1 Initial Term. The partnership begins on the date of the agreement and ends on December 31, 2050, unless terminated earlier.

4.2 Extension. The partnership may be continued beyond its scheduled termination date by an affirmative vote of all of the then remaining partners.

Section 5. Capital and Partnership Interests

5.1 Partnership Interests. Each partner's partnership interest (defined below) and each partner's percentage of the total partnership capital accounts (defined below) shall be set forth in a schedule to the agreement. A partner's percentage of partnership interest shall always be the same as his, her or its percentage of the total partnership capital accounts, and a change in a partner's percentage of the total partnership capital accounts shall automatically be reflected in the partner's percentage of partnership interest.

5.2 Additions. A partner shall not be compelled to make any additional capital contributions.

5.3 Adjustments. Each partner's capital account shall be adjusted as necessary to reflect the economic conditions of the partners and their partnership interests. These adjustments shall include, but are not limited to, the following:

5.3.1 Distributive Share. Adjustments to reflect each partner's distributive share of partnership profits and losses, including capital gains and losses, and tax-exempt income;

5.3.2 Additional Contributions. Adjustments to reflect each partner's additional contributions to the partnership;

5.3.3 Distributions. Adjustments to reflect distributions made by the partnership to each partner;

5.3.4 Tax-Sensitive Adjustments. Tax-sensitive adjustments (defined below).

5.4 Loans. A partner's loans to the partnership shall not be added to that partner's capital account.

5.5 Amount of Contributions. The amount of a partner's contributions of property to the partnership and of the partnership's distributions of property to a partner shall be reflected in the partner's capital account at the fair market value of the property on the date of the contribution or distribution, reduced by any liabilities secured by that property, if those liabilities are treated under applicable federal income tax laws as being assumed by or taken subject to by the transferee.

5.6 No Interest Paid. A partner shall receive no interest on his, her or its capital contributions or partnership interest.

5.7 Withdrawals. A partner may not withdraw any of his, her or its capital account, without the express written consent of the managing general partner.

Section 6. Profits, Losses and Cash Flow

6.1 Profits and Losses. The partnership's net profits and losses (and each item of income, deduction, gain, loss, and credit that makes up net profits and losses) shall be computed in accordance with generally accepted accounting principles, consistently applied, and shall be allocated among the partners in proportion to their respective capital accounts.

6.1.1 Gain, etc. On Contributed Property. Notwithstanding the general rule stated in Section 6.1, any income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of any variation between the basis and the fair market value of the contributed property at the time of the contribution, in accordance with any applicable U.S. Treasury regulations.

6.1.2 Income Offset. There shall be an income offset (defined below), under which net losses that would otherwise be allocated to a limited partner and that would cause the limited partner's capital account to be in deficit shall instead be allocated to the general partners. After such an allocation of net losses, net profits shall be allocated to the general partners, until the general partners shall have received an allocation of net profits equal to the aggregate allocation of net losses allocated under this paragraph.

6.1.3 Disassociated Partners. Profits and losses shall, whenever a partner is dissociated (defined below) from the partnership, be allocated among the partners based on the number of days (defined below) in that year during which each partner owned a partnership interest, or on any other reasonable basis selected by the managing general partner, consistent with applicable U.S. tax laws and regulations.

6.2 Cash Flow. The managing general partner shall cause the partnership to distribute its net cash flow (defined below) to the partners annually, in proportion to their partnership capital accounts.

Section 7. Management

7.1 AdministrativeGeneral Partner. The administrativegeneral partner shall have the full and exclusive power, on the partnership's behalf, to manage its business and affairs and to do or cause to be done anything deemed necessary or appropriate for the partnership's business, apart from determining the amount and timing of distributions of partnership income and capital or otherwise doing anything that would constitute control over the beneficial enjoyment by the other partners of their interests in the partnership and its assets. This authority includes, but is not limited to, the following:

7.1.1 Selling Assets. The administrative general partner may sell real or personal property to any person, giving any warranties or assurances deemed appropriate;

7.1.2 Acquiring Assets. The administrativegeneral partner may buy, lease or otherwise acquire real or personal property to carry on and conduct the partnership's business;

7.1.3 Borrowing. The administrative general partner may borrow money for the partnership's business;

7.1.4 Lending. The administrative general partner may issue promissory notes and other debt instruments (negotiable or nonnegotiable), in any amounts and secured by any encumbrance on all or any part of the partnership's assets;

7.1.5 Assigning Debts. The administrative general partner may assign any debts owing to the partnership;

7.1.6 Financing. The administrative general partner may engage in any other means of financing;

7.1.7 Profit-Sharing Agreements. The administrative general partner may enter into any agreement for sharing of profits and any joint venture agreement with any person or entity engaging in any business or venture in which this partnership may engage;

7.1.8 Operating and Improving Assets, Etc. The administrative general partner may manage, administer, conserve, improve, develop, operate, lease, utilize and defend the partnership's assets, directly or through third parties;

7.1.9 Executing Agreements. The administrative general partner may execute any type of agreement or instrument in connection with any other partnership power;

7.1.10 Employing Agents. The administrative general partner may employ all types of agents and employees (including lawyers and accountants), even if they are related by blood, marriage, or business relationship to the administrative general partner, and pay them reasonable compensation;

7.1.11 Acquiring Equipment. The administrative general partner may buy or otherwise obtain the use of any type of equipment or other property that may be convenient or advisable in connection with any partnership business;

7.1.12 Incurring Certain Expenses. The administrative general partner may incur any reasonable expense for travel, telephone, telegraph, insurance, taxes and such other things, in carrying on the partnership's business;

7.1.13 Litigating. The administrative general partner may sue and be sued, complain and defend in the partnership's name and on its behalf; and

7.1.14 Surrendering Assets. The administrative general partner may quitclaim, release or abandon any partnership assets with or without consideration.

7.2 Managing General Partner. The managing general partner shall have the full and exclusive power to determine the amount and timing of all distributions of partnership income and capital, to participate as a general partner in any decision to terminate the partnership or cause its assets to be distributed, and to do all other things specifically provided in the agreement.

7.3 Multiple Managing General Partners or Administrative General Partners. Multiple managing general partners shall act by unanimous agreement. Multiple administrative general partners shall also act by unanimous agreement.

7.4 Compensation and Expenses. Each general partner shall receive reasonable compensation for services provided to the partnership, and all reasonable expenses incurred by the a general partner in conducting the partnership's business, including (but not limited to) overhead, administrative and travel expenses, and such professional, technical, and other services, shall be reimbursed by the partnership.

7.5 Limited Partners. A limited partner (other than one who is also a general partner) shall take no part in the management of the partnership, except to the extent expressly provided by applicable state law.

7.6 Tax Matters Partner. The administrative general partner shall be the tax matters partner and, as such, shall be solely responsible for representing the partnership in all dealings with the U.S. Internal Revenue Service and any state, local, and foreign tax authorities. The tax matters partner shall keep the other partners reasonably informed of any partnership dealings with any tax agency.

Section 8. Financial Statements

Within a reasonable period after the close of each fiscal year, the administrative general partner shall, at the partnership's expense, give a written report to each partner who requests it, indicating that partner's share of the partnership income or loss and any changes in that partner's capital account. This requirement may be satisfied by giving each partner a copy of any tax form that includes such information.

Section 9. Banking

All partnership funds shall be deposited in the partnership's name in such accounts as the administrative general partner may designate. The administrative general partner may authorize other persons to draw checks on partnership bank accounts, but such authority must be in writing. Each bank in which a partnership account is maintained is relieved of any responsibility to inquire into a partner's authority to deal with such funds, and is absolved of all liability with respect to withdrawals from such partnership accounts by any person duly authorized by the administrative general partner.

Section 10. Admission, Expulsion and Transferees

10.1 Admission. Except as provided elsewhere in this paragraph 10.1, a person may be admitted as a partner only upon the unanimous vote of the other partners, and only after agreeing in writing to assume all of the obligations and undertakings of the offering partner under the agreement, and paying the partnership a fee (not to exceed one thousand dollars ($1,000)), covering the costs of preparing, executing, and recording all pertinent documents. A person to whom an interest an interest in this partnership is transferred shall become a partner without the unanimous vote of the other partners, if such person is: (a) the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; (b) a trust for the sole lifetime benefit of the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; or (c) a charity (defined below); provided, however, that such person shall be admitted as a partner only after agreeing in writing to assume all of the obligations and undertakings of the offering partner under the agreement, and paying the partnership a fee (not to exceed one thousand dollars ($1,000)), covering the costs of preparing, executing, and recording all pertinent documents.

10.2 Expulsion. Any partner may be expelled from the partnership on the unanimous decision of the other partners, excluding the administrative general partner. The partnership must pay an expelled partner an amount equal to the fair market value of his, her or its partnership interest. The fair market value of an expelled partner's partnership interest shall be determined by an independent appraisal performed by a professional appraiser selected by the partnership, whose decision in this matter shall be conclusive.

10.3 Transferable Interest. Generally, a partner's only transferable interest in the partnership is his, her or its share of the profits and losses of the partnership and his, her, or its right to receive distributions; provided, however, that a partner's transferable interest shall be his or her full partnership interest with respect to a transfer to: (a) the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; (b) a trust for the sole lifetime benefit of the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; or (c) a charity (defined below).

10.3.1 Transfer Does Not Disassociate. A partner's transfer (defined below) of his, her or its transferable interest in the partnership shall not, by itself, cause the partner's dissociation or the dissolution of the partnership.

10.3.2 Assignee Not Automatically a Partner. A person to whom a partner attempts to transfer his, her or its partnership interest, and to whom a partner does transfer his, her or its transferable interest in the partnership, shall not become a partner unless admitted into the partnership pursuant to Section 10.1. A transferee of a partner's transferable interest in the partnership shall not be entitled to participate in the management or conduct of the partnership business, to require access to information concerning partnership transactions, or to inspect or copy the partnership books or records, unless admitted into the partnership pursuant to Section 10.1.

Section 11. Right of First Refusal

A partner shall not transfer any of his, her or its transferable interest in the partnership except in accordance with the terms of this Section 11. An attempted transfer of any transferable interest in the partnership not in accordance with the terms of this Section 11 shall not be valid and shall not be reflected on the partnership's books.

11.1 Right of First Refusal. A partner who wishes to transfer any transferable interest in the partnership, or who has reason to believe that an involuntary transfer (defined below) or a transfer by operation of law is reasonably foreseeable (an offering partner), shall first give each other partner written notice of the intent to transfer such transferable interest in the partnership (the offered interest) or of the knowledge that an involuntary transfer or transfer by operation of law is reasonably foreseeable. This notice must contain a description of the portion of interest in the partnership to be transferred, the consideration (if any) to be paid, the terms of transfer and of the payment of consideration (including, but not limited to, the relative percentages of cash and debt, and the terms of any debt instruments), and the name, address (both home and office), and business or occupation of the person to whom the transferable interest in the partnership would be transferred, and any other facts that are or would reasonably be deemed material to the proposed transfer.

11.1.1 Cross-Purchase Right. Upon the receipt of such notice, each other partner shall have a right to buy that share of the offered interest having the same proportion to all of the offering partner's partnership interest as the buying partner's partnership interest bears to the partnership interests of all partners (except the offering partner).

11.1.2 Written Notice. Each partner may exercise this purchase option by giving the offering partner written notice within thirty (30) days after receipt of the latter's notice.

11.1.3 Completing Transfer. If the partners do not agree to buy all of the offered interest, the offering partner may complete the intended transfer. If this transfer is not completed within thirty (30) days after expiration of the option period, any attempted transfer shall be deemed pursuant to a new offer and this Section 11 shall again apply.

11.2 Purchase Price. The purchase price that the partners must pay for the offered interest under this Section 11 shall be the same as those of any proposed transfer if the proposed transfer for which notice was given is to be made for any valuable consideration in money or money's worth of property. Otherwise, the purchase price that the partners must pay for the offered interest under this Section 11 shall be the fair market value of the offered interest. The fair market value of a partnership interest shall be determined by an independent appraisal performed by a professional appraiser, selected by the managing general partner, whose decision in this matter shall be conclusive.

11.3 Purchase Terms. One quarter (1/4) of the purchase price shall be paid in cash or by good personal check at the closing for the sale of such partnership interest, and the balance shall be paid in twenty (20) equal quarterly principal payments beginning three (3) months after the date of such closing. Simple interest shall be added to each installment, computed against the outstanding principal balance at the applicable federal rate determined for federal income tax purposes on the date of the closing. The buyer shall give the offering partner a promissory note as evidence of this debt, and the buyer may prepay all or any part of the principal balance of the note at any time without penalty or premium.

11.4 The Closing. The purchase of a transferable interest in the partnership under this Section 11 shall take place at a closing to be held not later than the tenth (10th) day after the earlier of the date on which the partners' purchase options have all expired, or the earliest date on which the partners in the aggregate exercise their purchase options, if any, to buy all of the offered interest. The closing shall be held during normal business hours at the partnership's principal business office, or at any other place to which the parties agree. If the offering partner is not present at the closing, then the buyer shall deposit the purchase price by check, note, or both, as this Section 11 requires, with any state or federally chartered bank with which the partnership has an account, as escrow agent, to be paid to the offering partner as soon as is reasonably practicable, less an appropriate fee to the partnership (not to exceed one thousand dollars ($1,000)) to cover additional administrative costs, and the partnership shall adjust its books to reflect the transfer of these transferable interest in the partnership.

11.5 Admission. A transferee under this Section 11 must also comply with the requirements of Section 10.1, in order to become a partner.

Section 12. Dissociation

12.1 Dissociation as Limited Partner. A limited partner who dissociates from the partnership shall have no further rights as a limited partner, and shall own his, her or its interest as a transferee, and not as a partner.

12.2 Dissociation Events. A general or limited partner shall be dissociated from the partnership if any of the following events shall occur.

12.2.1 Withdrawing. The partner notifies the partnership of his, her or its intention to withdraw as a partner.

12.2.2 Expelling. The partner is expelled from the partnership.

12.2.3 Ending a Trust. The partner, if a trust or if acting as a partner by virtue of being a trustee of a trust, distributes the trust's entire transferable interest in the partnership.

12.2.4 Ending an Estate. The partner, if an estate or if acting as a partner by virtue of being a personal representative of an estate, distributes the estate's entire transferable interest in the partnership.

12.2.5 Ending Certain Other Partners. The partner's termination, if the partner is not an individual, partnership, corporation, trust or estate.

12.3 Dissociation by a General Partner. A general partner may dissociate as a general partner at any time, rightfully or wrongfully.

12.3.1 Not Participating in Management. A general partner who dissociates from the partnership shall have no right to participate as a general partner in the management and conduct of the partnership's activities and shall own his, her or its interest as a transferee, and not as a partner.

12.3.2 Other General Partner Disassociation. In addition to the provisions of Section 12.2, a general partner also dissociates from the partnership if:

(A) Death or Incompetency. The last then-serving general partner dies without leaving his or her general partnership interest to: (a) the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; (b) a trust for the sole lifetime benefit of the spouse of the transferor whose transfer was not made incident to a divorce or legal separation; or (c) a charity.

(B) Bankruptcy. The partner becomes a debtor in bankruptcy, executes an assignment for the benefit of creditors, seeks, consents to or acquiesces in the appointment of a trustee, receiver or liquidator of that partner or of all or substantially all of that partner's property.

(C) Receivership, Etc. The partner fails, within ninety (90) days after the appointment, to have vacated or stayed the appointment of a trustee, receiver or liquidator of the partner or of all or substantially all of the partner's property obtained without the partner's consent or acquiescence, or fails within ninety (90) days after the expiration of a stay to have the appointment vacated.

12.3 Wrongful Dissociation.

12.3.1 Wrongful Disassociation of Limited Partner. A limited partner's dissociation from the partnership before December 31, 2050, or such earlier date as the partnership shall otherwise terminate, shall be a wrongful dissociation.

12.3.2 Wrongful Disassociation of General Partner. A general partner's dissociation is wrongful if it occurs before December 31, 2050, or such earlier date as the partners shall elect to terminate the partnership and the general partner dissociates by voluntary withdrawal, by expulsion by judicial order, or pursuant to Section 12.3.2, Section 12.3.3, or Section 12.2.5.

12.3.2 Liability of Wrongfully Disassociating Partner. A partner who wrongfully dissociates is liable to the partnership and to the other partners for damages caused by the dissociation. The liability is in addition to any other obligation of the partner to the partnership or to the other partners.

Section 13. Dissolution

13.1 Dissolution. The partnership shall be dissolved upon the expiration of its stated term, the written vote of all of the partners (other than the administrative general partner), or the happening of any of the following:

13.1.1 Dissolution by Consent. The written consent of the managing general partner and of limited partners owning a majority of the rights to receive distributions as limited partners;

13.1.2 Disassociation of Managing General Partner. After the dissociation of a managing general partner, except that if the partnership then has no remaining managing general partners, the partnership shall be dissolved unless, within ninety (90) days after the dissociation, the limited partners holding a majority of the rights to receive distributions at the time the consent is to be effective vote to continue the partnership and to elect a new managing general partner, and a new managing general partner is, in fact, admitted;

13.1.3 Disassociation of Last Limited Partner. Ninety (90) days after the dissociation of the limited partnership's last limited partner, unless before the end of this period the partnership admits at least one limited partner; or

13.1.3 Declaration of Dissolution. The Secretary of State signs a declaration of dissolution.

13.2 Upon Dissolution. Upon its dissolution, the partnership shall end and commence to wind up its affairs. The partners shall continue to share in profits and losses during liquidation as they did before dissolution. The partnership's assets may be sold, if a price deemed reasonable by the managing general partner can be obtained. The proceeds from liquidation of partnership assets shall be applied as follows:

13.2.1 Third-Party Debts and Liabilities. First, all of the partnership's debts and liabilities to persons other than partners shall be paid and discharged in the order of priority as provided by law;

13.2.2 Partners' Debts and Liabilities. Second, all debts and liabilities to partners shall be paid and discharged in the order of priority as provided by law;

13.2.3 Remaining Assets. Third, all remaining assets shall be distributed proportionately among the partners based on their respective positive capital accounts.

13.3 Gain or Loss. Any gain or loss on the disposition of partnership properties in the process of liquidation shall be credited or charged to the partners in proportion to their positive capital accounts, except that gain or loss with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of any variation between the basis of the property so contributed and its fair market value at the time of contribution, in accordance with any applicable U.S. Treasury regulations. Any property distributed in kind in the liquidation shall be valued and treated as though it was sold and the cash proceeds distributed. The difference between the value of property distributed in kind and its book value shall be treated as a gain or loss on the sale of property, and shall be credited or charged to the partners accordingly.

13.4 Partnership Assets Sole Source. The partners shall look solely to the partnership's assets for the payment of any debts or liabilities owed by the partnership to the partners and for the return of their capital contributions and liquidation amounts. If the partnership property remaining after the payment or discharge of all of its debts and liabilities to persons other than partners is insufficient to return the partners' capital contributions, they shall have no recourse therefore against the partnership or any other partners, except to the extent that such other partners may have outstanding debts or obligations owing to the partnership.

Section 14. Amendments

The agreement shall be amended automatically to reflect any valid transfers of partnership interests. Otherwise, the agreement shall be amended only with the unanimous consent of the partners, except that the administrative general partner shall be excluded from any vote to amend the partnership agreement in a manner that would alter the beneficial enjoyment of the partnership assets.

Section 15. Power of Attorney

15.1 General. Each limited partner names the administrative general partner as the limited partner's attorney-in-fact, and gives the administrative general partner the full power and authority, in the place of the limited partner, to file and record any written instruments that are necessary or appropriate to (a) amend the certificate of partnership; (b) satisfy requirements of the laws of any state in which the partnership is doing business; (c) continue the partnership, admit additional or substituted partners, dissolve or terminate the partnership or any interest in it; (d) obtain or settle any loan; and (e) transfer any partnership assets.

15.2 Power With an Interest. The power of attorney granted under this Section 15 is coupled with an interest, is irrevocable and survives the limited partner's incompetency. The administrative general partner may exercise this power of attorney by a facsimile signature or by listing all of the limited partners with the signature of the administrative general partner as the attorney-in-fact for all of them. This power of attorney survives the assignment of a limited partner's interest, and empowers each administrative general partner to act to the same extent for any successor limited partner.

Section 16. Miscellaneous

16.1 Notices. Any notice under the agreement shall be given and served either by personal delivery to the party to whom it is directed, or by registered or certified mail, postage and charges prepaid, and if it is sent to a partner, it shall be addressed with his, her, or its address as it appears on the records of the partnership.

16.1.1 How Delivered. Any notice shall be deemed given when it is personally delivered, or, if mailed, on the date it is postmarked by the U.S. Postal Service, if it was addressed as required in this Section 16.

16.1.2 Change of Address. Any partner may change his, her or its address for purposes of the agreement by written notice to an administrative general partner, stating his, her or its new address. A change of address shall be effective fifteen (15) days after the notice is received by an administrative general partner.

16.2 Non-waiver. Any party's failure to seek redress for violation of or to insist upon the strict performance of any provision of the agreement shall not prevent a subsequent act, which would have originally constituted a violation, from having the effect of an original violation.

16.3 Severability. Every provision of the agreement is intended to be severable. If any term or provision hereof is invalid for any reason whatsoever, its invalidity shall not affect the validity of the remainder of the agreement.

16.4 Good Faith. The performance of any act, or the failure to perform any act, by a partner or the partnership, the effect of which causes any loss or damage to the partnership, shall not subject such partner or the partnership to any liability, if the decision to perform or not to perform the act was made pursuant to advice of the partnership's legal counsel or in good faith to promote the partnership's best interests.

16.5 Governing Law. The agreement is to be construed according to the laws of the state of *State*. The administrative general partner may not participate in any decision to change the law according to which the agreement is to be construed.

16.6 Cumulative Rights. The rights and remedies provided in the agreement are cumulative and the use of any right or remedy does not limit a party's right to use any or all other remedies. All rights and remedies in the agreement are in addition to any other legal rights the parties may have.

16.7 Other Activities. A partner may engage in whatever activities he or she chooses without any obligation to offer any interest in such activities to any party hereof.

16.8 Confidentiality. No partner may, without the administrative general partner's express written consent, divulge to others any information not already known to the public pertinent to the services, clients, customers, or operations of the partnership, whether before or after the partnership's dissolution.

16.9 Counterparts. The agreement may be executed in any number of counterparts with the same effect as if all parties hereto had all signed the same document. All counterparts shall be construed together and shall constitute one (1) agreement.

16.10 Waiver of Partition. Each partner waives any right to maintain any action for partition with respect to the partnership's property or assets during the partnership's term.

16.11 Binding Terms. The terms of the agreement are binding upon and inure to the benefit of the parties and, to the extent permitted by the agreement, their heirs, executors, administrators, legal representatives, successors and assigns.

16.12 Personal Property. The interests of each partner in the partnership are personal property.

16.13 Gender and Number. Unless the context requires otherwise, the use of a masculine pronoun includes the feminine and the neuter, and vice versa, and the use of the singular includes the plural, and vice versa.

Section 17. Definitions

17.1 Administrative General Partner. "Administrative general partner" means *AdministrativeGeneralPartner* and any additional or successor administrative general partner.

17.2 Agreement. "Agreement" means the agreement of *Name*, as amended from time to time, including all schedules, as they may be amended from time to time.

17.3 Capital Accounts. "Capital accounts" or "partnership capital" means the total of the partners' capital contributions, adjusted as provided in the agreement.

17.4 Certificate. "Certificate" means the certificate of limited partnership filed on behalf of the partnership, as amended from time to time.

17.5 Charity. "Charity" means an organization contributions to which are deductible for Federal income, estate and gift tax purposes.

17.6 Days. "Day" or "days" means a calendar day, including any days that fall on legal holidays or weekends.

17.7 General Partner. "General partner" means both the administrative general partner and the managing general partner.

17.8 Income Offset. "Income offset" is synonymous with and interpreted consistently with the "qualified income offset" defined in U.S. Treasury Regulations Section 1.704-1(b)(2)(ii)(d), as amended.

17.9 Limited Partner. "Limited partners" means *LimitedPartner1*, *LimitedPartner2*, and any persons who later become limited partners, each of whom is a limited partner.

17.10 Managing General Partner. "Managing general partner" means *ManagingGeneralPartner*, and any additional or successor managing general partner.

17.11 Net Cash Flow. "Net cash flow" means the partnership's total net income, computed for federal income tax purposes, increased by any depreciation or depletion deductions taken into account in computing taxable income and any nontaxable income or receipts (other than capital contributions and the proceeds of any partnership borrowing); and reduced by any principal payments on any partnership debts, expenditures to acquire or improve partnership assets, any proceeds from the sale or exchange of partnership assets, and such reasonable reserves and additions thereto as the managing general partner shall determine to be advisable and in the best interests of the partnership, having due regard to the interests of the limited partners.

17.12 Partners. "Partners" or a "partner," when used without the words "general" or "limited," means both the general partners and the limited partners.

17.13 Partnership. "Partnership" means *Name*.

17.14 Partnership Capital. "Partnership capital" means the total of the partners' capital contributions, as adjusted pursuant to the agreement.

17.15 Partnership Interests. "Partnership interests" means the interests of the partners in the partnership, as listed on a schedule to the agreement.

17.16 Tax-Sensitive Adjustments. "Tax-sensitive adjustments" means all adjustments to a partner's capital account that are not specifically required under the terms of the agreement, but that are required by U.S. Treasury Regulations Section 1.704-1(b)(2)(iv) ("Maintenance of Capital Accounts"), as amended. Such adjustments shall be made annually, unless these regulations require a more frequent adjustment.

17.17 Transfer. "Transfer" of a partnership interest means any sale, pledge, encumbrance, gift, bequest, or other transfer or disposition of the partnership interest or permitting it to be sold, encumbered, attached, or otherwise disposed of, or changing its ownership in any manner, whether voluntarily, involuntarily, or by operation of law. “Transfer” shall not include any assignment of any partnership interest to another partner or to any trust that is entirely revocable by the assignor, but such trust shall be treated as the agent of the assignor, and any subsequent disposition of such partnership interest by such trust shall be deemed to have been made by the trust’s settlor or grantor.

AGREED on the date first noted above.

[*Signatures, notarial clauses and schedule*]

Certificate of Limited Partnership

THIS CERTIFICATE is executed on [date], with respect to the agreement of *Name* (the “partnership”).

1. Name. The partnership’s name is *Name*.

2. Initial Designated Office. The street and mailing address of the initial designated office is [address].

3. Registered Agent. The name and street and mailing address of the partnership’s initial agent for service of process is *GeneralPartner*, [address].

4. General Partners. There are two (2) general partners. The name and street and mailing address of the general partners is: *ManagingGeneralPartner*, [address] and *AdministrativeGeneralPartner*, [address].

5. Date for Dissolution. The latest date on which the limited partnership is to be dissolved and its affairs wound up is December 31, 2050.

IN WITNESS WHEREOF, the undersigned general partners have signed and sealed this certificate, on the day and year first above written.

[Signatures and notarial clauses]

B Charitable Lead Annuity Trust—Annuity Amount Sufficient to Yield 50 Percent Deduction—Remainder Fixed in Children or Their Estates (Avoiding GST Tax)—Trust Is a Grantor Trust – Form Based on Rev. Proc. 2007-45, 2007-29 IRB 102 (July 16, 2007) [2]

Grantor Charitable Lead Annuity Trust

On [date], I, *Grantor* (hereinafter "the donor"), desiring to establish a charitable lead annuity trust within the meaning of Rev. Proc. 2007-45, hereby enter into this trust agreement with *FirstTrustee* as the initial trustee (hereinafter "the trustee"). This trust shall be known as the *Grantor* Grantor Charitable Lead Annuity Trust. All references to "section" or "§" in this instrument shall refer to the Internal Revenue Code of 1986, 26 U.S.C. § 1, et seq.

Article 1. Funding of Trust

The donor hereby transfers and irrevocably assigns to the trustee on the above date the property described in Schedule A, and the trustee accepts the property and agrees to hold, manage and distribute the property under the terms set forth in this trust instrument.

Article 2. Payment of the Annuity Amount

A. Annuity Amount Defined. In each taxable year of the trust during the annuity period, the trustee shall pay to *Charity* an annuity amount equal to that percentage of the initial fair market value of the assets of the trust as shall produce a charitable annuity interest equal in value to fifty percent (50%) of the initial value of the entire trust fund, valued as of the date of the transfer.

B. If *Charity* Not Qualified. If *Charity* is not an organization described in §§ 170(c), 2055(a), and 2522(a) at the time any payment is to be made to it, the trustee shall instead distribute such payments to one or more organizations described in §§ 170(c), 2055(a), and 2522(a) as the trustee shall select, and in such proportions as the trustee shall decide, from time to time, in the

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[2]**KEY:**

Grantor	--	Full name of the grantor
FirstTrustee	--	Full name of the initial trustee
duration	--	Number of years of trust duration
Charity	--	Full name of the primary charitable beneficiary
SecondTrustee	--	Full name of the alternate trustee
First671Person	--	Related person who holds grantor trust power
Second671Person	--	Alternate related person who holds grantor trust power

trustee's sole discretion. The term "the charitable organization" shall be used herein to refer collectively to the organization(s) then constituting the charitable recipient, whether named in this paragraph or subsequently selected as the substitute charitable recipient.

C. Annuity Period. The annuity period is a term of *duration* years.

Article 3. Distribution upon Termination of Annuity Period.

At the termination of the annuity period, the trustee shall distribute all of the then principal and income of the trust (other than any amount due to the charitable organization under the provisions above) in equal shares, with one (1) share for each of my then-living children and one (1) share for the estate of each of my children who are not then living.

Article 4. Trustees

A. Named Trustees. *FirstTrustee* is the initial trustee of this trust. No trustee named in this instrument or by the trustee shall be required to provide surety or other security on a bond.

B. Successor Trustees. *SecondTrustee*, of [locality, state], shall be the successor trustee, to serve if *FirstTrustee* is unable or unwilling to serve or to continue serving.

C. Bond. No trustee named in this instrument or by another trustee shall be required to provide surety or other security on a bond.

D. Additional Trustee. The trustee may appoint any person as an additional trustee, to serve at the pleasure of the appointing trustee.

E. Delegation. The trustee may delegate to another trustee any power or authority granted by me to the trustee, to continue at the pleasure of the delegating trustee, unless otherwise agreed. Any person dealing in good faith with a trustee may rely on that trustee's representation that a delegation has been made and remains in effect under this paragraph.

F. Resignation.

1. A trustee may resign by giving written notice specifying the effective date of the resignation to the designated successor.

2. If no successor is designated, the resigning trustee shall give notice to *Charity*, if during the lead term, or otherwise to my then-living adult children.

G. Vacancies. A corporation no substantial portion of the stock of which is owned by me, may be named as successor trustee to fill any vacancy, by the affirmative vote of *Charity*, if during the lead term, or otherwise by the majority vote of my then-living adult children.

H. Responsibility of Successors. No trustee shall be responsible for or need inquire into any acts or omissions of a prior trustee.

I. Compensation. In addition to reimbursement for expenses, each individual trustee is entitled to reasonable compensation for services. Each corporate trustee is entitled to compensation based on its written fee schedule in effect at the time its services are rendered or as otherwise agreed, and its compensation may vary from time to time based on that schedule.

J. Management Powers. The trustee may exercise the powers described below, in a fiduciary capacity. Except as provided expressly in Article 6, paragraph I, nothing in this trust instrument shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Otherwise, the trustee shall have the following powers.

1. The trustee shall invest and reinvest the trust assets (or leave them temporarily uninvested) in any type of property and every kind of investment (including, but not limited to, insurance contracts, including commercial annuity contracts), in the same manner as a prudent investor would invest his or her own assets.

2. The trustee may sell or exchange any real or personal property contained in the trust, for cash or credit, at public or private sale, and with such warranties or indemnifications as the trustee may deem advisable.

3. The trustee may borrow money (even from the trustee and from any beneficiary of the trust), for the benefit of the trust and secure these debts with assets of the trust.

4. The trustee may grant security interests and execute all instruments creating such interests upon such terms as the trustee may deem appropriate.

5. The trustee may compromise and adjust claims against or on behalf of the trust on such terms as the trustee may deem appropriate.

6. The trustee may take title to any securities in the name of any custodian or nominee, without disclosing this relationship.

7. The trustee may determine whether receipts are income or principal and whether disbursements are to be charged against income or principal, to the extent not established clearly by state law. Determinations made by the trustee in good faith shall not require equitable adjustments.

8. The trustee may make all tax elections and allocations the trustee may consider appropriate; however, this authority is to be exercised only in a fiduciary capacity and may not be used to enlarge or shift any beneficial interest except as an incidental consequence of the discharge of fiduciary duties. All tax elections and allocations made by the trustee in good faith shall not require equitable adjustments.

9. The trustee may employ such lawyers, accountants, and other advisers as the trustee may deem useful and appropriate for the administration of the trust. The trustee may employ a professional investment adviser in managing the investments of the trust (including any investments in mutual funds, investment trusts or managed accounts), delegate to this adviser any discretionary investment authorities and rely on the adviser's investment recommendations without liability to any beneficiary.

10. The trustee may divide and distribute the trust in kind or in cash, or partly in each, without regard to the income tax basis of any asset and without the consent of any beneficiary. The decision of the trustee in dividing any portion of the trust between or among two or more beneficiaries shall be binding on all persons.

11. The trustee shall distribute any of the trust assets to a minor by distributingthem to any appropriate person (who may be a trustee) chosen by the trustee as custodian under any appropriate Uniform Transfers (or Gifts) to Minors Act, to be held for the maximum period allowed by law. The trustee may also sell any asset that cannot legally be held under this custodianship and invest the sales proceeds in assets that can be held under this custodianship.

Article 5. Mandatory Lead Trust Provisions

A. Overriding Tax Purpose. This trust is established as and shall operate as a charitable lead trust the charitable interest in which is a guaranteed annuity under Section 170(f)(2)(B) of the Code and all provisions of this instrument shall be construed in a manner consistent with this purpose. The trustee shall not exercise any discretion under this instrument in a manner inconsistent with this purpose.

B. Payment of the Annuity Amount. The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal.

C. Excess Income. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

D. Incorrect Valuation. If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to the charitable organization (in the case of an undervaluation) or receive from the charitable organization (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

E. Proration of Annuity Amount. The trustee shall prorate the annuity amount on a daily basis for any short taxable year. In the taxable year in which the annuity period ends, the trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

F. Commencement of Annuity Period. The first day of the annuity period shall be the date the property is transferred to the trust, and the last day of the annuity period shall be the day preceding the date *duration* years thereafter.

G. Additional Contributions. No additional contributions shall be made to the trust after the initial contribution.

H. No Noncharitable Payments During Annuity Term. During the trust term, no payment shall be made to any person other than the charitable organization.

I. Prohibited Transactions. The trustee shall not engage in any act of self-dealing within the meaning of § 4941(d), as modified by § 4947(a)(2), and shall not make any taxable expenditures within the meaning of § 4945(d), as modified by § 4947(a)(2). The trustee shall not retain any excess business holdings that would subject the trust to tax under § 4943, as modified by §§ 4947(a)(2) and 4947(b)(3). In addition, the trustee shall not acquire any assets that would subject the trust to tax under § 4944, as modified by §§ 4947(a)(2) and 4947(b)(3), or retain assets which, if acquired by the trustee, would subject the trustee to tax under § 4944, as modified by §§ 4947(a)(2) and 4947(b)(3).

J. Taxable Year. The taxable year of the trust shall be the calendar year.

K. Limited Power of Amendment. This trust is irrevocable. However, the trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the annuity interest passing to the charitable organization is a guaranteed annuity interest under §§ 170(f)(2)(B), 2055(e)(2)(B), and 2522(c)(2)(B) and the regulations thereunder.

L. Grantor Trust Power. During the donor's life, *First671Person* shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. If *First671Person* is unable to exercise this power because of death or disability, it shall be exercisable by *Second671Person*.

Article 6. Trust Administration

A. Disabled Beneficiaries. The trustee may distribute income or principal, or both, for the benefit of a minor or disabled beneficiary to the beneficiary's parent, guardian or personal representative, or to the person with whom the beneficiary resides, without looking to the proper application of those payments.

B. Accountings. The trustee shall not be required to file annual accounts with any court or court official in any jurisdiction.

C. Change of Situs. The trustee may change the situs of this trust (and to the extent necessary or appropriate, move the trust assets) to a state or country other than the one in which the trust is then administered, if the trustees believe it to be in the best interests of the trust or the beneficiaries. The trustee may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances.

Article 7. Definitions and Miscellaneous

A. Applicable Law. The operation of the trust shall be governed by the laws of the State of [state]. However, the trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the requirements for the charitable deductions available for contributions to a charitable lead annuity trust.

B. Copies. There is only one signed original of this trust instrument. Anyone may rely on a copy of this trust instrument certified by a notary public or similar official to be a true copy of the signed original (and of any amendments) as if that copy were the signed original. Anyone may rely on any statement of fact certified by the person who appears from the original document or a certified copy to be a trustee.

C. Disabled. An individual is "disabled" or "under a disability" if the trustee (or, if the person whose disability is in question is a trustee, the next successor trustee) receives written certification from two (2) physicians, both of whom have personally examined the individual and at least one (1) of whom is board certified in the specialty most closely associated with the alleged disability. The certification must state that the individual is incapable of managing his or her own finances, regardless of cause and regardless of whether there is an adjudication of incompetence, mental illness, or need for a committee, conservator, guardian or other personal representative. No person is liable to anyone for actions taken in reliance on these certifications or for dealing with a Trustee other than the one removed for disability based on these certifications.

D. Number. Whenever the context requires, the singular number includes the plural and the plural the singular.

E. Tax-Related Terms. All tax-related terms shall have the same meaning that they have in the Internal Revenue Code of 1986, as amended.

F. Trust. "Trust," without further qualification or specification, shall refer to all trusts under this instrument.

G. Trustee. "Trustee" shall include each trustee individually, multiple trustees, and any successor trustee.

DECLARED AND AGREED on the date indicated above.

[signature] (Seal)
Grantor, Grantor

[signature] (Seal)
FirstTrustee, Trustee

Charity

By: [signature] (Seal)

[*Notarial clause and schedule*]

WAIVER OF CERTAIN RIGHTS

I, *Spouse*, waive all of my right, title, and interest in any property transferred to the attached trust, dated [date] (the "trust"), by *Grantor*. This waiver shall apply both to current and inchoate interests that I may have, including, but not limited to, rights to an intestate share of *Grantor*'s estate, to a statutory share of *Grantor*'s estate, to a share as an omitted spouse, and to a share in the nature of dower or curtesy. This waiver shall constitute a third-party beneficiary contract for the benefit of all the beneficiaries of the trust, and these beneficiaries or the trustee of this said trust may enforce this waiver by appropriate legal action.

Dated: ...., 20.....

[signature]
Spouse

Accepted: ....
[signature]
Grantor