Section of Real Property | Trust & Estate Law

eReport

A Bi-Monthly Electronic Publication for Section Members August 2008

Section News

A Year Gone By...RPTE Welcomes New Chair and Officers
The 2008-2009 ABA bar year officially commenced on August 12, 2008. The RPTE leadership looks forward to an informative and productive year for Section members. View RPTE's new Officers and a message from Steve Akers, new Section Chair.

Join Us in San Francisco for the RPTE/Taxation Joint Fall CLE Meeting
Network with colleagues, earn CLE credits and discuss the latest federal tax policies on September 11-13, 2008. View meeting details and the CLE program schedule here.

Do you have Spanish speaking clients?
The ABA Commission on Law and Aging is offering free bulk copies of its Spanish-language health and financial decisions brochure and video/DVD information package to all RPTE Members. Click here for more details.

The 2008 Spring Symposia CLE Program Materials Are Now Available Online
View program materials here.

Trust and Estate News Real Property News

Technology

New Bar Year Changes to RPTE Committee List Serves and Web Pages - Please Read!

If you're a RPTE committee member, be sure to read how the new ABA bar year affects you!

CLE Spotlight

TRUST AND ESTATE CLE
Critical Issues in Estate Administration - Part One of the Essential Issues in Trust and Estate Law Teleconference Series
(with Rana Salti and Stephen Parker)
Teleconference/Webcast
Date: September 16, 2008
Time: 12:00 p.m. to 1:30 p.m. CST

REAL PROPERTY CLE
Legal Opinions in Real Estate Financing Transactions - Part One of the Essential Issues in Commercial Real Estate Teleconference Series
(with Sterling Scott Wills, Kenneth Ezell, and Leta Principe)
Teleconference/Webcast
Date: September 25, 2008

Real Property News

[Clear Channel Outdoor, Inc. v. Nancy Knupfer, Chapter 11 Trustee; DB Burbank, LLC]
John Trott and Erik North
The recent *Clear Channel* case has called into question whether a sale under Bankruptcy Code § 363 can be made free and clear of all liens. John Trott and Erik North explain the issues raised by *Clear Channel*.

Mortgagees Beware: Proceed Promptly with Care or Find your Lien is Impaired
Kathleen Kraft
In her article, Kathleen Kraft describes how an incorrect legal description or the late perfection of lien can impair a lender's rights in a borrower's bankruptcy.

Caveat Emptor for Alabama Real Estate Buyers: Tax Withholding Obligations Now Exist
Riley Roby and Walter McKay
Alabama has enacted a new withholding requirement for non Alabama persons and entities selling real estate. Riley Roby and Walter McKay tell you what to look for when buying or selling Alabama real estate.
Download Alabama Department of Revenue Affidavit of Seller's Residence Forms Here.


Trust and Estate News

S Corps' Corporation Owned Life Insurance (C.O.L.I): No Accumulated Adjustment Accounts (AAA) Effect

Sample Charitable Lead Unitrust Forms From IRS

No Discounts for Restricted Management Accounts

String Inclusion: Final Regulations on

Time: 12:00 p.m. to 2:00 pm CST

Group & Committee News

TRUST AND ESTATE

Employee Benefit Plans and Other Compensation Arrangements Group
The RPTE Employee Benefit Plans and Other Compensation Arrangements Group is hosting and co-hosting several programs at the RPTE/Tax Section Joint Fall CLE Meeting.
View the programs here.

International Tax Planning Committee
At the request and invitation of the LMSB Division of the IRS, the International Tax Planning Committee has been collaborating with the AICPA's Foreign Trust Tax Force on the development of a new fiduciary income tax return for foreign trusts (Form 1041-NR).

Generation Skipping Transfers Committee
In July 2008, the Generation Skipping Transfers Committee, in conjunction with the Committee on Estate and Gift Taxes of the Section on Taxation, submitted comments to proposed regulations under section 2642(g)(1) the Code. These regulations provide guidance regarding the circumstances and procedures under which the IRS will grant an extension of time to allocate GST exemption and make certain elections relating to allocations of GST exemption.

REAL PROPERTY

Timesharing and Interval Use Committee
Click here to learn more about the e-newsletter the Timesharing and Interval Use Committee will

2036 and 2039
Jim Roberts

ERISA Alert: IRS Says Wall Street Cannot "Buy" Your Company's Pensions Plan --- at Least for Now
Michael Kushner

The Business Planning Group comments on Proposed Regulations 20.2031-1(f) concerning the estate tax alternate valuation of assets effected by post-death events other than market conditions.

Join a Committee Today!

RPTE members can join a group or committee (or several) online at www.abanet.org/rpte/join. For questions regarding membership, contact the Section at (312)988-5651 or email Bunny Lee at leeb@staff.abanet.org.

Would you like to write an article for the eReport?

If you have something to say, and would like your article considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

introduce this Fall.

Mortgage Lending
The Mortgage Lending Committee has primarily been tracking four subject areas: the new federal housing bill, the changes to FASB 140, proposed changes to RESPA, and attempts to amend the ACORD 28 form of proof of commercial property insurance. View more details here.

Young Lawyers

RPTE Welcomes New Fellows

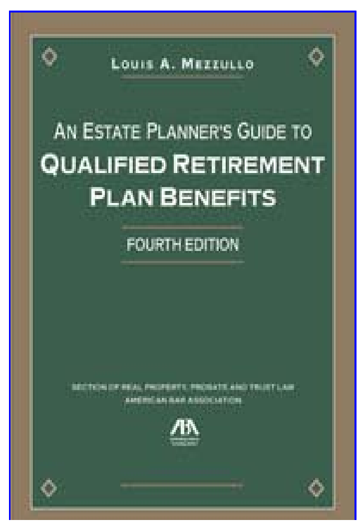
The RPTE Section supports a vibrant fellows program to encourage the involvement of young lawyers in the Section. Congratulations to the new RPTE 2008 fellows!

Law Students

Announcing the 2008 RPTE Law Student Writing Contest Winners

The results are in for the RPTE law student writing contest. Congratulations to all of this year's winners!

New Book from RPTE



An Estate Planner's Guide to Qualified Retirement Plan Benefits, Fourth Edition
Louis A. Mezzullo

This clearly written guide, now completely revised and updated, provides comprehensive, practical advice for the non-ERISA specialist on how to structure benefits from qualified retirement plans and IRAs to achieve maximum benefits for your client. This new edition reflects changes made by the Pension Protection Act of 2006 and the final regulations issued in April 2002 dealing with the required minimum distribution rules under Code § 401(a)(9), as well as many administrative pronouncements made since publication of the previous edition. The new edition also includes the appendices on an accompanying CD-ROM. Click here to learn more...

FOR OFFLINE READING:
- PDF version - print the whole issue
- PDF of Trust and Estate articles only
- PDF of Real Property articles only

About RPTE eReport

The **RPTE eREPORT** is the bi-monthly electronic publication of the Real Property, Trust and Estate Law Section. It includes practical information for lawyers working in the real property and estate planning fields, together with news on Section activities and upcoming events. **RPTE eREPORT** also provides resources for young lawyers and law students to succeed in the practice of law. For further information on **RPTE eREPORT** or to submit an article for publication, please contact: Susan Talley (Editor) at stalley@stonepigman.com; Cheryl Kelly (Real Property Editor) at CKELLY@thompsoncoburn.com; Robert Steele (Trust and Estate Editor) at steele@whafh.com; or Michael Goler (Managing Editor Emeritus) at Goler@MillerGolerFaeges.com. We welcome your suggestions and submissions.

Defending Liberty
Pursuing Justice

AMERICAN BAR ASSOCIATION

Section of Real Property, Trust and Estate Law
321 N. Clark Street
Chicago, Illinois 60610-4714
FAX: (312) 988-5262
http://www.abanet.org/rpte
e-mail: rpte@abanet.org

July 18, 2008

CC:PA:LPD:PR (REG-112196-07)
Internal Revenue Service
Room 5203, PO Box 7604
Ben Franklin Station, Washington, DC 20044
Submitted Electronically at http://www.regulations.gov (IRS-REG-112196-07)

RE: Proposed Regulations 20.2032-1(f) (Alternate Valuation)

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law ("RPTE Section"). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Business Planning Group, which includes the Committee on Estate Planning and Administration for Business Owners, Farmers and Ranchers and the Committee on Business Investment Entities, Partnerships, LLCs, and Corporations, of the Trust and Estate Division of the RPTE Section. Principal responsibility was exercised by William S. Forsberg of Leonard, Street and Deinard, Minneapolis, Minnesota, vice-chair of the Business Planning Group, and the principal authors of these comments were William S. Forsberg and Douglas W. Stein of Smith, Gambrell & Russell, LLP, Atlanta, Georgia. Also participating in the preparation of the comments were Hugh F. Drake of Brown, Hay & Stephens, LLP, Springfield, Illinois; Steven B. Gorin of Thompson Coburn LLP, St. Louis, Missouri; Lisa M. Rico of McCarter & English, LLP, Boston, Massachusetts; Darren Wallace of Day Pitney LLP Stamford, Connecticut; and Daniel McCarthy of The Blum Firm, P.C., Fort Worth, Texas (the "Task Force"). These comments were reviewed by Louis A. Mezzullo on behalf of the RPTE Section's Committee on Governmental Submissions.

Although members of the RPTE Section who participated in preparing these comments and recommendations have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or to otherwise influence the development or the outcome of, the specific subject matter of these comments.

We thank you for your consideration and are available to discuss any matters relating to this project. Questions should be addressed to William S. Forsberg, Leonard, Street and Deinard, 150 South Fifth Street, Suite 2300, Minneapolis, MN 55402, Phone: 612-335-1413, Fax: 612-335-1657, william.forsberg@leonard.com.

Sincerely,

Kathleen M. Martin

Kathleen M. Martin
Chair, Section of Real Property, Trust and Estate Law

cc: Steve R. Akers, Chair-Elect, ABA Section of Real Property, Trust and Estate Law
Armando Lasa-Ferrer, ABA Secretary
Thomas M. Susman, ABA Governmental Affairs

COMMENTS OF THE
REAL PROPERTY, TRUST AND ESTATE LAW SECTION
OF THE
AMERICAN BAR ASSOCIATION
Proposed Regulations 20.2032-1(f) (Alternate Valuation)
July 24, 2008

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (" RPTE Section"). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Business Planning Group, which includes the Committee on Estate Planning and Administration for Business Owners, Farmers and Ranchers and the Committee on Business Investment Entities, Partnerships, LLCs, and Corporations, of the Trust and Estate Division of the RPTE Section. Principal responsibility was exercised by William S. Forsberg of Leonard, Street and Deinard, Minneapolis, Minnesota, vice-chair of the Business Planning Group, and the principal authors of these comments were William S. Forsberg and Douglas W. Stein of Smith, Gambrell & Russell, LLP, Atlanta, Georgia. Also participating in the preparation of the comments were Hugh F. Drake of Brown, Hay & Stephens, LLP, Springfield, Illinois; Steven B. Gorin of Thompson Coburn LLP, St. Louis, Missouri; Lisa M. Rico of McCarter & English, LLP, Boston, Massachusetts; Darren Wallace of Day Pitney LLP Stamford, Connecticut; and Daniel McCarthy of The Blum Firm, P.C., Fort Worth, Texas (the "Task Force"). These comments were reviewed by Louis A. Mezzullo on behalf of the RPTE Section's Committee on Governmental Submissions.

Although members of the RPTE Section who participated in preparing these comments and recommendations have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or to otherwise influence the development or the outcome of, the specific subject matter of these comments.

Background

Section 2001[1] imposes an estate tax on the transfer of a decedent's taxable estate. Section 2031(a) values the decedent's property as of the decedent's date of death. Section 2032(a) provides that an executor may elect to value all of the property included in the decedent's gross estate as late as six months after the decedent's death. Any property that is sold, exchanged, or otherwise disposed of during the six month period after the date of the decedent's death must be valued as of the date the property is sold, exchanged or otherwise disposed. Any interest or estate which is affected by the mere lapse of time is valued at its date of death value with adjustments for any difference in its value as of the later date that is not due to the mere lapse of time. Section 2032(c) provides that no election is allowed unless it will

[1] The term "Section" throughout this letter refers to a section of the Internal Revenue Code of 1986, as amended, (the "Code"), unless otherwise indicated.

decrease the value of the decedent's gross estate and the sum of the decedent's federal estate and generation skipping transfer taxes. Section 2032(d) provides that the election is made on the decedent's federal estate tax return, and, once made, is irrevocable.

On July 25, 2006, the U.S. Tax Court, in *Kohler v. Commissioner*, 92 T.C.M. 48 (2006), held that valuation discounts attributable to certain transfer restrictions on newly issued closely held stock resulting from a post-death tax-free reorganization of the Kohler Company ("Kohler Stock") approximately two months after the decedent's death can be taken into account in valuing the Kohler Stock on the alternate valuation date. The Tax Court held that the alternate valuation date was not the date of the tax-free reorganization but six months after the decedent's death.

On March 3, 2008, the Internal Revenue Service (the "Service") nonacquiesced to the Tax Court opinion in *Kohler v. Commissioner, 92 T.C.M. 48, action on dec. (Mar. 3, 2008*).

On April 25, 2008, the Service issued proposed regulations to amend Section 20.2032-1 of the Treasury Regulations by restructuring paragraph (f) of that section to clarify that the alternate valuation election under Section 2032 is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events. The term "market conditions" is defined in the proposed regulations as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued."

Written and electronic comments to the proposed regulations under Section 2032 and requests for a public hearing must be received by July 24, 2008.

Comments and Recommendations

The Task Force supports the goals stated in the proposed regulations under Section 2032. We believe the proposed regulations are an important and necessary step in achieving fairness in carrying out Congressional intent. We commend the Service for taking the necessary steps to curtail certain abusive post-mortem transactions that artificially reduce value for the sole purpose of reducing estate taxes. We also acknowledge the difficult task that the drafters of the proposed regulations confronted. For estates comprised of primarily publicly traded marketable securities alternate valuation is much easier. However, alternate valuation under Section 2032 applies to all property and property interests, including closely held business interests, which can be very difficult to value. It is with this background in mind that we offer our comments and present our questions for review and consideration. Again, we are thankful for and pleased with the opportunity to make these comments.

The following is a summary of the manner of presentation of our specific comments:

I. Legislative and case law history of Section 2032;
II. General comments regarding the *Kohler* opinion;
III. General comments regarding the proposed regulations under Section 2032;

IV. Comments and discussion of existing law and reason for issuance of proposed regulations under Section 2032 with the Task Force's position;
V. Comments, discussion, and explanation of the term "market conditions" in the proposed regulations;
VI. Comments, discussion, and explanation of the term "other person whose property is being valued" in the proposed regulations;
VII. Comments and discussion regarding control premiums in the proposed regulations;
VIII. Comments and discussion regarding the "sale" of estate assets versus the "distribution" of estate assets during the alternate valuation period;
IX. Comments and discussion of the definition of "post-death events" to include "distributions of cash or other property to the estate from such entity" in the proposed regulations; and
X. Task Force examples of post-death events that cause a decrease in the fair market value of a closely held business and should qualify for alternate valuation under Section 2032.

I. Legislative and case law history of Section 2032

Predecessors to Section 2032

The predecessor to Section 2032, Section 302(j) of the Revenue Act of 1926, as amended, was enacted in 1935 in response to the Great Depression. Prior to the enactment of Section 302(j), a decedent's gross estate was valued in all cases as of the decedent's date of death. With the dramatic decline of the stock market between 1929 and 1934, property valued as of the decedent's date of death was, in many cases, worth far less by the time estate taxes were paid. In point of fact, the value of many estates was entirely consumed by estate taxes.[2] In response to this inequity, Congress amended the Revenue Act of 1926 to give executors the option of electing to value property on the date one year after the decedent's death.[3] At the time, this election was called "optional valuation."

The purpose of the amendment was to address this "shrinkage in value" problem and to prevent estate taxes from consuming the decedent's entire estate. Without the ability to elect a later valuation date after values dropped, high estate tax rates could completely absorb the estate's assets.[4] The legislative history of this amendment indicates that Congress intended to provide relief for post-death decreases in the value of estate property resulting from market forces.[5] While the stock market crash of 1929 was the impetus for the enactment of optional valuation, the policy reason for the amendment was primarily to ensure equitable treatment of estates when the value of property in the gross estate drops dramatically after the decedent's

---

2 *See Hearings on H.R. 8974 Before the S. Comm. on Fin.* 74th Cong., at 200-201 (1935) (statements of Robert H. Jackson, Assistant Gen. Counsel Treasury Dep't), *reprinted in 12 Internal Revenue Acts of the United States 1909-1950:Legislative Histories, Laws, and Administrative Documents* (Bernard D. Reams, Jr. ed. 1979).

3 Revenue Act of 1935, 74 Pub. L. 407 § 202(a), 49 Stat. 1014 (1935), *reprinted in* 101 *Internal Revenue Acts of the Unites States 1909-1950: Legislative Histories, Laws, and Administrative Documents* (Bernard D. Reams, Jr. ed. 1979).

4 S. Rep. No. 1240, at 8-10 (1935), *reprinted in* 101 *Internal Revenue Acts of the Unites States 1909-1950: Legislative Histories, Laws, and Administrative Documents* (Bernard D. Reams, Jr. ed. 1979) .

5 See 79 Cong. Rec. 14632 (Aug. 19-26, 1935) (statements of Rep. Hill), Congressman Samuel Hill, D-WA was a member of the House Ways & Means Committee and served in Congress from September 25, 1936, until his resignation, effective June 25, 1936.

death. The provision was intended to be equitable in its effects and to prevent the danger of complete confiscation of estates due to a sudden decline in market values.[6] Congress's continued commitment to the equitable purpose of optional valuation is evident in the Congressional record relating to later re-enactments of Section 2032. For instance, the 1984 Conference Reports state that the purpose of the provision is to provide "relief for estate tax purposes where the value of property decreased after death so that estate taxes are not inordinate." Declining market conditions, in fact market conditions as a whole, are not cited as the reason for the existence of the provision.

Section 2032 and Amendments

Section 302(j) was recodified by Section 811(j) of the Code of 1939, and Section 2032 recodified Section 811(j) in 1954. "Optional valuation" was renamed "alternate valuation," but neither amendment substantially changed the purpose or effect of the provision.

There have been two significant amendments to Section 2032. A 1970 amendment changed the one year alternate valuation period to six months. Prior to the amendment in 1970, the time for filing and paying estate taxes was fifteen months after the death of the decedent. Congress reduced the time period for filing and paying estate taxes to nine months to reduce the delay in the Government's receipt of taxes and speed up the distribution of property to beneficiaries.[7] The alternate valuation period was shortened to match the reduced time for filing the decedent's estate tax return and paying estate taxes.[8]

The second significant change to Section 2032 occurred in 1984 when subsection (c) was added, which limited the election to situations where the value of the gross estate and the estate tax were reduced by the alternate valuation election. Prior to the 1984 amendment, some taxpayers elected alternate valuation when the value of the estate had increased during the alternate valuation period so that the estate could receive an increase in the income tax basis of estate assets.[9] In many of these cases, even though alternate valuation increased the value of the gross estate, no increase in estate tax occurred because of the corresponding increase in the unlimited marital deduction.

Case Law and Rulings Interpreting Section 2032

In *Flanders v. United States*, 347 F. Supp. 95 (N.D. Cal. 1972) the court examined the legislative history of Section 2032. The *Flanders* court stated that Congress intended that the "character" of the decedent's property should be fixed as of the decedent's date of death. Alternate valuation merely allowed the estate to revalue the decedent's property on the alternate valuation date to take into account significant changes in value due to market conditions. The

---

6 H.R. Rep. No. 74-1681 (1935).

7 S. Rep. No. 91-1444, at 574 (1971).

8 Pub. L. No. 91-614 § 101(a), 84 Stat. 1836 (1970).

9 *See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 112-22, JCS-41-84 (1984). An increased income tax basis in estate property allowed a beneficiary to reduce his or her capital gain on the subsequent sale of the property to a third party.

Flanders court held that any “voluntary” change (by the executor) to the property, or any change that “artificially reduces” value should be ignored for alternate valuation purposes.

In *Flanders*, the executor elected the alternate valuation date and sought to discount the value of real property included in the estate due to a California land conservation agreement entered into during the alternate valuation period. The court held that the agreement effected a change in the character of the land which should not have been taken into account for purposes of alternate valuation. Since the character of the land was fixed at the decedent's date of death, the post-death conservation agreement was ignored, and the land was valued under the market conditions that existed on the alternate valuation date. The *Flanders* court held that “voluntary” post-mortem changes in the property should not be considered unless they resulted in a sale or other disposition between the date of death and the alternate valuation date. In such instances, the valuation date would be the date of such sale or other disposition. Any “artificial” reductions in fair market value should be ignored.

In *Hull’s Estate v. Commissioner*, 38 T.C. 512 (1962), the executor of the estate of a decedent, who was a partner in a law firm, entered into a post-death settlement agreement with decedent’s law firm relating to the estate’s share of the firm’s income. The court held that the terms of the settlement agreement should be taken into account when valuing the estate’s partnership interest on the alternate valuation date since the settlement agreement was “entered into at arm’s length between parties with clearly adverse interests,” and because the terms were a “known fact” on the alternate valuation date.

In *Maass v. Higgins*, 312 U.S. 443 (1941), the court decided that the valuation method used to value property on the alternate valuation date must be the same method used to value property on the decedent’s date of death. Considering whether dividends and interest accruing during the alternate valuation period should be included in the estate, the court held that the valuation method used on the alternate valuation date was not intended to be different from the valuation method used at the decedent’s death. The Service argued that interest and dividends paid out during the alternate valuation period must be added to the value of the gross estate on the alternate valuation date. But the court recognized that the usual method for valuing bonds was to add the amount of “accrued” (but unpaid) interest to the market value of the bond. To include interest “paid” on the bonds during the alternate valuation period ignored the character of such payments and contradicted general business practices.

A different result was reached in a case where oil and gas was extracted from property and sold during the alternate valuation period. The court in *Estate of Johnston v. United States*, 779 F. 2d 1123 (5th Cir. 1986), held that oil and gas production should be distinguished from income produced by stocks and bonds. They recognized that separation of oil and gas from the underlying property was essentially a change in form from in-place reserves to money. They found that, unlike payment of dividends and interest on stocks and bonds, separation of oil and gas from a well depletes the property and should be included when valuing the decedent's estate on the alternate valuation date. The quantity of oil and gas in reserve at the decedent's death must be valued under market conditions on the alternate valuation date.

In both *Maass* and *Johnston*, the courts focused on which party's arguments were "unreal and artificial and which comports with our common understanding."

The Service in Priv. Ltr. Rul. 93-49-003 (Sept. 3, 1993) stated that the recording of forged deeds after death does not affect the alternate valuation of property for estate tax purposes under Section 2032(a). In the ruling the estate owned ten parcels of real estate as of decedent's death and reported their full value on the decedent's estate tax return. Two days after decedent's death, the decedent's brother forged and recorded two warranty deeds, putting a cloud on title to the parcels. The estate elected alternate valuation, claiming the real estate was now worth only thirty percent of its date-of-death "actual" value because of the cloud on title. Citing *Flanders* and *Estate of Holl v. Commissioner*, 967 F. 2d 1437 (10th Cir. 1992),[10] the ruling noted that Congress intended that the character of the property is to be valued as it existed on the date of death, although it could be valued at "market conditions" existing on the alternate valuation date. The ruling stated that the alternate valuation election should only be available to estates where "unfavorable market conditions (as distinguished from voluntary acts changing the character of the property)" lessen the fair market value of property. In the ruling, the action of the decedent's brother to record and claim an interest in the estate's property had no effect on the value of the property for purposes of alternate valuation. The value of the properties as "commodities in the open market was not affected by the brother's action."

Kohler v. Commissioner

In *Kohler v. Commissioner*, 92 T.C.M. 48 (2006), the Tax Court considered whether transfer restrictions and purchase options placed on stock during the alternate valuation period could be taken into account when the stock was valued for estate tax purposes. The stock in question was stock in Kohler Company ("Kohler"), a privately held family business with substantial assets. Family members, charities, and trusts for the benefit of family members held 96% of the Kohler Stock.

Kohler began the process of reorganizing the company before the decedent's death in 1996. The purpose of the reorganization was to remove the outside shareholders, facilitate estate planning, give later generations a vote on company matters, and ensure that later generations would be able to take control when necessary. The reorganization replaced the old shares of common stock with new classes of stock that had various voting rights and dividend preferences. Old common stock shares were traded for either cash, or a combination of voting and nonvoting

[10] *Holl* involved the valuation of substantial oil and gas holdings valued at nearly $9 million at decedent's death. The estate valued these oil and gas interests on the alternate valuation date at approximately $3.1 million. Between date of death and the alternate valuation date the estate received $980,698 of net income from the sale of oil and gas. The estate gave an "in-place" value to the oil and gas sold on the alternate valuation date of approximately $686,489. The Tax Court determined in 95 T.C. 566 (1990) that the value of the oil and gas should be its sales price of $930,839. On appeal, the U.S. Court of Appeals (10th Cir.) held that the Tax Court erred in its application of the law when it used the sales price on the alternate valuation date. The court held that the Tax Court should have used the pre-change in-place value of the reserves reduced to possession and sold during the interim period from the date of death to the alternate valuation date. Citing *Flanders*, the court noted that the legislative history of Section 2032 showed an intent to consider the character of the property to be valued "as it existed on the date of death" although it could be valued at market conditions existing on the alternate valuation date.

stock. All shares were subject to transfer restrictions and a purchase option. Non-family members did not have a right to exchange their stock for stock, but received cash for each share. The reorganization qualified as a tax-free reorganization under Section 368(a).

Decedent shareholder died on March 4, 1998. The executor elected to value the gross estate on the alternate valuation date. Kohler's reorganization was completed on May 11, 1998, during the estate's alternate valuation period. The estate's appraisers valued the decedent's stock at $50 million on date of death and $47 million on the alternate valuation date. The Service's appraiser valued the decedent's stock at $144 million on the alternate valuation date.

The estate held a minority interest in Kohler and could not have blocked the reorganization, nor did it have the ability to control or change management or the board of directors, or to amend the Kohler Articles of Incorporation.

The Service argued that either the pre-reorganization stock should be valued on the alternate valuation date or that the post-reorganization stock should be valued without the transfer restrictions. The Tax Court held that the Kohler Stock should be valued at its fair market value on the alternate valuation date.[11]

The Tax Court's analysis focused on Treas. Reg. Section 20.2032-1(c)(1), which states that a tax-free reorganization under Section 368(a) is not treated as a distribution, exchange, sale or other disposition for purposes of Section 2032(a). The Service argued that the reorganization was a change in form akin to the restrictive land-use agreement entered into by the executor in *Flanders* and should be ignored for valuation purposes. The Tax Court disagreed, holding that the plain meaning of the statute, as adopted in the regulations, excepted tax-free reorganizations from treatment as a disposition of property for purposes of Section 2032 and that the stock should be valued as of the alternate valuation date.

II. **General comments regarding the *Kohler* opinion**

The Service nonacquiesced to the Tax Court's opinion in *Kohler v. Commissioner*, 92 T.C.M. 48, *action on dec.* (Mar. 3, 2008) and has issued the proposed regulations in response to *Kohler*. The facts presented in Example 1 of the proposed regulations are similar to the facts in the *Kohler* case, but with a few differences.

In Example 1, a closely held business stock is owned by a decedent and is valued at $50X at the date of death. Two months after decedent's death, his estate participates in a tax-free reorganization under Section 368(a). In *Kohler*, the estate held a minority interest in Kohler Stock and could not have blocked the reorganization, nor did it have the ability to control or change management or the board of directors, or to amend the Kohler Articles of Incorporation. In *Kohler*, the estate's only choice was to participate in the reorganization, a reorganization that was started prior to decedent's death, or to exercise its dissenters' rights. The facts in Example 1 appear to be slightly different from the *Kohler* facts. Example 1 states that decedent's estate

[11] Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having knowledge of relevant facts. Treas. Reg. Section 20.2031-1(b).

"opted" to exchange its stock for new stock in the reorganized company that was subject to certain transfer restrictions. The word "opt" suggests a choice. We respectfully request that Example 1 be clarified to include the percentage of ownership the decedent had in the closely held business stock as well as the level of involvement and participation by the estate in the reorganization. If the estate initiated and controlled the reorganization, then we agree with the conclusion reached in Example 1. However, if the estate did not initiate or control the reorganization, as in *Kohler*, we would respectfully disagree with the conclusion reached in Example 1.

The facts in Example 1 vary slightly from the facts in *Kohler* in one other way. In Example 1 the value[12] of the stock did not change during the alternate valuation period. In *Kohler* the value of the stock did change during the alternate valuation period, presumably because of market conditions.

III. **General comments regarding the proposed regulations under Section 2032**

In general, we agree with the approach taken to value the property or property interests identified in the examples in the proposed regulations. However, in most cases we believe that generally accepted valuation principles should determine value, unless the decedent (or the decedent's executor or trustee) has taken action to artificially reduce such value.

IV. **Comments and discussion of existing law and reason for issuance of proposed regulations under Section 2032 with the Task Force's position**

The proposed regulations identify a number of post-death transactions that artificially reduce value. Below are our comments on the examples in the proposed regulations.

1. ***Proposed Regulations—Examples 1 and 2: Anti-Kohler Examples***

Example 1 under the proposed regulations involves a post-death tax-free reorganization where the value of the stock owned by the decedent ("Old Stock") as of date of death and the "value" of the new stock received by the estate in the reorganization ("New Stock") as of the alternate valuation date are the same. In Example 1 the "value" of New Stock and Old Stock are the same after the reorganization, so discounts for lack of control and marketability cannot be applied to New Stock on the alternate valuation date. However, the terms "value," and "fair market value" are used interchangeably. We believe that the proposed regulations contemplate two concepts: 1) "fair market value," as that term is used and defined by law, and 2) "fair market value before the application of applicable discounts" (e.g., discounts for lack of marketability and control). It would be helpful, and we respectfully suggest, that the term "value" wherever used be defined and clarified in the proposed regulations.

We respectfully recommend that only the "artificial" use and application of valuation discounts should be disallowed. Please consider these facts. The fair market value of Old Stock **before** the application of valuation discounts was $70X. Valuation discounts for lack of control

---

[12] In the proposed regulations, the terms "value" and "fair market value" are used interchangeably. It would be helpful to know if the terms are intended to have the same meaning.

and marketability of $20X were applied, resulting in Old Stock having a fair market value on date of death of $50X. During the alternate valuation period a tax-free reorganization occurred and New Stock with a fair market value of $50X was issued to the estate in exchange for Old Stock having the same fair market value. Six months after death, on the alternate valuation date, the fair market value of New Stock before the application of valuation discounts was $60X. Valuation discounts for lack of control and marketability of $15X were applied, resulting in New Stock having a fair market value of $45X on the alternate valuation date. We respectfully suggest that the discounts taken on the alternate valuation date should be allowed. They were applied based on sound and generally accepted business valuation principles and methodology. This would also be true if the discounts applied on the alternate valuation date were higher than those applied on date of death.[13]

In *Kohler*, the pre-reorganization stock and the post-reorganization stock owned by the estate had the same fair market value on the date of the reorganization. Discounts for lack of control and lack of marketability were applied to the pre-reorganization stock, the post-reorganization stock, and the stock owned by the estate on the alternate valuation date.[14] The Tax Court allowed alternate valuation because the fair market value of the estate's stock was higher on the reorganization date than it was on the alternate valuation date.[15] It is also noted that the estate in *Kohler* owned a minority interest in the company (12.85% of the outstanding stock of the company), and could not have blocked or approved the reorganization on its own. Finally, certain non-family member shareholders exercised their dissenters' rights in the reorganization and litigated with the company to achieve a higher price for their shares.[16] We respectfully suggest that the *Kohler* reorganization was "outside the control of the decedent (or the decedent's executor or trustee)," and that no artificial reduction in value occurred.

We agree with the intent of the proposed regulations and suggest that if discounts are applied by the appraiser that artificially reduce fair market value, then they should have no affect on property value on the alternate valuation date. Also, we believe the new appraiser penalties under Section 6695A, the new preparer penalties under Section 6694, and the aiding and abetting penalties under Section 6701 should apply to remedy such action by the appraiser and executor.

---

13 In the above example, higher discounts for lack of marketability might be appropriate if the company had substantial real estate holdings that become contaminated during the alternate valuation period resulting in the underlying real estate and thus the company stock being less marketable.

14 *See Kohler v. Comm'r*, 92 T.C. M. 48, n. 7 (2006) ("We note that the fair market value of the post-reorganization stock must generally equal the fair market value of the pre-reorganization stock for the reorganization to be tax free,") citing Rev. Rul. 74-269, 1974-1 C.B. 87; Rev. Proc. 86-43, sec. 7.01(1), 1986-2 C.B. 722 (prerequisite to advance ruling that a Type A merger will be tax free is a representation that the fair market value of the acquirer stock and the other consideration received will be approximately equal to the fair market value of the target stock surrendered in the exchange); Rev. Proc. 81-60, sec. 4.03(2)(d), 1981-2 C.B. 680, 682 (prerequisite to advance ruling that a Type E reorganization will be tax free is a representation that the fair market value of the shares to be surrendered will equal the shares to be received in exchange).

15 It should be noted that there are tax-free transactions that do not look at value before and after for qualification under the Code. For example, the tax-free incorporation of a corporation under Section 351 or the tax-free formation of a partnership under Section 721 do not look at before and after value of contributed property to qualify for income tax–free treatment.

16 *Kohler v. Comm'r*, 92 T.C. M. 48 (2006).

2. ***Proposed Regulations Example 3—Post-death formation of family limited partnerships with estate assets***

In Example 3, the estate, in conjunction with family members, formed four limited partnerships with estate assets. The estate owned a 25% limited partnership interest (i.e., a minority interest) in each partnership and claimed discounts for lack of control and marketability on the alternate valuation date. Discounts for lack of control and marketability could not be taken into account in determining the value of the partnership interests on the alternate valuation date. We agree with the conclusion reached in Example 3. Action taken by and under the control of the executor that artificially reduces value should not affect property value on the alternate valuation date. We commend the Service for including this example in the proposed regulations. Such action is clearly contrary to the Congressional intent underlying Section 2032, and if not curtailed could lead to endless lawsuits by beneficiaries against executors for failing to form such entities post death.

If, however, an executor simply "invests" in a private partnership during the alternate valuation period with unrelated partners and is not in control of the partnership we respectfully suggest that a different result might be appropriate. Please consider the following facts: During the alternate valuation period, an executor transfers $500,000 ("Cash Investment Amount") to a limited partnership created and controlled by unrelated non-family members in exchange for a 10% limited partnership interest ("LP Interest"). Treas. Reg. Section 20.2032-1(c)(1) provides that the term "otherwise disposed of" does not include tax-free transfers of assets to newly formed entities.[17] Therefore, the alternate valuation date will be six months after death assuming there has been no sale, exchange or other disposition of the LP Interest during the alternate valuation period. The estate retains an appraiser to value its LP interest on the alternate valuation date. The appraiser uses generally accepted valuation principles and applies discounts for lack of control and marketability.[18] Will the appraiser's report be used to value the LP Interest on the alternate valuation date? We respectfully suggest that it might. If the executor's sole motive was to make a prudent business investment and to carry out his fiduciary duty, then we believe the appraiser's report should be considered when valuing the LP Interest on the alternate valuation date. The difficulty is that Section 2032 is not limited in its scope to easily valued assets such as publicly traded securities, but includes a wide range of property and property interests, some of which are hard to value, such as the one in the above example.

3. ***Proposed Regulations Example 4—Post-death distribution of minority interests in a limited liability company when the estate owned 100% of the limited liability company membership interests on date of death***

---

[17] *See* Treas. Reg. Section 20.2032-1(c)(1). The term "otherwise disposed of" does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which no gain or loss would be recognizable for income tax purposes under section 351." This regulation would likely be applicable to transfers to a partnership or limited liability company under Code Section 721 as well.

[18] In the example, when the estate acquired the LP Interest, discounts for lack of control and marketability were undoubtedly inherent in the investment price but based on the offering, although no formal valuation was performed.

In Example 4, the estate owned 100% of the units of a limited liability company (the "LLC"). Post-death, the estate makes a series of distributions of minority interests in the LLC to estate residuary beneficiaries and values the interests on the distribution dates applying discounts for lack of control and lack of marketability. The proposed regulations state that these discounts cannot be taken into account in determining the value of the LLC interests on the alternate valuation date (i.e., date of distribution). We agree with the conclusion reached in Example 4.

4. *Proposed Regulations Example 5—Post-death funding of testamentary trusts with fractional interests in real estate*

In Example 5, the estate owned 100% of Blackacre (i.e., an interest in real estate). Post death, the executor distributed an undivided 70% interest in Blackacre to a trust for the surviving spouse and an undivided 30% interest in Blackacre to trusts for children. The proposed regulations state that each interest is to be valued as a percentage of the whole (i.e., apparently without any fractional interest or partition discounts) on the distribution date. We agree with the conclusion reached in Example 5.

V. **Comments, discussion, and explanation of the term "market conditions" in the proposed regulations**

We respectfully request that you consider the following comments relating to the term "market conditions."

First, we respectfully disagree that the election to use alternate valuation should be limited to situations were there has been a decrease in the fair market value of estate property due solely to market conditions. Further, we respectfully disagree with the definition of "market conditions" as "events outside the control of the decedent (or the decedent's executor or trustee) that affect the fair market value of the property being valued." We believe that this definition may be too broad in its application and could capture and make suspect some actions of the decedent (or the decedent's executor or trustee) that were not intended by the proposed regulations.

Second, we respectfully recommend the following language as an alternative definition of "market conditions":

> "The term market conditions is defined as all events and forces [19] that affect the fair market value [20] of estate property, excluding, however, events arising solely from action that is controlled and initiated[21] by the decedent (or the decedent's executor or

[19] We chose not to use the term "market forces" as that term is too narrow and does not take into account forces that are not per se market driven but nonetheless affect value (e.g., a natural disaster).

[20] We chose to use the term "fair market value" because it is used and defined in the Treasury Regulations.

[21] The term "controlled and initiated" is used because we believe that only certain executor action should be questioned. There may be situations were the executor must act in reaction to market forces or other events. For example, an estate may own a minority interest in a closely held company but the majority shareholders who control the company vote to reorganize the company. In this situation, the estate's options are limited. Even if the estate voted against the reorganization, it most likely would still go through. Here the executor did not

trustee), that is not negotiated at arm's length,[22] that is independent of and not in reaction to market force events,[23] and[24] that artificially[25] reduces the fair market value of the property being valued on the alternate valuation date."

Below are our comments relative to our recommended definition of the term market conditions:

First, we respectfully suggest that the term "market conditions" should include "all" events and "forces" that affect the fair market value of property.

Second, we respectfully suggest that the term "market conditions" should only exclude action of the executor if such action was the only cause of the valuation reduction. If the executor's action was in "reaction" to a market force or other triggering event that preceded the executor's action, then we suggest that the executor's subsequent action should not necessarily be suspect.

Third, we respectfully suggest that the term market conditions should only exclude those actions of the executor that are initiated and controlled by the executor and that were not negotiated at arm's length. If the executor reacted to an event that was out of the executor's control (e.g., executor as majority shareholder and board member of a closely held commuter airline company decides to lay off a significant number of company personnel because of an unprecedented spike in fuel costs) or arose from an arm's length negotiation that affects fair market value (e.g., a post-death arm's length–negotiated key employee contract that significantly affected company operations), then we suggest that the executor's action should not necessarily be suspect.

Fourth, we respectfully suggest that the term "market conditions" should only exclude actions of the executor if such action has the effect of artificially reducing value. It is our view that the use of discounts should only be disallowed when their application results in an artificial reduction in value.

VI. Comments, discussion, and explanation of the term "other person whose property is being valued" in the proposed regulations

The proposed regulations define market conditions as "events outside the control of the decedent (or the decedent's executor or trustee) ***or other person whose property is being valued"***

---

control or initiate the reorganization, but simply reacted to it in a manner that was in the best interest of the estate.

22 The term "not negotiated at arm's length" is used because the Task Force believes, and the Service and Tax Court implicitly recognize, that transactions negotiated at arm's length are more likely to be accurate and a true reflection of fair market value. Also, the court in *Hull's Estate v. Comm'r,* 38 T.C. 512 (1962) viewed events precipitated by an arm's length negotiation as a credible indication of fair market value. See Example 11 *infra.*

23 The term "market force event" is used because it appears in the case law and legislative history of Section 2032.

24 The term "and" is used in the conjunctive, requiring that all elements listed be satisfied.

25 The term "artificial" is used because it was cited in *Flanders* and is defined in Merriam-Webster Online Dictionary as " produced by a human; lacking in natural or spontaneous quality", which is the opposite of how a true market force works.

(emphasis added). The property interest, or person who has an interest in such property interest, intended to be subject to this provision is not clear from the literal language (i.e., the italicized language) of the proposed regulations. We believe this was intended to include those persons who are in possession of property, or property interests, on the alternate valuation date that were included in the decedent's gross estate and possess such property because it passed to them either by operation of law outside of probate (e.g., property held in joint tenancy with right of survivorship, or property subject to a pay on death designation) or was property that was transferred by the decedent by gift during life that is included in the decedent's transfer tax base as an adjusted taxable gift. It would be helpful if the proposed regulations could clarify the language "or other person whose property is being valued."

VII. **Comments and discussion regarding control premiums in the proposed regulations**

We are unclear whether the proposed regulations preclude "premiums" or certain asset value enhancers (e.g., control premium) when valuing closely held business interests on the alternate valuation date. There are situations where a control premium may not be warranted when valuing stock on date of death, but will be warranted when valuing the same stock on the alternate valuation date.

For example, assume an estate holds a 40% non-controlling interest in a closely held business, and two family members (e.g., decedent's son and daughter) each hold a 30% non-controlling minority interest in the same company. No one shareholder is in control of the business at decedent's death. Assume that decedent's will provides for distribution of the residue of the estate equally between the two children. During the alternate valuation period the company redeems the daughter's shares, so that the estate now owns 57% of the company. The estate's shares were valued on the decedent's death without a control premium, because the estate held a minority interest in the company. After the redemption, the estate has a controlling interest in the company. What will the value of the estate's shares be on the alternate valuation date? Assume further, that the only other estate assets were marketable securities that decreased significantly in value as of the alternate valuation date, and that the estate as a whole decreased in value from date of death and otherwise qualified for alternate valuation. Will the estate's shares be valued on the alternate valuation date with or without a control premium? The answer to that question could significantly affect the amount of estate tax owed by the estate. It would be helpful if the proposed regulations could state whether or not "premiums" are included or precluded when valuing property or property interests on the alternate valuation date.

VIII. **Comments and discussion regarding "sale" of estate assets versus "distribution" of estate assets during the alternate valuation period**

The proposed regulations define post-death events other than market conditions to include only "distributions" of fractional interests in estate property. They do not discuss or mention "sales" of property by the estate in the text of the proposed regulations or in the examples. We respectfully point out that one could effectively accomplish with a "sale" what the proposed regulations are trying to prohibit with a "distribution." For example, Estate owns sixty shares of stock in a closely held company with a fair market value of $3,000,000 on date of death which constitutes the entire gross estate. The decedent's will provides that the decedent's residuary estate will pass to her three sons in equal shares. Instead of the executor making a "distribution" of twenty shares to each son during the alternate valuation period (where a discount for lack of control would not be allowed under the proposed regulations), what if the executor "sold" twenty shares to each beneficiary at fair market value with a discount for lack of control and then elected alternate valuation. Thereafter, the estate distributes the sales proceeds equally among the estate beneficiaries. Each estate beneficiary would then be in the same cash and financial position as they were before the sale, but the estate will have paid less estate tax because the stock is valued on the alternate valuation date at fair market value ***with discounts***.[26] If the sons buy the stock in the same proportion as their beneficial interest, then we believe the Service will properly view this as abusive and contrary to the spirit of the proposed regulations. However, if the sons buy the stock in different proportions at an arm's length price we believe this would not be abusive and would qualify for alternate valuation even if the stock sold includes valuation discounts.

It would be helpful if the proposed regulations could include examples of a "sale" of estate assets at fair market value that are both permissible and not permissible.

IX. **Comments and discussion of the definition of "post-death events" to include "distributions of cash or other property to the estate from such entity" in the proposed regulations**

Section 2032(a)(1) and the regulations thereunder provide that property distributed, sold, exchanged, or otherwise distributed will be valued on the date of distribution, sale, exchange or other disposition. Treas. Reg. Section 20.2032-1(d)(4) provides that ordinary stock dividends out of post-death earnings and profits are "excluded property" (i.e., that they are not taken into consideration when valuing the entity on the alternate valuation date unless the dividend would result in the stock at the subsequent valuation date not reasonably representing the same included property of the gross estate as existed at the date of the decedent's death).

The proposed regulations, however, state that an interest affected by a post-death event other than market conditions is included in the gross estate at date of death values. A "post-death event" is defined to include a "distribution of cash or other property to the estate from such entity." The Task Force believes that the proposed regulations should clarify that Treas. Reg. Section 20.2032-1(d) controls if and to the extent that Treas. Reg. Section 20.2032-1(f) conflicts with it.

X. **Task force examples of post-death events that cause a decrease in the fair market value of a closely held business that will qualify for alternate valuation under Section 2032**

Below are four categories of examples affecting the value of closely held businesses after the death of the decedent that are not addressed in the proposed regulations.

---

[26] The Task Force acknowledges that the proposed regulations are not limited in their reach to "distributions" of property. The caveat language in the proposed regulations that "post-death events includes, but is not limited to . . . and the language of "events outside of the control of the decedent (or the decedent's executor or trustee)" suggest that this type of planning might not be allowed.

1. ***Category 1.*** Action taken by the executor of an estate during the alternate valuation period that is preceded by and in reaction to a post-death market force event that ***is specific*** to the business being valued but that affects fair market value;

2. ***Category 2.*** Action taken by the executor of an estate during the alternate valuation period that is preceded by and in reaction to a post-death market force event that ***is not specific*** to the business being valued but that affects fair market value;

3. ***Category 3.*** Action taken by the executor of an estate that is negotiated at arm's length; and,

4. ***Category 4.*** -Post-death distributions from pass-through entities.

Category 1

Action taken by the executor of an estate during the alternate valuation period that is preceded by and in reaction to a post-death market force event that *is specific* to the business being valued but that affects fair market value

Discussion of Issue Raised by Task Force

We respectfully suggest that the proposed regulations should address the consequences of actions taken by the executor that is preceded by and in response to post-death events that are specific to the business being valued, such as the loss of a key employee, the loss of a key customer, the loss of a key supplier or key creditor, or the threat of a major lawsuit. Even if the executor might have been able to avoid the events, they have such independent significance that the executor's action or inaction relating to the default should not preclude use of alternate valuation. The following example illustrates the issue raised.

Example 1

Loss of key employee (termination of employment; threat of departure; threat of competition): A closely held business was in transition at the time of decedent's death. The decedent, a key person herself, was mentoring and transitioning the business to other key employees (possibly a key manager who developed a good relationship with a key customer). The transition process may not have been completed at decedent's death. No employment agreement or covenant not to compete was in place. Most of these facts were known and taken into account when the date of death valuation was done. However, sometime after death, but before the end of the alternate valuation period when things are in theory "settling down," the key employee starts "making noise" (possibly because the key employee does not like or want to work for the new owners, the decedent's children or spouse, or maybe the decedent's death was sudden and unexpected, and there was a vacuum in ownership and management was worried about the key employee). The key employee becomes uncomfortable and threatens to quit and start a competing business, and/or demands a long term employment contract with stock or other equity options, and/or a higher base salary, and/or a performance bonus with a lucrative deferred compensation package. With the decedent gone, the estate is put in an unequal bargaining position, so it acquiesces and submits to the key employee's demands-demands that hopefully will result in a long term benefit to the company, but cause a short term decrease in the value of the business. The actions taken by the executor were in response to a market force event and were not taken to artificially reduce the fair market value of the business. These events were not known by, reasonably foreseeable by, or under the control of the decedent or the decedent's executor. These events should therefore be taken into account when valuing the decedent's stock on the alternate valuation date.

Task Force Recommendation

We respectfully suggest that executor action taken in response to a post-death triggering event that is specific to the closely held business interest being valued and that was not foreseen or foreseeable at decedent's death, such as the loss of a key employee, key customer, key supplier, or key creditor, the threat of a major lawsuit, or a dramatic increase in material or fuel costs, is not action taken to artificially reduce the value of the decedent's business interest and should not necessarily be suspect when valuing the decedent's business interest on the alternate valuation date. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

Category 2

Action taken by the executor of an estate during the alternate valuation period that is preceded by and in reaction to a post-death market force event that *is not specific* to the business being valued but that affects fair market value

Discussion of Issue Raised by Task Force

We respectfully suggest that the proposed regulations should address the issue of post-death affirmative action taken by an executor/shareholder/board member of a closely held business, in response to and preceded by an unforeseen and uncontrollable event, such as a natural disaster.

Example 2

Action taken by executor/shareholder/board member of closely held business in response to a hurricane: Six months after the decedent's death the decedent's closely held company, located in New Orleans, was devastated by Hurricane Katrina. The physical plant was destroyed, production was completely shut down, employees had to be temporarily let go, and the company's business interruption and casualty insurance was inadequate. This single event had a significant detrimental effect on the value of the decedent's business. The executor of decedent's estate, who was also the sole shareholder, together with action of the board, made a decision to liquidate and dissolve the company. The liquidation and dissolution proceeding was not completed as of the alternate valuation date. The event that destroyed the business was not known by, reasonably foreseeable by, or under the control of the decedent or the decedent's executor. However, affirmative steps had to be taken by the executor, as shareholder and board member in response to the natural disaster. Section 2054 and the regulations thereunder allow an estate to deduct losses from casualties or theft incurred during settlement of the estate arising from fires, storms, shipwrecks, or other casualties, but very little guidance is provided with regard to losses incurred by and within a business. Does Section 2054 allow the estate a deduction, or is the estate's only recourse alternate valuation? If the latter, will the affirmative action taken by the executor to liquidate the company preclude alternate valuation under the proposed regulations, or cause the stock to be valued on a going concern basis on the alternate valuation date, rather than at liquidation value?

Task Force Recommendation

We respectfully suggest that post-death action taken by an executor of an estate that owns a closely held business interest, including action to liquidate, dissolve or sell the business, which action is in response to and precipitated by an unforeseen and uncontrollable post-death event that is not specific to the business, such as a natural disaster or act of terrorism, is not action taken to artificially reduce the value of the decedent's business interest and should not necessarily be suspect when valuing the decedent's business interest on the alternate valuation date. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

Category 3

Action taken by the executor of an estate that is negotiated at arm's length.

Discussion of Issue Raised by Task Force

We respectfully suggest that the proposed regulations should address the issue of post-death actions taken by an executor/shareholder/board member of a closely held business, in a transaction that is negotiated at arm's length.

Example 3

Action taken by executor negotiated at arm's length (hiring new president; compensation package includes stock; estate retains control): The decedent was sole director and president of a closely held company and owned 75% of the company's voting stock. At decedent's death a vacuum in management occurred so the estate sought to hire a new president to run the company. The prospective president is represented by separate counsel. The estate and the president negotiated at arm's length a compensation package that includes stock and stock options in the company and required the executor to further capitalize the business. The estate and the prospective president settled on the president acquiring 10% of the estate's voting stock currently with an option to acquire a controlling interest in the company if certain performance and financial goals and objectives are reached over then next two years. This left the estate owning 65% of the voting shares on the alternate valuation date subject, however, to the president's option to acquire a controlling interest if the performance and financial goals and objectives are met. We suggest that the estate's stock should be valued on the alternate valuation date subject to the president's stock option to acquire a controlling interest using generally accepted valuations principles, which would include discounts for lack marketability. The president's first option to acquire the company stock restricts the estate's ability to sell the stock and may result in discounts for lack of marketability at a level that is higher than those taken on date of death.

Task Force Recommendation

We respectfully suggest that post-death action taken by an executor of an estate that owns an interest in a closely held business in a transaction that is negotiated at arm's length should stand on its own merits, and the business interest should be valued using generally accepted valuation principles, including appropriate discounts for lack of control and marketability. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

Category 4
Post-death distributions from pass-thru entitles

Discussion of Issue Raised by Task Force

We respectfully suggest that the proposed regulations should address the issue of post-death distributions from pass through entities, such as S corporations or partnerships where there has been a historic pattern in the ordinary course of business of making cash distributions, and where such distributions do not constituted "all" of the entities earnings and profits earned prior to the decedent's death. Treas. Reg. Section 20.2032-1(d) (4) provides in pertinent part that:

> [O]rdinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to stockholders of record after the date of the decedent's death are "excluded property" and are not to be valued under the alternate valuation method. If, however, dividends are declared to stockholders of record after the date of decedent's death with the effect that the shares of stock at the subsequent valuation date ***do not reasonably represent*** (emphasis added) the same "included property" of the gross estate as existed at the date of the decedent's death, the dividends are "included property", except to the extent they are out of earnings of the corporation after the date of the decedent's death". Similarly, if a corporation, in which the decedent owned a substantial interest and which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in-capital, distributed all of its accumulated earnings and profits as a cash dividend to shareholders of record during the alternate valuation period, the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the alternate valuation method.

Example 4
Post-death distributions from S corporation in ordinary course-historic pattern: Decedent died January 1 when the decedent's S corporation had substantial undistributed earnings from the prior year (its distribution for its shareholders' fourth quarter estimated tax payments, plus its normal distribution of profits that it determines when it files its tax return). The company had a pattern of making these distributions each year and declared and paid them on April 1 of the year following the year of decedent's death. Will these distributions be "included property" or "excluded property" for purposes of alternate valuation? Do these distributions constitute "ordinary dividends out of earnings and profits declared to shareholders of record" after the decedent's death? The decedent's S corporation shares are the same shares as owned by the estate on the alternate valuation date. Does the answer change depending on whether it is an operating business or a holding company (assume no C corporation accumulated earnings and profits)? Does the answer change based on whether these distributions are part of a pattern

established during decedent's life, and were not made in contemplation of death? Does it matter if the only factor affecting the value of the decedent's S corporation stock on the alternate valuation date is the S corporation distributions? What if the distributions where not identified by the appraiser as a reason for the decrease in the decedent's stock on the alternate valuation date? Would it matter if the executor was also the majority shareholder and controlled the board?

Task Force Recommendation

We respectfully suggest that post-death distributions from pass through entities declared and paid out of earnings and profits from such entities, where there has been a clear historic pattern and record in the ordinary course of business of making such distributions, should not constitute "included property" on the alternate valuation date. We respectfully suggest that it should not matter if the executor is a majority shareholder, controls the entity, or sits on or controls the board or is the managing partner of the entity.

Conclusion

The proposed regulations under Section 2032 were well drafted and go a long way toward achieving fairness. We again commend the Service for taking the necessary steps in the proposed regulations to curtail certain abusive post-mortem transactions. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you. If you would like to discuss these comments, please contact the following:

William S. Forsberg
Leonard, Street and Deinard
150 South Fifth Street
Suite 2300
Minneapolis, MN 55402
Phone: 612-335-1413
Fax: 612-335-1657
william.forsberg@leonard.com

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Section News

The Trust and Estate Law Division of RPTE and the ABA Section of Taxation will be hosting the Joint Fall CLE Meeting. This year's meeting will take place in San Francisco on September 11-13!

- Meet with the country's leading attorneys and government officials to discuss the latest federal tax policies, initiatives, regulations and legislative forecasts
- Earn valuable CLE credits (including ethics)
- Network with Trust and Estate Division and Tax Section members and guests
- Explore beautiful San Francisco, including a Victorian Homes tour and a tour of the de Young museum

For more details and to register, click here!

ERISA ALERT: IRS Says Wall Street Cannot" Buy" Your Company's Pension Plan --- at Least for Now

By

Michael Kushner
Curtis, Mallet-Prevost, Colt & Mosle LLP

Recently hedge funds, private equity funds, investment banks and insurance companies ("Institutional Investors") have been seeking approval from the IRS, the Department of Labor and the PBGC to "buy" frozen pension plans (ones where participants are no longer earning new benefits). Such an opportunity could arise pursuant to a corporate transaction, such as where Company A buys the stock or assets of Company B but does not wish to assume B's frozen pension plan. Opportunities to buy plans also could arise in a corporate bankruptcy. One such transaction was completed in the U.K. in 2007 but there is no evidence that any have been attempted in the U.S. Institutional Investors seek to manage the plans and their assets for profit, since they represent such a lucrative potential source of new investment. Private pension assets in the U.S. are approximately $2.3 trillion, of which approximately $500 billion is held in frozen plans. These include the assts held in frozen plans by IBM, Hewlett-Packard, Verizon and Alcoa.

Advocates of this concept point to the benefits that plan participants would receive by having their benefits managed by a professional asset manager and to the fact that a well-capitalized Institutional Investor could help shield an underfunded pension plan and its participants from having to rely on the limited guarantees of benefits offered by the PBGC should the plan not have enough assets to pay benefits.

Critics point to the fact that an entity that has never had an employment relationship with plan participants has never been allowed to sponsor, much less purchase, a pension plan and that, because of this, they are less likely to be "employee friendly." They also argue that an Institutional Investor might take greater risks in investing pension assets than is traditionally considered prudent and that reporting of the underlying assets of many such Institutional Investors is considered by many to be too opaque.

On August 6, 2008, the IRS issued Revenue Ruling 2008-45, clarifying that pension plan buyouts by companies that are unrelated to the employer are impermissible under ERISA and the Code because such arrangements would violate the requirement that pension plans be operated for the "exclusive benefit" of plan participants and beneficiaries.

This, however, may not be the end of the matter. Accompanying the ruling, the Administration set forth a framework of principles that should guide the development of legislation that could permit such transactions, "in circumstances where the transaction is in the best interest of plan participants, their beneficiaries, employers, and the pension insurance system." The legislative framework was developed by Treasury, the Labor Department, the Commerce Department, and the PBGC, so in the view of the government, if Institutional Investors are going to be permitted to buy private pension plans, Congress will have to take the lead.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Law Students

RPTE 2008 Law Student Writing Contest Winners

The results are in for the Real Property, Trust and Estate Law Section's student writing contest.

Congratulations to all of this year's winners!

First-place - Amy Jo Smith from DePaul University - "Curbing the License to Steal: A Discussion of English Law and Possible Reforms for the Durable Power of Attorney"

Second-place - Tyson Tamashiro from University of Hawaii - "RLUIPA and the Individualized Assessment: Special Use Permits and Variances under Strict Congressional Scrutiny"

Third-place - Jessica Vollmer from University of Baltimore School of Law - "A Question of Property Rights: The Constitutionality of Maryland's Ground Rent Reform"

Amy Jo Smith, the first-place winner, will receive $1,500 cash, a one-year free membership to the Section (valued at $50), and free round-trip airfare and weekend accommodations to attend the Section's Fall Leadership Meeting, November 6th-9th in Montreal, Quebec, Canada (airfare, hotel accommodations, and luncheon ticket are valued at approximately $1,000). In addition, Amy's essay will be considered for publication in a future issue of the *Real Property, Trust & Estate Law Journal*. Tyson Tamashiro, the second-place winner, will receive $700 cash, and Jessica Vollmer, the third-place winner, will receive $500 cash.

The goal of the RPTE student writing contest is to encourage and reward law student writing on real property and trust and estate law subjects of general and current interest. As part of this effort, the Section sponsors the RPTE writing contest, which invites law school students to submit original essays on current topics in the fields. The essay contest is designed to attract students to these law specialties and to encourage scholarship in these areas.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Technology

RPTE List Serves & Committee Web Pages

The RPTE committee list serves for the 2008-2009 bar year will be updated on September 3, 2008. Committee web pages (also known as Dynamic Committee Homepages or DCHs) will be populated with new committee chairs on September 3 as well, and all chairs will have editing rights to their DCH web pages.

If you are a new committee chair, please read below for the basics on editing your DCH committee web page:

You will need your ABA ID or the email address associated with your ABA ID to log in. After logging in …

1. **To Change the Auto Response Email Message** – When a new person joins a committee, a default message is sent from the ABA database that details the committee chairs/vice chairs and their contact info. The second half of the auto response email message is the “Welcome Message”, which can be edited on the DCH web page. After logging in, please find your committee, click “edit”, then “enrollment options” and then check the box that says “On-line Committee Enrollment Email Options”. You can then fill in the text box with your desired “Welcome Message”.

2. **To Upload New Documents/Pdf’s** – For most of the content blocks/modules with a header, simply click on edit and you will be able to upload documents and post them in the desired order using the numbering system shown. You can add additional content blocks/modules by clicking on “edit” and then “add/delete module” (at the top of the page).

3. **To Update Programs/Meetings/Events** – If you choose to show upcoming programs, meetings and events, you can either choose to display default ABA events, display section specific events (the 3 upcoming events closest to the current date will be posted) or display neither. If you choose to display neither, you can add events manually as “custom events”, but you will have to update/delete them when necessary. If you choose to display the default ABA or section specific events, the ABA database will update and delete them automatically when necessary.

For more detailed information on how to update your committee web pages, please read through the DCH document for chairs. If you need additional help, please email or call Cynthia Dickmann at dickmannc@staff.abanet.org or 312-988-5540.

To keep the RPTE website as current as possible, please update your DCH web pages frequently. . Thank You!

Section News Upcoming CLE Group and Committee News Young Lawyers Law Students

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Section News

Congratulations to all 2008-2009 RPTE Officers

The new RPTE Officers were elected at the ABA Annual Meeting in New York on August 12, 2008, and look forward to serving Section members in the upcoming bar year!

Steve R. Akers - Chair
Roger D. Winston - Chair-Elect
Andrew F. Palmieri - Real Property Division Vice-Chair
Alan F. Rothschild, Jr. - Trust & Estate Division Vice-Chair
Susan G. Talley - Secretary
Gideon Rothschild - Finance and Corporate Sponsorship Officer
Kathleen M. Martin - Immediate Past Chair
David M. English - Section Delegate to House of Delegates
Leopold Z. Sher - Section Delegate to House of Delegates
David K.Y. Tang - Section Delegate to House of Delegates
Howard H. Vogel - ABA Board of Governors Liaison

A Message from Steve Akers, New RPTE Section Chair

"We are excited about the many outstanding services and resources provided by our Section to Section members and to the public. This year, we are planning to continue our major focus of emphasizing the value that is available to all of our members through our substantive Groups and Committees. Most of our Groups and Committees will be having periodic conference calls that are available free of charge to anyone who wishes to dial in to a toll-free number. The calls include discussions of substantive current developments, and the ability to dialogue with attorneys around the country as to how they are dealing with those issues in their practices. The conference call schedule will be available on the Section website soon! Be sure to check back periodically to find calls in your substantive areas of interest. In addition, Section members can join any of the Groups or Committees free of charge to receive communications about Group/Committee activities and substantive developments. Joining is **free** and easy! Simply contact Bunny Lee in the RPTE office (312-988-5651; leeb@staff.abanet.org) or go to www.abanet.org/rpte/cmtes to join one or more Committees."

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Section News

Spanish-Language Health and Financial Decisions Information Package Available FREE to RPTE Members

The ABA Commission on Law and Aging is offering a free Spanish-language information package to all RPTE members. The package includes the Commission's most popular consumer brochure, "Health and Financial Decisions: Legal Tools for Preserving Your Personal Autonomy," and a 19-minute Spanish-subtitled video, "In Your Hands: The Tools for Preserving Personal Autonomy." The video comes with a program guide that provides sample scripts and discussion points to help present the program and is available in DVD and VHS format.

The information package encourages seniors to use legal planning tools to ensure that their personal, health care and financial wishes are honored in the event they become sick, disabled or incapacitated. It is a valuable tool for attorneys and advocates who work with Spanish-speaking seniors, caregivers or family members!

To see the English version of the brochure, go to:
http://www.abanet.org/aging/publications/docs/HealthFinancial2004.pdf

To see the Spanish version of the brochure, go to:
http://www.abanet.org/aging/publications/docs/health_financial_desc_spa.pdf

To request free copies of the brochure and/or video/DVD (shipping included), please email:
abaaging@abanet.org.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Young Lawyers Network

RPTE Welcomes New Fellows

The Section of Real Property, Trust and Estate Law recently announced its new fellows for the class of 2008-2010. The new Real Property fellows are Kathleen K. Law of Des Moines, Iowa; Jin Liu of St. Petersburg, Florida; and Catherine Graves Williams of Chicago, Illinois. The new Trust and Estate fellows are Beth Ann R. Lawson of Virginia Beach, Virginia; Robert M. Nemzin of Bloomfield Hills, Michigan; and Donald L. West, Jr. of Atlanta, Georgia.

The fellows program encourages the active involvement of young lawyers in the Section. A fellowship appointment is for two years. To be considered for selection, a person must have practiced in the trust and estate or real property area for at least one year, be younger than 36 years of age or have been admitted to the bar less than 10 years, and have demonstrated leadership at the state or local bar level or in the Young Lawyers Division of the ABA.

Congratulations to all of the new fellows!

Section News Upcoming CLE Group and Committee News Young Lawyers Law Students

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

eReport

A Bi-monthly Electronic Publication for Section Members August 2008

Group and Committee News

Mortgage Lending Committee

The Mortgage Lending Committee has primarily been tracking four subject areas: the new federal housing bill, the changes to FASB 140, proposed changes to RESPA, and attempts to amend the ACORD 28 form of proof of commercial property insurance. The committee tracked the progress of the federal housing bill and held a telephone conference on August 12 on this subject. Another telephone conference on the housing bill is scheduled for September 18. Committee member Wogan Bernard has been tracking proposed changes by the Financial Accounting Standards Board to FASB 140 regarding special purpose vehicles. Wogan has written a paper on this subject, which is posted on the committee's website. Katya Gill has been following HUD's proposed changes to RESPA, and has provided links and other information for the committee's website. The committee maintains a page on its website regarding the ACORD controversy and has recently updated this information to post bulletins from state insurance commissioners on the ACORD form. More information about all of these topics can be found on the committee's website at http://www.abanet.org/dch/committee.cfm?com=RP282000. In addition, committee member Emily Bowman has been working on a paper regarding the status of the Gatekeeper Initiative for the website and a possible telephone conference on this subject.

Section News Upcoming CLE Group and Committee News Young Lawyers Law Students

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Group and Committee News

Timesharing and Interval Use Committee

The Timesharing and Interval Use Committee will introduce a new e-newsletter this fall to members providing brief overviews of new laws and regulations important to the timeshare legal community. As various states undergo law refinements, and as a number of foreign countries consider and enact their first fractional ownership regulations, the committee endeavors to keep its members apprised of current developments. The newsletter is intended to provide updates on changes to various state and federal laws, and will also cover international topics such as the recent enactment of timeshare regulations in the UAE.

Section News Upcoming CLE Group and Committee News Young Lawyers Law Students

Mortgagees Beware: Proceed Promptly with Care or Find your Lien is Impaired

by

Kathleen E. Kraft[1]

Thompson Coburn LLP

www.thompsoncoburn.com

Legal Description Error: Advantage Subsequent Tax Lienor

On June 30, 2008, the U.S. Bankruptcy Appellate Panel for the Eighth Circuit held that an incorrect legal description in a mortgage rendered the mortgage avoidable under 11 U.S.C. § 544 and gave priority to subsequently filed IRS tax liens on the property. Ameriquest Mortgage Co. v. Stradtmann (In re Stradtmann), B.A.P. 8th Cir., No. 07-6056 (June 30, 2008).

In May of 2004, Ameriquest took a mortgage on the Debtors' homestead to secure a $183,000 promissory note. The mortgage correctly stated the property's common address, but contained a legal description for an entirely different piece of property. Ameriquest recorded the mortgage with the incorrect legal description on May 20, 2004. Subsequently, the IRS filed three notices of tax lien against the Debtors' property.

Approximately one year after granting the mortgage to Ameriquest, the Debtors filed for Chapter 7 bankruptcy. Ameriquest moved for relief from the automatic stay to reform the mortgage to correct the legal description of the property. The bankruptcy court granted Ameriquest relief from the stay to reform the mortgage in state court. The Chapter 7 trustee removed the action and filed a counterclaim seeking to avoid the defective mortgage under 11 U.S.C. § 544(a)(3). The bankruptcy court ruled that the mortgage "was avoidable under § 544; that the interest avoided was preserved for the benefit of the estate, to be administered by the Trustee; and that the I.R.S's tax liens were superior to the interests of the Trustee." Ameriquest appealed the bankruptcy court's decision to the U.S. Bankruptcy Appellate Panel for the Eighth Circuit (the "Eighth Circuit B.A.P." or "Panel").

The Eighth Circuit B.A.P. affirmed the decision of the bankruptcy court, finding that the Chapter 7 trustee, standing in the shoes of a bona fide purchaser under Minnesota law, could avoid the conveyance to Ameriquest because the defective mortgage failed to provide either constructive or implied notice of Ameriquest's interest in the Debtors' property. Ameriquest argued that the defect in the mortgage was apparent, and thus the mortgage gave constructive notice of Ameriquest's interest, because the legal description conflicted with the common address and the tax identification number listed on the mortgage. Relying on Lindquist v. Household Industrial Finance Co. (In re Vondall), a case affirmed by the Eighth Circuit Court of Appeals in June 2008, the Panel rejected Ameriquest's argument. The Eighth Circuit B.A.P. found that, under Vondall, "a conflict between a tax identification number and a legal description is not considered apparent …If there is northing in the property description to trigger a duty of further

---

[1] KATHLEEN E. KRAFT is an associate with Thompson Coburn LLP, 1909 K Street N.W., Suite 600, Washington, D.C. 20006, where she concentrates her practice in the areas of business bankruptcy, corporate restructuring and creditors' rights. Ms. Kraft graduated *magna cum laude* from Saint Louis University with an honors Bachelor of Arts degree in English. She received her J.D., *magna cum laude*, from Saint Louis University School of Law. Ms. Kraft is admitted to practice in Missouri and Illinois, and has admission to practice pending in the District of Columbia. She is a member of the American Bar Association and the American Bankruptcy Institute. She can be reached at kkraft@thompsoncoburn.com; .202.585.6922 (ph) or 202.508.1035 (fx)

inquiry, then a conflict between the legal description and the common address is not apparent, and therefore does not trigger constructive or implied notice."

A Preference for Procrastination: Late-Perfecting Lender's Lien Avoided as a Preference

On June 26, 2008, the U.S. Court of Appeals for the Sixth Circuit held that a late-perfected mortgage lien was avoidable as a preferential transfer and that the earmarking doctrine did not shield the lender from preference exposure. Chase Manhattan Mortgage Corp. v. Shapiro (In re Lee), 6th Cir., No. 06-1538 (June 26, 2008).

In 2001, the Debtor purchased a piece of property in Pontiac, Michigan and obtained a 30-year mortgage from Flagstar Bank. The Flagstar mortgage was properly recorded with the Oakland County Recorder of Deeds. Later in 2001, Flagstar assigned the mortgage and related note to Federal National Mortgage Association, in care of Chase Mortgage Company. Chase Mortgage Company later merged with Chase Manhattan Mortgage Corporation ("Chase"). In October 2003, the Debtor refinanced the original loan by obtaining a new mortgage loan from Chase, using the proceeds of the new loan to pay off the original loan. In connection with the refinancing, Chase obtained a new 30-year mortgage on the property. Chase discharged the original mortgage by a "Discharge of Mortgage" dated October 27, 2003. The Discharge of Mortgage was recorded on January 16, 2004. The new mortgage was recorded on December 17, 2003—51 days after the original mortgage was discharged and 72 days after the closing on the new loan.

On March 4, 2004, 77 days after Chase recorded the new mortgage, the Debtor filed for bankruptcy protection. The trustee sought to avoid the new mortgage as a preferential transfer under 11 U.S.C. § 547(b). The bankruptcy court found that the new mortgage could be avoided as a preference because the perfection of the new mortgage did not relate back to the initial transfer under § 547(e)(2)(B) and the recording of the new mortgage caused a diminution of the Debtor's estate. The bankruptcy court also rejected Chase's argument that the earmarking doctrine protected the transaction, finding that the doctrine only protected the first transfer (the transfer of the funds). After the district court reversed the bankruptcy court, the trustee appealed the case to the Sixth Circuit Court of Appeals.

The Sixth Circuit Court of Appeals (the "Court") found that the earmarking doctrine did not apply to protect Chase from preference liability. As stated by the Court, the earmarking doctrine applies where "(a) the agreement is between a new creditor and the debtor for the payment of a specific antecedent debt; (b) the agreement is performed according to its terms; and (c) the transaction according to the agreement does not result in a diminution of the debtor's estate." The Court found that Chase could not rely on the earmarking doctrine to protect the transfer of the new mortgage because (1) Chase was not a "new creditor," in that Chase refinanced its own loan; (2) the two transfers made by the Debtor in the refinancing transaction cannot be treated as one for purposes of applying the defense in direct contradiction to the meaning of "transfer" in §§ 101(54) and 547(e); (3) the doctrine cannot be applied to the transfer of a lien interest, as opposed to a transfer of funds, because the grant of a lien does not involve a transfer of "earmarked" property; (4) the transfer caused a diminution in the Debtor's estate because Chase did not hold a perfected security interest from the time the original mortgage was discharged to the time the new mortgage was recorded, and the subsequent perfection of the new mortgage encumbered non-exempt equity in the property that would have been available for payment to the Debtor's unsecured creditors; and (5) allowing Chase to avoid preference liability under the earmarking doctrine would "essentially write § 547(e) out of the Bankruptcy Code" and defeat the discouragement of secret liens.

The Court also rejected Chase's argument that "it would be unfair and against public policy [to impose preference liability] because the refinancing transaction involved a mere substitution of its New Mortgage for the Original Mortgage and ultimately benefitted the Debtor's other creditors, not Chase." The Court stated that although the result in the case may be harsh, Chase could have readily prevented such result by timely perfecting its security interest.

Caveat Emptor for Alabama Real Estate Buyers: Tax Withholding Obligations Now Exist

by
Riley W. Roby and Walter H.C. McKay
Balch & Bingham LLP
www.balch.com

Beginning August 1, 2008, buyers, transferees and closing agents involved in Alabama real estate transactions must be mindful of new obligations to withhold and remit to the Alabama Department of Revenue (***"ADOR"***) a percentage of the purchase price otherwise payable to a nonresident of Alabama that sells or transfers Alabama real estate. With the recent passage of Act 2008-504 (the ***"Act"***), Alabama sails a similar course charted by numerous other states imposing tax withholding obligations on parties to real estate transactions.[1]

Summary of Alabama Tax Withholding Act

The Act applies to a sale of Alabama real estate by a seller that is a nonresident of Alabama. The Act and related forms[2] published by ADOR permit a seller that is a nonresident of Alabama to establish (for purposes of withholding obligations) Alabama residency by affirming to the buyer by sworn affidavit that the seller is an Alabama resident or the seller satisfies each of the following four conditions:

1. Seller has filed Alabama income tax returns for the 2 prior tax years; **and**

2. Seller is presently in business in Alabama and will continue substantially the same business after the sale ***or*** Seller has other real property in Alabama at the time of closing of equal or greater value than the withholding tax liability as measured by 100% of the tax assessed value; **and**

3. Seller will report the subject sale on an Alabama income tax return for the year of sale and file the Alabama income tax return by the due date with any applicable extensions; **and**

4. If Seller is a corporation or limited partnership, Seller is registered to do business in Alabama.

There are 2 basic methods for calculating the amount to be withheld by the buyer of Alabama real estate from a nonresident of Alabama. Under the first method, an individual buyer

[1] See California (Cal. Rev. & Tax. Code Sec. 18662 (West 2008)); Colorado (Colo. Rev. Stat. Sec. 39-22-604.5 (2007)); Georgia (Ga. Code Ann. Sec. 48-7-128 (West 2008)); Hawaii (Haw. Rev. Stat. Sec. 235-68 (West 2007)); Maine (Me. Rev. Stat. Ann. tit. 36, Sec. 5250-A (1995)); Maryland (Md. Code Regs. 03.04.12.01 (2008)); Mississippi (Miss. Code Ann. Sec. 27-7-308 (1972)); New Jersey (N.J. Stat. Ann. Sec. 54A:8-9 (2005)); New York (N.Y. Tax Law Sec. 663 (2004)); Oregon (See 2008 Or. Law 1st Sp. Sess. Ch. 54(S.B. 1101)); Rhode Island (R.I. Gen. Laws Sec. 44-30-71); South Carolina (S.C. Code Ann. Sec. 12-8-580 (2007)); and Vermont (Vt. Stat. Ann. tit. 32, Sec. 5847 (1997)), all of which impose laws similar to the Act.

[2] It is important to note that these recently promulgated forms are not ADOR regulations. Although it is anticipated that ADOR will issue formal regulations to interpret certain provisions of the Act, there have been no official regulations promulgated by ADOR at this time.

must withhold 3% of the purchase price, while a corporation, partnership or unincorporated association or other entity buyer (such as an LLC) must withhold 4% of the purchase price. Under the second method, an Alabama nonresident seller may affirm to the buyer by sworn affidavit the amount of gain recognized by the seller on the transaction, and the applicable withholding rate would then apply only to the gain amount. Under either calculation method, the buyer (a) must file the required tax return and remit the applicable withholding amount to ADOR by the last day of the calendar month following the month that the Alabama real estate transaction closed, and (b) shall not withhold and remit an amount greater than the net proceeds payable to the seller from the real estate transaction.

Noteworthy Alabama Tax Withholding Act Issues for Practitioners

The Act creates a number of unresolved issues which transaction parties must handle in connection with a closing. Although not comprehensive, the following discussion highlights issues implicated by the Act that are of particular importance to real estate practitioners:

1. *Tax-Free Exchanges*: Transferors of property often engage in tax-free exchanges under IRC Section 1031 in order to defer taxable gain which would otherwise be recognizable. Although the Act does not expressly exempt tax-free exchanges from the withholding obligations, ADOR has recently issued certain Frequently Asked Questions [Concerning] Withholding on Sales/Transfers of Real Property and Associated Tangible Personal Property by Nonresidents (Act 2008-504) (the ***"FAQs"***), which state that "[w]ithholding is not required to the extent that the income from the sale is not subject to Alabama income tax." Because income from a 1031 transaction is not subject to Alabama income tax, the FAQs suggest that the withholding obligations do not apply in a 1031 transaction. However, because the FAQs are provided by ADOR as guidance in advance of regulations, it is anticipated that such regulations or perhaps even a statutory amendment will specifically address this issue.

2. *Single Asset Entities*: For numerous planning reasons, real estate is often titled in an entity whose sole asset is that single piece of real estate. If a non-resident[3] single asset entity (i.e., one that is neither organized under Alabama law nor maintains it principal place of business in Alabama) sells its real estate, then the buyer will be required to withhold the applicable percentage of the purchase price from the sales proceeds. Such a seller would fail the second prong of the 4-prong Alabama residency test because it would not likely substantially continue the same business after the closing or own any other Alabama real estate at the time of the closing. In certain circumstances, Alabama composite tax return filers are exempt from the Act's withholding requirements, which may assist certain non-resident transaction parties. The disparity created by ADOR's favoring residents over non-residents under these circumstances may be subject to attack as violative of the Commerce Clause of the U.S. Constitution.

3. *Liability For Act Compliance*: The parties involved in a modern commercial real estate closing rarely are all in the same room to close the transaction. Indeed, a typical commercial closing involves representatives of the seller and buyer overnighting closing documents with an escrow instruction letter to a settlement agent, who is charged with handling the receipts and disbursements involved in the transaction and charged with drafting a closing statement to accurately reflect those receipts and disbursements. Although the Act solely imposes

[3]The recently published ADOR instructions for the Alabama residency affidavit under the Act exempt Alabama residents, including individuals and business entities either organized under Alabama law or with their principal place of business in Alabama, from the Act's withholding requirements.

liability on the buyer relating to violations of its provisions, a settlement agent involved in a transaction with parties represented by out-of-state counsel should nevertheless be proactive in disclosing the Act's provisions to the parties. Such disclosure should likely involve having the transaction parties execute a written acknowledgment describing the Act's terms, which might also include a provision whereby the parties indemnify the settlement agent for any potential exposure it may incur under the Act. ADOR should consider issuing future written guidance to explicitly limit a settlement agent's exposure under the Act to alleviate these concerns.

4. *Purchase Price Thresholds*: Practitioners should be mindful that ADOR has provided written guidance concerning certain purchase price thresholds, affording an additional exemption from the Act's withholding requirements. Issued in connection with the FAQs, this exemption applies to any transaction with a purchase price less than $800,000 which closes after August 1, 2008 but prior to January 1, 2009, and any transaction with a purchase price less than $300,000 which closes after December 31, 2008.

Where to Find More Information About the Alabama Tax Withholding Act

The FAQs are available for review in full at ADOR's website at www.revenue.alabama.gov/incometax/nonresidentwh.htm, together with the following forms promulgated by ADOR which are intended to facilitate compliance with the Act: (i) Form NR-AF1 (Affidavit of Seller's Residence); (ii) Form NR-AF2 (Affidavit of Seller's Gain); (iii) Form NR-AF3 (Seller's Certificate of Exemption); and (iv) Form WNR-V (withholding on Sales or Transfers of Real Property and Associated Tangible Personal Property by Nonresidents Payment Voucher). Copies of each of these four forms follow this article.

Clear Channel Outdoor, Inc.
v.
Nancy Knupfer, Chapter 11 Trustee; DB Burbank, LLC

By John Matthew Trott and Erik M. North

There are two ways of selling assets in a bankruptcy case: (1) pursuant to a confirmed plan of reorganization; or (2) pursuant to § 363 of Title 11 of the U.S. Code (the "Bankruptcy Code"). In recent years, more and more cases are being resolved by the sale of assets pursuant to Bankruptcy Code § 363 for a number of reasons, including that (i) a § 363 sale can be done far more quickly than confirming a plan of reorganization, (ii) until the recent *Clear Channel* case, it was clear that a sale under Bankruptcy Code § 363 was free and clear of all liens, claims and encumbrances and (iii) until the *Clear Channel* case, it was clear that unless a stay pending appeal is obtained, appeals of § 363 sales are generally going to be moot pursuant to Bankruptcy Code § 363(m).

The recent 9th Circuit Bankruptcy Appellate Panel ("BAP") decision in *Clear Channel Outdoor, Inc. v. Nancy Knupfer, Chapter 11 Trustee; DB Burbank, LLC* (2008 WL 2840659 (9th Cir. BAP (Cal.)) casts doubt on two of the above reasons for conducting a § 363 sale. The BAP held that even though no stay pending appeal had been obtained, the appeal from a § 363 sale was not moot. The BAP also found that the sale was not, in fact, free and clear of all liens, claims and encumbrances.

The Facts

PW, LLC ("PW"), a single-asset real estate entity holding several contiguous parcels of land in Burbank, California (the "Property"), had obtained the necessary entitlements pursuant to a development agreement with the City of Burbank to develop a mixed-use complex of luxury condominiums and retail space. Due to "problems large and small," the project did not progress as planned and, in July 2006, DB Burbank, LLC ("DB"), the holder of a claim for over $40 million secured by a first-priority lien on the Property, initiated foreclosure proceedings. On November 20, 2006, just prior to foreclosure, PW filed a chapter 11 bankruptcy case. DB immediately moved for, and the bankruptcy court granted, the appointment of the trustee, Nancy Knupfer ("Trustee").

Facing several immediate problems, including implementing the development agreement for the Property, the Trustee proposed to sell the Property and entered into negotiations with DB to accomplish the sale. These negotiations resulted in a "binding term sheet" between DB and the Trustee, establishing detailed procedures for an auction and sale of all of PW's assets, including the Property. The term sheet provided that DB would serve as a stalking horse bidder for the Property. If there were no qualified overbidders, DB would buy the Property for a credit bid of approximately $41.4 million. As a condition to the proposed sale, DB agreed to pay the Trustee a "Carve-Out Amount" of up to $800,000 to be used for certain administrative fees and other expenses, and not to seek relief from the automatic stay.

The Trustee filed a motion to approve the sale of the Property free and clear of all liens, claims and encumbrances under § 363(f)(3) and (f)(5) of the Bankruptcy Code. The

Property was encumbered by a junior lien in favor of Clear Channel Outdoor, Inc. ("Clear Channel"), securing a claim of approximately $2.5 million. Clear Channel opposed the motion, asserting that § 363(f) of the Code (*see below for text of § 363(f)*), was not applicable. Over Clear Channel's objection, the bankruptcy court entered an order authorizing the sale free and clear of Clear Channel's lien.

There were no qualified overbidders and on May 31, 2007, the bankruptcy court entered an order approving the sale and finding that DB was a purchaser in good faith. Clear Channel received no proceeds from the sale of the Property and timely filed an appeal of the order. The bankruptcy court declined to stay its order pending Clear Channel's appeal.

Mootness of Clear Channel's Appeal

The BAP noted that there were three types of mootness that might apply to the sale: constitutional, equitable and statutory. Constitutional mootness arises from the constitutional limitations on the federal courts to adjudicate only live cases and controversies. A appeal is constitutionally moot if it is impossible to grant relief. *Church of Scientology of Cal. v. United States*, 506 U.S. 9, 12, 113 S.Ct. 447, 121 L.Ed.2d 313 (1992). The BAP concluded that the appeal was not constitutionally moot. Even though the sale was completed, the court could still fashion some relief, such as reversing the sale or reversing the stripping of Clear Channel's lien.

The doctrine of equitable mootness applies when: (1) the appellant has failed to obtain a stay; and (2) even though relief on appeal is possible, the transactions that have taken place in the absence of a stay are too complex and difficult to unwind. The BAP agreed with DB and the Trustee that the doctrine of equitable mootness applied to the sale of the Property to DB. Citing *In re Popp*, 323 B.R. at 271, the BAP stated that "[e]quitable mootness requires the court to look beyond impossibility of a remedy to 'the consequences of the remedy and the number of third parties who have changed their position in reliance on the order that is being appealed'." The BAP noted that "[u]ltimately, the decision whether to unscramble the eggs turns on what is practical and equitable," *Baker & Drake, Inc. v. Pub. Serv. Comm'n (In re Banker & Drake, Inc.)*, 35 F.3d 1348, 1352 (9th Cir. 1994). The BAP concluded that based on the actions taken by DB and the reliance on such actions by third parties, the transaction under consideration was too "complex and difficult to unwind" and declined to reverse the bankruptcy court's order approving the sale.

That was a pyrrhic victory for DB, however, since the BAP did not find Clear Channel's appeal as to the stripping of its lien moot. Finding that (a) the issues before the BAP regarding the sale of the Property free and clear of all liens, which resulted in the stripping of Clear Channel's junior lien, were not complex, and (b) the reversal of this aspect of the bankruptcy court's order did not negatively impact third parties, the BAP held that this aspect of the appeal was not equitably moot.

The BAP then analyzed whether Clear Channel's appeal of the stripping of its lien was statutorily moot under § 363(m).

Section 363(m) protects sales of bankruptcy estate property, stating:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of [§ 363] of a sale or lease of property does not affect the validity of the sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Since Clear Channel did not obtain a stay pending its appeal of the court's order, DP and the Trustee asserted that the BAP was prevented from reversing the bankruptcy court's order that the Property be sold free and clear of all liens. The BAP disagreed, and, applying an exceptionally literal reading of the statute, noted that § 363(m) on its face only applies to subsections (b) and (c) of § 363. Since the lien-stripping was ordered under § 363(f), the BAP held that the § 363(m) protection did not apply.

The BAP also noted that the language of § 363(f) refers to authorizations to "use, sell or lease . . . property of the estate," while § 363(b) only limits the ability to "affect the validity of a *sale* or *lease* under such authorization . . . ." The BAP reasoned that by omitting "use" along side "sale and lease" in § 363(m), Congress only intended to extend such protection to "changes of title or other essential attributes of a sale, together with the changes of authorized possession that occur with leases." Accordingly, the BAP held that while § 363(m) protects the actual sales from appellate review, the terms of such sales, specifically, in this case, lien-stripping, are not afforded such statutory protection.

Lien-Stripping under § 363(f) of the Bankruptcy Code

The BAP's analysis of the bankruptcy court's stripping Clear Channel of its junior lien centered on § 363(f), which states:

> (f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if:
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction or such interest.

The BAP restricted its analysis to subsections (3) and (5), finding that subsections (1), (2) and (4) were inapplicable to the facts of the case (i.e., (1) applicable California law would preserve Clear Channel's lien in the event the Property was sold, (2) Clear Channel did not consent to the transfer free and clear of its lien, and (4) Clear Channel's lien was not in dispute).

The question was whether subsection (3) of § 363(f) allowed a sale free and clear of all liens, claims and encumbrances when the Property sold for less than the total amount of the claims that it secured. The answer to this question turned on the phrase "aggregate value of all liens."

DB and the Trustee asserted that the phrase "aggregate value of all liens" meant the economic value of the liens, not their face value. The BAP disagreed, finding that in the context of the Code, "aggregate value of all liens" as it appears in § 363(f)(3) does not mean "the *economic* value of such liens, rather than their face value" (i.e., the value of the secured claims).

The BAP further reasoned that because subsection (3) permits a free and clear sale only when "the price at which such property is to be sold is *greater* than the aggregate value of all liens," "the paragraph could *never* be used to authorize a sale free and clear…when the claims exceed the value of the collateral that secures them," because '[I]n any case in which the value of the property being sold is less than the total amount of clams held by secured creditors, the total of all allowed secured claims will *equal*, not exceed, the sale price [of the property], and [§ 363(f)(3)] requires the price to be "greater than" the "value of all liens.'" Therefore, the BAP held that "§ 363(f)(3) does not authorize the sale free and clear of a lienholder's interest if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property being sold."

The BAP then turned to § 363(f)(5), which was the basis of the bankruptcy court's order. The BAP determined that § 363 (f)(5) did not support stripping Clear Channel's lien from the Property.

In an effort to avoid § 363(f)(5), Clear Channel argued that it's lien was not an interest. The BAP was not swayed by this argument and determined that Clear Channel's lien was an "interest" (a term not defined in the Code) for the purposes of § 363(f)(5). The BAP then addressed whether Clear Channel "could be compelled…to accept a money satisfaction" of such interest.

The bankruptcy court had found that § 363(f) (5) is satisfied whenever a claim or interest can be satisfied with money. The BAP found this analysis too simplistic. The BAP noted that this analysis would, in essence, subsume § 363(f)(3) since payment of money would satisfy most claims and interests.

In order not to have § 363(f)(5) subsume § 363(f)(3), the BAP assumed for its analysis that § 363(f)(5) referred to "a legal and equitable proceeding in which the nondebtor could be compelled to take *less* than the value of the claim secured by the interest," (i.e., "the existence of another legal mechanism by which a lien could be extinguished without full satisfaction of the secured debt."). The BAP stated that this narrow interpretation prevented an overlap with § 363(f)(3), but nonetheless preserved a role for § 363(f)(5) in such circumstances as buy-out arrangements among partners or joint venturers or in cases where liquidated damages could be used as a remedy in place of specific performance. Accordingly, the BAP held that a "bankruptcy court must make a finding of the existence of such a mechanism and the trustee must demonstrate how satisfaction of the lien 'could be compelled'."

Finally, in clarifying its finding that there must be at least the possibility of an applicable proceeding at law or equity "in which a nondebtor could be forced to accept money in satisfaction of its interest," the BAP held that a cramdown under § 1129(b)(2) of the Code is not an applicable procedure for the purpose of § 363 (f)(5). The BAP reasoned that if the cramdown proceeding were sufficient in and of itself, there would have been no Congressional purpose in including § 363(f)(5) in the Code.

Having decided that Clear Channel's appeal to reverse the bankruptcy court's stripping of its junior lien was neither equitably nor statutorily moot and that the bankruptcy court did not apply the correct legal standard under § 363(f)(5) in ordering the Property's sale free and clear of all liens, the BAP reversed the lien-stripping part of the bankruptcy court's order and remanded the case, providing the parties the opportunity to identify provisions of state law, if any, that would allow for the sale of the Property free and clear of Clear Channel's lien.

While the *Clear Channel* case has yet to be published, it nonetheless casts a shadow across chapter 11 cases in which extinguishing existing liens on estate property is an important component of the economics of the sale. The result in *Clear Channel* is that DB ended up owning the Property subject to the $2.5 million lien in favor of Clear Channel. Obviously, this is not the result DB desired, nor would this have been the result had DB foreclosed under its first-priority lien.

By severely limiting the protection provided to good faith buyers under § 363(m), the BAP's holding may cause potential purchasers of chapter 11 properties to think twice before engaging in a § 363(f) transaction in cases where a lien holder could rise from the dead even after such a sale is completed.

John Matthew Trott is a partner and Erik M. North is an associate in the Los Angeles office of Cox, Castle & Nicholson LLP, where they represent parties in commercial real estate transactions.

STRING INCLUSION: FINAL REGULATIONS ON 2036 AND 2039

By

Jim Roberts
Glast, Phillips & Murray, P.C.
Dallas, Texas

A little over a year ago, on June 6, 2007, the Treasury and IRS published proposed regulations on what part of a trust is includable in a deceased settlor's estate under Sections 2036 or 2039 if the settlor retained an interest in the trust property – a so-called "string." This past month, Treasury finalized those regulations (TD 9419, issued July 11, 2008, effective July 14, 2008).

Major Points. Four major points can be made:

(a) inclusion will be computed under section 2036 and its newly amended Reg.Sec. 20.2036-1;

(b) inclusion will not be addressed or computed under section 2039, so says newly amended Reg.Sec. 20.2039-1;

(c) other sections of the Code, such as sections 2035 through 2039, can still be applied where the IRS thinks appropriate (at least one example illustrates that point); and

(d) the amount to be included is not the present value of the stream of payments.

Trusts Addressed. The trusts addressed by the regulations all have two things in common: (a) the settlor set up the trust; and (b) the settlor retained some income or other right. The trusts come in many different varieties, from certain charitable remainder trusts (CRTs) such as charitable remainder annuity trusts (CRATs) within the meaning of section 664(d)(1), charitable remainder unitrusts (CRUTs) within the meaning of section 664(d)(2) or (d)(3), and charitable remainder trusts that do not qualify under section 664, as well as other trusts established by a grantor (collectively GRTs) such as grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs), and various forms of grantor retained income trusts (GRITs), such as qualified personal residence trusts (QPRTs) and personal residence trusts (PRTs). A CRT is within the scope of the regulations whether or not the CRT met the qualifications of section 664(d)(1), (d)(2), or (d)(3) because either the CRT was created prior to 1969, there was a defect in the drafting of the CRT, there was no intention to qualify the CRT for the charitable deduction, or for any other reason. A GRT is within the scope of the regulations whether or not the grantor's retained interest was a "qualified interest" as defined in section 2702(b).

The Basic Computation. Basically, the new regulations say that the amount includable is determined by taking the stream of payments the decedent was supposed to receive, and then, using the 7520 rate, determining what amount of money would be required to produce that stream of income. The 7520 rate to be used is the one in effect at the death of the decedent (or the alternate valuation date, whichever is applicable). If the payments were to be made at other intervals, then the appropriate adjustment factor or

7520 rate for payment frequency, whether semiannual, quarterly or monthly, is to be used.

The above computation gets more complicated when dealing with unitrusts. The inclusion amount is determined by dividing the trust's equivalent income interest rate by the section 7520 rate. The equivalent income interest rate is determined by dividing the trust's adjusted payout rate by the excess of 1 over the adjusted payout rate.

After the computation, if the principal needed is less than 100% of the value of the trust, the estate inclusion is the lesser amount. If the principal needed is computed to be more than 100% of the trust, then the amount includable in the settlor's estate is limited to the value of the trust assets.

Comments. The proposed regulations were the subject of multiple comments. One commonly made objection was inclusion should be computed by reducing to present value the stream of payments, rather than the above computational method which can cause 100% inclusion. And if the present value is zero, then the stream of payments must have been purchased for full and adequate consideration and, therefore, there should be no inclusion. But the Service argued that section 2036 is the applicable section, and, because of that, the Service said 2036 was originally adopted by Congress, and has been interpreted since then, to cause inclusion of the value of the asset as to which a "string" was held back by the grantor, not the value of just the string.

Similarly, when a commentator suggested that section 2036 applies only to the extent that the trust principal alone is insufficient to fully satisfy the annuity payment, the IRS and Treasury Department responded by saying that this would condition the estate tax treatment on the nature and performance of the investments selected by the trustee, and the application of section 2036 should not be dependent on either the trustee's exercise of his or her discretion to invest in income or nonincome producing assets, or the actual performance of the trust assets.

And where the remainder interest in a trust is zero, some suggested that the full and adequate consideration clause of section 2036 should apply, and, therefore, there should be no inclusion. But Treasury and the IRS argued that there is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a trustee. The former includes negotiation and agreement between two parties operating in his own interest, but when a grantor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property, and there is no other property owner negotiating for his own best interests. All of there terms are dictated by the transferor, and the transferor is retaining certain rights, whether possession, enjoyment in another form, or income. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death, the property is subject to inclusion in the grantor's gross estate under section 2036.

A commentator requested that the regulations address the formulas used to determine a pooled income fund's rate of return, and thus the value of the charitable gift, saying that funds that are at least three years old use the highest of the three last taxable years' rates of return, and funds that are less than three years old generally use the highest of the three calendar-year annual averages of the section 7520 rates minus 1 percent. See section 1.642(c)-6(e)(3) and (4). But Treasury and the IRS said this distinction based on the duration of the fund is not relevant because the retained interest is the right to all of the income, thus mandating the inclusion of the entire share of the fund's corpus attributable to the transferor. But a pooled income fund example was added for clarification.

Some commentators requested specific types of examples, or changes to examples. One request was for an example on how the alternate valuation date rules in Reg. Sec. 20.2032-1(d) affect the trust's value, but Treasury declined to deal with that, saying any such example should go into those regulations. Another request was to have examples or discussions of what happens when a donor creates a CRT for a term of years, and Treasury responded by modifying its examples, and concluded that a term of years CRT versus a lifetime CRT makes no difference on the amount includable. And a request for an example of how to deal with a graduated GRAT was thought to be a good idea, but Treasury declined to create one now, citing the need for further consideration. A similar response was given in response to a request that the example in the existing, non-amended part of the regulations at Reg. Sec. 20.2036-1(c)(1)(ii) be re-written to change the reference to a spouse with a child to avoid complications with section 2523.

Examples. The illustrations are very helpful. For example, Example 1 in the annuity-unitrust section, a CRAT is funded with $100,000, and the annual annuity payment back to the settlor is $7,500, with the annuity continuing after settlor dies for the settlor's child for life. At the settlor's death, the trust has grown to $300,000, the 7520 rate at that time is 6%, and the child is 40 years old. Only $125,000 is required, at 6%, to pay $7,500 per year, so only $125,000 is includable in the estate. And the result is the same if the settlor had relinquished his annuity payment within 3 years of death because of section 2035. The child's age is of no importance. If the settlor could change the charitable remainderman or revoke the child's annuity, then section 2038 might apply. And, finally, because of these new regulations, section 2039 does not apply.

Example 2 illustrates a 10 year CRAT with monthly payments. Example 3 is a CRUT, and shows how a computation that exceeds the trust assets can occur (the inclusion is limited to the assets in the trust). Example 4 illustrates a 15 year GRIT. Example 5 shows how to deal with a pooled income fund. And Example 6 shows full inclusion of a residence in a QPRT.

Revenue Rulings Now Obsolete. Rev. Rul. 76- 273, 1976-2 C.B. 268, and Rev. Rul. 82-105, 1982-1 C.B 133, are spotlighted in the preamble of the regulations. Basically, the IRS explained that these rulings could have provided a means for claiming only a part of the value of a trust in the decedent's estate. The IRS explained that the new regulations are designed to incorporate those rulings into the regulations, and, in doing so, render them obsolete.

NO DISCOUNTS FOR RMAs

By

Jim Roberts
Glast, Phillips & Murray, P.C.
Dallas, Texas

Restricted Management Accounts, or RMAs, are considered by many to be a simple, yet effective, means of discounting assets, particularly, stocks and cash, without the need for complex limited partnerships agreements or split-ownership planning. A parent might deposit stocks and bonds into an RMA for a fixed term, perhaps five years. By agreement, the institution, whether a bank or brokerage company, manages the account. It has discretion over the investments, while the person who established the account retains only a property interest in the assets. The RMA cannot be canceled, but the person who set up the account can transfer, with the consent of the institution, the rights of the creator of the account to a family member, a trust, or other permitted transferee. Typically, parents have used RMAs, funding them and then gifting interests in them to children. The restrictions on access to the account are that the parent holds an asset that has a lesser or discounted value and, thus, the gift of an interest in the account to a child or other is a discounted value gift.

While certain commentators earnestly believe that RMA discounts are viable and, if litigated, would be upheld, nonetheless, the Internal Revenue Service has ruled in Rev. Rul. 2008-35, 2008-29 IRB116, that an interest in an RMA is to be valued for transfer tax purposes without any reduction or discount on account of the restrictions imposed by the RMA agreement. For this reason, Reg. Sec. 20.2031-2(g) provides that if a decedent holds a trading account with a broker, all securities belonging to the decedent and held by the broker at the date of death must be included at their fair market value as of the applicable valuation date, even if pledged to secure a debt. Similarly, Reg. Sec. 20.20315 says that the amount of cash belonging to a decedent at the date of death, whether in the possession of the decedent or another person, or deposited with the bank, is included in the gross estate.

The IRS took the position that an RMA agreement is merely a management contract between the owner of the property and the person agreeing to serve as the property manager, whether a broker, bank or other. The restrictions imposed by the RMA agreement relate primarily to the performance of the management contract, and do not place substantive restrictions on the underlying assets. Any restrictions in the RMA agreement on the ability of the depositor to withdraw assets, terminate the agreement, or transfer interests do not impact at all the price of those assets and, thus, do not affect the value of the assets in the RMA for gift or estate tax purposes. The Service reasoned that a RMA is comparable to a retirement fund or an Individual Retirement Account. They cited the cases of *Estate of Smith v. United States*, 391 F.3d 621 (5th Circuit 2004) and *Estate of Kahn v. Commissioner*, 125 TC 227 (2005) where courts reached the conclusion that assets in retirement accounts, which are subject to restrictions, are not entitled to any discount. From that, the Service concluded that assets in an RMA are not subject to any discount either.

S CORPS CORPORATION OWNED LIFE INSURANCE (C.O.L.I): NO ACCUMULATED ADJUSTMENT ACCOUNTS (AAA) EFFECT

By

Jim Roberts
Glast, Phillips & Murray, P.C.
Dallas, Texas

Estate planners commonly deal with clients who own interests in S corporations. Many times the planning involves life insurance to provide funds to pay off debts to lenders, or to provide a means for the corporation to survive at the death of the S corporation shareholder, or for other reasons. Those companies purchase and maintain S corporation-owned life insurance, generally referred to as "C.O.L.I." or, in this case "S.C.O.L.I." A question that has been raised from time to time is the impact of the payment of premiums for S.C.O.L.I. on the "accumulated adjustment accounts," or "AAA." AAA track the amount of undistributed income that has been taxed to the S corporation shareholder, similar to the manner in which E&P generally tracks a C corporation's undistributed income. AAA are the mechanism that allows previously-taxed but undistributed income to be distributed tax-free to S corporation shareholders to the extent of the shareholders' basis in their stock. If the payment of premiums reduces the AAA, then the S corporation's shareholders can take fewer distributions tax free.

Rev. Rul. 2008-42, 2008-30 IRB1, answers the question in a positive way for taxpayers, saying that the payment of premiums does not reduce AAA. As a result, the undistributed income accounted for in AAA is not reduced, and the shareholders may continue to take that amount tax free to the extent of their basis. The Service reasoned that Sec. 264(a)(1) prohibits the S corporation from taking a deduction for premiums paid on any life insurance, endowment or annuity contract if the S corporation is directly or indirectly a beneficiary. Similarly, Reg. Sec. 1.264-1(a) provides that premiums paid for life insurance on the life of any officer, employee or other person financially interested in a business carried on by the taxpayer, including an S corporation, are not deductible where the S corporation is directly or indirectly a beneficiary of the policy.

Reg. Sec. 1.1368-2, provides for the calculation and maintenance of AAA. It says that AAA are generally decreased by certain items of loss or deduction, including any non-deductible expense not properly chargeable to a capital account. Because premiums on life insurance are not deductible, then that portion of the regulation would indicate that the AAA should be reduced by those premiums.

However, the Service cited Reg. Sec. 1.1366-1(a)(2)(viii) which provides that, for the purposes of Subchapter S, <u>tax-exempt income</u> is permanently excludable from gross income in all circumstances. Normally, we might think of income from municipal bonds as tax-exempt. But, the Service reasoned that death benefits are also tax-exempt income. Sec. 1368(e)(1)(A) regulations under that, previously cited, say that the non-deductible expenses referred to above reduce AAA, <u>unless</u> the expenses are related to tax-exempt income. Since the premiums are related to the life insurance death benefits, and because the death benefits are tax-exempt income, even though the premiums are non-deductible and are not properly chargeable to a capital account and, thus, otherwise would reduce AAA, the exception for expenses related to tax-exempt income means that AAA are not reduced by those premiums.

This ruling is important. Without it, some would have suggested that having the S corporation buy, pay for, and be the beneficiary of, a life insurance policy, would have a double-negative effect: (1) the payment of the premiums would not be deductible; and (2) the payment would reduce AAA, thus making distributions taxable that otherwise would not have been. With this ruling, that double-negative effect is eliminated. The premiums are still not deductible; thus, the income used to pay them is still taxable, not being offset by any such deduction. But, at least the premiums don't increase the amount of tax on distribution from AAA as previously suggested.

SAMPLE CHARITABLE LEAD UNITRUST FORMS FROM IRS

By

Jim Roberts
Glast, Phillips & Murray, P.C.
Dallas, Texas

The Treasury and Internal Revenue Service are continuing in a project to provide sample forms for various uses that the IRS has determined are acceptable and can be used without being challenged by them. Most recently, the Service has issued two Revenue procedures: Rev. Proc. 2008-45, 2008-30 IRB224, and Rev. Proc. 2008-46, 2008-30 IRB238, both released July 28, 2008. In those, the Service is providing sample Charitable Lead Unitrust Forms. The first Rev. Proc. provides inter vivos forms and the second provides testamentary forms.

The forms are annotated and explain their purposes. For example, in the first of those two Revenue procedures, the IRS defines the Charitable Lead Unitrust Form as "an irrevocable split interest trust that provides for a specified amount to be paid to one or more charitable beneficiaries during the term of the trust. The principal remaining in the trust at the end of the term is paid over to, or held in a continuing trust for, a non-charitable beneficiary or beneficiaries identified in the trust." The annotations continue by giving guidance on whether and to what extent there may be charitable deductions, and the annotations explain, in the inter vivos trust forms, the difference between a grantor CLUT and a non-grantor CLUT.

In both of the Revenue procedures, the IRS has indicated that, in general, it will not issue private letter rulings for the inter vivos or testamentary CLUTs to the extent that they use these standard forms. They did, however, say they would issue letter rulings related to the tax consequences of the inclusion in the CLUT document of substantive trust provisions other than those contained in the sample documents.

These unitrust forms complement the Charitable Lead Annuity Trust Forms, both inter vivos and testamentary, issued on June 22, 2007, in Rev. Proc. 2007-45, 2007-29 IRB1, and Rev. Proc. 2007-46, 2007-29 IRB1.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e|Report

A Bi-monthly Electronic Publication for Section Members August 2008

Group and Committee News

Employee Benefit Plans and Other Compensation Arrangements Group

The RPTE Employee Benefit Plans and Other Compensation Arrangements Group is hosting and co-hosting several programs at the RPTE/Tax Section Joint Fall CLE Meeting to be held in San Francisco September 11-13.

Programs include:

• PBGC, Underfunded Plans & Distressed Companies: A Practical Guide at 10:30 a.m. on September 12
• Health Plan Design and Compliance Issues at 2:00 p.m. on September 13
• Reporting & Disclosure of Fees for 401(k) and Other Plans - Coping with the New Regime at 3:30 p.m. on September 13

The Group also invites members and other interested individuals to participate in its next quarterly conference call focusing on welfare plan matters on October 14, beginning at 1:00 p.m. Eastern (call-in number: 1-800-504-8071; passcode: 9885683#). The Group hosts conference calls each quarter as a free benefit to Group members. The calls generally feature a brief presentation of a timely topic followed by an open discussion among participants about the topic area. The July conference call featured a discussion, lead by the Fiduciary Responsibility, Administration and Litigation Committee, about the standard of review of claims decisions when a fiduciary has a conflict of interest after the *Glenn* decision. In addition to its regularly scheduled quarterly conference calls, the Group hosted a series of supplemental conference calls during which Group members discussed special challenges associated with assisting clients to comply with Internal Revenue Code Section 409A. For 2009, the quarterly conference calls presently are scheduled to occur at 1:00 p.m. Eastern on the third Wednesday in January, April, July and October.

About the Group:

Employee benefits and compensation are critical components of the economic wealth, well-being and welfare of employees and their families. Concurrently, compensation and benefit matters also play a vital role in the ability of businesses to recruit, retain and motivate employees, to structure and execute real estate and other common business transactions and create legal risks for businesses and others involved in employee benefit plan sponsorship and administration. This group focuses on all aspects of employee benefit plans and other compensation arrangements, including issues relating to qualified plans, medical and other welfare plans and nonqualified deferred compensation plans, the fiduciary responsibilities of plan trustees, plan administrators and other plan fiduciaries, plan administration, plan transactions, plan terminations, and litigation involving this area of practice.

The Group invites persons interested in joining or other involvement opportunities to contact Chair Mike Macris (mmacris@cahill.com) or Vice Chair Cynthia Marcotte Stamer (cstamer@gpm-law.com).