# 2008 Early Winter Musings: Estate Planning Hot Topics and Current Developments

**January 7, 2008**

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## Introduction

Some of my observations from seminars earlier this year and other estate planning hot topics are summarized below. I do not take credit for the many interesting ideas discussed below. I attribute all the good ideas to the many speakers at the conferences and committee meetings. I have not researched the various issues to confirm the correctness of or to endorse all of the ideas presented by the various speakers. I often have not identified individual speakers who made each of the comments (primarily in case I have misinterpreted any of their comments).

## 1. Estate Tax Legislation Update

a. Estate Tax Reform. Because of the difficulty of reaching 60 votes in the Senate in light of the entrenched positions of Senators on the estate tax issue, it is certainly possible (perhaps even more likely than not) that a compromise will not be reached until 2009 when the "gun is at the heads" of Congressmen to avoid the drastic changes that will occur in 2010 and 2011 under current law. Both sides have taken very entrenched positions, as evidenced by the Trifecta bill this summer when the Republicans could not pick up any additional votes even by adding an increase in the minimum wage that has been long awaited by the Democrats. An effect of the delay is that the ever important ten-year revenue cost of legislation gets considerably larger closer to 2010, because the reform legislation would replace a system for most of the ten-year window that is based on pre-2001 law. We are likely to see extremely long phase-ins to reduce the ten-year revenue cost. Reform measures would likely include estate and GST exemptions in the $3.5-5.0 million range and reduced rates (how low is a major point of disagreement). As a measure of providing some revenue offset, it is likely that there may be a provision disallowing some types of intra-family discounts.

Reform efforts are continuing. H.R. 3170 was filed on July 24, 2007 by Reps. Mitchell (D. Az.) and Shays (R. Ct.) which provides for reunification of the gift and estate tax, increasing the exemption amount in stages to $5.0 million by 2015, with an inflation adjuster after 2015, reducing the rate to the long term capital gains rate on the first $25 million and two times that rate on the excess over $25 million (and the $25 million would be indexed for inflation after 2015), repeal of the deduction for state death taxes, and portability of the unified credit between spouses.

There is not strong impetus for action on estate tax reform, and key legislators seem to have other tax issues of a higher priority. Reaching compromise on a reform package may not be realistic until 2009 (or after the 2008 elections), and there is the realistic possibility of no compromise being reached even in

2010 (which would leave open the possibility of carryover basis for some period of time).

b. Comments of Democratic Staff Director to Senate Finance Committee. A recent presentation by the Russ Sullivan, Democratic Staff Director of the Senate Finance Committee, suggests that legislation might come as early as the second half of 2007. Stephanie Heilborn and Jonathan Blattmachr (with Milbank, Tweed, Hadley & McCloy in New York) have provided the following summary of his presentation to the Estate & Gift Tax Committee and Trusts, Estates & Surrogate's Courts Committee of the NYC Bar Association on December 19, 2006:

"Congress expects to address the estate tax in the second half of 2007. The bottom line is that for any bill to pass both houses, it cannot reduce the revenues raised by estate/gift tax by more than 50% (apparently the reason last year's proposal didn't pass is that it cost just a little too much (it reduced revenues by 60%) for some key Democratic senators to support it). Any new estate tax law is highly likely to contain the following provisions:

Step-up in basis (the feedback regarding carryover basis has been loudly and uniformly negative—sorry Jonathan!)

Estate tax exemption between $3.5 million and $5 million

Estate tax rate will correspond to the capital gains rate—possibly 15% rate for the first $5-10 million and a higher rate, which "will start with a 3", for the balance over that

Exemptions will be transferable between spouses

No state tax deduction (Apparently the state governors have been terrible lobbyers——not a single one has complained about the loss of state estate tax revenues.)

There will be "offsets" in exchange for the reduction in tax rates. **These are likely to include restrictions on discounts available for family limited partnerships, especially those funded with mostly marketable securities.** He told us, "Take a good look at some of the proposals from during the Clinton administration."

Unclear whether the estate and gift tax will be reunified—there has been disagreement within the Senate Finance Committee staffs

If we get to 2010 and no estate tax bill has been passed, they will extend the 2009 provisions for a while—even the more progressive Democrats agree that we can't go back to the pre-2001 law."

c. 2008 Budget Resolution. The Senate on May 23, 2007 passed S. Con. Res. 21 setting forth the congressional budget for fiscal year 2008 and including appropriate budgetary levels for fiscal years 2007-2012. An amendment by Max Baucus was passed by the Senate on March 21 (by a vote of 97-1) that addressed tax issues. There was an estimate that the resolution would produce a $132 billion budget surplus in 2012. The Baucus amendment would make the surplus available to offset tax cuts that would otherwise occur. The amendment does not mandate tax cut extensions but would merely "accommodate" an extension of some of the tax cuts enacted in 2001 and 2003. In the debate, Senator Baucus listed seven possible targets for the tax cut extensions. "Reforming the estate tax" was the last on the list, and the only item on the list that did not reflect a clear pattern of middle class relief. As to the estate tax, Senator Baucus stated in the floor debate that the amendment "contemplates extending the estate tax provisions that are in effect in 2009 permanently" (and in the context of this budget resolution, "permanently" means through 2012). The amendment clearly would leave the details of implementation to future considerations by the Senate Finance Committee.

An amendment by Senator Kyl to raise the estate tax exemption to $5 million (indexed for inflation) with a 35% rate. That amendment was defeated by a 51-48 vote. The Senate passed its fiscal 2008 budget resolution by a 52-47 vote on March 23, 2007.

The House of Representatives has passed its own budget blueprint, which assumes that the tax cuts enacted during President Bush's first term, including the estate tax, will expire, generating a huge surplus in 2012. The House budget plan includes a "pay-as-you-go" requirement.

d. Ron Aucutt's Bottom Line Summary Regarding Current Reform Discussions

- "The zenith for the possibility of estate tax repeal has passed, and probably will not arise again for at least another generation."
- "I'm talking about talk….When all was said and done, there was a lot said."
- Seventy Senators have voted for a $5 million exemption and a 35% rate, when votes on the various reform measures are compiled. But we do not know how a particular Senator will vote when the Senator knows that the vote is really meaningful.
- It does not matter which party controls Congress or the Presidency; ultimately the reform compromise will be worked out by 8 Senators in the middle, and the House will have to go along with whatever comes out of the Senate.

- There is no political will to raise the estate tax ever. Therefore, if the reform measure is not completed before 2009, the exemption will not fall below $3.5 million.
- A 15% bottom bracket could be touted as a victory for each party. Proponents of a low rate can declare victory. Opponents of a low rate can also declare victory (that the bracket only applies to a small bottom bracket). The compromise may be a bottom 15% bracket and a top bracket of 30% (or in the 30s).
- The *federal* estate tax rate under the pre-2001system was 39% (55% - 16% state credit top brackets).
- The credit for state estate tax will never reappear, and indeed even the deduction for state tax may disappear.
- The effective date of any reform package will be no earlier than 2010.
- There will be significant phase-ins, and likely inflation adjusters.
- The estate tax and GST rate will be the same. The gift tax exemption is likely to stay at $1 million.
- Portability of the exemption between spouses is likely to return, but details of the provision to avoid abuse may change.
- "Last year's proposals had 'artificial sweeteners' and we may see 'natural sweeteners' in the future—entity based discounts may be disallowed."
- Planning around state death taxes will continue in complexity. Twenty-four states have a stand-alone estate tax; Washington has a 19% top bracket.
- There may continue to be some type of relief for farmers and ranchers. Senators Baucus and Grassley are from Montana and Iowa, respectively. While there is little empirical evidence that farms are sold because of the estate tax, the public believes it, so Congress is sensitive.
- In one poll, 19% of the public said they were personally affected by the estate tax.

e. Numbers of Estate Tax Returns Are Falling Dramatically. The summer of 2007 issue of the Statistics of Income Bulletin (IR 2007-153) indicates that the number of estate tax returns filed fell by 58 percent to about 45,000 in 2005 from about 108,000 in 2001. (The estate tax exemption increased from $675,000 in 2001 to $1,500,000 in 2005.) The total amount of assets represented by the returns fell by 14% to $185 billion in 2005 from $216 billion in 2001. However, the net estate taxes reported on these returns declined by only 8%. (The fact that the estate taxes fell much less than the assets reported is quite interesting, because the rate highest marginal estate tax bracket rate fell from 55% in 2001 to 47% in 2005, which would by itself seem to suggest that the estate taxes would be falling by even more than the drop in assets reported on estate tax returns.)

## 2. Legislation: Small Business and Work Opportunity Act of 2007 Provisions Impacting Estate Planners; Proposed Ammendment to Circular 230 Regarding Return Preparer (and Advisor) Standards

a. Kiddie Tax Extended; Sam Donaldson: "Maybe You Can Vote, and Maybe You Can Drink, But You're Still a Kiddie". Effective for 2007, the "kiddie tax" was extended from age 14 to age 18 (children under that age). The kiddie tax is further extended by the Small Business and Work Opportunity Tax Act of 2007, effective for tax years beginning after May 25, 2007 (meaning that for individuals, the new rules apply beginning in 2008). Under the extended rules, the kiddie tax applies to children under the greater of (i) age 18 or (2) age 24 if the child is a full time student. There is an exception if the child's earned income for the tax year exceeds one-half of the child's support. (The kiddie tax applies if the child's unequal income exceeds an indexed amount—$1,700 in 2007.)

b. Tax Return Preparer Penalties Broadened. Penalties apply to a practitioner who signs a return (I.R.C. §6694) or to a practitioner who does not sign a return but gives advice about a position on a tax return (Circular 230, §10.34(a)). Section 6694 has been amended to strengthen the penalties, and amendments have been proposed to Circular 230 to conform the professional standards with the civil penalty standards for return preparers in §6694.

i. Elevated Standard. Under prior law, penalties generally were imposed against a "return preparer" if the return did not have a realistic possibility of being sustained on its merits (which Regulation §1.6694-2(b)(1) has interpreted as a 1/3 or greater likelihood of prevailing on the merits of an issue; ABA Formal Opinion 85-352 also used a one-in three standard). I.R.C. §6694. However, if the signing practitioner made adequate disclosure of the position (as described in §6662(d)(2)(B)(ii)), penalties were imposed only if the position was frivolous. I.R.C.§6694(a)(3). A non-signing practitioner qualified for the lower "non-frivolous" standard only if the practitioner advised the client about the opportunity to avoid penalties through disclosure. Circular 230, §10.34(a)(2).

The standard is applied to a signing preparer on the date the return is signed, and to a nonsigning preparer on the date that the preparer provides advice. Reg. §1.6694-2(b)(5).

Section 6694 is amended to elevate the general rule from a realistic possibility of success standard to a "more likely than not" (greater than 50% likelihood of success) to avoid penalties. I.R.C. §6694(a)(2)(B). If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is elevated to a reasonable basis standard. I.R.C. §6694(a)(2)(C).

In order to take advantage of the lower reporting standard, disclosure *must* be made on a Form 8275 (or a Form 8275 if the position is contrary to a regulation.) Reg. §1.6694-2(c)(3). However, advice by a nonsigning preparer can be adequate if the advisor notifies the taxpayer advice that the advice does not meet the "more likely than not" standard and advises that the taxpayer may be subject to penalty unless adequately disclosed. Reg. §1.6694-2(c)(3)(ii).

Who is a Return Preparer? Section 6694 applies to both signing and nonsigning tax return preparers. Reg. §1.6694-1(b)(2). In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return. I.R.C. §7701(a)(36)(A); Reg. §301-7701-15(a). (An example in the regulations suggests that giving advice regarding the treatment of a "significant" item on the return constitutes preparation of a "substantial portion" of the return. Reg. §1.6694-1(b)(3).) The definition of a nonsigning "return preparer" who only gives advice on specific issues of law is described in Regulation §301.7701-15(a)(2). An important limitation is that a nonsigning preparer is limited to someone who gives advice "with respect to events which *have occurred* at the time the advice is rendered and is not given with respect to the consequences of *contemplated* actions." Id. (emphasis added).

As discussed below, Circular 230 also applies to practitioners who sign returns or give advice regarding a position on a return. The Circular 230 provisions do *not* contain the limitation that advice about a position on a return is limited to advice about transactions that have already occurred and not just contemplated transactions.

Notice 2008-13 provides interim guidance, pending the revision of regulations, regarding implementation of the preparer penalty provisions of §6694 and the related definitional provisions of §7701(a)(36). Return preparers may rely on the guidance "until further guidance is issued." The guidance clarifies that "any determination as to whether a person has prepared a substantial portion of a tax return and thus is considered a tax return preparer will depend on the relative size of the deficiency attributable to the schedule, entry, or other portion."

Circular 230 Amendment. Section 10.34 of Circular 230 addresses the standards for advising with respect to tax return positions and for preparing or signing returns. Prior to an amendment effective on September 25, 2007, §10.34(a) applied a realistic possibility standard to practitioners signing a tax return or giving advice about a position on a tax return. "Realistic possibility" was defined as being "approximately a one in three, or greater, likelihood of being sustained on it merits." §10.34(d)(1). Section 10.34 was amended as of 9/25/07 to eliminate the provisions regarding standards (but leaving just sections dealing with documents and affidavits, and regarding advising clients on potential penalties), and the IRS proposed amended sections dealing with the standards. The proposed amendment to Circular 230 will conform the professional standards of practitioners to the same general requirements as are described in §6694. A practitioner may not sign a tax return as a preparer or advise a client to take a position on a return unless (1) "the practitioner has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits (the more likely than not standard)", or (2) "there is a reasonable basis for each position and each position is adequately disclosed to the Internal Revenue Service."

In addition to conforming to the "more likely than not" and "reasonable basis if there is disclosure" standards of §6694, this amendment to Circular 230 makes two important changes.

First, the amendment removes the statement that the reasonable basis standard is satisfied if the position has a one-in-three chance of being sustained. Instead, the amendment provides that "[r]easonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account."

Second, Circular 230 currently provides that a practitioner who gives advice about a position taken on a return can avoid the realistic possibility standard and qualify for a lower "not-frivolous" standard by specifically advising the taxpayer about the opportunity to avoid penalties through disclosure. Merely advising a taxpayer about avoiding penalties through disclosure will no longer suffice under the proposed amendment; the taxpayer must *actually* disclose the position to the IRS in order for the practitioner to qualify for the lower "reasonable basis" standard.

The Circular 230 amendment will be effective for returns filed or advice provided on or after the amendment is finalized, but no earlier than January 1, 2008 (the January 1, 2008 date is added to be consistent with Notice 2007-54, as discussed in paragraph vi below.)

Types of Authority That May be Considered. Treasury Regulation §1.6662-4(d)(3)(iii) describes the types of authority that may be considered. Generally, cases, the Code, regulations, revenue rulings, revenue procedures, treaties, congressional intent (reflected in committee reports, joint explanatory statements in conference committee reports, "Blue Book" explanations), private letter rulings and technical advice memoranda issued after October 31, 1976, actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin), IRS information or press releases, notices, and announcements may be considered. However, opinions of "experts" cannot be considered. "Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item." Reg. §1.6662-4(d)(3)(iii).

An authority does not continue as authority if it is overruled or modified. "However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals." Id.

Notice 2008-13. Notice 2008-13, which provides interim guidance regarding the return preparer penalties, reiterates that the standard is applied as of the date the return is signed (for a signing preparer) or the date advice is given (for a nonsigning preparer). The Notice makes clear that “the regulations expected to be finalized in 2008 may be substantially different from the rules described in this notice, and in some cases more stringent.” Highlights of the interim notice regarding the reporting standards include:

- More likely than not standard. This standard is met if the preparer analyzes the pertinent facts and authorities in the manner described in the current regulations (§1.6662-4(d)(3)(iii)) and reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS (not taking into account the possibility that the return will not be audited, that the issue will not be raised on audit, or that the issue will be settled.) The preparer “may rely in good faith without verification upon information furnished by the taxpayer as provided in §1.6694-1(e) … [and] on information furnished by another advisor, tax return preparer or other third party…The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.”
- Reasonable basis. The reasonable basis standard will be interpreted in accordance with the current regulations (§1.6662-3(b)(3).
- Reasonable cause and good faith. The reasonable cause exception in the statute was not changed (i.e., “reasonable cause for the understatement and such person acted in good faith”). Notice 2008-13 changes the “reliance on advice” rules in §1.6694-2(d)(5). A preparer acts in good faith “when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return peparer and who the tax return preparer had reason to believe was competent to render the advice.” The advice may be written or oral (but the burden of establishing the advice is on the return preparer). However, the advisor’s reliance is not in good faith if (i) the advice is unreasonable on its face, (ii) the preparer knew or should have known that the third party was not aware of all relevant facts, or (iii) the preparer knew or should have known that the advice was no longer reliable due to developments in the law since the time the advice was given.
- Disclosure for signing preparers. The interim guidance gives some additional exceptions (in addition to

disclosure on a Form 8275 or 8275-R) to satisfy the disclosure requirement in order to lower the standard to the reasonable basis standard: (1) providing the taxpayer with the prepared return that includes the appropriate disclosure [presumably even if the taxpayer does not actually include the disclosure with the return that the taxpayer actually files]; (2) "If the position would otherwise meet the requirement for nondisclosure under section 6662(d)(2)(B)(i) [i.e., if there is "substantial authority," which is the standard for the taxpayer to avoid penalty without disclosure], the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided;" or (3) "If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C) [which applies to "tax shelters"], the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided." [*OBSERVATION: This is the IRS's response to the ethical problem that professionals have raised in light of the inherent conflict that preparers have in representing clients because the standard for the preparer to avoid penalties is higher than the standard for the taxpayer to avoid penalties. If the "substantial authority" standard is satisfied, so that the taxpayer does not have to disclose to avoid penalties, the preparer can avoid penalties by merely advising the taxpayer of the difference between the penalty standards applicable to taxpayers and preparers. Stated differently, if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a "more likely than not" standard to a "substantial authority" standard. Presumably, preparers will begin giving that notice on a routine basis to all taxpayers. Keep in mind, however, that the IRS observed that the final regulations may adopt rules more stringent than the rules described in the Notice.*]

- <u>Disclosure for nonsigning preparers</u>. The nonsigning return preparer can use the lower reasonable basis standard "if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure." [*OBSERVATION: This is very helpful, because the advisor otherwise would have to assume that the higher "more likely than not" standard would always apply, because the advisor would have no way of guaranteeing that the return as actually filed would include disclosure. It is interesting that this option was effectively removed from the analogous Circular 230 rules under the amendments proposed last fall. Hopefully, the IRS will add this provision back into the revisions of §10.34(a) of Circular 230 and remove the requirement that the taxpayer actually disclose in order to get the benefit of the lower reasonable basis standard as long as the advisor advises the taxpayer of the standards and disclosure requirements for the taxpayer to avoid penalties.*] If a nonsigning preparer gives advice to another preparer, the nonsigning preparer can use the lower standard "if the advice to the tax return preparer includes a statement that disclosure under section 6694(a) may be required." If the advice is in writing, the statement must also be in writing, but the advice and statement may both be oral. "Contemporaneously prepared documentation in the nonsigning tax return preparer's files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer."

ii. Extension Beyond Income Tax. Section 6694 applies to practitioners generally, and not just to income tax matters (it now applies to "tax return preparers" rather than to "income tax return preparers" as provided previously.) While §6694 under prior law applied only to income tax returns, Circular 230, §10.34 imposed a similar obligation on all tax advisors.

iii. Increased Penalty Amounts. The general penalty for unreasonable positions (applicable in the situations described above) is increased from $250 to the greater of (1) $1,000 or (2) one-half of the preparer's fee for the return (or a claim for refund). I.R.C. §6694(a)(1). The penalty for an understatement due to willful or reckless conduct is increased from $1,000 to the greater of (1) $5,000 or (2) one-half of the preparer's fee for the return. I.R.C. §6694(b)(1).

iv. Reasonable Cause Exception. Unless the understatement is due to willful or reckless conduct, there is a reasonable cause exception to the penalty if the practitioner acted in good faith. I.R.C. §6694(a)(3). (That same exception applied under prior law as well, although the formatting of the section has been revised.)

v. Refund Claims. Under prior law, there was no specific penalty for filing refund claims that had no reasonable basis—penalties are generally based on the underpayment of tax. There was a concern that taxpayers who over withheld could make aggressive refund claims without risk of a penalty. New §6676 imposes a 20% penalty for filing an erroneous refund claim unless the claim had a "reasonable basis." I.R.C. §6676(a). (The penalty is 20% of the excess of the amount of the claim over the amount allowable. I.R.C. §6676(b).) To avoid cascading penalties, the new penalty on claims does not apply in several situations in which present law penalties might apply, namely, the special accuracy related penalty (§6662) or civil fraud penalty (§6663).

Internal Legal Memorandum 200747020 explains that the new penalty on erroneous refunds is 20% of the excessive amount, which is defined by the statute as the amount by which the claim for refund or credit exceeds the allowable amount of the claim. Therefore, the penalty is 20% of the amount by which the refund or credit request exceeds the refund or credit actually allowed.

vi. Effective Date; Transitional Relief for Required Standard of Conduct Through 2007. The new rules apply to returns filed after or refund claims made after the date of enactment (May 25, 2007). However, Notice 2007-54, 2007-27 IRB provides transitional relief for all returns, amended returns, and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing); to 2007 estimated tax returns due on or before January 15, 2008; and to 2007 employment and excise tax returns due on or before January 31, 2008. The transitional rule only relaxes the standard of conduct requirement (but not the increased penalty amount or the extension to returns beyond just income tax returns).

Under the transitional rule, for income tax returns, amended returns, and refund claims, the standards under current law will apply (i.e., reasonable basis if no disclosure and "not frivolous" basis if there is disclosure). (The disclosure requirement under both the prior law and the new law is satisfied if the disclosure is made on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement.) For all other returns, and claims for refund (including estate, gift and GST tax returns) the reasonable basis standard will apply without the disclosure requirement to determine if a penalty is under §6694(a). (No transitional relief is available for penalties under §6694(b) regarding willful or reckless conduct.)

The transitional relief is clarified in Notice 2008-11. It clarifies that the transitional relief generally applies to returns filed on or before December 31, 2007, even if the return’s due date had extended beyond December 31, 2007. Also the transitional relief applies to advice given by nonsigning preparers on or before December 31, 2008.

vii. General Observations.

1. Surprise Legislation. There was practically no warning of this legislation. The IRS was surprised as well as tax professionals. There is no legislative history with respect to these changes (other than the Joint Committee on Taxation Technical Explanation, which is brief.) (There were similar provisions in a 2006 bill that did not get enacted.)

2. Professional Community Reaction. There has been a strong negative reaction from the accounting and legal communities.

3. Conflict of Interest. Part of the negative reaction relates to the fact that the standards in §6694 creates an inherent conflict of interest between professionals and their clients. Taxpayers are only subject to a “substantial authority” standard (which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits) for undisclosed positions and a “reasonable basis” standard (which the Joint Committee on Taxation says is approximately a 20% likelihood of success on the merits) in order to avoid penalties under §6662. Preparers are subject to the more stringent “more likely than not” standard under §6694, thus creating the inherent conflict. (One reaction has been the submission of a bill that would increase the taxpayer penalty standards to the “more likely than not” standard as well.)

In Notice 2008-13, the IRS responded to this concern with a rule providing that if the preparer advises the taxpayer of the difference between the taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a “more likely than not” standard to a “substantial authority” standard (so that the same standard would apply to both). Presumably, preparers will begin giving that notice on a routine basis to all taxpayers.

See the discussion in subparagraph i above about the changes under Notice 2008-13.

4. Unrealistic Standard. The major concern is that a "more likely than not" standard is unrealistic in the tax world where there are so many factual and legal uncertainties.

"The more significant problem with this revision is that Congress did not take into account the fact that a practitioner often will not be able to determine whether a position is more likely than not correct. There are no clear answers to numerous common issues with respect to items reported on tax returns …[N]ow the preparer would need a much higher level of certainty concerning the correctness of the position taken on the return.

This is particularly a problem for factual issues… Since many factual issues reasonably may be viewed in more than one way, as long as the position taken by the return preparer was solidly grounded in the facts, there was little risk that the preparer would by subject to a penalty even if the IRS ultimately determined that there was an understatement of liability." Lipton, What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, J. TAX'N (Aug. 2007).

5. Presumption of Preparer Penalty. Indeed, if the IRS wants to get ugly with preparers, in effect there would seem to be an initial presumption that a preparer penalty could be imposed whenever the IRS does not agree with every position taken on a return (that is sustained). How will the preparer rebut that the return position was more likely than not correct when a determination has already been made that the position was in fact not correct? That is an unreasonably high standard to place on preparers to avoid the imposition of personal penalties.

6. Reaction of Professionals; Either Extreme Conservatism or "Overdisclosure". There has been a very strong adverse reaction to these new rules by the tax professional community. One complaint is that substantial preparer penalties may apply even though there is only a very small tax deficiency. Another major complaint is that tax professionals are put in an inherent conflict situation with their clients and may lead to extreme conservatism.

"The new Section 6694 makes practitioners the insurer of the accuracy of their clients' returns. Practitioners likely will react very cautiously to this change in the law. Indeed, some practitioners may conclude that they are better off disclosing every position taken on a return on Form 8275 rather than risk the penalty, and the IRS will be flooded with returns disclosing, on a line-by-line basis, that there is no certainty that each number reflected on the return is more likely than not correct. The Service would be swamped by disclosures, effectively eliminating some of the benefit of the amendment to Section 6694 by offsetting administrative costs. Other practitioners may become more circumspect in the advice they give their clients, which ultimately may lead to less compliance." Lipton, What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, J. TAX'N (Aug. 2007).

The concern of professional tax advisors go far beyond the monetary penalties that may apply. Professionals point out that the effect with the most impact may be the stigma attached to have preparer penalties being assessed rather than the direct money penalty.

c. S Corporations. Various changes are made for S corporations, including the following.

(i) ESBT May Deduct Interest on Debt to Acquire Stock. Under prior law, interest paid by an ESBT to buy S corporation stock was allocated to the S portion of the ESBT, but was not deducible in determining the taxable income of the S portion (that is taxable at the highest individual income tax rate [now 35%]). For years beginning after 2006, interest that the ESBT pays to acquire S stock is deducted in determining the taxable income of the S portion of the ESBT. I.R.C. §641(c)(2)(C)(iv).

(ii) S Corporation Capital Gains Not Passive Income. An S corporation is subject to the corporate-level tax at the highest corporate rate on its "excess net passive income" if the corporation has (1) accumulated earnings and profits at the close of the taxable year (i.e., accumulated earnings and profits from its years as a C corporation as of the close of the year) and (2) gross receipts more than 25 percent of which are passive investment income. In addition, the S corporation election will terminate whenever the corporation has accumulated earning and profits at the close of each of three consecutive taxable years if more than 25% of its gross receipts are passive investment income in each of those years. For tax years beginning after May 25, 2007, gains on sales of stock and securities are not passive investment income.

## 3. 2007-2008 Treasury-IRS Priority Guidance Plan

The annual Treasury-IRS Priority Guidance Plan (running from July to June of each year) was published for the 2007-2008 year on August 13, 2007. It includes 13 projects under the "Gifts, Estate and Trusts" heading. Eight of these projects are new or do not merely involve the finalization of proposed regulations that have already been issued.

a. Final regulations under §67 regarding miscellaneous itemized deductions of a trust or estate. (See Item 5.c of this outline, below.)

b. Guidance under §642(c) concerning the ordering rules for charitable payments made by a charitable lead trust. (New item)

c. Revenue ruling on the division of charitable remainder trusts under §664. (New item) (There have been a large number of ruling requests dealing with severing charitable remainder trusts between the charitable and non-charitable beneficiaries.)

d. Proposed regulations under §664(c) to reflect the 2006 Tax Relief Act amendment concerning the effect of UBIT on charitable remainder trusts. (New item) These regulations will address the change to §664(c) providing a 100% excise tax on UBIT in a CRT rather than causing a CRT to lose its tax exemption entirely for any year in which it has any unrelated business taxable income.

e. Proposed regulations under §2032(a) regarding the imposition of restrictions on estate assets during the 6 month alternate valuation period. (New item) (This will presumably address a technique that has been used by some planners to have someone purchase a minority interest from the estate within the first six months, and elect the alternate valuation date. If the remaining interest is a minority interest, the alternate valuation date values would reflect minority interest values in the estate. Alternatively, some planners consider merely distributing minority block of stock, and valuing the block distributed (minority interest) and the remaining block of stock in the estate at the end of the six month period (which might also be a minority interest). See Treas. Reg. §20.2032-1(c)(1)(phrase "distributed, sold, exchanged or otherwise disposed of" includes surrender of stock in complete or partial liquidation of a corporation but not "mere changes in form" such as a transfer of assets to a corporation in a manner that no gain or loss is recognizable under §351); Kohler v. Comm'r, T.C. Memo 2006-152 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Proposed regulations will apparently restrict this strategy.)

f. Guidance regarding the consequences under various estate, gift and generation-skipping transfer tax provisions of using a family-owned trust company as the trustee of a trust. (First appeared in 2004-2005 Guidance Plan). In prior years, this has just been labeled "Guidance regarding family trust companies."

Hopefully, the omission of income tax from the description in this year's listing does not suggest that the IRS will omit guidance regarding the application of grantor trust rules.

g. Guidance under §2036 regarding the tax consequences of a retained power to substitute assets in a trust. (New item) (A non-fiduciary substitution power is often used to cause a trust to be a grantor trust for income tax purposes. I.R.C. §675(4)(C). Most planners believe that a non-fiduciary power in the grantor to substitute assets of equivalent value should not cause estate inclusion under §2036, bolstered by the dictum in *Estate of Jordahl v .Comm'r*, 65 T.C. 92 (1975), *acq*., 1977-1 C.B. 1. [In *Jordahl*, the grantor was one of three trustees, but the court's reasoning would suggest that the same result—no inclusion—would occur if the grantor's power was not held in a fiduciary capacity.] However, the IRS has recently refused to rule in a ruling request that a *non-fiduciary* substitution power would not cause §2036 inclusion. Letter Rulings 200603040 & 200606006. Whether a power is held in a fiduciary or nonfiduciary capacity usually makes no difference for estate tax purposes. See Item 8b and 8c of this outline.

See Item __ for a more detailed discussion of the issue of using grantor or third party substitution powers.

h. Final regulations under §§2036 and 2039 regarding the portion of a split-interest trust that is includible in a grantor's gross estate in certain circumstances in which the grantor retains an annuity or other payment for life. (Proposed regulations were issued earlier this year. See Item 8.a of this outline.)

i. Final regulations providing guidance under §2053 regarding the extent to which post-death events may be considered in determining the value of the taxable estate. (Originally appeared in 2003-2004 Priority Guidance Plan; Proposed regulations were issued earlier this year; See Item 4 of this outline.)

j. Revenue Procedure under §2522 containing sample inter vivos Charitable Lead Unitrusts. (New Item, following up on other sample charitable split-interest trust forms that have been promulgated in prior years)

k. Guidance under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. (New Item) (See Item 11 of this outline.)

l. Guidance under §2703 regarding the gift and estate tax consequences of the transfer of assets to investment accounts that are restricted. (New Item) This will apparently address the use of "restricted management accounts," which some planners believe can support substantial valuation discounts.

m. Guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership. (First appearing in 2003-2004 Priority Guidance Plan) This probably relates to the statutory authority to issue regulations regarding the effect of a restriction that have "the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." I.R.C. § 2704(b)(4). A Treasury official indicated in 2007 that this regulation may be issued sometime in 2007, but that obviously did not happen.

Several additional projects of interest are included under the "Tax Administration" heading.

a. Tax patents (Item 6).

b. Security requirements under §6166 (Item 20). (See Section 13 of this outline, below.)

c. Declaratory judgment procedures for gift tax valuation issues (Item 52). This is presumably in response to the legislative changes in 1997 (i) adding §2001(f) denying revaluation for estate tax purposes of gifts adequately disclosed on a gift tax return once the gift tax statute of limitations has passed, (ii) revising §2504(c) dropping the requirement that a current gift tax be paid to achieve finality, and (iii) adding § 7477 empowering the Tax Court to issue declaratory judgments regarding the value of gifts. Under this scheme, the IRS might have to raise any objections that it has to gift valuations even if all of the donor's unified credit has been utilized by the aggregate gifts to that time—so the donor would know that the remaining gift tax unified credit is indeed available.

## 4. Proposed Regulations Limiting Estate Tax Deductions For Uncertain Claims Against Decendents and Other Administration Expenses Under §2053

The IRS has issued proposed regulations (which will apply to decedents dying on or after the adoption of final regulations) dealing primarily with the deductibility of claims against a decedent's estate that are uncertain in amount at the date of death. The general approach for such contingent or uncertain claims is that a deduction is allowed only as payments are actually made by the estate, but there is an exception for estimated amounts that are ascertainable with reasonable certainty.

While the proposed regulations change a number of the provisions dealing with various administration expenses under §2053, the most important change in the proposed regulations deals with claims against the estate, §20.2053-4. The one short paragraph in the current regulations has been expanded to 5 pages of detailed provisions regarding the deductibility of claims against the estate. In particular, no deduction may be taken on an estate tax return for a potential or unmatured claim or for a contested claim, but the estate can file a protective claim for refund.

a. Background.

There have been various cases in the last several years dealing with the deductibility of claims against the estate when the precise amount of the estate's liability is uncertain at the date of death. For example, there may be threatened or pending litigation against the decedent at the date of death. The trend of the recent cases has been to value the claim based on facts known at the date of death and not considering post-death facts including settlement agreements. There is a split among the circuit courts of appeal on this issue. Aghdami, Effect of Post-Mortem Facts On Claims Against the Estate, TR. & EST. 18 (May 2004); Loeb, Crossed Circuits on Estate Tax Deductibility of Disputed or Contingent Claims, 12 CALIF. TR. & ESTS. Q. 6 (Summer 2006). The Preamble to the proposed regulations points out that there are two lines of cases dealing with this issue, going back to the 1920s. The lack of consistency in the lines of cases results in disparate treatment of similarly situated estates, and the IRS determined that a consistent rule is needed. The IRS states that the date of death approach often requires a "re-trial" of the valuation of the claim on the date of death in a tax proceeding even though the underlying claim has been resolved by a settlement or court proceeding. The IRS concludes that the date of death approach is inefficient, expensive (appraisal and litigation costs), often results in a deduction different than the amount actually paid, and forces the taxpayer to take contradictory positions in the tax proceeding and the court proceeding on the underlying claim.

The Preamble justifies taking a different position for valuing §2053 deductions (using amounts actually paid) versus the valuation of assets in the gross estate (which is based on the date of death values) based on statutory differences. It observes that §2031(a) specifically refers to "the value at the time of his death" whereas §2053 does not refer to value at the date of death.

b. Observations.

(1) Approach Favors IRS But Seems a Reasonable Approach Except For Different Treatment of Claims and Counterclaims. The IRS has argued for the actual payment approach in the recent litigated cases and in its informal notices. See Field Service Advice 200217022. The actual payment approach generally favors the IRS, preventing estates from arguing for a high date of death value of a claim against the estate despite an actual settlement and payment of a much lower amount. In this respect, the position of the

proposed regulation is self-serving in reversing the trend of recent cases that favors the date of death approach. (Of course, the opposite can also occur. For example, much more serious environmental liability facts may become known after the date of death, resulting in a higher deduction under the actual payment approach.) Despite the self-serving result, using an actual payment approach seems to be a reasonable approach for efficient administration of the tax system—except that the system would seem more complicated than ever if there are claims and counterclaims involved. (See paragraph C below.) In light of those complications, perhaps the approach is not sound.

(2) Contrast With Valuation of Claim Owned By Estate Against Another Party. The flip side is the valuation of claims owned by the estate (rather than claims against the estate.) Claims owned by the estate are assets of the estate and are governed under the general valuation principles based on date of death values. These two different types of claims will be treated differently in the future.

The issue is even more acute with a claim owned by the estate—because it is not possible to just wait until after the claim has been resolved. The IRS will want to make a determination of the amount of the claim as an asset of the gross estate to determine the amount of the estate tax. This exacerbates the problem of the contradictory positions dilemma, discussed in Paragraph J below, because the executor will have to take a position on the estate tax return as to the value of the claim owned by the estate.

(3) Effect of Counterclaims. What if there is a claim against the estate, but the estate makes a counterclaim, or the reverse situation in which the estate has a claim against another party but that party makes a counterclaim against the estate? (This is a very real problem because it is very typical in many, if not most, lawsuits to have counterclaims.) The claim against the estate would be governed by one set of rules (possibly deferring any deduction until the claim is paid, allowing a deduction only for the amount actually paid) and the claim by the estate against the other party would be governed by a different set of rules (deferring the value of the estate's claim presumably would not be delayed until the time of actual payment, and the value of the claim would be based on the date of death value rather than the actual amount of the payment). The goal of the IRS's position in the proposed regulations is largely based on administrative convenience and efficiency, but this very common situation

will result in even more complexity in light of the different approaches that will apply to the claim and counterclaim.

(4) Claims of Family Members and Related Parties. Claims by family members or related parties may be deducted only if the estate overcomes the presumption that such claims are not legitimate and bona fide. §20.2053-4(b)(4). This documents the IRS's long term hesitancy to allow a deduction for "trumped up" intra-family claims.

(5) Unenforceable Claims. The executor will have to be careful not to pay claims after they have become unenforceable, because such amounts will not be deductible even though actually paid. §20.2053-4(b)(5). (Of course, the payment of unenforceable claims raises fiduciary liability concerns as well.) This may be particularly important with claims by family members, where the executor and family members agree that a valid claim of a family member should be paid by the estate. The parties will need to be careful to pay the claim within the applicable statute of limitations period.

(6) Settlements. One of the requirements for relying on settlements to recognize the deductibility of expenses under all of §2053 is that the settlement is based on arm's length negotiations of parties who are adverse to each other. §20.2053-1(b)(3). That may be difficult to establish in a harmonious family situation. The parties may wish to obtain a court decree regarding the claim, because that requirement does not exist in the provision dealing with court decrees. (Even court decrees based on consent do not have a stated arm's length negotiations requirement, but the parties must establish the bona fides of the claims). §20.2053-1(b)(2).

(7) Recurring Payments. The estate may be entitled to a larger deduction if the underlying claim has some contingency or if payments will not likely extend beyond the final determination of the estate tax. In that case, a deduction is allowed only as payments are made, but the full amount of the payments would be deductible, not just the present value of the payments discounted back to the date of death.

(8) Protective Claim for Refund; Later Actual Claim for Refund. If there is any uncertainty at all regarding the ultimate amount of a claim against the estate or if a claim is not paid, the executor must be careful to file a protective claim for refund before the statute of limitations runs on refund actions. Once the amount of the uncertainty is resolved, the executor should then file an actual claim for refund to get a refund attributable to the additional

administration expense. The precise procedures for handling protective claims for refund after the underlying claim has been resolved are not totally clear. For example, must the claim for refund be asserted within a particular period of time after the uncertainty is resolved?

(9) Contradictory Positions; Practical Dilemma. The Preamble observes that the estate may take contradictory positions in the tax proceeding and the underlying proceeding to determine the amount of the claim against the estate. A practical problem is how to balance estate tax reporting with the defense of the actual litigation. The plaintiff suing the estate may depose the executor the day after the estate tax return is due and subpoena a copy of the return. If the claim against the estate is reported at a high value on the estate tax return (to support a large deduction), the plaintiff will use that as "Plaintiff's Exhibit 1" to argue that even the estate thinks the claim is valid and large. The best approach seems to report the claim against the estate on the Form 706 and list its value as "Undetermined."

The problem is even worse if the estate owns a claim against another party. The executor will have to take a position on the estate tax return as to the value of the asset. Even if the executor lists the value as "uncertain" on the estate tax return, the issue will be addressed in the audit, and it is more likely that the attorney defending the claim will be able to discover the negotiated value than in the case of a claim against the estate, for which a deduction can just be delayed until after the underlying claim is resolved.

(10) Graegin Loans. The proposed regulations do not seem to impact Graegin loans at all. While §20.2053-1(b)(1) limits §2053 deductions to amounts actually paid, §20.2053-1(b)(4) allows the deduction of estimated amounts that are ascertainable with reasonable certainty, with a requirement to contact the IRS if the actual amount that is later paid differs from the estimate. The current and proposed regulations both allow a deduction of estimated amounts of administration expenses that may be ascertained with reasonable certainty and will be paid. Current Reg. §20.2053-1(b)(3); Proposed Reg. §20.2053-1(b)(4).

In Estate of Graegin v. Comm'r, T.C. Memo, 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. The estate borrowed $204,218 from a corporation, 97% of whose stock was owned by the decedent or the decedent's son. The $204,218 unsecured note provided a fixed 15% interest rate for the entire 15 year term and the note provided for a substantial prepayment penalty. Even though the estate could have made some annual payments on the note (because it anticipated receiving dividends on its preferred stock in the corporation of $70,000 per year), the note was structured to require payment of all principal and interest in a single balloon payment at the end of the 15 year term. The 15 year term and the balloon payment were utilized because the decedent's wife had a 15 year life expectancy, and a trust for the wife that would terminate when she died contained liquid funds which could be used to pay off part of the note. The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. The court observed that it was "disturbed by the fact that the note requires only a single payment of principal and interest", but determined that such a repayment term was not unreasonable given the decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. ¶88,477 PH Memo TC at 2446-88. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.

(11) Post-Death Interest Expenses. Similarly, the proposed regulations do not appear to impact the deductibility of post-death interest expenses. If the interest expense cannot be estimated with reasonably certainty it would only be deducted as actually paid, particularly in light of the additional sentence added to Reg. §20.2053-1 limiting deductions under §2053 to amounts actually paid unless the estimated amounts provision applies. (The cases have been pretty lenient in allowing an estate tax deduction for post-death interest.)

Various cases have permitted the deduction of post-death interest with respect to loans obtained by an executor for general estate purposes, where the loans were necessary for the administration of the estate. E.g., Estate of Huntington v. Comm'r., 36 B.T.A. 698 (1937); Estate of Todd v. Comm'r, 57 T.C. 288 (1971); Hipp v. U.S., 72-1 U.S.T.C. ¶ 12,824 (D. S.C. 1971). However, an interest deduction will not be permitted where the estate administration is unduly prolonged or where the estate could have sold assets other than at distress prices instead of borrowing funds. See Hibernia Bank v. U.S., 75-2 U.S.T.C. ¶13,102 (N.D. Calif. 1975), *aff'd*, 581 F.2d 741 (9th Cir. 1978).

The IRS position is to allow a deduction for post death interest on amounts borrowed to pay estate taxes in order to avoid a "forced sale of assets." Rev. Rul. 84-75, 1984-1 C.B. 193. Some of the cases cited above also involved borrowings to pay estate taxes. The cases have even allowed post-death interest deductions for amount borrowed from family entities to pay estate taxes. Estate of Thompson v. Comm'r, T.C. Memo 1998-325; McKee v. Comm'r, T.C. Memo. 1996-362; Estate of Graegin, T.C. Memo. 1988-477.

### 5. Application of 2% Haircut Under §67 to Trust Investment Advisor Fees; Rudkin (Now Knight)

a. Tests From Circuit Level Courts of Appeal to Meet the "Second Prong" Requirement. The issue is the meaning of the "second prong" of the §67(e) exception for trusts and estates, namely that the exception applies for costs "which would not have been incurred if the property were not held in such trust or estate."

- All agree: The statute is clear and unambiguous.
- Sixth Circuit: The costs are **"incurred because of fiduciary duties."** [William J. O'Neill Jr. Irrevocable Trust v. Commissioner, 994 F.2d 302 (6th Cir. 1993), nonacq., 1994-2 C.B. 1.]
- Fourth and Federal Circuits: The costs are **"not commonly incurred by individuals."** [Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. 2001); Scott v. United States, 186 F. Supp.2d 664 (E.D. Va. 2002) , aff'd, 328 F.3d 132 ($4^{th}$ Cir. 2003).]
- Second Circuit: The expenses are **costs that individuals "are incapable of incurring"** (giving as examples, trustee fees, judicial accountings, and fiduciary income tax returns—the same examples that the Scott court gave for its more lenient test). [Rudkin Testamentary Trust v. Commissioner, 98 A.F.T.R.2d 2006-7368 ($2^{nd}$ Cir. October 18, 2006).]

b. Supreme Court Review and Oral Argument. The U.S. Supreme Court heard the oral argument for the Rudkin appeal on November 27, 2007. (The name of the case is Knight v. Commissioner (S. Ct. Doc. No. 06-1286).) In light of the rarity of a Supreme Court review of issues affecting estate planning attorneys, I will review some of the testimony from the oral argument.

(1) Legislative History. None of the Justices found anything particularly persuasive regarding the construction of the statute in the legislative history, or that the exception is meant to disallow only deductions from pass-through entities that are owned by a trust. For example:

"JUSTICE BREYER: I've read the legislative history, which show to me, anyway, precisely no light whatsoever. It's – the only relevant sentence, which is the third sentence, simply repeats the statute. And, therefore, I thought that what Congress is trying to do is say, treat trusts like individuals, except in respect to special expenses.

…

JUSTICE BREYER: There's nothing that I could find anywhere that talked about pass-throughs in respect to the special situation of trusts and estates. In the first sentence it speaks to it in respect to individuals. It all makes sense. And what they seem to be saying is just what I said initially. We do agree trusts do have a special claim, but only in respect to special trust expenses. And which are they? They're the ones an individual wouldn't have incurred."

Justice Ginsburg, however, found some support in the legislative history for interpreting the second prong narrowly. The taxpayer's attorney (Peter Rubin) pointed out that the statute initially passed both the House and Senate without the second prong limitation on the exception. The government attorney began his argument by stating that "Section 67(e) creates a narrow exception to the 2 percent floor…" Justice Ginsberg immediately pointed to the history of the second prong being added by the Conference Committee:

"JUSTICE GINSBURG: It wasn't narrow in the beginning right?

…

JUSTICE GINSBURG: This is somewhat of a mystery, the working of that clause. And since it came in at the very last minute, isn't it appropriate to give it a limited reading, rather than, in your suggestion, that this provision that up until the very end read just administration, "costs paid or incurred in connection with the administration of the estate or trust," period? And then there was this add-on. Why should we give that an expansive meaning?

MR. MILLER [the government's attorney]: I think, regardless of the timing, Your Honor, Congress chose to enact it and that choice has to be given effect."

Justice Scalia, who has a history of giving little credence to legislative history, questioned whether Congress really meant to subject most trust expenses to the 2% haircut rule:

"JUSTICE SCALIA: … I don't care about legislative history but some of my colleagues do. Is there any – is there any indication that Congress thought it was, it was whacking trusts with the immense new tax with respect to their major expenditure? I expect it [i.e., investment advice] must be their major expenditure.

MR. MILLER: To take your second question first, the legislative history is silent on specifically what Congress's objective was in section 67(e).

JUSTICE SCALIA: The dog didn't bark.

…

JUSTICE SCALIA: Well, you know a trust is sort of like a business. And deductions that an individual could not take if he were not in a business are perfectly okay for a business. And I don't know why trusts wouldn't be treated the same way. A trust has to get investment advice. True? When it's – when it's an individual getting it, you wouldn't allow a deduction, but a trust is different.

And unless Congress is clearer than this statute, I – it seems to me that no individual would get trust investment advice. Only a trust can get trust investment advice."

(2) <u>"Would" Does Not Mean "Could"—Very Important Potential Impact on Proposed Regulations.</u> The Second Circuit concluded that the second prong permits a full deduction only for costs that individuals are "incapable" of incurring. The Second Circuit reasoned that

"the statute does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue…. Instead, the plain meaning of §67(e)(1)'s second clause excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust….While the Federal and Fourth Circuits' approach property focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is 'customarily' or 'commonly' incurred by individuals is unnecessary and less consistent with the statutory language. We believe the plain text of §67(e) requires that we determine with certainty that costs **could** not have been incurred if the property were held by an individual. We therefore hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs that **could** not have been incurred by an individual property owner." (italicized words were italicized in original; emphasis has been added to the boldfaced words).

Justice Scalia, in particular, pointed out the absurdity of saying that "would" means the same as "could" in his questioning of the government's attorney:

JUSTICE SCALIA: Why do you think that the only instances where the expense would not have occurred are those instances where it could not have occurred? That doesn't strike me as self-evident.

I mean, I understand why you do it, so that can you have a nice clear line, which I am all for. But the line given by your colleague is just as clear. I don't know why I should accept yours when – I mean, 'would' just does not mean 'could.' I mean, would have, could have, should have, it's – they're different words.

MR. MILLER: … But we are suggesting that there are contexts in which the word 'would' can carry the same meaning that is also expressed through the word 'could.' … Another example would be if I were to say that that glass would not hold more than 8 ounces of water, that would mean that it could not hold more than 8 ounces of water.

…

JUSTICE SCALIA: Anything that could not be done of course would not be done. But that doesn't mean that the – that the two words mean the same thing.

…

JUSTICE SCALIA: It's true that one is included within the other, but they don't mean the same thing. … What could not happen would not happen, of course. But it doesn't mean that – the two concepts are not the same.

MR. MILLER: I think, when – when you have the word 'would,' as we have in this statute, that's not qualified in any way, it's ambiguous in the sense that it can mean definitely would not have been incurred, probably would not have been incurred, customarily, ordinarily would not have been incurred, which is the meaning –

CHIEF JUSTICE ROBERTS: You didn't think much of this argument before the Second Circuit adopted it, did you? You didn't argue that before the Court of Appeals?

(Laughter)

MR. MILLER: We did not argue it before --

CHIEF JUSTICE ROBERTS: So you have a fallback argument.

MR. MILLER: Well, that – that's right.

CHIEF JUSTICE ROBERTS: Well, now might be a good time to fall back.

(Laughter)"

This humorous exchange is very important with respect to the IRS's proposed regulations, which adopt the very strict test of the Second Circuit and allow only expenses that are "unique" to trusts and estates to be deducted fully without applying the 2% floor of §67. The balance of the oral argument centered on what line should be drawn as to the meaning of the statute other than a "could not incur" line. The exchange suggests that the Supreme Court will not adopt the "expenses that individuals are incapable of incurring" standard used by the Second Circuit. This would suggest that the IRS will have to change its proposed regulations, to use some standard other than the "unique" standard (which is just a different way of referring to expenses that only trusts and estates incur and that individuals could not incur.)

(3) Fiduciary Income Tax Return vs. Fiduciary Investment Advice. Several of the Justices questioned a line drawn by the IRS in the proposed regulations of treating fiduciary income tax returns as being within the exception, but not fiduciary investment advice.

"JUSTICE ALITO: … you give as an example of something that wouldn't fall within the 2 percent floor the cost of preparing and filing a fiduciary income tax return. What is the difference between that and getting fiduciary investment advice? … Just because it's a different form that's filled out?

[The government's attorney responded that it's more expensive because the trust has to file a return and individual beneficiaries must also file a return, and because a trust must also prepare Form K-1s.]

JUSTICE SOUTER: Yes, but it's the individual who has to file the 1040. What the trustee is filing is the 1041. And – and why do you place – I was going to ask the same question that Justice Alito did, and that is why do you place so much significance either in the label, i.e., it's fiduciary return, or in the peculiar fact that it is a fiduciary who is filing that return?

It's a tax return and – and I think you – the government's argument is that with respect to – to other items that may be disputed, you should regard them at a fairly general level, i.e., investment advice, not fiduciary investment advice. But when you come to the tax return, you don't regard it as a general – at a general level; you regard it at a very specific level, i.e., a fiduciary tax return. It seems to me that the government with respect to the tax return is doing exactly what it criticizes the taxpayer for doing with respect to investment advice. And I don't understand the distinction."

(4) A Distinction Between Individuals and Trustees Obtaining Investment Advice: Damages Protection. Justice Souter pointed out a distinction between individual and trustee investment advice that I have not seen argued previously. It is a corollary of the principal argument that trustees must obtain investment advice to properly carry out their fiduciary duties to satisfy investment standards under trust law principles. He argues that a trustee is purchasing protection from damages by obtaining appropriate investment advice, even if the investments later decline in value:

"JUSTICE SOUTER: Well, can't you ask it – can't – can't you ask this question pointing towards something unique: If the individual investor does a very poor job of managing his investments, all he can ultimately do is cry about it. But if the trustee does a very poor job, the trustee is going to get sued. So that when the trustee asks for an investment advisor's advice, the trustee is addressing an issue that the individual does not have. The trustee wants to be covered. He also, I presume, wants to be a good trustee. But he is in fact doing something which is, to use your phrase, in addition to what the individual investor would do. He is looking out for somebody else and he is looking out for himself if the investment goes south. Why isn't that a sufficient difference that is at least comparable to the difference that you talk about in the filing of a fiduciary tax return?

…

…whether he gets socked with damages or not is going to depend in part whether he is covered by an investment advisor's bit of advice; and that is – that is a different item in the calculus of liability. He is providing for something that the individual investor does not provide for or need to provide for."

(5) Discussion of Investing for Total Return in Proposed Regulations Suggests that Some Investment Advice Is Fully Deductible. While the proposed regulations do not impact the *Knight* case (they are not even effective yet), the Justices referred to the proposed regulations often in terms of addressing the line that the IRS is attempting to draw as to what trust expenses satisfy the second prong of the §67(e)(1) exception. For example, several Justices addressed the fact that the proposed regulations list "advice on investing for total return" as an example of a "non-unique" expense (that would not qualify for the exception).

"JUSTICE ALITO: But doesn't your proposed regulation concede that there is investment advisory advice that is unique to – to estates and trusts? Isn't that what subparagraph C says?

MR. MILLER: No Subparagraph C has two lists, both of which are nonexclusive: a list of items that are unique to trusts and a list of items that are not unique to trusts. In the list of items that are not unique to trusts is investing for total return. There is no type of investment advice –

JUSTICE GINSBURG: Why that limitation? Why wouldn't it say just 'investment advice.' But it's – investing for total return is more limited?

MR. MILLER: I think perhaps because that's most obviously the type of advice that is not unique to trusts. But the – the proposed regulation does not identify any kind of [investment] advice that is unique to trusts.

JUSTICE GINSBURG: It doesn't say it's one or the other. So it's not so sure, right? It's sure about advice on investing for total return.

…

JUSTICE SCALIA: Can you really s[p]lice up advice that way? You ask the advisor, say, which – what percentage of your advice was the advice that went to maximizing total return and what percentage went to this other thing? I mean, gee, I don't want to get courts into trying to figure that out, or private individuals or financial advisors in trying to figure that out. That's just a crazy way to run a tax system, it seems to me.

…

Mr. MILLER: I think the best reading of the proposed regulation, and perhaps the Service may well clarify this during the rule-making process, is that all advice is not unique to trusts because there's no type of advice that a trustee could seek that an individual could not –

JUSTICE GINSBURG: They certainly weren't sure about it when they drafted this regulation, proposed regulation."

(6) Appropriate Test. None of the Justices seemed willing to adopt a "could not have been incurred test" that includes only expenses that individuals are incapable of incurring. They struggled with what other standard to use, pointing out problems with various approaches.

Justice Breyer suggested several times using a "reasonable man" test to exclude expenses that an individual would reasonably have incurred:

"JUSTICE BREYER: … And what they seem to be saying is just what I said initially. We do agree trusts do have a special claim, but only in respect to special trust expenses. And which are they? They're the ones an individual wouldn't have incurred.

And I'll put a gloss on it, like we do in law. I say a reasonable individual. I say wouldn't reasonably have incurred. And then I leave it up to the IRS to say which are the expenses that an individual would likely incur and which ones he wouldn't likely incur.

…

JUSTICE BREYER: Not buying into they're [sic] thing with 'could.' I mean, that isn't my problem.

…

JUSTICE BREYER: …What that means is would a – an investor not in the trust, not holding it in trust, reasonably have been, or a reasonable investor have been likely to make this expenditure? That turns it into a more quasi-legal question where people – and then it's a matter of judgment, which these things do come down to.

…

JUSTICE BREYER: I'm looking really for a form of words to write that does not use the word 'could' but which gets at what I think the statute was after, which is: Let them have this no floor for their special stuff but not for ordinary stuff that others would have incurred regardless.

…

JUSTICE BREYER: If I reject this word ‘could’ and ‘uniqueness,’ now what form of word should I write?

MR. MILLER: I think ‘ordinarily’ or ‘customarily’ is also a permissible interpretation of –

MR. BREYER: If had you to choose between that and getting the idea of the reasonable taxpayer who didn’t hold this in trust, which would you choose?”

Other Justices focused on the “commonly incurred by individuals” standard. Justice Roberts inquired as to whether that might depend on the size of the trust or on how many individuals might incur the expense.

“CHIEF JUSTICE ROBERTS: So how does your customary or commonly incurred test work? Let’s say you have two trusts, one $10 million, the other 10,000. I think an individual with $10 million might well seek investment advice, but an individual with only 10,000 might decide it’s not worth it. Would you have a different application of the 2 percent rule for those two trusts?

…

How many – how many individuals do you need? Let’s say it’s $3 million in the trust, and we think maybe 60 percent of people would hire an investment advisor; 40 percent would think they can do just as well on their own. Is that customarily incurred by individuals?

MR. MILLER: I think it might well be enough that – something that the Service could clarify through –

MR. CHIEF JUSTICE: Your answer to both questions is ‘might well be,’ and that’s a fairly vague line when it comes to taxes.

MR. MILLER: The –

JUSTICE SCALIA: And whatever line you – you pick, I guarantee you, trusts are going to break themselves up into mini-trusts that fall under the line. I mean people aren’t stupid.”

(Laughter.)”

Justice Alito wrestled with how to apply an “ordinary or customary” test to particular types of expenses, perhaps suggesting that he would be inclined to a rule one way or the other for fiduciary investment expenses:

“JUSTICE ALITO: It seems to me the difficulty is in characterizing the level of generality at which you describe the cost, not whether it’s ordinary or customary or unique. You run into the same problem no matter how you do that, but you have to decide whether you're talking about investment advice or fiduciary investment advice, tax preparation costs or fiduciary tax preparation costs. And what is the formula for making that distinction?"

Various Justices inquired about whether there should be an allocation of the portion of investment expenses that are subject to the exception and those that are not in each particular case. The attorneys for both the taxpayer and the government argued for a categorical rule that trust investment advice would come within the exception or would not. (The government's attorney at one point argued that all investment advice for a trust is subject to the 2% rule [ see subparagraph (5) above) but later acknowledged that the government would allow a limited exception, for example, if the advisor imposed an "extra charge" on the fiduciary accounts that an individual going to the same advisor would not incur.) However, Justice Breyer did not suggest in his analysis that there would be a categorical rule including or excluding all investment advice:

"JUSTICE BREYER: … Children get into fights trying to split up the assets. Millions is [sic] paid on lawyers and investment advisors to see if each share, figured 14 different ways, is going to earn this money or that money. And that kind of thing exists. And there the investment advisors are likely to be special. So you can't say investment advice is always special or never special."

Chief Justice Roberts asked specifically about splitting out an advisor's fee based on the type of the advice:

"CHIEF JUSTICE ROBERTS: What if you get a bill from the investor advisor, and it's $50,000 and it's broken up, 30,000 is general stock picking advice, and 20 percent is specialized fiduciary advice? …You would – would you agree that the $20,000 is not subject to the 2 percent floor but the 30,000 is? "

As mentioned above, Justice Scalia is wary of imposing that burden on the tax system:

"JUSTICE SCALIA: Can you really s[p]lice up advice that way? You ask the advisor, say, which – what percentage of your advice was the advice that went to maximizing total return and what percentage went to this other thing? I mean, gee, I don't want to get courts into trying to figure that out, or private individuals or financial advisors in trying to figure that out. That's just a crazy way to run a tax system, it seems to me."

(7) Unbundling. There was absolutely no discussion in the oral argument of the unbundling issue raised in the proposed regulations, and whether trustees must unbundle the portion of their fees that are attributable solely to investment advice. None of the Circuit level courts have suggested an unbundling requirement (and indeed, most have said that trustee fees are not subject to the 2% rule without any suggestion of having to unbundle trustee fees.)

(8) Predictions. Carol Cantrell, who has represented the taxpayer in the case, predicts a 6-3 decision for the taxpayer, counting Justices Scalia, Souter, Ginsburg and Alito as being aligned with the taxpayer's position. (She counts Justice Breyer as clearly sympathetic with the government's position, leaving Justices Kennedy, Stevens, Roberts and Thomas [who, in his typical fashion, did not ask any questions] as wild cards.) Steve Leimberg's Estate Planning Newsletter, Message #1217 (Dec. 17, 2007). Some other planners have predicted a government victory. In any event, it would seem unlikely that the Supreme Court will keep the Second Circuit's "incapable of being incurred by individuals" test. The Supreme Court's reasoning will obviously have a huge impact on the proposed regulations (discussed below), and whether they will have to be totally revamped.

c. Proposed Regulations. Proposed regulations were issued after the Supreme Court accepted certiorari in Rudkin. They use a standard similar to the very strict test in Rudkin, and add that executor and trustee fees must be "unbundled" to identify the portion of the fee representing services that are unique to estates and trusts. Prop. Reg. §1.67-4. The proposed regulation provides that a cost incurred by an estate or non-grantor trust that is unique to the entity is not subject to the 2-percent floor, but costs that are not unique to estates or trusts are subject to the 2-percent floor. Prop. Reg. §1.67-4(a). The regulation identifies the following non-exclusive list of **unique** services (that are not subject to the 2-percent floor): "fiduciary accountings, judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters." The regulation gives the following non-exclusive list of **non-unique** services (the costs of which are subject to the 2-percent rule): "custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property." Prop. Reg. §1.67-4(b).

Fiduciary fees must be "unbundled". If an estate or trust pays a single fee for both costs that are and that are not unique to estates and trusts, the estate or trust "must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estate and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estate and trusts and other costs." Prop. Reg. §1.67-4(c).

d. Observations of Proposed Regulations.

(1) Timing. Interestingly, the IRS waited 21 years to issue regulations to §67(e), and then issued regulations within weeks after the Supreme Court granted certiorari to address this issue.

(2) Adopts Strict Rudkin Approach; Logic Issues With the Approach. The regulations about this practice approach that was used in Rudkin (i.e., expanse that could not be incurred by individuals) rather than the more moderate approach that was used in Mellon Bank and Scott (expense "commonly" or "customarily" incurred by individuals). However, it is not yet clear what additional specific expenses the strict standard will subject to the 2% rule. In practice, the differences might not be substantial.

The "incapable of incurring" test announced in Rudkin and the "unique" test in the proposed regulation combined with the purported safe harbors mentioned in the case and in the proposed regulations seem somewhat illogical. Individuals are capable of incurring liability for trustee fees, guardianship fees, conservator fees, etc. They have to pay for tax return preparation (albeit on a different tax form that is used by trusts). They can be called to account for their actions and provide accountings. It is hard to imagine expenses that individuals are *incapable* of incurring.

(3) Safe Harbor List Not Make Sense As Being Unique to Estates and Trusts. Much of the safe harbor list of expenses that are unique to an estate or trust makes no sense. The list includes accountings, income tax preparation, will or trust contests or constructions, and bond premiums. These are included despite the fact that individuals commonly incurred those types of expenses. (The regulations apparently tried to distinguish those items by adding the modifier "fiduciary"—"fiduciary accountings," "fiduciary income tax returns," etc.—but that adjective could just as

easily be applied to other types of expenses such as "fiduciary investment advisory fees (in light of the fact that fiduciaries' have special fiduciary duties [and liabilities] regarding a variety of investment issues.)

(4) Non-Unique List. Advise on investing for total return is on the non-unique list—despite the fact that the concept of total return investing is somewhat irrelevant to individuals for whom there are typically no limitations on being able to access the corpus or the income of their investments. The concept of fiduciaries investing for total return is only important in the context of the differing interests of income beneficiaries and corpus or remainder beneficiaries. While advising of investing for total return is on the "non-unique" list, what about analogous advice related to whether to exercise the power to adjust between income and principal (for example, under §104 of the Uniform Trust Code)? That would seem to be "unique" to trusts, but that advice is directly related to the total return investment issues.

(5) Estate Tax Audits "[T]he defense of claims by creditors of the decedent or grantor" is on the non-unique list. Are the very substantial expenses of defending against an estate tax audit by the IRS (who would be a creditor to whom the estate owes a liability) be on the non-unique list? Is the preparation of the estate tax return a unique item but the defense against the IRS as a creditor of the estate a non-unique item?

(6) Unbundling Trustee Fees Position Is Contrary to All Four Appellate Cases. Even though not accepting investment advisory fees as being an exception to the 2-percent rule, the federal appellate courts in Mellon Bank, Scott, and Rudkin cases all stated the trustee fees would not be subject to the 2-percent rule. For example, Mellon Bank stated that it is "undisputed that trustee fees are fully deductible." O'Neill recognized investment advisory fees as being within the exception, and certainly would have also recognized trustee fees as being excluded from the 2-percent rule. Thus, all four of the federal appellate courts that have addressed §67(e) have concluded that the statute is clear and unambiguous, and have recognized that trustee fees are not subject to the rule.

Observe that the unbundling requirement in the new regulations will apply to payments made after the date of the issuance of final regulations. Prop. Reg. §1.67-4(d). Therefore, the unbundling requirement in the regulation does not apply for payments made in 2007, and as indicated above, prior cases have not imposed an unbundling requirement.

(7) IRS Has Hinted That It Would Require Unbundling. Despite statements in the federal court of appeals cases that trustee fees are fully deductible, there have been reports that the IRS has in some audits requested corporate trustees to "unbundle" their trustee fees, and to specify in particular what portion of the trustee fee was attributable to investment functions. The IRS's brief to the Second Circuit in the Rudkin case emphasized the IRS's authority to require corporate trustees to unbundle their fees for this purpose. The brief states in footnote 14: "The use of the verb "incurred" [in the second prong of §67(e)(1)] also emphasizes the IRS's authority to promulgate regulations requiring financially sophisticated trustees (*e.g.* Mellon Bank) to unbundle their trustee fees to reflect internal investment advice costs incurred but never directly paid." The brief also states that "the IRS has the authority to require trustees to 'unbundle' their fees into those that are unique to trust administration (and thus are not subject to the 2% floor) and those that are not unique (and that, consequently, belong under the floor)."

(8) Unbundling Approach Conflicts With Tax Simplification Goal of §67. One Congress is very this is that it announced for adopting a 2% floor on miscellaneous itemized deductions was to simplify record-keeping and prevent common errors. The requirement to unbundle fees will add substantial complexity.

(9) Difficulty for Corporate Fiduciaries. Corporate fiduciaries will have difficulty isolating out the portion of the trustee's fee that is unique to estates and trusts. For example, isolating the portion of the fee attributable to "communications with beneficiaries regarding estate or trust matters" is very unclear. Regulations merely provide that the taxpayer "must use any reasonable method" to make the allocation.

(10) Legal and Accounting Fees. No case has ever hinted that legal and accounting fees are not fully deductible, but legal and accounting fees are not on the safe harbor list of expenses considered "unique" to an estate or trust. Form 1041, line 14 invites the trust or estate to deduct "attorney, accountant, and return preparer fees" without any limitation on the deductibility of the fees. Attorneys will now have to allocate their fees between those that all are and are not unique to estates and trusts. For example,

attorneys fees on a lawsuit in a contractual matter would be subject to 2% rule, but legal fees incurred by trust in a will contest suit would not.

(11) Will Regulation Be Upheld by Courts? All four federal appellate courts that have reviewed the application of §67 to trust investment advisory fees have agreed that the statute is clear and unambiguous (and have also all agreed that trustee fees would be fully deductible). If a statute is unambiguous, the Supreme Court has held that an interpretive regulation, such as this one, cannot overrule a federal court of appeals interpretation of the statute. National Cable & Telecomms. Assn. V. Brand X Internet Services, 545 U.S. 967 (2005). Accordingly, restricting the full deductibility of trustee fees may be suspect. In addition, applying the strict "unique" approach may be suspect in every jurisdiction other than the Second Circuit. Furthermore, restricting the deductibility of investment advisory fees may not be recognized at all in the Sixth Circuit, based on that court's interpretation of the "unambiguous" statute.

While the Supreme Court will not directly address the validity of the regulation, its reasoning may have a substantial impact on the regulations on validity. It will be interesting to see if the IRS delays finalizing the regulation until the Knight case is decided.

Standard for Upholding Regulations. The Tax Court recently addressed the deference that should be accorded regulations in Estate Of Gerson v. Comm'r, 127 T.C. 139 (2006).

- In Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 476 U.S. 837 (1984), the Supreme Court held that if a statute was silent or ambiguous with respect to the specific issue, the question for a court was whether the agency's action was based on a permissible construction of the statute. Further, considerable weight was to be accorded to an agency's construction of a statutory scheme. The Court noted that while the legislative history of the statute was silent on the particular issue involved in the case, it did reveal that the EPA's interpretation was fully consistent with one of the two principal goals of the statute — namely, allowance of reasonable economic growth. Accordingly, the EPA's interpretation was entitled to deference.
- The court in Gerson acknowledged that the IRS re-wrote the relevant regulation in that case (i.e., that the exercise of a general power of appointment over a pre-9-

25-85 trust destroys GST grandfather protection) after receiving the unfavorable judicial interpretation by the Eighth Circuit in Simpson. The U.S. Supreme Court in Natl. Cable & Telecomm. Association v. Brand X Internet Services, 545 U.S. 967 (2005) stated: "A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." However, the Tax Court in Gerson concluded that the Natl. Cable limitation does not apply where there are conflicting judicial constructions of the statute in question.

- "Legislative regulations" are written under specific authority in a statute to provide regulations regarding that statute. Those regulations are entitled to more deference than "interpretive regulations" that are written without specific statutory authority. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843-44 (1984)). (The dissent by Judge Vasquez in Gerson cites various other cases supporting this proposition.)
- The majority opinion in Gerson stated that the standard for reviewing interpretive regulations (where the statute in question is silent or ambiguous with respect to the specific issue) is whether the regulation implements a congressional mandate in a **reasonable manner** (citing Natl. Muffler Dealers Association, 440 U.S. 472 (1979)) and whether the regulation is "based on a **permissible construction** of the statute" (quoting Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)). A concurring opinion by Judge Holmes in Gerson concludes that "**reasonableness** is all that's required in step two of Chevron."
- A dissent in Gerson (by Judge Vasquez) disagrees with the standard for reviewing interpretative regulations. The dissent maintains that a subsequent Supreme Court case, United States v. Mead Corp., 533 U.S. 218 (2001), changes the standard for reviewing interpretative regulations:

  "In Mead … [t]he Supreme Court held that an agency's interpretation of a particular statutory provision qualifies for Chevron deference when (1) Congress delegated authority to the agency to make rules or regulations carrying the force of law, and (2) the agency interpretation claiming deference was promulgated in the exercise of that authority. United States v. Mead Corp ….

When an agency's interpretation of a particular statutory provision does not qualify for Chevron deference, it is entitled to the deference accorded under Skidmore v. Swift & Co., 323 U.S. 134 (1944). United State v. Mead Corp, supra at 234-35, 237. Pursuant to Skidmore, the agency's interpretation is accorded respect proportional to its 'power to persuade'. Id. at 235; Pool Co. v. Cooper, [274 F.3d 173, 177 (5thCir. 2001)] (in the absence of Chevron deference, pursuant to Mead the agency's interpretation is accorded respect under Skidmore according to its 'power to persuade'); Landmark Legal Foundation v. IRS, 267 F.3d 1132, 1135-1136 (D.C. Cir. 2001) (when Chevron deference does not apply, the Internal Revenue Service's interpretations are entitled to 'no more than the weight derived from their 'power to persuade'')."

Judge Vasquez reasoned that the general authority of the IRS to write regulations under §7805 is not a delegation of authority from Congress "to make rules or regulations carrying the force of law." Accordingly, interpretive regulations are not entitled to Chevron deference (i.e., whether the regulation is a permissible interpretation of the statute), but only to Skidmore deference (regulations are accorded respect proportional to their "power to persuade").

e. Effect on Trust Beneficiaries. If the 2% limitation applies, the effect will be to increase DNI—so there will be a larger hit to beneficiaries of the DNI carryout. Trustees have typically taken the position that the 2% rule does not apply to the payment of investment advisory fees. If the IRS reverses that position on audit, the most significant concern is for beneficiaries who received distributions (and had trust income carried out to them up to the amount of the trust's DNI) and who may have to go back and file three years of returns and pay penalties and interest.

f. Trust Distributions Reduce Trust AGI and Minimize the Impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income). For example, if the trust distributes enough so that the adjusted gross income, after subtracting the distribution deduction, is $10,000 and if there are $10,000 of administration expenses, then there is only a $200 "hit" even if the 2% rule applies. If the trust distributed even more, the trust would get more distribution deduction and drive the AGI even lower, but then trust would lose the benefit of the $10,000 of administration expenses.

g. Practical Impact of 2% Floor May Be Limited. They practical impact of applying the two percent floor to investment advisory fees may be minimal. A commentator on a listserv has pointed out that even if a small portion of the expenses of the trust are subject to the 2% rule, they may "soak up" most of the portion that would be subject to the 2% rule. Making additional trust expenses subject to 2% rule would only have a minimal impact.

h. What to Do on April 15, 2008. It is unclear whether there will be final regulations or a Supreme Court decision by April 15, 2008, when trustees will be filing 2007 income tax returns. How should the investment advisor fees be reported, in light of the potential penalties that could apply to trustees and to return preparers? Taxpayers can face understatement penalties unless their position is based on the weight of authorities as enumerated in Reg. § 1.6662-4(d)(3)(iii) or a "well-reasoned construction of an applicable statutory provision." Reg. § 1.6662-3(b)(3) & 1.6662-4(d)(3)(ii). Substantial authority for a position exists if the weight of authority supporting the position is "substantial" in relation to the weight of authorities supporting contrary treatment, Reg. § 1.6662-4(d)(3)(i). These possible penalties can be avoided by disclosing the position in question on Form 8725. See Reg. § 1.6662-3(e-f).

Observe that the unbundling requirement in the new regulations will apply to payments made after the date of the issuance of final regulations. Prop. Reg. §1.67-4(d). Therefore, the unbundling requirement in the regulation does not apply for payments made in 2007, and as indicated previously, prior cases have not imposed an unbundling requirement.

Return preparers can also face penalties under §6694 for signing a return with a position that does not have a "more likely than not" chance of being upheld on the merits. If disclosure of the position is made on Form 8275, preparer penalties will not apply if there is a reasonable basis for the position. I.R.C. §6694(a)(2)(B-C). See Section 2.b of this outline.

## 6. FLP Planning Issues

a. Rector: Judge Laro Finds Implied Agreement Under §2036; Applies §2036 to the Assets Contributed to the FLP Rather Than to the Gifts of LP Interests Under a "Single Plan" Analysis; Suggestion that Payment of Estate Taxes Out of Partnership Assets Evidences an Implied Agreement of Retained Enjoyment Under §2036.

**Synopsis**

In this case that is appealable to the 9th Circuit (and that therefore relies heavily on *Bigelow*, discussed in Item 6b below), Judge Laro (who somehow seems to be drawing a disproportionately high number of the FLP cases) easily finds the existence of an implied agreement of retained enjoyment under §2036. *Rector v. Commissioner*, T.C. Memo 2007-367 (December 13, 2007). The result is not surprising, and there are strong facts suggesting the existence of an implied agreement that the decedent would retain enjoyment of partnership assets (including that almost all of the decedent's liquid assets were transferred to the FLP and the FLP in fact paid significant amounts of the decedent's living expenses and made significant non pro rata distributions to or for the decedent's benefit). The court also noted that substantial distributions were made for the payment of estate and gift taxes of the decedent. The court also reasoned (interestingly, as part of the §2036(a)(1) analysis rather than under §2036(a)(2)) that the decedent kept control of the FLP because she owned all of the general partnership interest (at first initially, and later through her revocable trust). The court finds that the bona fide sale exception to §2036 does not apply, because there was no change in the underlying pool of assets or the likelihood of profit, and there was not a legitimate and significant nontax business purpose.

**Key Facts**

Decedent created the FLP when she was 92 (while living full-time in a convalescent hospital), and her revocable trust transferred virtually all of her wealth to the partnership. There was a meeting of the decedent and her two sons with the attorneys, but the FLP was formed without any negotiation over its terms.

When the partnership was formed, the decedent was the sole general partner (2%) and her revocable trust received the 98% limited partnership interests.

There was a $2.5 million credit shelter trust for the decedent created by her predeceased husband, but she only received the income from the trust, and the trust agreement said that principal distributions should be made from that trust for objective standard needs only if assets in a Marital Trust could not be readily used for these purposes.

The partnership was not funded for about 3 months, when the revocable trust transferred practically all of its assets ($174,000 cash and $8.6 million of marketable securities) to the FLP. That same month, the decedent gave each of her two sons an 11.1% limited partnership interest.

The decedent's expenses substantially exceeded the income distributions that she received from the credit shelter trust. The FLP paid about $77,000 of these expenses directly, and transferred about $350,000 to the revocable trust for it to pay the decedent's gift taxes. In the two years prior to decedent's death, 86 to 90 percent of the total distributions were made to decedent (even though she only owned a 2% general partnership interest and a 75.78% limited partnership interest). After decedent's death, the FLP drew on a line of credit to pay the federal and California estate tax liability.

Two years after the partnership was funded (and one week before the decedent died), decedent transferred her 2% general partnership interest to the revocable trust, and her revocable trust transferred a 2.754% limited partnership interest to each of her sons.

### Section 2036(a)(1) Retained Enjoyment

The court's analysis and factors that it emphasized provide guidance as to how FLPs should be planned and operated. The court had little difficulty in finding the existence of an implied agreement for retained enjoyment in light of the fact that the revocable trust transferred just about all of its assets to the partnership, and the decedent had a substantial shortfall of cash flow in meeting her living expenses, and she in fact received substantial distributions from the partnership.

Factors mentioned by the court include:

- "The transfer of practically all of decedent's wealth to RLP [the abbreviation the opinion used to refer to the Rector Limited Partnership] left decedent with insufficient liquid assets with which to pay her living expenses."
- Decedent's living expenses were about three times as large as the income distributions that she received from the bypass trust.
- Absence of negotiation over terms of the trust.
- Absence of independent counsel for the decedent and her two sons.
- At the time of the creation of the partnership, no one other than the decedent intended to make contributions to the partnership and the decedent intended to make gifts of limited partnership interests to her sons.
- The partnership paid significant personal expenses of the decedent.
- Statements of activity and capital accounts were not regularly maintained.
- The decedent never even asked her sons as trustees of the bypass trust to distribute principal of that trust to her in order to cover her living expenses.
- Summary: "Decedent derived economic benefit from using RLP's assets to pay her living expenses, to meet her tax obligations, and to make gifts to her family members. Such use of RLP's assets shows an agreement among decedent and her

sons that decedent would retain the enjoyment of and the right to income from the transferred assets by withdrawing those assets and/or income from RLP at will."

**Section 2036(a) Bona Fide Sale for Full Consideration Exception**

Judge Laro stated that the exception was not met for two general reasons: (1) There was no change in the underlying pool of assets or likelihood of profit, which Judge Laro says is necessary to constitute full and adequate consideration; and (2) The transfer to the partnership was not in "good faith," which considers whether "the terms of the transaction differed from those of two unrelated parties negotiating at arms' length" and which "requires that the transfer be made for a legitimate and significant nontax business purpose." (Judge Laro repeatedly adds the word "business" to the "legitimate and significant nontax reason" standard announced by the full Tax Court in *Bongard,* despite Judge Laro's failure to convince the majority of the full Tax Court in that case there must be a "business" purpose to satisfy the bona fide transfer for full consideration exception to §2036.)

As to the lack of a change in the underlying pool of assets, the opinion repeatedly observed that the decedent made all contributions to the FLP.

As to the terms differing from those of unrelated parties negotiating at arm's length, the court noted the absence of negotiation, the absence of independent counsel, that decedent made all contributions, that her contributions constituted the "vast bulk of her wealth," that the partnership was not actually funded until nearly 3 months after it was formed, and that the decedent intended to be the only person contributing to the partnership although the partnership agreement contemplated that more than one partner would contribute property.

As to the "need for a significant nontax business purpose" the court concluded that transfer of asserts to the partnership was not reasonably likely to serve such a purpose. The opinion rejected the various purposes asserted by the estate, including facilitating gift giving (which the opinion said is always a testamentary purpose), providing efficient management (because the assets did nor require any special kind of active management), asset protection (because of the absence of any legitimate concern about liabilities of decedent, and because decedent or her revocable trust was a general partner at all times), and diversification (because the ownership and management of assets was the same as in the revocable trust, and because there was no investment strategy or business plan of providing added diversification of investments). The opinion also pointed to the decedent's age and health, and the fact that only decedent's cash and marketable securities were contributed to the partnership.

**Observations**

(1) Result not surprising. The result is not surprising. The facts strongly suggest the existence of an implied agreement of retained enjoyment.

(2) Full consideration requires change in pool of assets or likelihood of profit. Judge Laro reverted to the pre-*Bongard* position of the Tax Court that full consideration for purposes this exception is not met if there is mere recycling where there is no change in the underlying pool of assets or prospect for profit. That standard was rejected in *Bongard* (which instead focused on receiving interests proportionate to contributions and a legitimate and significant nontax business reason [that is the only time in *Bongard* that it inserted the word "business" in that standard; the court stated the "legitimate and significant nontax reason" standard many other times without inserting the word "business"]). Judge Laro interestingly cites *Bongard* as well as *Bigelow* for support of his statement that "Without such a change [in the underlying pool of assets] or a potential for profit, decedent's receipt of the partnership interests does not constitute the receipt of full and adequate consideration."

*Bigelow* does literally require (a) the "genuine" pooling of assets, AND (b) "a potential [for] intangibles stemming from pooling for joint enterprise" to meet the §2036 exception. The literal requirement in that case of a genuine pooling of assets has not been taken seriously because of the almost total lack of contributions by anyone other than the decedent in that case.

(3) Decedent serving as sole general partner. It is never a good idea for the decedent to serve as the sole general partner in order to avoid §2036 and to sustain valuation discounts. In *Rector*, the decedent served as the sole general partner up until about one week prior to her death (when her revocable trust became the general partner). Following Judge Cohen's memorandum decision in *Strangi* (T.C. Memo 2003-145), planners have generally avoided having the decedent serve as sole general partner (or often even as a co-general partner) in order to avoid an argument of applying §2036(a)(2) (right to designate who shall possess or enjoy the transferred assets or the income from

them). Interestingly, Judge Laro points to the decedent's ability to control the assets as part of his analysis under §2036 (a)(1).

"The RLP agreement reflects an understanding among decedent and her sons that decedent would retain her interest in the transferred assets by virtue of her ability to control those assets, including the management and disposition thereof. Initially, as the direct general partner of RLP, decedent was given the right by the RLP partnership agreement to cause a distribution of RLP's net cashflow to RLP's partners in proportion to their partnership interests, and she was given the power 'to do anything reasonably connected' with RLP's assets. Later, as an indirect (through the 1991 revocable trust) general partner of RLP, decedent continued to retain that right and power directly in that she was a cotrustee of the 1991 revocable trust and, most importantly, she had the absolute power to revoke the trust as if it had never been created in the first place. Thus, at all relevant times, decedent held both a majority interest in RLP and the powers incident to serving as RLP's general partner."

(4) Payment of estate taxes by partnership. *Erickson* (T.C. Memo 2007-107) emphasized the payment of estate taxes by the FLP as the primary reason supporting its application of §2036(a)(1) (in light of the fact that no distributions were made to the decedent in that case, and no distributions to her from the partnership were anticipated in light of the fact that she had a $1 million bypass trust that could pay her living expenses). That analysis seems wrong, because §2036 refers to retained enjoyment *for life*. (If §2036 applies in that circumstance, then it would also seem to apply to all irrevocable life insurance trusts under the same reasoning. See Item 6c below.)

*Rector* is not nearly as direct as *Erickson* in relying primarily on the payment of estate taxes using partnership assets to trigger the application of §2036, but it does state explicitly (in footnote 9) that the payment of estate taxes using assets transferred to the partnership evidences an implied agreement of retained enjoyment under §2036:

"RLP transactions in 2002 and 2005 also illustrate the implied agreement among decedent and her sons that the transferred assets would continue to be used for the liabilities of decedent, even after her death. In those years, an RLP credit line was used to pay decedent's Federal and State tax liabilities of $2,038,098 and $262,654, respectively. A check also was written on the

RLP credit line for $384,535 to pay some of decedent's Federal estate tax."

(5) Application of §2036 to all assets transferred to partnership rather than just being applied to transfer of limited partnership interests. The decedent transferred assets to the partnership and immediately gave 11.11 % limited partnership interests to each of her two sons (and made further gifts of limited partnership interests about a week before her death). If §2036 just applies to the gifts of the limited partnership interests, those interests would come back into the estate (but the interests would likely be valued with a discount). On the other hand, applying §2036 to the assets transferred to the partnership means that no discount is allowed. If §2036 applied to the assets transferred to the partnership before the gifts of limited partnership interests, §2035(a)(2) would continue to cause §2036 to apply to the assets contributed to the partnership (thus avoiding any discount) because the retained interest was relinquished within three years of the date of death. However, Judge Laro did not rely on a §2035 analysis, but rather he relied on a "part of a single plan" analysis to apply §2036 to the partnership assets attributable to partnership interests that she had given to her sons during her lifetime. (Interestingly, this discussion also appeared in a footnote—footnote 7.)

"The estate further argues that sec. 2036(a), to the extent it applies to this case, applies only to decedent's transfer of the limited partner interests to her sons and not to her transfer of the assets to RLP. To this end, the estate asserts, decedent received 100 percent of the interests in RLP in exchange for the assets, which means that the value of decedent's gross estate was not depleted by that transfer but was depleted when decedent gave away the limited partner interests….As detailed herein, we find on the basis of the credible evidence at hand that **decedent's transfer of her assets to RLP and her ensuing gifts of the limited partner interests to her sons were part of a single plan to minimize decedent's Federal estate tax**, lacked a significant nontax business purpose, and accomplished no genuine pooling of assets. On the basis of those findings, we reject this argument." (emphasis added)

That concept might suggest that partnership assets attributable to gifts of limited partnership assets would still be included in the estate even though the gifts were made long before the decedent's death—if the IRS could show that there was an intent to make gifts to minimize federal estate taxes as part of the plan of creating the partnership. That is a far reaching and quite troublesome suggestion. For example, it might also apply to the somewhat analogous situation of making gifts under a "single plan" for the recipient to acquire life insurance on the decedent's life, resulting in the inclusion of the life insurance owned by the third party in the donor's estate. Section 2035(b) is intended to deal with these kinds of transfers, and to extend the three rule of §2035 indefinitely under a "single plan" doctrine makes §2035(b) somewhat meaningless and seems unsupportable.

b. Bigelow: Ninth Circuit Upholds Implied Agreement Under §2036; Applies Non-Tax Benefit Analysis and Comparability Analysis to §2036 Exception; and Includes Troublesome Statement That Pooling of Assets is Required to Apply §2036 Bona Fide Transfer for Full Consideration Exception.

**Synopsis**

The Ninth Circuit now joins the Third, Fifth, and Eighth Circuits in weighing in on the application of §2036 to family limited partnerships. Bigelow v. Commissioner, 100 AFTR2d 2007-xxxx (9th Cir. September 14, 2007), affg, T.C. Memo 2005-65. The Ninth Circuit upheld the Tax Court finding that §2036 caused the inclusion of all partnership assets in the decedent's gross estate without a discount. The Ninth Circuit decision is not surprising and generally does not plow new ground. The facts of an implied agreement for retained enjoyment of the assets contributed to the partnership are strong. The court focused on the lack of purported non-tax benefits to find that the bona fide sale for full consideration exception did not apply. The court seemed to be looking for *actual* particular claims or risks to support a liability protection purpose, an *actual* threat of a partition action to support avoiding partition as a purpose, and *particular assets or a business* requiring active management to support a management purpose. The court said that a heightened scrutiny analysis would apply, and the court said to consider whether the terms of the transaction differed from those of two unrelated parties negotiating at arm's length (in effect, suggesting a "comparability" test to determine if unrelated parties would have contributed assets to the partnership in the same situation as the decedent.)

The opinion contains a startling "requirement" for the full consideration exception to §2036. The opinion literally says that there must be more than just transfers to the partnership for a proportional number of units of the partnership, and that there "must" be a "genuine pooling" of assets—which would seem to require significant contributions by other partners. However, the reasoning in the next several pages of the opinion refers to other factors (primarily the absence of non-tax benefits) in addressing the bona fide transfer for full consideration exception to §2036. In fact, there were no significant contributions by other partners in that case, but the court made no mention of that as a reason to refuse application of the full consideration exception. Planners probably will not drastically change their planning for family limited partnerships to urge strongly that clients have other family members make substantial contributions to the partnership in light of this troublesome statement in the opinion—which the court itself did not seem to apply.

**Key Facts**

Decedent created a revocable trust in 1991 and transferred her interest in her residence to the trust. The trust exchanged the residence for other rental property, and borrowed $350,000 and $100,000 under separate loans secured by the rental property. In December 1994, the revocable trust contributed the investment property to an FLP (but not the $450,000 of liabilities secured by the property, which remained as liabilities of the revocable trust). (The decedent's children each contributed $100 for very small limited partnership interests.) After contributing the property to the partnership, the decedent had a monthly cash flow shortfall of $1,200 (and three years later the shortfall grew to $2,700 per month.) The partnership made payments on the $350,000 loan (which were owed by the revocable trust) and paid some of the decedent's living expenses. The son (as agent) made 40 transfers between the partnership and the revocable trust during a period of a little over two years.

In December of 1994 and 1995, the son (as agent under the power of attorney) withdrew some of the trust's units in the FLP and made gifts to himself and his sisters and to the decedent's grandchildren. (No gift tax returns were filed until after the decedent's death.)

Decedent died in August 1997 (when the revocable trust owned the 1% general partnership interest and a 45% limited partnership interest), and the FLP was terminated a little over one year later.

The estate claimed a 31% marketability discount on the gifts of the limited partnership interests and claimed a 37% marketability discount on the value of the limited partnership interests for estate tax purposes.

### Section 2036(a)(1) Retained Enjoyment

The Ninth Circuit upheld the Tax Court’s finding “that decedent and the Bigelow children impliedly agreed that decedent would have access to income from the transferred property and that decedent continued to enjoy the economic benefit that the property secured her personal debt.” (Because § 2036(a)(1) applies, the Tax Court did not consider § 2036(a)(2) or §2038(a)(1).) The court’s holding supporting the finding of an implied agreement of retained enjoyment is not surprising. The combination of substantial disproportionate distributions to the decedent, the inability of decedent to meet her living expenses, and the use of the partnership property to secure the decedent’s liabilities evidence the implied agreement to retain income from and enjoyment of the rental property that was transferred to the partnership.

The Ninth Circuit pointed to various factors suggesting an implied agreement that decedent could access partnership funds as needed, including the following:

- The contribution of the rental property to the FLP impoverished the decedent and left her vulnerable to monthly shortfalls.
- The children knew that decedent’s long-term coverage was expiring soon after the contribution to the FLP (one policy in 9 months and another policy in 17 months).
- There were 40 transfers between the partnership and the revocable trust. The transfers were characterized as interest free loans (unaccompanied by a promissory note). Eventually a distribution was made from the partnership to the revocable trust to repay the earlier advances and later to pay decedent’s expenses.
- The FLP made substantial payments on the $350,000 debt owed by decedent’s revocable trust, but did not reflect those as distributions on the partnership accountings.
- The children considered having the partnership sell the rental property to have funds available to cover the decedent’s living expenses.
- One child testified that she would not pay decedent’s expenses out of her own pocket, but the children were committed to maintaining their mother in the manner to which she was accustomed.
- Partnership formalities were not observed. (1) Capital accounts were adjusted annually to reflect gifts made to the children, but not to reflect payments on the revocable trust’s debt; (2) No other partner benefited from such informal access to partnership funds; (3) A post-mortem accounting reflected

an implied agreement (to reflect the payments on the $350,000 debt owed by the revocable trust) indicated that decedent could access income from the transferred asset.

The implied agreement facts were bad, and the court's decision is not surprising.

**Section 2036(a) Bona Fide Sale for Full Consideration Exception**

(1) Not Two Distinct Requirements. Unlike other courts, the Ninth Circuit refused to break down the analysis into two discrete requirements, "bona fide sale" and "adequate and full consideration." Instead, the Ninth Circuit said "we consider the 'bona fide sale' and 'adequate and full consideration' elements as interrelated criteria." "The validity of the adequate and full consideration prong cannot be gauged independently of the non-tax-related business purposes involved in making the bona fide transfer inquiry."

(2) No *Per Se* Disqualification for Exception. The IRS argued that a transfer of assets to a partnership in return for interests that are worth less than the value transferred, even though proportional to other contributions, means that the transfer cannot meet the exception. The Ninth Circuit responds that a transfer of real property to a partnership, which reduces the value of the decedent's interests, "does not *per se* disqualify the transfer from falling under §2036(a)'s exception." (The Ninth Circuit said that it was agreeing with the Third and Fifth Circuits in that regard.) In effect, the Ninth Circuit seems to reject the IRS argument that a contribution of assets in return for partnership interests that are proportional but that have a lesser value than the contributed assets necessarily means that the full consideration element is not satisfied.

(3) More Than Proportionality Required; Pooling of Assets as a Factor. Proportionality of interests compared to contributions is not enough to satisfy the exception; the estate must also show (a) the "genuine" pooling of assets, AND (b) "a potential [for] intangibles stemming from pooling for joint enterprise." However, the court's subsequent analysis does not emphasize these two purported requirements, but instead focuses on supporting the Tax Court's finding of a lack of "good faith" (and specifically, the absence of non-tax benefits) as a reason to find that the exception does not apply.

OBSERVATION: This would be a very significant planning feature if we were to believe that the court is absolutely requiring a genuine pooling of assets. The court opinion literally says that an estate must do more than show a proportional exchange of assets contributed to the partnership in return for the units received, and the estate "MUST" also show a "genuine" pooling of assets, AND a potential for intangibles stemming from the pooling. Despite this very strong language, the court never mentions it again, but instead focuses primarily on the absence of non-tax benefits. This genuine pooling requirement would be particularly ironic in this case in which there was practically NO pooling of assets from various partners. The decedent's children just contributed $100 each for their miniscule partnership interests before the decedent made gifts of partnership interests to them in later years, and the court made absolutely no mention of the almost complete absence of "pooling" of assets under the facts of this case. Having significant contributions by others to create a genuine pooling of assets may be a helpful factor, but it does not yet appear to be a requirement to satisfy the exception. Still, the court's literal language is troubling. Having a legitimate non-tax purpose, avoiding causing the impoverishment of the client, and following partnership formalities appear to be more important factors in the court's discussion, as discussed immediately below.

(4) Good Faith; (a) Impoverishment, (b) Formalities, and (c) Non-Tax Benefit. The Tax Court found that the transfer to the partnership was not in good faith because (a) the transfer resulted in the impoverishment of the decedent, (b) the partnership did not follow formalities, and (c) the transfer did not create a potential non-tax benefit. The Ninth Circuit found evidence to support each of these findings, focusing particularly on the absence of non-tax benefits.

(a) Non-Tax Benefit: Avoiding Potential Liability. The taxpayer argued that the partnership shielded family members from personal liability for injuries occurring on the property. The court responded that the decedent was not shielded from liability because her revocable trust was both general partner and limited partner. Also, there was no evidence that the family member-partners "reasonably faced any genuine exposure to liability." The court later pointed to the absence of "some concrete incident or circumstance," the absence of any "particular incident," and "no general conditions of the business venture that posed inherent risks of litigation." The court noted that in *Strangi*, the court was not persuaded that a possible claim by a housekeeper was a reason for liability protection planning when "no evidence was presented that the maid ever threatened to take such action."

(b) Non-Tax Benefit; Avoiding Partition. Similarly, the court rejected the proferred non-tax rationale that the formation of the partnership would protect the property from a partition sale where there was no evidence that other family member-partners contemplated a partition or had creditors that might resort to a forced sale.

(c) Non-Tax Benefit; Facilitating Management. Efficient management might count as a credible non-tax business purpose "only if the business of the FLP required some kind of active management." Here, the court said that the decedent's son managed the property as trustee of her revocable trust, and nothing changed after the property was contributed to the FLP. The court distinguished the situation in *Kimbell* where working interests in oil and gas properties were contributed to a partnership.

(d) Non-Tax Benefit; Facilitate Gift Giving. The court agreed with other courts that "gift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification"

(5) Heightened Scrutiny; Comparability Analysis. The court evaluated these arrangements "through the heightened scrutiny of intra-family transactions." In particular, the court considered whether "the terms of the transaction differed from those of two unrelated parties negotiating at arm's length" (citing *Bongard*). In effect, the court applies a "comparability" test, to determine if unrelated parties would have contributed assets to the partnership in the same situation as the decedent.

Court Did Not Address Reason For Including Partnership Assets Attributable to Gifts of Partnership Interests to Family Members

All of the rental property that was contributed to the partnership was included in the gross estate even though the decedent made gifts of about 54% of the limited partnership interests and only owned a 45% interest at her death. Perhaps this issue was not raised by the taxpayers, because neither the Tax Court nor the Ninth Circuit addressed the reasoning for this conclusion. One possible explanation is that § 2036 applied to the transfer of assets to the partnership, so those assets must be included in the estate regardless of any subsequent transfers or when they occur. That would seem troublesome as a general proposition—assuming that the decedent does not retain a § 2036(a)(1) right to income from or enjoyment of all of the partnership property or a § 2036(a)(2) right to designate who can enjoy all of the partnership property—and contrary to the purpose of having a three-year rule under §2035. Another possible explanation is that the court found an implied agreement that all of the FLP assets would be made available to the decedent. Apparently, distributions were only made to or for the benefit of the decedent, even though the decedent only owned a 45% interest in the FLP at her death. Another explanation is that §2035 applies because all of the gifts were made within three years of the decedent's death so the assets contributed to the partnership that are attributable to those transfers must also be included in the gross estate. (This was the reasoning of the full Tax Court in Bongard.) It would not seem appropriate to include the value of the underlying partnership assets attributable to transfers of partnership interests that are made more than three years before the decedent's death—if the decedent does not retain "(a)(1) or (a)(2)" rights with respect to the partnership property attributable to the transferred interests.

### Planning Implications From This Case

(1) Do not transfer so many assets to the partnership that it is apparent that the decedent must receive distributions from the partnership to maintain his or her lifestyle. Arguments could be made that individuals often make investments with the expectation of receiving an investment return without having the transaction recast as a § 2036 transfer. However, the cases that have found an implied agreement of retained rights to income or enjoyment of property transferred to an FLP often involve situations where the decedent is likely to need distributions from the partnership.

(2) Do not transfer assets that are subject to liens without also having the partnership assume the liability. (Of course doing so can have significant income tax implications, which might then suggest not distributing that particular encumbered asset to the partnership.)

(3) Do not have the client (or client's revocable trust) serve as the sole general partner (at least without letting the client know that doing significantly weakens the response to various attacks that the IRS might make.) Among other problems, having the decedent or a revocable trust serve as

general partner removes the possible nontax reasons of liability protection and providing for management.

(4) Maintain proper capital accounts and make appropriate adjustments to the capital accounts to reflect the fair market values of all contributions and to reflect all distributions and gifts of partnership interests.

(5) If possible provide for some change in the management of the assets after they are transferred to the partnership.

(6) If possible, provide for some pooling of assets by having other partners make significant contributions (but the court did not emphasize that factor, despite its literal statement that genuine pooling of assets is a requirement to apply the §2036 bona fide transfer for full consideration exception).

(7) When distributions are made, make proportionate distributions to all partners.

(8) Do not have numerous continuous transactions between the client and the partnership. The court pointed several times to the fact that there were transfers between the trust and the partnership 40 different times over about a two-year period.

c. Erickson Extends §2036 to Using Partnership Funds to Pay Decedent's Estate Taxes.

Estate of Erickson v. Commissioner, T.C. Memo 2007-107 is another §2036 victory for the IRS in a "bad facts" case. The case is particularly interesting in that the retained enjoyment of the partnership was the use of partnership funds to pay estate taxes (albeit through the purchase of an estate asset and a redemption of part of the estate's interest). However, the case was surrounded with other facts that made readily apparent that the only purpose of the partnership was to try to secure an estate tax discount.

**Key Facts**

(1) The decedent was an Alzheimer's patient in poor health in her 80's when the partnership was created.

(2) There was a delay in funding, including scurrying to fund interests in several condos on the decedent's deathbed.

(3) The decedent had two daughters, one of whom managed the decedent's affairs under a power of attorney and acted under the power of attorney to create and fund the partnership and (on the decedent's deathbed) to make gifts of partnership interests.

(4) The other daughter (who was also a partner) testified that she did not understand anything about the particulars of the partnership except that it saved taxes.

(5) The partnership was funded with almost all of the decedent's liquid assets (including $2,000,000 of marketable securities) and interests in several condominiums; the decedent initially acquired an 86% limited partnership interest.

(6) There was also a $1.0 million credit shelter trust for the decedent that had been created at her husband's prior death.

(7) Two days before the decedent died, the daughter (acting under the power of attorney) scrambled to convey the various interests in condominiums to the partnership and to make gifts to the decedent's grandchildren, reducing the decedent's percentage of the partnership from 86% to 24%.

(8) The partnership assets had the same managers of the investment portfolio and the same management company managing the condominiums as before the partnership was created.

(9) Post-death, partnership funds were used to pay part of the decedent's estate and gift taxes. The estate sold the decedent’s home to the partnership for $123,500 and the partnership redeemed some of her partnership interests for $104,000.

**Bona Fide Sale for Full Consideration Exception to §2036**

(The court analyzed the section 2036(a)(1) application before addressing whether the bona fide sale exception applied. Instead, I will first summarize the bona fide sale exception discussion.)

The court first gave the obligatory regurgitation of general factors bearing on whether a legitimate and significant nontax reason existed for the partnership. The court listed the following factors: (1) “Standing on both sides of the transaction” (one daughter did everything regarding creation and funding of the partnership); (2) financial dependence on distributions from the partnership; (3) commingling of partnership and personal funds; (4) failure to transfer assets to the partnership; and (5) the partnership is just a vehicle to change the form of the investments, a "mere asset container." [The last factor was also mentioned in Gore v. Comm’r, T.C. Memo 2007-169. That last factor is a throwback to the Tax Court’s “recycling of value” theory of the full consideration requirement before Bongard, but now called the “mere asset container” theory.]

The court next rejected the estate's purported non-tax reasons for the partnership. (1) Centralized management—the management of the investment portfolio and condominiums did not change after the assets were contributed to the partnership. (2) Creditor protection—the court's one sentence response reflects that the court does not at all understand (or refuses to understand) the potential asset protection advantages of a limited partnership: "A creditor who sought funds from the partnership, however, would have a significant asset base from which to recover from the partnership, over $2 million." [That's beside the point. The point is that a limited partner's creditors generally cannot reach inside the partnership and get access to partnership assets.] However, the facts of the case do not reflect any particular creditor concerns. (3) Facilitating gift giving—which the court says is not a significant nontax purpose.

The court emphasized that all facts and circumstances must be reviewed to determine whether the transaction is bona fide. The Court pointed to the following factors, among others, to conclude that the bona fide test is not satisfied:

- Partnership consisted mainly of passive assets (including marketable securities and rental properties)
- Same managers as before the partnership was created.
- Making loans to family members of the partnership on favorable terms.
- Partnership was planned unilaterally by one daughter.
- Same law firm represented all partners in the creation and funding of the partnership.
- Delay in funding—the key seemed to be scurrying around on the decedent's death bed to complete the funding (suggesting testamentary motivations)
- Financial dependence—$227,000 of partnership assets were used to pay estate taxes; the disposition of cash from the partnership was characterized partly as a purchase of the decedent's residence and partly as a redemption, but the form is not controlling.

### Section 2036(a)(1) Application

The court mentioned many of the same factors as in the bona fide test analysis. It gave the following list of general factors that, courts have previously considered in determining whether a decedent impliedly retained the right to possession and enjoyment of transferred assets: "co-mingling of funds, a history of disproportionate distributions, testamentary characteristics of the arrangement, the extent to which the decedent transferred nearly all of his or her assets, the unilateral formation of the partnership, the type of assets transferred, and the personal situation of the decedent."

The court noted the delay in funding the partnership (suggesting a failure to respect formalities of the partnership) and then the scurry to complete the funding of the decedent's and other family members' contributions on the decedent's deathbed: There was "no hurry to alter their relationship to their assets until decedent's death was imminent."

The court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Ericsson (or the estate) could use the assets if needed."

The partnership had little practical effect during the decedent's life and was mainly an alternative method to provide for the decedent's heirs.

The court concluded that no one factor is determinative, but the court must consider all facts and circumstances. The court's summary seems to emphasize its "smell test" problem with the partnership: "The transaction represents decedent's daughters' last-minute efforts to reduce their mother's estate's tax liability while retaining for decedent the ability to use the assets if she needed them."

**Key Planning Points from Erickson**

(1) The partnership involves a transfer of all liquid assets from an Alzheimer's patient in her 80s and in poor health by her daughter acting under a power of attorney, with some transfers and gifts being made on her deathbed.

(2) This is the first case to focus on the post-mortem use of partnership assets to pay estate tax liabilities. (The Fifth Circuit Strangi case addressed post-mortem use of partnership assets to pay estate liabilities, but did not focus on the payment of estate and gift tax liabilities.) Apparently, there were no distributions from the partnership to the decedent during her lifetime, and indeed there was $1 million in a credit shelter trust for her support.

(3) Looking to implied post-death use of transferred assets in applying §2036(a)(1) makes no sense in other contexts. For example, is a transfer of cash to an ILIT to produce life insurance proceeds that will be used to make loans to or purchases from the grantor's estate to generate needed funds for estate taxes a transfer with a retained life estate? If so, thousands of transfers routinely made to ILITs become §2036(a)(1) transfers.

(4) This Erickson approach suggests keeping assets outside the partnership to pay for living expenses *and* anticipated post-death expenses, including estate taxes (or at least a substantial part of them). Query whether future cases will similarly focus on the use of partnership assets to pay estate taxes, even when the payment occurs in a sale and redemption transaction.

If the estate has insufficient liquid assets to pay estate taxes and the partnership has excess liquidity, consider the following alternatives.

- Have the client's children purchase the estate's limited partnership interests (so that liquid assets inside the partnership are never used to pay the estate's estate taxes).
- Have the estate borrow funds secured by the estate's partnership interest. (One attorney reports that the IRS is attacking a case on audit where that approach was used.)
- Have the partnership redeem some of the estate's interests or purchase estate assets. (While that approach did not help in Erickson, it is preferable to a direct distribution from the partnership to the estate.)

(5) Management activities for some assets contributed to the partnership should change if centralized management is a nontax purpose of the partnership.

(6) This is yet another case mentioning a lack of negotiations, the fact that one partner planned the entire transaction, and that the same law firm represented all parties

(7) This is also another case mentioning disproportionate distributions, but the court particularly focused on the fact that distributions were made only to the decedent (really the decedent's estate).

(8) Finally, this is yet another case (reminiscent of Rosen) in which the court failed (or refused) to understand the potential asset protection advantages of owning limited partnership interests rather than owning assets directly.

(9) Despite the many "bad facts" surrounding this case, what would the Tax Court have done in this case if the decedent had retained sufficient assets to pay estate taxes, and only contributed the balance of the estate to the partnership? It would seem that neither §2036(a)(1) nor 2036(a)(2) would apply. Would the court have to apply a "no economic substance" theory to defeat what the court perceived as an abusive transaction?

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

The step transaction doctrine should not apply here. The step transaction doctrine ignores unnecessary steps to determine tax consequences, and the donees never ended up owning the underlying assets.

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

There was an audit last year in which the IRS agent argued this indirect gift theory even though the gift of the partnership interest was not made until made 8 months after the partnership was formed. (Part of the reason for the delay was that the client could not decide how much gifts to make.) The agent has issued a notice of deficiency and that case went to the Tax Court. The IRS position throughout the audit was that the discount should be zero under the indirect gift theory; the discussion did not center around negotiating the amount of the discount. (Perhaps the case was settled at Appeals. I do not know the results in that case.)

John Porter tried the Holman case in December 2005 to the Tax Court and is still awaiting decision. In that case, the IRS made the indirect gift argument even though the partnership interest was not given until 8 days after the partnership was created.

**Practical planning pointers:**

- Make clear that assets are held by the partnership and verify that before making gifts of limited partnership interests.
- Discuss with the client the possibility of making gifts, but do not discuss with the client how much the client wants to give when the FLP is created. Leave that as an open question so no one can argue step transaction or prearranged transaction.
- To help rebut an integrated transaction attack, the planner should be careful that documents do not describe overall transactions anticipating the transfer of particular amounts of limited partnership units.

e. Gore Applies Section 2036 Where Formalities Were Not Followed. The IRS won another §2036 argument in a "bad facts" case, in which the court emphasize the failure to follow formalities as the basis of its decision. Gore v. Comm'r, T.C. Memo 2007-169. The surviving spouse withdrew assets from a Marital Trust and ostensibly "assigned" them to a family limited partnership, but the assignment was not clear. Legal title to the assets was not transferred. Accounting records were created after the decedent's death. The decedent received all income from the partnership.

Commentators Jonathan Blattmachr and Professor Mitchell Gans point out that the court did not address whether §2036 might possibly apply for transfers from a marital trust (in this case a general power of appointment marital trust) if the trust had clearly created and assigned assets to the partnership. They suggest that §2036 could conceivably apply if the general power is currently exercisable, because §2041(a)(2) provides that the release or exercise of a general power causes the donee of the power to be treated as if she made a transfer for purposes of §2036. However, §2036 would not appear to apply to transfers from a QTIP or a testamentary general power of appointment trust (because no exercise or release occurs during the decedent's life). Leimberg Estate Planning Newsletter 1151 (July 25, 2007).

f. Marital Trust Trustee Did Not Breach Fiduciary Duty By Failing to Invest Trust Assets in FLP, Galloway. Lou Mezzullo has reported on his involvement as an expert witness on behalf of a corporate trustee in a case against the trustee (U.S. Bank) for failing to contribute marital trust assets to an FLP. The court held that the trustee does not have a fiduciary duty to transfer marketable securities held in a QTIP trust to an FLP. A long decision by the trial court emphasized that a non-tax reason is necessary to avoid a §2036 attack, significant discounts would likely not be available in any event if the trust were both the general partner and holder of most of the limited partner interests, that saving taxes was not one of the surviving spouse's primary objectives, that creation of the partnership could violate the trustee's fiduciary duty of confidentiality to the surviving spouse because she did not want to share financial information with her family, and interestingly concluded that even if the strategy would be respected by the IRS to reduce the estate tax value of the assets, there would be no damages because the tax savings would be exceeded by the loss in value of the assets transferred to the FLP. In the Matter of Janice Galloway T. Galloway Nonexempt Marital Trust created by the Herbert Galloway R. Galloway Revocable Trust dated February 18, 1988 as Amended, (2nd Judicial Dist. Ct, County of Ramsey, MN April 23, 2007).

g. Miscellaneous Recent Observations of Tax Litigators.

(1) IRS agents are asking about whether any estate tax payments have been made using directly or indirectly any partnership assets (in light of Erickson).

(2) Estate and gift tax audit questionnaires about FLP matters are getting longer.

(3) There are fewer estate tax agents and perhaps fewer estate and gift tax audits overall. But for FLPS that are audited, the audits are getting increasingly intrusive.

(4) There is a trend of the IRS seeking discovery of communications between the decedent (or donor) and advisors (and medical personnel if there are poor health issues when the FLP is created).

(5) IRS agents often ask the professional advisors for an affidavit of all non-tax reasons for the partnership.

(6) As a practical matter, the discovery in FLP estate tax cases occurs during the audit.

(7) IRS agents are asking many of the same questions about motivation for creating the partnership, non-tax reasons, etc in gift tax audits (even though §2036 does not apply).

(8) Agents are closely reviewing all disbursements from the partnership; if the agent can find just one disbursement that was "written out of the wrong account" and that benefited the client directly, the IRS will urge that demonstrates that there was an implied agreement of retained enjoyment.

(9) Agents are also closely reviewing the operation of the partnership or LLC with the detailed requirements in the governing documents. If there are any discrepancies, the

agent assert that the partnership is being ignored and that it should be ignored for transfer tax purposes as well.

(10) Except in pretty extreme fact situations, IRS agents are generally treating FLP cases as "negotiate the amount of the discount" cases rather than "go to the mat on zero discount under §2036" cases. IRS agents have told me that the IRS will not take "good facts" cases to court. "Hopefully, no more Kelley cases will be tried by us."

(11) Many litigators are reluctant to try FLP cases in the Tax Court. The result seems to be very dependent on what judge is assigned the case. There is a trend toward taking FLP cases to District Court.

(12) One planner/litigator indicates that over 50% of the FLPs and LLCs that he does are for people who do not have taxable estates—because they are the cheapest form of asset protection possible.

## 7. Bond or Special Lien Requirement for Section 6166 Election

a. Roski—IRS Cannot Imposed Absolute Bond or Special Lien Requirement by Revising Internal Revenue Manual. The Tax Court recently held that the IRS does not have the authority to impose an absolute bond or special lien requirement by merely revising the Internal Revenue Manual. Estate of Roski v. Comm'r, 128 T.C. No. 10 (April 12, 2007). The case outlines the history of the Commissioner changing his mind four times over the last 15 years regarding whether a bond is required for a §6166 election. Interestingly, the IRS argued that the Tax Court did not have jurisdiction to review this administrative decision regarding §6166 under the authority in §7479 to bring declaratory judgments in the Tax court relating to §6166. The court noted the obvious "glaring contradiction" of the IRS's argument that §7479 only gives the Tax Court authority to review the eligibility requirements of §6166 (which does not include a bond requirement) while simultaneously taking the position that the provision of a bond or special lien is required. The court reasoned that the substantive requirements of §6166 are in §§6166(a) and (g), and none of the requirements include securing a bond or special lien. Rather than imposing a substantive requirement, §6166(k)(1-2) incorporates the IRS's discretionary authority under §6165, which says that the IRS "may" require a bond. "Implicit in this grant of discretion is a statutory obligation to exercise discretion." The court concluded that "[b]y adopting a bright-line rule in every case, the Commissioner has shirked his administrative duty to state findings of fact and reasons to support his decisions that are sufficient to reflect a considered response to the evidence and contentions of the losing party and to allow for thoughtful judicial review." The court denied the IRS's motion for summary judgment.

The court in Roski refused to decide the "merits of the dispute," observing that the record does not contain sufficient facts for the court to decide "the merits of the estate's assertion that furnishing security is not necessary in this case." The court did not give much insight as to the factors (and the proper weighting of those factors) that would be appropriate for consideration in each case. The IRS argued that it should be able to consider factors other than specific factors for the particular estate, such as the estate's creditworthiness. The IRS stated that other valid general factors for consideration are the difficulties in administering the deferrals, the inherent risk of default in a debtor-creditor relationship and that IRS collection experience showed a high default rate in collection. The court's response to this argument indicates that these general factors can be part of the consideration in the exercise of discretion in each particular case: "We agree that respondent should be able to consider factors such as administrative convenience and revenue collection. However, considering these factors *exclusively* precludes any exercise of discretion in a particular case…" (emphasis added). Under that approach, any guess as to how many (if any) estates will be able to establish to the IRS's satisfaction that the creditworthiness of the estate, and its anticipated creditworthiness over the subsequent 14 years, overrides those general factors? The Tax Court may be faced with making that determination with some regularity, at least until the appropriate standards for exercise of the discretion are resolved by the court.

In footnote 9, the Roski court specifically declined to address whether the IRS could have exercised its discretion through the promulgation of a regulation as opposed to just amending the Internal Revenue Manual without any opportunity for notice and comment. (However, in light of the court's reasoning that considering only general factors "such as administrative convenience and revenue collection" is improper, it is difficult to understand how exercising the discretion in a regulation to require a bond or special lien in every case could be upheld."

b. Notice 2007-90, Factors IRS Will Consider In Determining Whether to Require Bond or Special Lien. The IRS issued Notice 2007-90, 2007-46 IRB in response to Roski. The Notice clarified that the IRS's general concern is that the general estate tax lien under §6324(a) extends for only 10 years after the date of death. Therefore, a 14 year deferral under §6166 would be secured only for 9 years and 3 months (after the due date of the estate tax return). The IRS intends to issue regulations regarding the appropriate standards to be applied by the IRS in exercising its discretion of whether a bond or special lien is required for a §6166 extension, and requests comments as to appropriate standards. As interim guidance, the IRS indicates that it will apply the following factors: (a) duration and stability of the business, (b) ability to make payments timely, and (c) compliance history of that business.

c. Internal Legal Memorandum 200747019, Considerations for Using Closely Held Stock Itself as Collateral.

Background: Practical Recent Experiences. IRS agents have operated under the belief that they have substantial leeway as to how much collateral and what kind of collateral is required. The collateral need not be owned by the estate. Realize that requiring a real estate lien can be particularly difficult if the closely held business does not own the real estate on which the business is located, but rents it from other family entities. Some attorneys have reported being successful convincing the IRS agent to accept a lien on the business interest itself (which is the asset in the gross estate) rather than requiring a lien on hard assets. This is very advantageous because having a direct lien on assets in the business may drastically limit the financing options available to the business for business needs. However, some attorneys report that some agents require hard assets as collateral. One attorney reports of a case in which such a lien on hard assets of the business would disrupt the business, and the family refused to give a lien in order to obtain a §6166 deferral. The attorney was able to use the inability to qualify for a §6166 deferral to justify lengthy Graegin notes.

A federal bankruptcy case, which addressed the effect of a tax lien on the owner of a business, may impact the way that the IRS approaches liens. In re: Roth; IRS v. Skiba, 93 AFTR2d 2004-1663 (W.D. Pa. 2004) In that case, the business went into bankruptcy, and the court held that the IRS was just an unsecured creditor of the corporation because the IRS only held a lien on the taxpayer’s stock in the corporation, not the corporation’s assets. In light of this case, there has been a concern that the IRS may become even more inclined than ever to require a lien on real estate and not just the stock of the closely held business.

Some practitioners report that making the process as easy as possible on the special procedures group within the IRS may help in getting a cooperative attitude. Otherwise, they may just lien all of the real property in the estate regardless of how many multiples of the liability that represents. Typically, however, most local IRS offices are comfortable with a lien on real estate that equals or exceeds the amount of the deferral.

In light of the significant uncertainty and differing treatment across the country regarding the amount and type of collateral that is required for a §6166 election, a detailed discussion from the IRS regarding the collateralization requirement is most welcome.

Internal Legal Memorandum 200747019, "Taking Stock as Collateral for the Special Estate Tax Lien Under Section 6324A". ILM 200747019 has a detailed discussion of the statutory authority regarding collateralization requirements and provides helpful answers to a number of questions regarding the amount of collateralization required, when stock of the closely held business may be used as collateral, and procedures for perfecting the lien and for monitoring the sufficiency of the collateral over time.

1. When Must the IRS Accept Closely Held Stock as Collateral? The closely held stock may be used as collateral (and must be accepted by the IRS) when the three requirements in §6324A are satisfied.

a. The stock must be expected to survive the deferral period. §6324A(b)(1) (A). To make this determination the IRS should first value the business, using the most relevant financial information supplied by the estate (including appraisals, annual reports and other relevant financial documents). Based on the valuation, the IRS must next judge whether the business can be expected to survive the deferral period. "There is a risk that the Service may err in its conclusion, but Congress intended that the Service bear such a risk."

b. The closely held stock must be identified in the written agreement. §6324A(b)(1)(B). This means that the executor must file a written agreement showing that all of the persons having an interest in the collateral agree to the creation of the special lien and those persons must be bound by the agreement. §6324(c)(1).

c. "The value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest." (While the ILM does not cite Code support for this statement, it is consistent with the "maximum value of required property" described in §6324A(b)(2). The "required interest" means the aggregate amount of interest payable over the first four years of the deferral period. §6324A(e)(2); Reg. §20.6324A-1(e)(2).)

   The ILM then makes perfectly clear that the IRS *must* accept only the closely held stock as collateral if these requirements are met:

> "If the three requirements under section 6324A are met, the section 6324A special lien arises and the collateral *must* be accepted by the Service. The Service does not have the authority to reject collateral proffered by the estate on the grounds that it would be burdensome for the Service to make the economic or business calculations to determine the value. *Nor does the Service have the authority to reject collateral proffered by the estate because the Service would prefer other collateral.* Congress gave the Service a very limited role in the creation of the section 6324A special lien: the Service determines whether the statutory requirements have been met.
>
> Even when the statutory requirements under section 6324A have been met, we understand that *some Service employees would prefer not to take stock as collateral because of the risks*: some of the concern stems from the fact that the stock may become worthless….
>
> These concerns, as well as others are legitimate. Taking stock as collateral is a risky endeavor. Nevertheless, section 6324A and its legislative history, illustrate that Congress was aware of that risk. By enacting section 6324A(d)(5), and giving the Service the authority to demand additional collateral when the initial collateral declines in value, Congress chose to reduce, rather than eliminate the risks to the Service." (Emphasis added)
>
> "The value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest." (While the ILM does not cite Code support for this statement, it is consistent with the "maximum value of required property" described in §6324A(b)(2). The "required interest" means the aggregate amount of interest payable over the first four years of the deferral period. §6324A(e)(2); Reg. §20.6324A-1(e)(2).)

2. <u>What Criteria Are Used to Determine the Adequacy of the Stock</u>? Whether a stock will retain its value is a factor to be considered in determining whether the company will survive the deferral period. However, "[t]he Service should not assume that a stock's failure to retain its value automatically means that a company will not survive the deferral period. Indeed stock accepted as collateral may decrease in value, requiring the Service to request additional collateral under §6324A(d)(5).

3. <u>What Requirements May Be Imposed to Determine Whether There Has Been a Disposition or Withdrawal of Funds That Triggers</u>

<u>Acceleration</u>? Section 6324A(d)(5) states that if the value of the collateral is less than the unpaid portion of the deferred amount and the required interest, the IRS may require additional collateral (but not exceeding such unpaid portion). If additional collateral having a value equal to such unpaid deficiency is not added to the lien agreement within 90 days of demand, such failure will be treated as an act accelerating payment under §6166(g). The ILM states that the Service has statutory rights under §6324A to determine whether there has been a disposition of interest or withdrawal of funds that would trigger the acceleration of payment under §6166(g)(1). [I do not find that authority that broad in §6324A, but merely to determine if the value of the collateral falls below the unpaid deferred amount and the required interest.] The IRS can require relevant financial information from the estate to monitor the value of the collateral. "Specifically, the Service could require the estate to provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period."

4. <u>How Should the IRS Secure Its Interest in Stock Pledged As Collateral</u>? The IRS should file a Notice of Federal Tax Lien (NTFL), Form668-J, in the office mandated by applicable state law. §6324A(d)(1); 6323(f). Stock is generally considered personal property and is situated at the residence of the taxpayer at the time the NTFL is filed. §6323(f)(2). "Since the taxpayer in this case is an estate, applicable state law will determine where the NTFL will be filed." (The ILM does not suggest whether this will typically at the place of the residence of the decedent or at the place of residence of the executor.) In addition to filing the NTFL, the ILM recommends that the Service take possession of the stock certificates. While purchasers of the stock would take it encumbered with the special estate tax lien (because purchasers are not listed as having a superpriority in §6324A(d)(3)), the ILM recommends that the IRS take possession o f the certificates to avoid potential litigation.

5. <u>What Steps Should the IRS Take to Protect Its Interest in Other Assets In the Gross Estate That Are Not Used as Collateral for the §6324A Special Lien</u>? The recording of a §6324A special lien divests the IRS of any lien under §6324 for that same property with respect to the same estate—but not other assets. §6324A(d)(4).

   There are two other lien provisions, other than the §6324A special estate tax lien on designated collateral for §6166 extensions. One is the general estate tax lien under §6324(a), which attaches to all assets of the gross estate that arises at the date of death and lasts for 10 years (which period of time cannot be extended). The other is the general tax lien under §6321 that arises only after estate taxes become due and following assessment, demand and refusal or neglect to pay. The general tax lien does not have priority over a purchaser or certain others until a Notice of Federal Tax Lien is filed.

"Accordingly, to protect its interest in the remainder assets of the gross estate more than 10 years after decedent's death, the Service could file a NFTL under section 6321…Whether the Service should file a NFTL in a particular situation is a business decision to be made by the Service."

General Background Regarding the §6324(a) General Estate Tax Lien. The general estate tax lien arises under §6324(a) on all property includible in the decedent's estate for 10 years. The general estate tax lien does not have to be recorded; it is automatic.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person's possession, unless the executor has been discharged from personal liability for the estate tax under §2204. For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under §2204 or request that the IRS release the lien. A release of lien is requested by filing Form 4422, and can be allowed if—

i. the remaining property in the estate is double the value owed the IRS,

ii. payment is made to the IRS equal to the value of the property being discharged,

iii. the government does not have a valuable interest in the specific property, or

iv. sale proceeds are to be substituted for the discharged property.

The general estate tax lien divests when the sale proceeds are "for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof." This exception was addressed in First American Title Insurance Company v. United States, 95 AFTR2d 2460 (W.D. Wash. 2005). The court applied a strict tracing requirement described in Northington v. United States, 475 F.,2d 720 (5th Cir. 1973). The court granted the IRS's motion for summary judgment because it determined that the title company could not affirmatively demonstrate that the payments were used for charges against the estate, and that the taxpayer must petition a court for allowance and that non-intervention powers do not qualify as allowance. See generally Note, 59 TAX LAWYER 901 (2006).

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F. Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; however a like lien attaches to all of the transferor's property. IRS §6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a "transfer" for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under §6324(a): (1) The beneficiary is personally liable for the estate tax; (2) The lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) There is a lien against the beneficiary's property.

6. Should Full Audits be Required of All Estates That Propose Using Closely Held Stock as Collateral? There is no legal requirement to do so; this is a business decision for the Service.

7. What Procedure Should be Used to Determine If the Closely Held Business Interest Collateral Is Adequate Security? The proper procedure to follow is a business decision to determine if the three statutory requirements in §6324A (as discussed in Item 1 above) are met. If the IRS decides to reject the closely held business interest as collateral, it "should detail, in writing, the basis for the rejection."

8. What Procedure Should be Used to Deny or Terminate a §6166 Election If the Property Initially Proferred As Collateral Is Insufficient? If the proferred collateral is less that the unpaid deferred amount and required interest, the IRS may require additional security, and if the estate does not provide the additional security requested within 90 days after notice and demand, the estate's refusal will be treated as an event accelerating payment of installments under §6166(g). The IRS will issue a preliminary determination letter, "such as Letter 950, which contains a notice of Appeal rights." Following the enactment of §7479 in 1997, this decision may be contested in the Tax Court (for example, if the estate thinks the value of the property is greater than the amount of unpaid deferred tax plus required interest) by filing a timely petition after exhausting administrative remedies. (After receiving the Letter 950, the estate must request an Appeals conference to exhaust administrative remedies. After that conference, the IRS will issue a final determination letter

"such as Letter 3570." The estate may then petition the Tax Court for a declaratory judgment under §7479. The procedures are described in Rev. Proc. 2005-33, §4.01(1), 2005-24 I.R.B. 1231.

9. What Procedure Should Be Used to Review the Continuing Sufficiency of Collateral? The IRS has the implicit right to monitor the value of the collateral to determine if the value has become less than the unpaid deferred tax and required interest. If so, the IRS can ask for additional collateral. While the decision of whether to monitor and the procedure for monitoring the value is a business decision for the IRS, the report strongly recommends that the IRS does monitor the sufficiency of the collateral.

## 8. Grantor Trust Planning Update

a. IRS Reconfirms Informal Rulings That Using Crummey Trust Does Not Invalidate "Wholly Owned" Status of Grantor.

In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. Theoretically, this may be endangered if the trust contains a Crummey withdrawal clause. However, recent private letter rulings reconfirm the IRS's position that using a Crummey clause does not endanger the grantor trust status as to the original grantor.

The Potential Problem. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. See Ltr. Ruls. 200011058, 200011054-056, 199942037 & 199935046.

The IRS's position under Section 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. (Sections 2041b)(2) and the 2514(e) provide that "the lapse of a power … shall be considered a release of a power.") Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights. Section 678(b) generally provides that if grantor trust status is conferred on the grantor under Section's 673-677 and on a beneficiary under Section 678, the grantor trust status on the original grantor will prevail. However, Section 678(b) literally applies only as to "a power over income" and a withdrawal power is typically a power to withdraw corpus. However, the 1954 Committee Reports make apparent that the language of section 678(b) contains a drafting error and that it was intended to apply to a power over income and corpus, similar to Section 678(a)(1).

Despite arguments from the literal statutory language (the exception in section 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will "trump" a section 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., PLRs 200011054; 9309023; 9321050. (See also PLR 9141027, but in that ruling the spouse also had an inter vivos power of appointment of principal.) This issue was raised in a PLR request that was discussed by Jonathan Blattmachr at the 2005 Heckerling Institute and the IRS said (during discussions in 2004) that this issue was "in a state of flux." A recent PLR held that where a Crummey withdrawal power was held by the grantor's spouse, the trust was still a grantor trust as to the grantor "notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under §678." PLR 200603040 & 200606006. Jonathan Blattmachr indicates that the IRS has informally confirmed that this issue is no longer "in a state of flux" with the IRS.

This has been confirmed by a number of recently issued private letter rulings, which all concluded that the original grantor continued to be treated as the "owner" of the all of the trust under the grantor trust rules despite the existence of a Crummey clause in the trust. Ltr. Ruls. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 200729016, 200730011.

In any event, the IRS can change its position from that taken in prior PLRs. If grantor trust treatment for the entire trust is really important, at least consider this issue in determining whether to use a Crummey withdrawal power. A message dated February 17, 2007 has been published that was sent from David Handler to Catherine Hughes (U.S. Department of Treasury) describing the problem of using a Crummey provision in a grantor trust and concluding that the issuance of private letter rulings does not solve the problem:

"However, we cannot rely on private letter rulings, as you know. This uncertainty has caused great headaches or inconvenience for many practitioners and their clients. Guidance confirming what the letter rulings have concluded would be most helpful."

Unfortunately, the IRS and Treasury Department has not acted on that request. The 2007-2008 IRS Priority Guidance Plan does not list this issue as one of the projects for the upcoming year.

If grantor trust treatment for the entire trust is really important, at least consider this issue in determining whether to use a Crummey withdrawal power.

b. <u>Does Grantor Non-Fiduciary Substitution Power Cause Estate Inclusion Under Section 2036?</u> One of the items on the 2007-2008 Treasury-IRS Priority Guidance Plan is "guidance under §2036 regarding the tax consequences of a retained power to substitute assets in a trust." A non-fiduciary grantor substitution power is often used to cause a trust to be a grantor trust for income tax purposes. I.R.C. §675(4)(C). Most planners believe that a non-fiduciary power in the grantor to substitute assets of equivalent value should not cause estate inclusion under §2036, bolstered by the dictum in *Estate of Jordahl v.Comm'r*, 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1, which held that §2038 did not apply to a grantor substitution power where the grantor was a trustee. Among other things, the IRS argued that the decedent, through repeated exercise of the substitution power, could cause the trust to hold "highly productive property to deprive the remaindermen of benefits or, similarly, in unproductive property to deprive an income beneficiary of property." As to that argument, the court responded.

"This Court and others have considered cases involving settlors who have retained the power to direct trustees as to investments, and, where settlors have been bound to act in good faith and in accordance with fiduciary standards, the retained powers over investment have not been treated as powers to alter, amend, or revoke."

In *Jordahl*, the grantor was one of three trustees, but the court's reasoning would suggest that the same result—no inclusion—would occur if the grantor's power was not held in a fiduciary capacity:

"Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust...We do not believe that decedent could have used his power to shift benefits in [a manner to deprive the remainder of benefits or to deprive an income beneficiary of property]."

Several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion. Ltr. Ruls. 200001015 & 200001013 (ruled that if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor's gross estate under section 2036(a); did not specifically address grantor's nonfiduciary substitution power in the analysis), 199922007 (charitable lead trust contained substitution clause, and IRS held trust assets not includible in estate, but no specific discussion of effect of substitution clause on estate inclusion issue), 9642039 (substitution clause in charitable lead trust, which causes charitable lead trust to be a grantor trust for income tax purposes, does not cause estate inclusion under §§2033, 2035-38, or 2041), 9548013 (grantor trust holding S corporation stock), 9413045 (no estate inclusion under sections 2036, 2038, or 2042, with discussion of Jordahl), 9227013 (unclear whether substitution power was in fiduciary or nonfiduciary capacity), and 9037011. But see Ltr. Rul. 9318019 (declined to rule on whether amending GST grandfathered trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status or whether it would create estate tax exposure to the grantor).

Despite the prior private letter rulings and the *Jordahl* dictum and, the IRS has recently refused to rule in a ruling request that a *non-fiduciary* substitution power would not cause §2036 inclusion. Letter Rulings 200603040 & 200606006. In the negotiation process over those rulings, IRS officials reportedly stated that the IRS is considering issuing a published ruling taking the position that a non-fiduciary substitution power causes §2036 inclusion, but suggested that if the IRS were to take such a position, it might be prospective only.

For example, PLR 200603040, issued on 1-20-2006, addresses a trust with a substitution power where "the instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity." The PLR concluded that the substitution power would not cause estate inclusion under §§2033, 2036(a), 2036(b), 2038 or 2039. The PLR focused on the fact that the instrument said that the substitution power could only be exercised in a fiduciary capacity. In Jordahl, the decedent was a co-trustee so one might infer that all powers held by the grantor in that case were held in a fiduciary capacity. However, the PLR interpreted Jordahl as follows: "Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries." Under this reasoning, would any substitution power be exercisable only in a non-fiduciary capacity? That reasoning might suggest why the IRS refuses to rule in PLRs whether a substitution power is held in a nonfiduciary capacity (to be a grantor trust trigger under §675(4)) even though the instrument specifically says the power is not held in a fiduciary capacity.

However, the regulations and other authority under §§2036 and 2038 say that it makes no difference how the power is held. Treas. Reg. §§20.2036-1(b)(3) ("it is immaterial … in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent") & 20.2038-1(a) ("immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent"). The courts have focused on whether there is a standard of fairness that can be enforced in court.

Indeed, this issue has reached a new level of sensitivity in light of the IRS announcing it as an issue on the Treasury/IRS Priority Guidance Plan for 2007-2008. (Hopefully, if the IRS were to take the position that holding a nonfiduciary substitution power causes §2036 inclusion, it would only apply that position prospectively as to trust transfers to trust before the effective date of the regulation. Even more hopefully, the IRS will see the folly of treating fiduciary and nonfiduciary powers differently under §2036/2038—if the grantor must pay full value, what difference does it make whether full value must be paid in a fiduciary or nonfiduciary capacity?)

In light of the additional uncertainty created by the inclusion of this issue on the 2007-2008 IRS "Business Plan," planners may at least consider giving a substitution power to a spouse or child instead of routinely giving the grantor a substitution power. (Any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules. §672(e).)

c. Substitution Power Held By Third Party. Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. E.g., Ltr. Rul. 199908002 (grantor's brother held substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). In addition, allowing a third party to hold the substitution power could create additional flexibility to "turn off" or to "toggle" grantor trust status.

The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. §675(4) (power "exercisable in a nonfiduciary capacity by any person"); Treas. Reg. §1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by "any non adverse party"). However, the statute refers to the power to "reacquire" trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property.

Letter Rulings 199908002, 9810019, and 9713017 ruled that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. (If the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under §4941(d).) Letter Ruling 9037011 gave one of the trustees a power to "acquire any property that held in trust by substituting property…". The IRS similarly held that power caused grantor trust status. Those rulings did not address the statutory requirement of a power to "reacquire" trust assets.

Observe that the "reacquire" possible IRS argument does not exist if the grantor's spouse holds the substitution power, because any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules. I.R.C. §672(e).

The IRS issued Rev. Proc. 2007-45 (inter vivos trusts) and 2007-46 (testamentary trusts) describing sample forms for charitable lead annuity trusts. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status.

d. Inter Vivos Power of Appointment—A Little Used Trigger Power. Carlyn McCaffrey suggests giving a third party (who is not a trustee and is not a beneficiary) a presently exercisable power of appointment. Because the person is not a trustee, the exception in §674(c) would not apply. Because there is no standard, the exception in §674(d) would not apply. The testamentary power of appointment exception in §674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in Section 674 would apply, so the general rule of §674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the asset.

## 9. Disclaimer QTIP Trusts

A recent article by Peter Crawford suggests an interesting alternative to outright gifts (with large current gift taxes) and GRATs (in which some of the appreciation is returned to the grantor). Crawford, Disclaimer QTIP Trusts, 146 TRUSTS & ESTATES 30 (Sept. 2007). For example, assume that a family corporation is appraised at $10 million, but might potentially sell in the near future for up to $40 million but could also decline in value to $1 million if the business climate changes. A current gift would cost gift taxes next April 15, and the use of gift exemption and the payment of gift taxes would be wasted if indeed the business drops in value. A GRAT would avoid the loss problem if the business declines in value, but some of the future appreciation would be returned to the grantor.

The “Disclaimer QTIP Trust” approach would allow up to 21 ½ months to decide if and how much of the initial transfer to treat as a taxable gift.

### The Technique

H would transfer the business interest to a QTIP for W. W and a disinterested third party would be the trustees. W would have a mandatory income interest, and principal would be payable to W in the disinterested trustee’s sole discretion. If W disclaims her interest in the trust, the assets would pass to H’s children (or an irrevocable trust for their benefit). H would retain a nonfiduciary substitution power so that the trust is a grantor trust.

### First Lookback—Nine Months

Within nine months, W could disclaim her interest in the trust, and the assets would pass to H’s children (or the trust for them). Letter Ruling 200442027 approved a disclaimer somewhat similar to this from a marital deduction trust to a trust for children. If the business sells for $40 million within the first nine months, W likely would disclaim. The transfer to the QTIP would not qualify for the marital deduction, and would represent a $10 million taxable gift. (A split gift election might be made so that both spouses’ $1 million gift tax exemptions could be used.) For this relative low gift tax cost, the parents would transfer $40 million to their children. If the asset does not sell within the first nine months, W may choose not to disclaim.

### Second Lookback—Oct 15 of Following Year

If W does not disclaim her interest, H can wait up until the time of filing the gift tax return to make the decision of whether to make the QTIP election. The gift tax return is initially due on April 15, but can be extended to October 15. If no buyer is located by then, or if the business declines in value, the QTIP election would be made so that the initial transfer to the trust is covered by the gift tax marital deduction. If the business sells for $40 million within that time frame, H can choose to make the QTIP election for a sufficient amount to avoid having to pay current gift taxes. (For example, if the QTIP election is made with respect to 80%, the taxable gift would be $10 million times 20%, or $2 million—which would be covered by the spouses’ $2 million aggregate gift exemptions [assuming the split gift election is made].) Alternative, H may choose to not make any QTIP election and pay some gift tax, but have the full $40 million removed from the estates or H and W for estate tax purposes. The assets would remain in trust for the balance of W's lifetime, with a mandatory income interest for W. To minimize income distributions, the trustee could invest primarily for growth and not yield.

**Observations**

This is an interesting creative planning idea. Although I do not know of any cases or rulings specifically approving the approach, all of the elements seem workable. The approach does not have the benefit of the built-in "savings clause" feature of GRATs, and valuation would be critical in the event that the decision is ultimately made to treat the transfer as a gift. Many planners may prefer the straightforward approach of using a GRAT and being willing to put up with the fact that it is a "leaky freeze," returning approximately 5% per year of the future appreciation to the donor.

## 10. New Questions and Changes on Form 706

a. September 2006 Form; Question 12e About Transfers to Trusts. The 2006 version of Form 706 asks if decedent ever transferred an interest in a closely held entity to certain trusts that are in existence at the decedent's death. (Part 4, Question 12e). One way around the question would be to terminate the trusts before the client's death. (But that is not practical in many situations.) Be careful in looking for technical ways to avoid this question. If the planner is "too clever," the IRS may say the planner is being misleading and allege a Circular 230 violation.

This question underscores the desirability of reporting sales of discounted interests in closely-held entities on a gift tax return. Eventually the IRS will learn about this transaction. This new question applies retroactively to all transfers made by decedents filing the new Form 706. Even if the planner could avoid the current question, the IRS can change the form in the future in reaction to clever plans to avoid the question.

Recognize that the question only applies to transfers to trusts and not to transfers to individuals.

b. September 2007 Form Changes. The new Form 706 (dated September 2007, for decedents dying between 12/31/06 and 1/1/08) makes several additional changes including the following: (a) The instructions on the reverse side of Schedule F lists detailed information that must be supplied to support any valuation discounts of assets listed on Schedule F; (b) any foreign account for which the decedent has an interest or signature authority must be disclosed (Part 4, new question 14); and (c) any private annuity being received by the decedent must be disclosed (Part 4, question 15).

### 11. 9100 Relief Allowing Late GST Exemption Allocations

a. Statute and (Absence of) Regulations. Section 2642(g)(1)(B), adopted as part of ERTA 2001, directs the Treasury to adopt regulations describing the circumstances and procedures for granting extensions of time to make the election to allocate GST exemption and to grant exceptions to the time requirement. If such relief is granted, the gift or estate tax value of the transfer to the trust would be used for determining the GST exemption allocation. IRS released Notice 2001-50 providing guidance regarding the procedures for requesting relief for retroactive GST exemption allocations, pointing out that taxpayers should follow the procedures for 9100 relief. However, in the intervening five years since the statute was passed, the IRS has not observed the direction in the statute to adopt regulations implementing this change. The 2007-2007 Treasury-IRS Priority Guidance Plan at last includes this regulation project as an item on the Plan for the upcoming year.

b. New IRS Restrictive Position. A large number of these extensions have been granted, but the IRS has recently adopted a new and very restrictive internal written rule providing that late allocations will not be granted if the original transfer involved a discounted asset and if the gift tax statute of limitations has expired on the initial transfer. The new rule is binding in all situations. It does not matter that the initial transfer did not involve an FLP and that the discount was reasonable. However, the decision was made "at the highest levels" not to apply this rule if the original transfer was reviewed in a substantive gift tax audit. One attorney, however, has reported that the IRS questioned granting an extension even though the gift tax return had been audited, when the IRS thought the taxpayer got “too good a deal” in the gift tax audit. If the gift tax statute of limitations is still open, presumably the late exemption allocation request would be granted, but a gift tax audit would be opened.

c. Legislative History. The new IRS position appears to conflict with the legislative history adopting §2642(g)(1)(B). The Joint Committee Report said that the decision to grant relief would be made “without regard to whether any period of limitations has expired.” (What limitations period could that be referring to other than the gift tax limitations period?)

d. IRS Suspicious. The IRS seems to be very suspicious about these requests. Some attorneys report that they are being asked why they waited so long in making the extension request.

e. Practical Pointer. Call the IRS to determine if they will entertain the extension request before spending thousands of dollars drafting the request.

f. Accountant Response. Accountants are very actively moving forward to address this. They are very concerned. There are many cases where accounting firms were lined up to submit requests. Some are filing their requests even with the ruling position in place—to get it on record. When (and if) this situation is straightened out, their rulings will be in line, and it will appear that they are being responsive and not just delaying to "game the system" by determining if the values are going up or down.

g. 2007-2008 Treasury/IRS Priority Guidance Plan. The 2007-2008 IRS "business plan" includes "[g]uidance under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption."

## 12. Proposed Legislation Restriciting Tax Patents

Various bills have been introduced restricting tax patents. For example, the Stop Tax Haven Abuse bill (S. 681, Senators Levin, Coleman, Obama) contains a provision that would eliminate most tax patents. Some of the proposals would just restrict the enforceability of patents regarding inventions to minimize, avoid, defer, or otherwise affect liability for taxes (for example, H.R. 2365, introduced by Representatives Boucher, Goodlatte and Chabot on May 17, 2007.) Others provide that tax planning methods would not be patentable in the first place. For example, the terms of H.R. 2365 were revised to adopt that approach in the Boucher-Goodlatte Tax Planning Method Amendment to H.R. 1908 that was adopted by the House Judiciary Committee on July 18, 2007. It defines a "tax planning method" as "a plan, strategy, technique, or scheme that is designed to reduce, minimize, or defer, or has, when implemented, the effect of reducing, minimizing or deferring, a taxpayer's tax liability, but does not include the use of tax preparation software or other tools used solely to perform or model mathematical calculations or prepare tax or information returns." The Act would apply to any application for patent or reissue patent for which a patent or reissue patent has not been issued before the date of enactment. H.R. 1908 passed the House on September 7, 2007 by a vote of 220-175.

The House Judiciary Committee released a report (H. Rept No. 110-314) detailing its concerns about tax patents and potential damage to the tax system. The report was released with a letter from House Ways and

Means Committee Chairman Charles Rangel and ranking Republican Jim McCrey urging support for a tax patent ban.

The Senate Judiciary Committee passed its own patent reform legislation in July (S. 1145) that does not include any tax patent ban. The political direction of the Senate toward a ban on tax patents is unclear. However, following the House passage of a ban on tax patents, Senate Finance Committee Chairman Max Baucus, ranking Republican Charles Grassley, and others (foru Democratic Senators, Bengaman, Levin, Obama, and Wyden) introduced a similar ban on tax patents (S. 2369). The Senate bill bans a "tax planning invention," meaning a "plan, strategy, technique, scheme, process, or system that is designed to reduce, minimize, avoid, or defer" tax liability. In addition, it covers an invention "which has, when implemented, the effect of reducing, minimizing, determining, avoiding, or deferring, a taxpayer's tax liability, or is designed to facilitate compliance with tax laws."

The legislative movement to ban tax patents seems to be gaining momentum. It seems momentous that the Chairmen and ranking Republican members of both the House Ways and Means Committee and Senate Finance Committee will urge the passage of a ban on tax patents. In statements issued in connection with S. 2369, Senator Baucus observed that "[t]axpayers should not have to pay a toll charge or worry that they're violating patent law when they try to file their tax returns." Senator Grassly said that tax patents "undermine the integrity and fairness of the federal tax system. They put taxpayers in the undesirable position of having to choose between paying more than legally required in taxes or paying a royalty to a third-party for use of a tax planning invention that reduces those taxes."

On the heels of that legislative action comes the IRS in proposing an amendment to the reportable transactions regulations to make a "patented transaction" a reportable transaction under §6011 and 6111. The preamble states that the IRS and Treasury continue to be concerned about the patenting of tax advice or tax strategies, because a patent for tax strategies might by interpreted as approval by the IRS, which might impede efforts to obtain information regarding tax avoidance transactions and have an impact on effective tax administration. There are detailed definitions of what constitutes "patented transactions." Generally, a patented transaction is a transaction for which a taxpayer pays (directly or indirectly) a fee to a patent holder or the patent holder's agent for the legal right to use a "tax planner method" that the taxpayer knows or has reason to know is the subject of the patent. The term "patent" includes patents that have been applied for but not yet granted. A "tax planning method" means any plan, strategy, technique, or structure designed to affect Federal income, estate, gift, generation skipping transfer, employment, or excise taxes (but not including tax preparation software or tools to perform calculations). In addition, a patented transaction will include a transaction for which a patent holder (or its agent) has the right to payment for another person's use of a tax planning method that is the subject of the patent. Proposed Reg. §§1.6011-4(b)(7), 1.6011-4(c)(3)(i)(F), 1.6011-4(c)(3)(ii) Exs. 4-7, 301.6111-3(b)(2)(ii)(E) & (b)(3)(i)(C).The new rules regarding patented transactions will apply after the regulations are finalized to transactions entered into on or after September 26, 2007 (i.e., they will apply to transactions entered into even before the regulations are finalized—if the transactions occurred after September 26, 2007). Proposed Reg. §1.6011-4(h)(2).

On September 26, 2007, John Cross III, associate tax legislative counsel for the Department of the Treasury, said that Treasury prefers that Congress statutorily ban tax strategy patents, rather than having the issue handled through regulations. Assistant Treasury Secretary for Tax Policy Eric Solomon has said that the disclosure rules will not be sufficient to address the government's concern. "A disclosure regulation isn't going to fix it. It's going to take Congress to ban them. As tax guys, we don't think that we can ban them."

### 13. Mere 5% Discount For Undivided Interest In Art

A mere 5% discount for owning 50% of an art collection was allowed in Stone v. U.S., 100 AFTR 2d 2007-XXXX (N.D. Calif. August 10, 2007). (The court does not make clear, but this may be a 50% community property interest.) The court's earlier decision specified that, after hearing expert witness testimony from both the taxpayer's appraiser (a managing director at FMV Opinions) and the government's appraisers (one of whom was an art dealer and member of the IRS art advisory panel, and the other of whom was the chair of the IRS art advisory panel), a discount would be allowed for legal fees to enforce the right to partition, actual costs of selling the art by an auction house, and for the uncertainties involved in waiting to sell the art until after the partition action is resolved. 99 AFTR 2d 2007-2992 (N.D. Calif. May 25, 2007). The government's experts testified that "while they were aware of sales of undivided interests in art occurring, none of these had ever occurred at a discount." The expert seemed to be suggesting that instead of selling undivided interests in art at a discount, the entire piece of art would be sold and the proceeds would be divided. In the subsequent proceeding, the IRS maintained that no discount was appropriate, but agreed to a 5% discount "in the spirit of compromise." The court stated that a hypothetical seller under no compulsion to sell would not accept the discount proposed by the taxpayer. The court's decision is largely based on the taxpayer not carrying the burden of proof beyond a 5% discount. The court accepted the government's expert testimony that a 2% discount is warranted for the estimated costs to sell the art at auction before the proceeds are split among the interest holders. [This seems remarkably low. Art aficionados indicate that selling costs at auction are often 20% or more.] The court allowed $50,000 as the estimated legal fees for a partition action, and allowed a 1.2% discount for the uncertainties involved in waiting for the partition action. That yielded a total 5%—which is what the government agreed to. The court acknowledged that the 1.2% amount seemed low for the uncertainties element, but concluded that the taxpayer had not met its burden of proof for anything beyond the 5% agreed to by the government.

### 14. Material Participation By Estate Or Trust For Purposes Of Passive Activity Losses

Losses from passive activities can only offset against income from passive activities. A passive activity is one that involves the conduct of a trade or business in which the taxpayer does not materially participate. I.R.C. § 469(c)(1). The regulations list seven ways in which an individual can materially participate. There are no regulations or case law addressing how an estate or trust materially participates. The regulations suggest that the capacity in which one participates does not matter. Treas. Reg. §1.469-5(a)(1). However, the legislative history says that "an estate or trust is materially participating in any activity … if an *executor or fiduciary, in his capacity as such*, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986) (emphasis added).

The Mattie K. Carter Trust V. U.S., 91 AFTR 2d 2003-1946 (N.D. Tex. 4/11/2003) is a case of first impression that addresses what activities can qualify as material participation under the passive loss rules for trusts and estates. There has been almost no guidance regarding this issue since the time the passive loss rules were adopted. The IRS took the position in this case that only the trustee's activities, in his capacity as trustee, can be used to test material participation. On the other hand, the taxpayer argued that because the trust (not the trustee) is the taxpayer, material participation in the ranch operations should by determined by assessing the activities of the trust through its fiduciaries, employees, and agents. The court accepted the taxpayer's position, based on an interpretation of the statute itself. Section 469 states that "a taxpayer" is treated as materially participating in a business if "its" activities in pursuit of that business are regular, continuous, and substantial. I.R.C. § 469(h)(1). Therefore, participation is tested by the activities of the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of the trust. Although the "snippet of legislative history" might suggest otherwise, legislative history has no application where the statutory language is unclear, as it is here. Furthermore, the court concludes that the activities of the trustee alone were also sufficient to constitute material participation.

The IRS disagreed in Technical Advice Memorandum 200733023, concluding that notwithstanding the decision in Mattie K. Carter Trust, the sole means for a trust to establish material participation was by its fiduciaries being involved in the operations, relying primarily on the legislative history that made specific reference to “an executor or fiduciary, in his capacity as such” clause. The ruling also reasoned that because a business will generally involve employees or agents, a contrary approach would result in a trust invariably being treated as materially participating in the trade or business activity, rendering the requirements of §469(h)(1) superfluous.

TAM 200733023 also addresses the effect of having Special Trustees with responsibility for the business. The ruling concluded under the facts of that situation, the Special Trustees were not fiduciaries for purposes of §469, because they gave recommendations but they were not able to commit the trust to any course of action or control trust property without the trustees’ express consent. The trustees retained final decision-making authority over all facets of the business. The ruling reasoned that if advisors, consultants, or general employees could be classified as fiduciaries simply by labeling them so, the §469 material participation requirement for trustees would be meaningless. Furthermore, the ruling concluded that even if the Special Trustees were considered fiduciaries, many of their activities would not count in determining the trust’s involvement in the business, because time spent negotiating the sale of the trust’s interest in the company and resolving a tax dispute with another partner was not time spent managing or operating the business.