held all rights to foreclosure. The borrowers never made payments to MERS and MERS did not service the loan in any way. MERS simply provided electronic tracking of ownership interests in residential real property security interests. Still, MERS asserted that it held bare legal title because it held the authority, as an agent of the lender, to exercise the rights of the lender, regardless of who the lender may be under the MERS electronic registration.[2]

The court found that MERS did not hold legal title under the deed of trust and therefore was not a necessary party to the foreclosure action initiated by Southwest Homes. In its decision, the court described the relationship between parties to a deed of trust – the borrower, who conveys legal title to the trustee; the lender, who is the beneficiary of the deed of trust and holds the indebtedness secured by the deed of trust; and the trustee, who takes legal title and whose duties are limited to undertaking foreclosure upon default and reconveying the deed of trust upon satisfaction of the underlying debt. Because MERS was not the trustee under the deed of trust, the deed of trust did not convey legal title to MERS. Also, MERS was not the beneficiary of the deed of trust, although so designated in the deed of trust, because it did not receive the payments on the underlying debt.

Chief Justice Jim Hannah authored the opinion. Justice Danielson authored a concurring opinion, in which Justices Imber and Wills joined. Justice Danielson's concurring opinion discusses the Kansas Appellate Court opinion in *Landmark National Bank v. Kesler*.

[2] The court specifically rejected this argument, stating "We specifically reject the notion that MERS may act on its own, independent of the direction of the specific lender who holds the repayment interest in the security instrument at the time MERS purports to act."

LIBOR UNDER ATTACK:
UNDERSTANDING THE CURRENT CONTROVERSIES

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The London InterBank Offered Rate (commonly known as "LIBOR") is the most commonly used benchmark for short-term interest rates both in the international and domestic markets. According to the British Banking Association (the "BBA"), which oversees the calculation and publication of LIBOR quotes, at least $350 trillion of retail and wholesale financial instruments are linked to LIBOR. Over the past three decades, LIBOR has replaced the Prime Rate as the most common index used to determine the interest due under floating rate, short-term commercial loans (such as construction loans and land loans) and most home mortgages. The rate has historically been fairly stable and not subject to sudden, wide swings. That began to change last fall with the collapse of Lehman Brothers and the worldwide credit crunch. The global financial crisis and resulting governmental interventions in the financial sector have raised a number of questions regarding the immediate and long-term viability of LIBOR as a reliable indicator of the interbank lending market and a useful index for banks involved in real estate lending. This article will provide a short refresher on the basics of LIBOR and discuss the current controversies.

Background

In a nutshell:

> [LIBOR] is a benchmark; giving an indication of the average rate a leading bank, for a given currency, can obtain unsecured funding for a

> given period in a given currency. It therefore represents the lowest real-world cost of unsecured funding in the London market.[1]

The first LIBOR rates were published by the BBA for three currencies in 1986. Today, LIBOR is quoted each business day for ten currencies with 15 maturities quoted for each, ranging from overnight to 12 months. Current rate quotes are widely available from a variety of print and on-line sources– interested parties can even sign up for daily updates via Twitter.[2]

Each currency has a panel of eight to 16 banks which are asked the following question:

> At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 a.m.?

Between 11:00 and 11:20 a.m. BST each business day, each panel bank forwards its answers to that question for the appropriate currencies and maturities to Thomson Reuters, the BBA's designated number-cruncher. None of the banks can see the others' information until the final rates are issued. Thomson Reuters uses a "trimmed arithmetic mean process" to determine LIBOR. In other words, it ranks panel submissions in descending order and then drops the top and bottom quartiles. The middle 50% of the quotes are then averaged to create the LIBOR quote. An example from the BBA website:

[1] British Banking Association, "bbalibor Explained: The Basics," (http://www.bbalibor.com/bba/jsp/polopoly.jsp?d=1627).
[2] Visit http://twitter.com/BBALIBOR to sign up. Currently, only the 3 month British Pound Sterling rate is quoted via Twitter.

~~Barclays Bank plc~~	~~2.15~~	
~~Bank of Tokyo-Mitsubishi UFJ Ltd~~	~~2.15~~	
~~HSBC~~	~~2.12~~	
~~Royal Bank of Scotland~~	~~2.11~~	
UBS AG	2.105	
Abbey National	2.1	
Bank of America	2.1	
Citibank NA	2.1	LIBOR Rate =
Mizuho Corporate Bank	2.1	2.10063
Rabobank	2.1	
Royal Bank of Canada	2.1	
WestLB AG	2.1	
~~BNP Paribas~~	~~2.05~~	
~~Lloyds Banking Group~~	~~2~~	
~~Deutsche Bank AG~~	~~1.95~~	
~~JP Morgan Chase~~	~~1.95~~	

It is important to note that LIBOR is based on the panel banks' best guess of the offered rate, not actual transactions. As the BBA explains, "[s]ubmissions are based upon the lowest perceived rate that a bank on a certain currency panel could go into the inter-bank money market and obtain sizable funding, for a given maturity." Obviously, there is a significant amount of subjectivity in that determination.

Not surprisingly, given the "London" bit of "London InterBank Offered Rate," the panel banks are chosen only among those banks active in the London money market. They are chosen based on: (1) the scale of market activity; (2) credit rating; and (3) perceived expertise in the currency concerned. The panels are re-evaluated each year and adjusted as necessary. The panel for the U.S. Dollar was most recently established as of June 1, 2009. It was not changed from last year and currently consists of the following banks:

Bank of America	Lloyds TSB Bank plc
Bank of Tokyo-Mitsubishi UFJ	Rabobank
Barclays Bank plc	Royal Bank of Canada
Citibank NA	Société Générale
Credit Suisse	The Norinchukin Bank
Deutsche Bank AG	The Royal Bank of Scotland
HSBC	UBS AG
JP Morgan Chase	West LB AG

After the panels were last established on June 1, 2009 the BBA issued a press release entitled "Defining the L in BBA LIBOR."[3] Prior to June 19, 2009, quoted rates included the following note: "Contributions [to the rate fixing process] must represent rates formed in London and not elsewhere." The BBA determined that the phrase "formed in London" could be confusing and outdated because many major participants in the London money markets are not physically located in London or do not book trades there. Therefore, the BBA changed the note to read: "Contributions must represent rates at which a bank would be offered funds in the London Money Market." This change has no immediate impact on LIBOR but is seen as a potential liberalization of the panel determination method which will allow banks which had not previously been qualified to join a currency panel to apply to do so. It is also designed to prevent the disqualification of banks that currently participate in the panels because of the closure of London operations by non-British banks.[4] The BBA will next re-evaluate the panels in May 2010, so any impact of this change will not be seen until that time.

[3] The press release can be found at:
http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=16133
[4] Adam Bradbery, "Libor No Longer Just London," Wall Street Journal (June 19, 2009).

The LIBOR system described above has been subject to serious criticism over the past year because of the impact of several aspects of the global financial crisis and governmental responses to it. Each of these criticisms essentially questions whether LIBOR, as currently formulated, is an accurate measure of the true cost of borrowing in the interbank money market and, ultimately, whether it is a reasonable index to use in consumer lending, particularly commercial and residential real estate loans.

Impact of TARP

James Bianco of Arbor Research recently wrote a piece that observed the behavior of LIBOR panel banks which accepted TARP funds versus those which did not. Analyzing the rates submitted by three TARP banks (Bank of America, Citibank, and JP Morgan Chase) and two Japanese banks (Bank of Tokyo and Norinchukin), Bianco noted that from 2004 to 2007, there was little difference in the rates submitted by the five banks. Since the three U.S. banks accepted TARP funds, however, the difference between the two groups has broadened, with the U.S. banks submitting LIBOR rate quotes significantly below the Japanese banks. To Bianco, this suggests that the TARP program has had an important and skewing impact on LIBOR.[5] The Federal Reserve Bank of San Francisco has recently voiced similar concerns, which Bianco interprets as suggesting that LIBOR no longer reflects real risk in the system because of the guarantees by the U.S. government.[6]

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[5] "The Uselessness of LIBOR," Seeking Alpha (June 22, 2009) (http://seekingalpha.com/article/144506-the-uselessness-of-libor?)

[6] Jens H. E Christensen, Jose A. Lopez, and Glenn D. Rudebusch, "Do Central Bank Liquidity Facilities Affect Interbank Lending Rates?" FRBSF Working Paper 2009-13 (June 2009).

Two-Tiered System

Another criticism of LIBOR which has gained significance since the September 2008 collapse of Lehman Brothers is that it is based on the fiction that there is a single money market in London. There are actually at least two distinct tiers of money markets – banks with low credit ratings have to pay more to borrow cash than do higher-rated ones. That has always been true to a limited extent, but the gap has widened since the advent of the current global economic crisis. In the middle of 2008, according to the BBA, the average difference between the highest and lowest quote submissions from panelists for the one-month euro was 6.9 basis points. By the end of the year, the difference had exploded to 43.9 basis points. For the first quarter of 2009, it had receded a bit to 26.4 basis points. The same trend is generally true for other currencies, especially the dollar, where the impact of TARP may be felt more sharply. One commentator recently observed that "the biggest institutions are able to fund themselves at around Libor levels while smaller institutions have to pay, in some cases, more than 100 basis points above Libor."[7]

The impact of this disparity could be significant for smaller institutions. If a smaller institution made a commercial construction loan at LIBOR plus 250 basis points a year ago, when it could actually borrow funds at LIBOR, but now it is forced to pay LIBOR plus 100 bp to borrow, its modest spread has taken a big hit while, in all likelihood, its risk on the loan has risen.

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[7] David Oakley and Michael Mackenzie, "Fall in Libor fails to paint a true picture," Financial Times (June 3, 2009).

The BBA's decision to expand the "L" in LIBOR may permit smaller banks to participate in the currency panels, which should theoretically have the impact of raising LIBOR to reflect the true borrowing cost for the middle tier of banks.[8] However, some commentators point out that this will further distort LIBOR by raising the average rates above the "true" cost of borrowing for the top tier of banks, which will raise the cost to borrowers (including, ultimately, consumers) and potentially increasing the profit spread for banks that can borrow money more cheaply.[9] So long as there is a great disparity between the borrowing power of large and small institutions, but a single index which attempts to capture both ends of the spectrum, this problem will persist.

Oversight of Panels

A final criticism levied against LIBOR is that the process allows panel banks the potential to understate their true costs of borrowing in order to avoid the appearance that they are experiencing funding difficulties. In December 2008 the BBA took steps to address this concern by establishing a three-step disciplinary procedure to punish banks that inaccurately report rates. Of course, given that the banks are supposed to quote the rates that they perceive are correct, rather than reporting rates used in recent transactions,

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[8] Id.

[9] Lucy Tobin, "Revealed: How the Banks are Profiteering from Lending," Evening Standard (August 10, 2009) ("Banks were thrown into fresh controversy over excess profits today after it emerged that the spread between their cost of borrowing and the interest rates they levy on businesses and homeowners has rocketed to new highs. Figures compiled by the Evening Standard reveal the difference between the three-month Libor, the London inter-bank offered rate, and the average interest rate charged on mortgages has shot up to 3.7%, almost seven times higher than the difference recorded this time last year. . . . The picture is even worse for business customers, where the spread can commonly be as high as 7.12%. Critics said the staggeringly large number shows how easy it is in the current environment for banks to make huge profits at the expense of customers.")

it is unclear whether the BBA's actions will have the intended impact. The optimal solution, according to Jan Misch, a money market trader at Germany's biggest state-owned bank, is to require the panel banks to "prove they can transact at the rates they submit to the BBA."[10] There is no indication that the BBA is moving to adopt such a change to the LIBOR determination process.

The Future of LIBOR

It has been suggested by a number of analysts that LIBOR's inadequacies, brought to light by the current financial crisis, mean that it should be replaced by another index. That seems unlikely in the near term, as there is currently no consensus on an alternative index. Instead, it is more likely that the BBA will attempt to preserve the viability of LIBOR by continuing to tweak the system to respond to criticisms by analysts and banks.

The current controversies surrounding LIBOR may have no immediate impact on how real estate attorneys draft loan documents, but they may help illuminate changing term sheets. Lenders, particularly smaller institutions, are much more likely to design a floating rate based on LIBOR to include a floor. For example, the rate for a loan may be 30 day LIBOR plus 250 basis points, provided that 30 day LIBOR shall not be less than 1.5%.

In light of recent changes to LIBOR by the BBA, it may also be a useful exercise for attorneys to revisit the definitions of LIBOR used in form loan documents to ensure

[10] Ben Livesey and Gavin Finch, "Libor to Be Set by More Banks as BBA Boosts Scrutiny," Bloomberg.com (June 10, 2008) (www.bloomberg.com/apps/news?pid=20601087&sid=alj8baVXsFA8&refer=home)

that any future changes made by BBA to the methods of calculation will not have unintended consequences.

Estate of Miller v. Commissioner, T.C. Memo. 2009-119

Taxpayer Section 2036 Partial Victory For Marketable Securities FLP; Purpose of Providing Active Management of Portfolio Satisfied Bona Fide Sale Exception For Initial Contributions to FLP; For Additional Contributions Made Days Before Death, Court Looked Primarily to Post-Death Distributions to Pay Estate Taxes as Triggering §2036(a)(1) Inclusion

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Synopsis:

The bona fide sale for full and adequate consideration exception to §2036 applied to transfers of marketable securities to an FLP made about 13 months prior to the decedent's death. The court concluded that there were legitimate and significant nontax reasons for the contributions to the partnership, finding credible the witnesses' testimony "that the driving force behind decedent's desire to form [the FLP] was to continue the management of family assets in accordance with Mr. Miller's investment strategy." The court emphasized that there was active management of the partnership's assets by the decedent's son as the general partner, that there was a change in the investment activity after formation of the FLP, and that the decedent retained sufficient assets for living expenses.

The court refused to apply the bona fide sale exception to additional contributions to the FLP made only 13 days before the decedent's death following very serious health problems, finding that "the decline in her health and the decision to reduce her taxable estate were clearly the driving forces" behind the subsequent contribution of assets to the FLP. As to those assets, the court held §2036(a)(1) applied, primarily pointing to pro rata post-death distributions from the partnership 8 months after the date of death, where the estate used its 92% pro rata portion of the distributions to pay estate taxes. The court also observed (after a detailed discussion of the post-death distributions for paying estate taxes) that the additional contribution was almost all of the decedent's assets and that an implication arose that the assets would be made available to her for living expenses if needed.

Basic Facts:

1. H devoted his time following retirement to researching and investing securities and used a specific charting methodology to purchase and sell securities "on the basis of an analysis of their daily high and low values."
2. H died on February 2, 2000 with a gross estate of about $7.67 million, 99.6% of which was securities held by his revocable trust.
3. H's executor made a QTIP election as to $1,060,000 of assets passing to a QTIP trust, funded on October 6, 2000. While W was entitled to all income from the QTIP trust, no distributions were made to her from the trust. (The oldest son was the trustee of the QTIP trust.)
4. On October 9, 2000, the remaining assets in the revocable trust (approximately $3.6 million — apparently, there were significant market declines from the $7.67 million value at the date of death in early 2000) were distributed to W's revocable trust. (The opinion does not make clear, but the oldest son might also have been a co-trustee of W's revocable trust. He clearly was a co-trustee of the trust in 2003.)
5. On November 21, 2001, a certificate of limited partnership was filed for Miller Family Limited Partnership ("MFLP") on the advice of W's estate planning attorney. A December 31, 2001 valuation indicated that MFLP had marketable securities with a net value of about $3.8 million (net of a margin account payable), after applying a 35% discount. (Apparently this was based upon amounts that the oldest son said would be contributed to the partnership.) A limited partnership agreement was signed in late February, 2002 and a revised agreement was signed and limited partnership units certificates were issued in late March, 2002. The documents reflected that W owned 92% of the units as a limited partner, and four children owned the remaining 8% — each owned a 2% limited partnership interest except that the oldest son owned a 1% general partnership and 1% limited partnership interest.

6. Despite the filing of the certificate (in November 2001) and the subsequent signing of the partnership agreement and issuance of units certificates in February-March of 2002, no assets were actually contributed to MFLP until April 2002. [Observe: When assets were contributed to MFLP, the four children already owned 8% of the partnership units.] W contributed about 77% of her assets to MFLP. (The court acknowledged that she retained enough assets to pay her day-to-day living expenses.) Within days of contributing securities to MFLP, the partnership sold some securities and distributed cash back to W's revocable trust to pay off the net liability on her margin accounts.

7. H had taught the oldest son his special charting and securities management process, and W wanted the oldest son to continue managing the family assets using that process after H died. The oldest son actively managed the securities in MFLP (through his wholly owned company). He devoted about 40 hours a week to the management of the partnership assets, including continuing the sale and purchase analysis based on his father's charting system. Before W contributed assets to MFLP, her accounts made very few trades, and "trading activity increased after the securities were transferred to MFLP." However, the actual trading activity was relatively small ("about $3,000 to $4,000 per month"), representing sales and purchases of only about 1% per year of MFLP's securities.

8. On April 25, 2003, W fell and broke her hip. As with a lot of people in their 80s who suffer broken hips, various serious health problems followed. Within days, W had pacemaker implantation surgery and a subsequent surgery to repair her hip. A week later, W was moved from the hospital to a continuing care facility, but returned to the hospital on May 12, 2003 with congestive heart failure. On May 19, 2003, a CT scan revealed a traumatic brain injury, and W died on May 28, 2003.

9. The oldest son, in his capacity as co-trustee of W's revocable trust, transferred almost all of the remaining assets in the trust (about $878,000) to MFLP on May 15, 2003 (after knowing that W was in seriously declining health and suffered from congestive heart failure).

10. Eight months after W died, MFLP made a pro rata cash distribution to its partners of about $1.2 million, about $1.1 million of which passed to W's revocable trust. A portion of the $1.1 million was used to pay W's estate's federal and state estate tax liabilities.

11. W's estate tax return was filed on February 22, 2004, reporting a gross estate of about $2.64 million, almost all but about $48,000 of which consisted of W's limited partnership units in MFLP. A 35% discount was applied in valuing the units. The $878,000 of assets in the QTIP trust were not included in the gross estate (but the return did disclose the existence of the trust and that H's estate had been granted a marital deduction under §2056(b)(7) for assets in the QTIP trust).

Issues and Holdings:

1. Should the QTIP assets be included in W's estate, even though she did not in fact receive any income distributions from the trust?
   - The QTIP assets are includable in W's gross estate.

2. Is the full value of the partnership assets included in the gross estate under §2036, or do "those transfers [to MFLP] qualify for a discount"? [The IRS did not contest the amount of the discount (35%) if §2036 did not apply.]
   - The approximate $4 million of contributions to MFLP in April 2002 (13 months before W's death) qualified for the bona fide sale exception to §2036 because the driving force in the

creation of the partnership was to continue H's special approach to investing the securities and not tax savings.)

- The approximate $878,000 of contributions made in May 2003 (13 days before W's death) did not qualify for the bona fide sale exception because "the decline in her health and the decision to reduce her taxable estate were clearly the driving forces" behind the contribution. Section 2036(a)(1) was triggered, primarily because of the use of partnership assets to pay W's federal and state estate taxes.

Analysis:

1. Burden of Proof. Neither party addressed the burden of proof, and the court's decision was based on a preponderance of the evidence.

2. QTIP Inclusion. The estate argued that W never needed the income, never received income or distributions from the trust, and was therefore never considered to have an interest in the trust (or if she did have an interest, she "refuted it before her death.") The court rejected that argument. The instrument required that all income be distributed to W, H's estate made a valid QTIP election and was allowed a marital deduction, and W did not dispose of her income interest in the trust before she died.

3. Section 2036 Bona Fide Sale Exception — Positions of Parties.

   a. Taxpayer Position. The exception in §2036 for bona fide sales for full and adequate consideration applied because there were legitimate and significant nontax business reasons for the transfer to the partnership, including asset protection, succession of management, centralized management, and continuation of the family's investment strategy. Also, taxpayer pointed out "that the securities were actually transferred to MFLP and never co-mingled with decedent's personal assets, and partnership formalities were satisfied."

   b. IRS Position. "Respondent points to the following factors as evidence that the transfer was not bona fide: (1) MFLP's lack of a functioning business operation; (2) the delay in making contributions to MFLP after MFLP was formed and the partnership agreement was signed; (3) the type of assets transferred; (4) decedent's age; (5) that decedent stood on both sides of the transaction; (6) decedent's failure to retain sufficient assets outside of MFLP; and (7) the stated reason for MFLP's formation [apparently referring to the reason of buying, selling and trading securities]."

   c. Full Consideration Requirement Not Contested. The IRS apparently did not argue that contributions to the partnership failed to satisfy the full consideration requirement. The court simply quoted Bongard in saying that the exception applies in the context of an FLP "where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received limited partnership interests proportionate to the value of the property transferred."

4. April 2002 Contributions to MFLP; §2036 Bona Fide Sale Exception Applies.

   a. Continue H's Investment Philosophy.

   "Decedent established and funded MFLP to ensure that her assets continued to be managed according to Mr. Miller's investment philosophy…

… We find credible the witnesses' testimony that the driving force behind decedent's desire to form MFLP was to continue the management of family assets in accordance with Mr. Miller's investment strategy.

… Decedent wanted her assets to be traded according to her husband's investment philosophy and set up MFLP to do just that. Virgil G [i.e., the oldest son] was the only family member versed in Mr. Miller's trading philosophy, and he was given authority to trade securities on behalf of MFLP."

b. Active Trading. The court emphasized the active management of the partnership assets by the oldest son. "Before contribution, the assets in decedent's accounts were not regularly traded. However, Virgil G. began monitoring and trading the assets regularly once they were contributed to MFLP."

c. Business Not Required; Marketable Securities Partnership. The IRS argued that the trades MFLP actually made were not sufficient "to qualify MFLP as a legitimate operation." Also, it argued that the types of assets (i.e., marketable securities) weigh against the finding of a valid nontax business purpose. The court disagreed.

> "MFLP's activities need not rise to the level of a 'business' under the Federal income tax laws in order for the exception under section 2036 (a) to apply [citing Mirowski and Stone]. Respondent's argument concerning the types of assets transferred fails for the same reason. The nontax purpose behind formation of MFLP was to continue Mr. Miller's investment philosophy and to apply it to family assets. This goal could not have been met had decedent not transferred securities to MFLP."

The court distinguished the Thompson and Rosen cases, which had referred to the absence of a business enterprise, because those cases involve "property that was not actively managed by family limited partnerships."

d. Age and Health. The IRS argued that the transfers were made to MFLP because the decedent's health was failing and to reduce her taxable estate. The court did not agree. At the time of the April 2002 transfers, "decedent, although dealing with some chronic conditions, was generally in good health. Neither decedent nor her family expected any significant decline in decedent's health in the near future."

e. Retained Sufficient Assets. The IRS argued that the decedent would need to rely on the distributions from MFLP to pay living expenses. The court disagreed, pointing out that she kept about $1 million in securities and also was a beneficiary of the QTIP trust. The sale by the partnership and distribution to W's revocable trust to pay off the margin account was not evidence of retained personal enjoyment. "This is not an example of partnership funds being used to pay personal expenses of the decedent."

f. Delay and "Standing on Both Sides of Transaction" Arguments Not Addressed. There was a significant delay between the date of filing the certificate of limited partnership, and the signing of the partnership agreement, and the funding of the partnership, but the court did not see any need to respond to the "delay in funding" argument at all. The court began its discussion of the bona fide sale exception with a general statement that it applies "where the transferor 'has received benefits in full consideration in a genuine arm's length transaction.' Estate of Goethchius v. Commissioner, 17 T.C. 495, 503 (1951)." It made no further mention of the "standing on both sides of the transaction" issue.

g. Summary. The bona fide sale for full consideration exception applied, so §2036 did not apply to the partnership assets attributable to the April 2002 contributions.

5. May 2003 Contributions to MFLP; §2036(a)(1) Applied.

a. Bona Fide Sale Exception Not Apply Due to Poor Health.

"In addition to breaking her hip, decedent had just undergone pacemaker implantation surgery. Further, decedent's rehabilitation was not progressing, and she was forced to return to the hospital with congestive heart failure.

The witnesses' testimony that decedent's family hoped for her recovery is credible, but her health was in decline. Given the lapse in time between the April 2002 contributions and the May 2003 contributions, the decline in her health and the decision to reduce her taxable estate were clearly the driving forces behind Virgil G."s decision to make additional contributions to MFLP."

b. Post-Death Distributions to Pay Estate Tax Evidences §2036(a)(1) Retained Enjoyment. After determining that the exception to §2036 did not apply, the court then had to determine if §2036(a)(1) applied by virtue of the decedent's retention (either directly or by implied agreement) "the possession or enjoyment of, or the right to the income from, the property." The court primarily pointed to the post-death distribution of $1.1 million to W's revocable trust, which was used to pay federal and state estate taxes, as causing §2036(a)(1) to apply, quoting the 5th Circuit opinion in Strangi: "[P]art of the 'possession or enjoyment' of one's assets is the assurance that they will be available to play various debts and expenses upon one's death."

There were pro rata distributions to all partners, but the court viewed the approximate $100,000 distributions to the four children "as de minimis amounts."

After discussing the post-death distribution for paying estate taxes in a full page of the opinion, the court also briefly observed that the 2003 transfer resulted in completely depleting W's resources (citing Strangi, Rector, and Rosen). "It is inconceivable that had decedent recovered and faced, for example, increased day-to-day living expenses or catastrophic medical costs, Virgil G., as general partner of MFLP, would not have provided her with access to the securities used to fund MFLP."

Observations:

1. "Cut to the Chase" on Discounting. The court phrased the issue regarding the FLP matter as whether transfers to the partnership qualified for a discount. That is the ultimate effect of a successful §2036 argument, but the court cut right to the bottom-line effect.

2. QTIP Ruling Not Surprising. The court readily concluded that inclusion of QTIP assets in the spouse's estate under §2044 cannot be avoided by merely failing to make distributions of income to the surviving spouse. That result seems clearly correct.

3. One of Relatively Few Successes For Taxpayers Under §2036. Only six prior cases held that the taxpayer established that transfers to an FLP qualified for the bona fide sale exception — Church (preserve family ranching enterprise, consolidate undivided ranch interests); Stone (partnerships to settle family hostilities); Kimbell ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); Bongard (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller

rather than by multiple trusts); Schutt (maintaining buy and hold investment philosophy for family du Pont stock); and Mirowski (joint management and keeping a single pool of assets for investment opportunities). This is now the seventh FLP case in which the taxpayers have survived an attack under §2036 (at least as to part of the assets contributed to FLPs). (This case continues the unbroken string of analysis in cases resulting in taxpayer successes against a §2036 attack — in every case the court relied on the bona fide sale exception to §2036.)

Interestingly, four of those seven cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the Miller case and authored the Tax Court's opinion in Bongard. Judge Chiechi decided both Stone and Mirowski. (Judge Wherry decided Schutt, and Church and Kimbell were federal district court opinions ultimately resolved by the 5th Circuit.)

Including the partial inclusion of FLP assets in Miller (with respect to the 2003 contributions 13 days before death), 19 cases have applied §2036 to FLP or LLC situations: Schauerhamer, Reichardt, Harper, Thompson, Strangi, Abraham, Hillgren, Bongard (as to an LLC but not as to a separate FLP), Bigelow, Edna Korby, Austin Korby, Disbrow, Rosen, Erickson, Gore, Rector, Hurford, Jorgenson, and now Miller. In addition, the district court applied §2036 in Kimbell, but the 5th Circuit reversed.

4. Successful Nontax Reason — Preserve Investments Strategy, Provide Active Management, Change of Investment Activities. The court emphasized that the driving force behind the 2002 transfer was to continue the management of the family's assets according to H's investment strategy, that the partnership had active management, and that the nature of the management of the assets changed after assets were contributed to MFLP.

Observe that some courts have suggested that proper management could be provided by the trustee of the revocable trust rather than by needing to form an FLP. In this case, the oldest son could have provided the same management services as co-trustee or agent of the revocable trust. (Indeed, after MFLP was created, he gave investment advice to other family members.) In this respect, the court's observation that the purpose of continuing Mr. Miller's investment philosophy "could not have been met had decedent not transferred to securities to MFLP" seems to be somewhat of an overstatement. In Bigelow v. Commissioner, 503 F.3d 955 (9th Cir. 2007), affg, T.C. Memo 2005-65, the court held that providing management did not constitute a nontax reason for creating the partnership, reasoning in part that decedent's son managed the property as trustee of her revocable trust, and nothing changed after the property was contributed to the FLP. See also Rector (ownership and management of assets was the same as in the revocable trust).

In addition, while the son worked 40 hours a week on the partnership management, the extent of the actual transfers was rather small, resulting in a turnover of only about 1% of the partnership assets each year. The court distinguished Thompson and Rosen on the basis of the presence of active management rather than just passively holding marketable securities. Having more actual sales would seem to provide a stronger active management argument.

5. Business Purpose. It is not essential to have an operating business. This partnership held 100% marketable securities. The court clearly focused on active management rather than requiring activities that "rise to the level of a 'business' under the Federal income tax laws."

6. Satisfying Qualified Purchaser and Accredited Investor Rules. Analogous to the concern of providing appropriate managements of a securities portfolio is the very real concern of being able to qualify for investment opportunities available only to qualified purchasers and accredited investors. A concern of many wealthy families is that the parents have sufficient wealth to qualify as "qualified purchasers" (which generally requires that individuals have $5 million of net

"investments" — not including the home or assets that are not held for investment) and "accredited investors" and are able to invest in unregistered securities, but their children may not. Pooling of assets in this situation, to allow the flexibility of making future investments in such opportunities if they arise, is an important nontax reason for pooling investments in a partnership. That reason apparently did not exist in the Miller situation, but if it applies in another family situation, highlight that nontax reason. (It is important to implement such an investment program under the actual operation of the partnership.)

7. Post-Death Payments of Estate Taxes by Distributions From Partnership Assets. With respect to the May 2003 contribution, the court looked *primarily* to post-death distributions from the partnership that were used to pay the decedent's estate tax liabilities as the justification for finding retained personal enjoyment of assets contributed to the partnership triggering the application of §2036(a)(1). Furthermore, the partnership did not just make payments directly to the IRS as an implied non-pro rata distribution, but instead made pro rata distributions to all partners, and the decedent's revocable trust used its distribution to pay estate taxes. Still, the court viewed the post-death distribution, the estate's pro rata portion of which was used to pay estate taxes, as indicating retained "personal enjoyment" under §2036(a)(1).

   This is now the *seventh* case that has viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1). The prior cases are the Rosen, Korby, Thompson, Erickson, and Jorgensen Tax Court cases and the Strangi Fifth Circuit Court of Appeals case. Miller and Erickson are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1).

   Not all judges take the same view; Judge Chiechi was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in Mirowski. However, many judges clearly now do take that position.

8. Don't Be Piggish With Deathbed Contributions. By making the 2003 contributions of almost all of the decedent's assets while she was "circling the drain," the family risked tainting the entire FLP with an overall purpose of getting estate tax discounts. Some judges may have viewed the situation differently.

9. Arm's Length Negotiations. There were statements in the Jorgensen case placing more emphasis on having arm's length negotiations to satisfy the bona fide sale requirement than in any of the prior cases. However, the court did not mention the complete absence of negotiations in this case as a factor regarding the bona fide sale issue.

10. Indirect Gift. This is an estate tax case, and the opinion does not indicate whether the IRS took the position that the initial and subsequent contributions to the partnership constituted indirect gifts of an undivided 8% interest in the assets contributed (without a discount based on partnership restrictions). If not, the estate was fortunate that the IRS did not catch that argument.

11. IRS Not Contest 35% Discount For Marketable Securities FLP. The IRS only contested whether §2036 applied; it did not contest the applicability of a 35% discount for this partnership that consisted entirely of marketable securities.

12. Appealable to 7th Circuit. The decedent's executor resided in Indiana, so the case is appealable to the 7th Circuit Court of Appeals.

13. Planning Implications From Miller. If possible, include the following in the planning structure.

    a. Change the management of the assets in some significant manner.

    b. Provide for active management rather than merely passively holding partnership assets.

c. Do not transfer all (or almost all) of the owner's assets to the partnership.

d. Retain assets for living expenses.

e. Retain assets for paying estate taxes (or at least a substantial part of the estate taxes, or make arrangements for other family members to purchase the decedent's interest in the FLP without using the FLP's assets).

f. Do not make transfers of partnership interests until after the partnership has been funded. The IRS could clearly take the position in situations like Miller that the gift tax amount is based on a pro rata value of assets contributed rather than the discounted increased value of the donees' limited partnership interests.

Linton v. U.S., U.S. Dist. Ct. W.D. Washington, Cause No. C08-227Z (July 1, 2009)

Contributions of Property to LLC and Gifts of LLC Interests on the Same Day Resulted in Application of Indirect Gift and Step Transaction Doctrines to Eliminate Any Discounts for Gift Tax Purposes

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Synopsis

The court found factually that undeveloped real property, cash, and municipal bonds were contributed to an LLC on the same day that gifts of LLC interests were made to a trust (also created on that same day for the donor's children). (Despite factual testimony as to the intended dates of the gifts, the trust agreement itself stated that the gifts of LLC interests to the trust were made "[a]t the time of signing of this Agreement" and the trust agreement was signed on the same date as the date of the contributions.) In a gift tax refund action, the court upheld the government's motion for summary judgment, finding that no discount should be allowed with respect to the LLC interests. The gifts constituted indirect gifts of the underlying assets (the facts are particularly similar to those in *Senda* where the contribution and gift occurred on the same day and the facts did not make clear which occurred first).

The most significant impact of this case is its analysis of how the step transaction doctrine applies to gifts of partnership or LLC interests. Although not necessary to grant the government's motion for summary judgment, the court also added that the step transaction would apply. The *Holman* and *Gross* cases were the first cases (both decided by Judge Halpern) to address the application of the step transaction doctrine in this context. Even though various commentators have criticized the analysis in *Holman* and *Gross*, the court's analysis followed the same general approach as in the *Holman* and *Gross* cases. The court repeated all three of the alternative tests for the step transaction doctrine that were mentioned in *Holman* and *Gross* and concluded that all three tests would apply. The court's reasoning regarding especially the last two tests was very broad and might leave open an argument by the IRS in future cases that the step transaction doctrine could apply to gifts of partnership or LLC interests made long after the time that the entities are funded. The court distinguished *Holman* and *Gross* because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. The court specifically observed that the assets involved in this case (real property, cash, and municipal bonds) were not as volatile as the assets involved in *Holman* and *Gross*.

Basic Facts

(1) H created an LLC in November 2002.

(2) On January 22, 2003, H gave 50% of his percentage interest in the LLC to W.

(3) *On the same day*, H signed documents transferring assets, including undeveloped real property, cash, and municipal bonds to the LLC.

(4) Furthermore, o*n the same day*, H and W signed trust agreements for their four children, providing that the agreements were "entered into effective upon contribution of property to the Trust," and stating further the "[a]t the time of signing of this Agreement, the Grantors have transferred percentage interests in the WLFB Investments, LLC… to the Trustee …."

(5) Finally, *on the same day* H and W signed gift assignments collectively assigning 90% of the LLC interests to the trusts for their children. The gift assignment documents were not dated when they were signed, but their lawyer later filled in January 22, 2003 on the gift assignment documents.

(6) H testified in a deposition that his "team of experts" suggested creating the LLC and stated that between 40 and 49% discounting would be allowed for gifts of the LLC interests based on the blend of assets being considered. Based on that, H "just did some back math to figure out how much money to put into the LLC."

(7) H and W filed gift tax returns reporting gifts of about $725,000 each (after applying discounts), but the IRS concluded that no discounts should be allowed and that the gifts by each were about $1.5 million. (The opinion does not state the discount claimed by the donors, but the gift amount

claimed on the returns reflected discounts of about 52-54% of the gift amounts claimed by the government.)

Analysis and Observations:

(1) <u>Dispute as to Intent</u>. The court allowed testimony by the donors and their attorney regarding the intent with respect to the timing of the transactions. However the court concluded that the testimony only reflected that the donors did not date the trust agreements or gift documents, and that the dates added by the attorney may been incorrect as a result of a scrivener's error. However, the taxpayers cannot by parol evidence contradict the express language of the trust and the gift documents, and they explicitly indicate that the gifts to the trusts occurred before or with the signing of the trust agreements, which undisputedly took place on January 22, 2003.

(2) <u>Indirect Gift</u>. Regulation §25.2511-1(h)(1) applies the indirect gift approach for contributions to a corporation, resulting in an indirect gift of the property to each shareholder of the corporation to the extent of his or her proportionate interest in the corporation. The regulation does not directly address partnership or LLC contributions, and the court concludes in that context that "the distinguishing factor for gift tax purposes is whether the donating partner's contribution of property was apportioned among the other partners or was attributed only to the donor's own capital account." If the contribution is apportioned directly among the other partners' capital accounts, the contribution is treated as an indirect gift to the other partners.

The court analyzes three separate types of factual circumstances.

a. <u>Partnership Transfers Preceded Contributions</u>. In *Shepherd,* 115 T.C. 376 (2000), the donor's sons owned partnership interests before land was contributed to the partnership. "[B]ecause the contributions of property were allocated, pursuant to the partnership agreement, to the taxpayer's and his sons' capital accounts according to their respective partnership shares, and because each son would be entitled upon dissolution of the partnership to receive payment of the balance in his capital account, the taxpayer had made indirect gifts to the sons."

b. <u>Contributions Preceded Partnership Transfers; Contributions Allocated to Contributor's Own Capital Account</u>. In *Estate of Jones,* 116 T.C. 121 (2001), the decedent and his children contributed to several partnerships, with the contributions being allocated to their respective capital accounts. Subsequently that same day, the decedent gave limited partnership interests to his children. (The facts were clear that the gifts occurred *after* the contributions, even though they were made the same day.) The court refused to treat contributions made by the decedent as indirect gifts to his children, based on their subsequently donated partnership interests, because his contribution was originally allocated to his own capital account.

In *Gross*, T.C. Memo 2008-221, the taxpayer's contributions to a partnership were allocated entirely to her capital account and she made gifts of partnership interests of 11 days later. The court refused to apply the indirect gift approach.

c. <u>Uncertain Sequence of Events</u>. In *Senda*, T.C. Memo 2004-160, *aff'd*, 433 F.3d 1044 (8th Cir. 2006), the transfer of partnership interests and contributions to the partnership occurred on the same day and the facts were not clear which occurred first. "Absent adequate proof of the chronology of events, the transactions in *Senda* were deemed to mirror those in *Shepherd*; the taxpayers were treated as having gifted partnership interests to their children before transferring property to the partnership, and the contributed property… constituted an indirect gift to each child."

d. Application to Linton Facts. "Because the Trusts were created, and gifts of LLC interests were made to the Trusts, on January 22, 2003, either before or simultaneously with the contribution of property to WFLB, LLC, the Court holds that this case is analogous to both *Shepherd* and *Senda*, and that the Lintons' transfers of real estate, cash, and securities enhanced the LLC interests held by the children's Trusts, thereby constituting indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC."

(3) Observations Regarding Indirect Gift Analysis. There is no surprise or new ground broken in the indirect gift analysis. Once the court made its factual finding that the gifts of LLC interests were made before or simultaneously with the contributions, the *Senda* case (which was affirmed by the 8th Circuit Court of Appeals), directly applies to cause the indirect gift analysis to apply.

Practical Planning Tip: As additional contributions are made to a partnership or LLC, the contributions should increase the percentage interests owned by the contributing partner, and the value of the additional contributions should be credited to that partner's capital account. (Various private rulings reasoned that merely booking additional contributions to the transferor's capital account is not sufficient. TAM 200432015 & 200212006. However, *Estate of Jones, Gross* and now *Linton* all place considerable reliance on the fact that additional contributions were first allocated to the contributing partner's capital account.)

(4) Observations Regarding Possible Argument of Ignoring Gift From H to W. Observe, that the IRS might have also argued that the initial gift from H to W and her subsequent gifts that *same day* to trusts for the children might also be treated as an indirect gift from H to the trusts for the children. Cf. Treas. Reg. 25.2511-1(h)(2,3,9) (examples of indirect transfers for gift purposes). The facts do not make clear whether annual exclusions were claimed for these gifts. From the amount of gift taxes reported on the returns, it appears that H and W had previously used all of their $1.0 million lifetime gift exemption amounts. If annual exclusions were available, the gift taxes were obviously lowered by using W's annual exclusions as well as H's. (Perhaps the IRS would have raised this issue if more than just four additional annual exclusions were at issue.)

This indirect transfer approach has also been applied in the estate tax context to determine who was the transferor of a particular transaction for estate tax purposes. For example, if A transfers cash to B, with the understanding that B will transfer property to a trust for A's benefit, A is treated as the grantor of the trust even though he never owned the property that was transferred to the trust. *Estate of Shafer v. Comm'r*, 749 F.2d 1216 (6th Cir. 1984). *See Brown v. U.S.*, 329 F.3d 664 (9th Cir. 2003)(husband made gift to wife; wife made gift to trust; husband died within three years; applied step transaction doctrine to determine that husband was the "real donor" so that §2035 applied to gift tax on transfer within three years of death). As another example, if a husband owes funds to his wife from a prior loan, but pays the funds into a trust for the wife instead of repaying her, the wife will be treated as the grantor of the trust. *Estate of Marshall v. Comm'r,* 51 T.C. 696 (1969), nonacq. 1969-2 C.B. xxvi. *See also Estate of Kanter v. Comm'r*, 337 F.3d 833 (7th Cir. 2003) (son was treated for income tax purposes as grantor of trusts purportedly established by his mother where son funded trusts).

(5) Step Transaction Doctrine.

a. Legal Tests. "The step transaction doctrine 'treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." Much like the analysis in *Holman*, 130 T.C. 170 (2008) and

Gross, T.C. Memo 2008-221 (2008), the court reasoned that three separate tests have been applied in determining if the step transaction doctrine applies. The court concludes that each of those three separate tests would apply on the facts of this case.

- The "binding commitment test," based on whether there was a binding commitment to undertake the later step at the time the first step is entered into, is met because the donor "executed binding Trust Agreements and Gift Documents at the same time they took the first step of contributing property to the LLC."
- The "end result test," based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result," is satisfied because the donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability."
- The "interdependence test" inquires whether the steps were "'so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series' of transactions." This test is met because the donors "would not have undertaken one or more of the steps at issue absent their contemplation of the other integrating acts", and "[b]ut for the anticipated 40% to 49% discount in calculating gift taxes, premised on the low market appeal of WLFB LLC's structure, plaintiffs would not have contributed assets to the LLC. Indeed, the quantum of property transferred to WLFB LLC was determined solely on the basis of maximizing the tax advantages of the transaction."

b. Distinguishing *Holman* and *Gross*. The court distinguished *Holman* and *Gross* because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. The court recited the "real economic risk" reasoning by Judge Halpern in *Holman* and *Gross*. Because there was a real economic risk of a change in value between the time of the contribution and the subsequent gifts of partnership interests, *Holman* and *Gross* "refused to disregard the passage of time or to treat the contributions to the partnership and the subsequent gifts as occurring simultaneously pursuant to the step transaction doctrine." Based on the types of assets involved in *Holman* and *Gross*, (Dell stock in *Holman* and a portfolio of marketable securities in *Gross*) the court determined that there was a real economic risk of a change in value during the six and eleven day delays, respectively, in those cases between the date of funding and the date of the subsequent gifts of interests in the entities. The court specifically observed in *Holman* that the IRS did not make the step transaction argument with respect to a gift made two months after contributions to the partnership, thus suggesting that some appropriate delay is sufficient to avoid the step transaction argument.

In this case, the donors did not delay the gifts for some period of time after funding of the LLC. Furthermore, the court observed that there was no data concerning the fluctuations, if any, and the prices of the various securities issue on a daily basis during the period in question. The court observed that because of the assets in question (i.e., real property, cash, and municipal bonds), "plaintiffs cannot show the volatility necessary to establish a real economic risk associated with" any delay that may have existed in this case.

(6) Observations Regarding Step Transaction Doctrine Analysis.

a. <u>Dictum</u>? The indirect gift analysis by itself is sufficient to grant the IRS's motion for summary judgment ignoring LLC discounts in determining the gift amount. In that respect, the additional step transaction analysis is dictum (or is the indirect gift analysis dictum to the step transaction analysis)?

b. <u>Adopts General Approach of *Holman* and *Gross* Despite Criticism by Commentators</u>. Various commentators have criticized the approach of the step transaction analysis in *Holman* and *Gross*. The IRS's argument is that the donor makes an indirect gift of the contributed assets to the other members of the LLC in proportion to their percentage interests (without a discount attributable to the LLC). However, the children who own membership interests do not end up owning the assets. The step transaction doctrine treats a series of formally separate steps as a single transaction. Even so, in this situation the end result is that the donee-partners do not end up owning a pro rata undivided interest in the assets contributed to the LLC. That would seem sufficient to say that the step transaction doctrine does not apply. (The step transaction argument is different from the indirect gift argument, where there is a regulation providing that a transfer to an entity may be treated as indirect gifts to the other shareholders even though they do not end up owning the assets. However, if there is not an "indirect gift" under the regulation, there is no indication that the fiction in the regulation should be extended to the totally separate step transaction argument.)

Observe the significance of the first cases to rule on a particular issue. Despite the criticism that Judge Halpern's analysis in *Holman* and *Gross* has received, the first district court to address this issue applied the same general approach toward the step transaction issue in the context of gifts of partnership or LLC interests.

c. <u>Length of Delay Required Based on Types of Assets Involved</u>. Judge Halpern's analysis in *Holman* and *Gross* suggested that the amount of delay required to avoid a step transaction argument will depend on the nature of the assets contributed to the partnership or LLC. The court acknowledged in *Holman* in footnote 7 that the "real risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a six-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond." Similarly, footnote 5 in *Gross* suggested that an 11-day delay might not be sufficient for certain types of assets, such as a preferred stock or a long-term Government bond.

Linton reiterates this concern, by specifically questioning whether there would be sufficient volatility over a ten day delay period to establish a real economic risk for the assets involved with this LLC, namely, real property, cash and municipal bonds. (Query why it looked at ten days? A ten-day period does not seem to appear anywhere in the facts.)

For assets with low volatility, a significantly longer delay than 6-11 days may be required to avoid the analysis of the three cases that have now considered the step transaction argument in the context of gifts of partnership or LLC interests. For non-volatile assets, delay as long as possible. Some have noted that the IRS did not make the step transaction argument for the gift made two months after the initial contribution in *Holman*, but there is no magic about even a two month delay for non-volatile assets.

Indeed, the court's analysis of the "end result test" and "interdependence test" seems to leave open a possible argument by the IRS that the step transaction doctrine could apply with respect to partnership interest transfers made long after the contribution of assets to the partnership. The court reasoned that the end result test is satisfied because the donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability." That same reasoning would seem to apply to gifts of partnership or LLC interests made years after the contribution to the entity. The court's reasoning as to the interdependence test also seems to apply broadly: "But for the anticipated 40% to 49% discount in calculating gift taxes, premised on the low market appeal of WLFB LLC's structure, plaintiffs would not have contributed assets to the LLC." If that is sufficient to apply the interdependence test, the step transaction doctrine similarly might be applied to subsequent gifts made years later. (This nonsensical result seems to underscore that the reasoning of this approach to analyzing whether the step transaction doctrine applies does not seem appropriate to determine if the donor has made a gift of a pro rata portion of the assets contributed to an entity.)

Heckerman v. U.S., U.S. Dist. Ct., W.D. Washington, Cause No. C08-0211-JCC (July 27, 2009)

Contributions of Cash to LLC and Gifts of LLC Interests on the Same Day Treated as Indirect Gifts and as Step Transaction to Eliminate Discounts for Gift Tax Purposes

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Synopsis

This gift tax refund case is very similar to a case decided in the same federal district court (though by a different judge) earlier in July, *Linton v. U.S.* 104 AFTR2d 2009-5176 (W.D. Washington July 1, 2009). Not surprisingly, the *Heckerman* case reaches a very similar result as the *Linton* case — the court granted the IRS's motion for summary judgment eliminating any discount for gift tax purposes as to cash contributed to an LLC on the same day that interests in the LLC were transferred to trusts for the donors' children.

An oversimplification of the facts is that Parents transferred liquid assets in the form of mutual funds to an LLC and made gifts of LLC interests to trusts for their children on the same day. The IRS argued that the transfer of cash constituted an indirect gift to the trusts, and alternatively that the step transaction doctrine applied to eliminate discounts as to the cash transfers. (The IRS did not make the indirect gift or step transaction arguments as to a similar transfer of real estate made fifteen days before the assignment of LLC interests to the trusts.)

The court concluded that the transfer of cash was an indirect gift (because the taxpayer could not establish that the transfer of the mutual funds occurred before the assignment of LLC interests to the trusts.) The court also concluded that the step transaction doctrine applied, using very broad reasoning, like the *Linton* case.

The court distinguished *Holman* and *Gross* because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts and because of the nature of the property transferred (cash rather than volatile stocks).

Basic Facts

(1) Parents sought advice for a plan to transfer property in a manner that would make their children work for their money and that would not trigger a gift tax. Based on the advice, they created two trusts for their two children and three LLCs on November 28, 2001. (There was a Real Estate LLC, an Investments LLC, and a Family LLC — which was an umbrella entity that owned all of the interests in the other two LLCs.)

(2) On December 28, 2001, Parents transferred a beach house to the Family LLC, which in turn conveyed it to the Real Estate LLC on the same day.

(3) Fifteen days later (on January 11, 2002) Parents transferred mutual funds (which the opinion consistently characterized as "cash") to the Investment LLC, and *on the same day*, transferred 49.60% interests in the Family LLC (i.e., the umbrella holding company) to the two trusts, collectively. The LLC assignment documents, and the documents admitting the trusts as members of the LLC stated that the interests were assigned "effective January 11, 2002."

(4) An appraisal was prepared reflecting January 11, 2002 as the valuation date. The appraisal concluded that a 58% discount applied to the gifts of the LLC interests.

(5) Parents claimed a 58% discount on the gift value. On audit, the IRS argued that the transfer of cash constituted an indirect gift to the trusts, and alternatively that the step transaction doctrine applied to eliminate discounts as to the cash transfers. (The IRS did not make the indirect gift or step transaction arguments as to the transfer of real estate fifteen days before the assignment of LLC interests to the trusts.) The Parents paid the assessed gift tax deficiency and sued for a refund in the District Court.

Analysis and Observations:

(1) Indirect Gift. Regulation §25.2511-1(h)(1) applies the indirect gift approach for contributions to a corporation, resulting in an indirect gift of the property to each shareholder of the corporation to the extent of his or her proportionate interest in the corporation. The same result is applied to partnerships (citing *Gross* and *Shepherd*). The taxpayer had the burden to prove that the transfer of cash to the LLC was made before the assignment of LLC interests, and the taxpayer could not meet that burden. Parents argued that the gift of LLC interests was not effective until delivery to the trustee and that the cash transfer was first allocated to Parents' capital accounts. The court pointed to various factual elements evidencing a January 11 effective date of the assignment (the Assignment document, the Admission document, the appraisal, and the refund claim [which stated that the gifts were made "on January 11, 2002, or thereafter"]). The court also noted that the taxpayers raised the "delivery" argument too late (after the audit) and that the capital account adjustments were not contemporaneous with the transfers, but were made a year or so later when the taxpayers' 2002 tax returns were prepared.

The court summarized the *Shepherd*, *Estate of Jones*, *Senda*, and *Linton* cases. The facts of this case are very similar to those of *Senda* and *Linton*, in that the transfer of assets and gift of interests in the entity were made the same day, and the taxpayers could not prove which happened first. It is not surprising that the IRS prevailed on the indirect gift argument.

Practical Planning Tip: As additional contributions are made to a partnership or LLC, the contributions should increase the percentage interests owned by the contributing partner, and the value of the additional contributions should be credited contemporaneously to that partner's capital account.

(2) Step Transaction Doctrine.

a. Legal Tests. "The step transaction doctrine 'treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.'" Unlike *Linton*, the court noted that the application of this doctrine depends on whether there are non-tax purposes of the actions:

> "The Ninth Circuit has recognized the need to balance this doctrine with the competing principle that 'anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury.' *Brown*, 329 F.3d at 671... Recognizing this tension, the Ninth Circuit has 'attempt[ed] to distinguish between legitimate "tax avoidance" — actions which, although motivated in part by tax considerations, also have an independent purpose or effect — and illegitimate "tax evasion" — actions which have no, or minimal, purpose or effect beyond tax liabilities.' *Id*."

Much like the analysis in *Holman*, 130 T.C. 170 (2008), *Gross*, T.C. Memo 2008-221 (2008), and *Linton*, the court reasoned that three separate tests have been applied in determining if the step transaction doctrine applies. The court concludes that two of those three separate tests would apply on the facts of this case.

- The "binding commitment test," based on whether there was a binding commitment to undertake the later step at the time the first step is entered into, was not met because there was no binding commitment to make gifts of interests after making contributions to the LLCs.

- The "end result test," based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result," is satisfied because the donors

  > "clearly had a subjective intent to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of 'pre-arranged parts of a single transaction[.]' *Penrod*, 88 T.C. at 1429. Such intent is evident in Mr. Heckerman's testimony that he and his wife 'wanted to fund the LLCs in such a way that would not trigger a gift tax.'"

- The "interdependence test" inquires whether the steps were "'so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series' of transactions." This test is met because

  > "it is clear from the record that but for the anticipated discount in calculating gift taxes, based on the low market appeal of Family LLC's structure, Plaintiffs would not have transferred the cash into Investments LLC. This is most apparent in a December 2001 email chain in which Mr. Heckerman explained to his advisors that he would determine how much cash to transfer into the LLC based on the size of the tax advantage: '[r]egarding the securities LLC, once I know how much discount I can get as a function of how much value is in this LLC, I will determine the funding of this LLC.'"

Observe that the analysis of the end result test could apply to many estate planning transactions (as discussed below). However, the analysis of the interdependence test is not as broadly stated as in *Linton*, and there may be situations in which taxpayers can establish that there are reasons for the initial transfer of assets to an LLC in addition to just getting a valuation discount.

b. <u>Distinguishing *Holman* and *Gross*</u>. The court distinguished *Holman* and *Gross* for two reasons. First, those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. Second, because of the nature of the gifts (cash) taxpayers could not establish that there was any real economic risk that the LLC units would change in value between the time of the funding and gifting of the LLC units. (*Linton* also distinguished *Holman* and *Gross* under similar reasoning. *Linton* involved transfers of cash and municipal bonds.)

(3) <u>Observations Regarding Step Transaction Doctrine Analysis</u>.

a. <u>Non-Tax Purpose</u>. The §2036 cases invariably focus on whether there are "legitimate and significant non-tax purposes" for transferring assets to an FLP or LLC. That traditionally has not been an issue in gift tax cases. However, that may become an important issue in gift tax cases if future cases addressing this step transaction doctrine issue continue to place importance on whether there is a non-tax purpose for transferring assets to the FLP or LLC other than just getting valuation discounts. It is interesting that the *Heckerman* case specifically addressed the importance of the non-tax purpose element to balance between "tax avoidance" and "tax evasion," depending on whether there is an "independent purpose or effect" in addition to the tax savings.

b. Continued Adoption of General Analysis of *Holman* and *Gross*. Commentators have criticized the *Holman* and *Gross* analysis approach because even ignoring intervening steps in the transaction does not leave the taxpayer with making a gift of assets to donees — the donees do not actually end up with those assets but instead own an interest in an entity with substantial state law restrictions.

c. Reasoning for "End Result" Test is Very Broad. The rationale of the opinion is that the donors had a subjective intent to transfer assets to their children with minimal (or no) gift tax. If that is enough to conclude that the step transaction doctrine applies, a wide variety of estate planning transactions might be caught. That subjective intent is present with most donors.

As an example, a donor may choose to make "sliver" gifts of interests in an asset over a period of years rather than all at once. An effect is to take advantage of minority discounts as to each "sliver" gift under Revenue Ruling 93-12. Could the IRS argue that the intent is to achieve the end result of transferring the asset with minimal gift taxes, and therefore ignore the intervening sliver gifts over a number of years, and treat the transfer as being made all at once? As another example, if a client creates voting and non-voting stock and makes gifts of the non-voting stock, could the lack of control discount be ignored because the end result is to transfer the entire interest in the entity (through lifetime and testamentary transfers)? An obvious response to an attempt to apply the step transaction doctrine in that situation is that the children in fact end up with only non-voting stock after the gift. However, in the FLP context, the donees similarly end up with only restricted FLP or LLC interests rather than the hard assets.

d. Indirect Gift and Step Transaction Argument Not Made as to Real Estate Transferred Fifteen Days Before Gifts. The IRS chose not to make the indirect gift or step transaction arguments, to eliminate any discount for gift tax purposes, with respect to the transfer of real estate into the Real Estate LLC 15 days before the gift of LLC interests. In light of the reasoning of the *Linton* and *Heckerman* cases, it will be interesting to see if the IRS makes the step transaction argument for similar transfers in the future.

(4) Observations Regarding Tiered Entity Valuation. The case does not clarify the basis for the appraiser's 58% discount with respect to gifts of interests in the Family LLC (which in turn owned interests in the Real Estate LLC and the Investments LLC). If part of the reason for the discount is attributable to the fact that the underlying assets are held in subsidiary entities, the IRS may have contested the second level discount, under the same rationale as the IRS's approach in *Astleford*, T.C. Memo 2008-128. The tiered-entity discount issue was not mentioned in this case that dealt only with the motions for partial summary judgment on the specific issues included in those motions.

Recent IRS Chief Counsel Memorandum on I.R.C. § 6166--
Installment Payment of Estate Tax

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In a recent memorandum the Office of Chief Counsel of the Internal Revenue Service dealt with the issue of security (bonds and liens) under I.R.C. **§** 6166. An executor may elect under I.R.C. **§** 6166(a)(1) to pay all or a portion of the estate tax attributable to a closely held business in two or more (but not exceeding ten) equal annual installments if the value of the decedent's interest in the closely held business exceeds 35% of the value of the decedent's adjusted gross estate. The amount of estate tax that may be deferred is limited to the estate tax attributable to the value of the decedent's interest in the closely held business. The IRS has the right to require a bond to secure the unpaid estate tax. In lieu of a bond the executor may elect to provide a lien under I.R.C. § 6324A. As a result of the Tax Court's decision in Estate of Roski v. Commissioner, 128 T.C. 113 (2007) and IRS Notice 2007-90, 2007-46 I.R.B. 1003, the IRS must now determine on a case-by-case basis whether an estate will be required to provide a bond. It is rare that a bond will be issued, however, because the cost is prohibitive. Therefore, when the IRS determines that security is appropriate, the executor will generally opt for the special lien under § 6324A (the "Special Lien"). Since *Roski* and Notice 2007-90, however, there remained a number of unanswered questions about security for the bond and Special Lien. The questions were recently addressed and answered in Office of Chief Counsel Internal Revenue Service Memorandum CC:PA: BO#: LUDaly, POSTS-113182-07 (February 25, 2009) ("CCM"). Below are the questions raised in the CCM with the short answer in bold. The full, complete answer and explanation is contained in the CCM.

1. Can the required bond or lien amount include accrued interest on the tax? **Yes.**

2. Can the bond or lien amount be compromised? **Yes.**

3. Can Appeals make valuation determinations with respect to the property upon which the lien will attach? **Yes.**

4. Can Appeals determine whether certain types of property are adequate security for the section 6324A lien? **Yes**.

5. When Appeals determines the value of property, how should this determination be made? **It should be made based on the current fair market value of the property as of the date of the lien agreement.**

6. Must Appeals rely upon the value of the asset listed on the estate tax return, Form 706, or can Appeals determine value based upon other factors? **Other factors, such as the property's current and anticipated use and on the interest which the government would have in the property if the lien were foreclosed upon.**

7. If property is valued under section 2032A as farm property, can it be valued as business or residential property for the lien? **No**

8. Can the undiscounted value of a family limited partnership ("FLP") be used for the lien, even though the FLP interest was discounted on the estate tax return, Form 706? **No.**

9. Can previously pledged or mortgaged property be used for the section 6324A lien? **Yes**

10. Is the value for mortgaged property the full value or the net equity? **Net equity**

11. When Appeals settles a nondocketed case and determines that the taxpayer is entitled to the election, for example by determining the value or type of asset to which the lien will attach, in what format should Appeals issue its determination to the taxpayer and how should it notify the IRS of its determination? **Appeals should either require the taxpayer to submit a revised Form 13925**, **Notice of Election of and Agreement to Special Lien Under Internal Revenue Code Section 6324A, or require a Lien Agreement with the required information.**

Conclusion:

The answers to the questions posed in the CCM seem appropriate and workable in light of the purpose and policy behind IRC § 6166, and appear to strike a good balance between the need for the Service to adequately secure its estate tax lien and the need of the taxpayer for certainty as to how security will be determined or modified.

IRS NOTICE 2009-55: TRANSACTIONS OF INTEREST

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On July 15, 2009, the IRS published Notice 2009-55[1] (the "Notice"), which listed transactions that it has determined to be "transactions of interest." Persons entering into one of the listed transactions must disclose their participation in the transaction. Taxpayers who fail to disclose participation may be subject to penalties. Material advisors who fail to disclose or follow list maintenance obligations also may be subject to penalties.

The Notice sets forth four specific transactions of interest, two of which involve trust transactions. The Notice specifically states that the list may be updated and that they will be listed at www.irs.gov/businesses/corporations and click "abusive Tax Shelters and Transactions."

Sale of Charitable Remainder Interest

One of the trust transactions of interest is set forth in detail in IRS Notice 2008-99[2]. In this situation, a Grantor establishes a charitable remainder trust ("CRT") and contributes appreciated assets to the CRT. (The CRT can be a Charitable Remainder Annuity Trust or a Charitable Remainder Unitrust.) The CRT then sells the appreciated assets – and the CRT is typically exempt from capital gains tax -- and invests in a traditional diversified portfolio. So far, this is not an unusual or suspect transaction -- and the Notice states that "such events alone do not constitute the transaction subject to this notice."

The next step, however, is what triggers IRS scrutiny. The Grantor and the charitable remainderman then sell their interests in the CRT to an unrelated third party for fair market value. The trust then terminates and the buyer acquires the trust property. The Grantor claims a charitable deduction for the portion of the fair market value of the contributed assets attributable to the charitable remainder interest; again, not unusual. Grantor also claims no taxable gain from the trust sale or the asset liquidation. When the Grantor and charitable remainderman sell their interests in the CRT to the third party, Grantor claims that basis provisions under IRC §§1001 and 1014 lead to the conclusion that the uniform basis rules utilize the basis of the newly acquired diversified portfolio, not the contributed appreciated assets. The result is that the capital gain on the sale of the appreciated assets is never taxed even though a portion of the gain is distributed to the Grantor – not the charitable remainderman -- on the sale of the trust.

The 2008 Notice specifically notes that the fact pattern may vary from the prototype transaction, but the result may be the same, and the transaction is still of interest. The key concern is the coordinated sale of the Grantor's interest and the charitable remainder interest in a manner in which the Grantor claims the increased basis coupled with the termination of the trust in a coordinated transaction in order to avoid the capital gain on the earlier sale of the appreciated assets.

Turning Grantor trust status on and off

A second transaction of interest was set forth in Notice 2007-73[3] and involves the turning on and off – the toggling – of Grantor trust status of a trust, specifically in situations which allow the Grantor to claim a tax loss greater than his or her actual economic loss, or to avoid the recognition of capital gain.

The 2007 Notice explains in detail two forms of the transaction – one involving the purchase of options and the other involving the substitution of appreciated assets in a trust. The details vary significantly, but several key aspects place the transactions on the transactions of interest list.

The Grantor creates the subject trust and retains a non-contingent remainder interest in the trust, which makes the trust a Grantor trust for income tax purposes. The Grantor then sells the remainder interest to an unrelated party in a manner in which little or no gain is realized. The sale of the remainder interest, the Grantor claims, removes the trust from the Grantor trust rules and the trust then becomes responsible for income and gain generated by the trust. Transactions immediately thereafter are not taxed to the Grantor. Then, at a specified date under the trust instrument, the Grantor, in a non-fiduciary capacity, gains a power to reacquire trust property by substituting other assets of equivalent value (the “substitution power”). When the substitution power becomes effective, Grantor trust status is restored – it has been toggled back on. The buyer then purchases the income interest from the income beneficiary, giving buyer both the income interest and the remainder interest. The trust is then terminated and buyer receives the trust assets.

Depending on the variation of the transaction, the Grantor has either claimed tax losses greater than the economic loss (in the options purchase scenario) or the Grantor has avoided gain on the disposition of appreciated assets (in the substitution situation). Furthermore, all of the described transactions – from the funding of the trust through the

premiums, "tax lot" accounting, legal research, review of the governing instrument, verification of situs, review of life and other insurance policies, review of distribution requirements, review of investment policies and portfolio allocation in light of the governing instrument and the Prudent Investor Act, appraisal fees, supplies, salaries, consultants' fees, rent, consideration of tax elections, analysis of generation-skipping tax implications, communicating with the beneficiaries, lawyers, accountants, and others, and a host of other products and services too numerous to mention.

We are concerned that if, for example, the trustee's fee is allocated half each to income and principal, the principal beneficiaries may claim that the separate components identified for tax purposes should be allocated entirely to income, if those separate components would be so allocated under applicable state law. On the other hand, if the trustee allocates the separate components to income based on state law or the terms of the governing instrument, the income beneficiaries will bear a greater share of the administrative costs. Thus, they will likely claim that the allocation to income is not proper because the components are really part of the overall trustee fee, which is generally allocated one-half to principal. To avoid such disputes, it may be incumbent on trustees in the 27 states that authorize conversion to a unitrust, for those trustees to consider converting, because after such a conversion, the allocation of an expense to income or to corpus does not affect the amount that must be paid to the income beneficiaries. We do not believe that Congress intended such a far reaching effect under IRC § 67(e).

We also believe that unbundling will cause other administrative problems for trustees – and the government. Under the laws of most states, the amount of a fiduciary's fee is required to constitute "reasonable compensation." Fiduciaries' fees, therefore, generally reflect the unique aspects of the specific trust or estate in question. They also vary widely from trust to trust, year to year, and from state to state. As a consequence, an unbundling requirement would require trustees to unbundle on a case by case basis each trust and estate, at an enormous cost to trustees, executors, and their beneficiaries as well as to the IRS. Unbundling also increases the overall uncertainty of fiduciary administration. Therefore, it seems that unbundling is an impractical and unworkable requirement aimed at nonexistent abuses, and which has consequences far beyond what Congress intended under Section 67(e).

Nonetheless, if the final regulations maintain the unbundling requirement, we request that they advise fiduciaries in detail how unbundling should be accomplished in a manner that is both fair and workable. The regulations could, for example, require a breakdown by each person of a trust company that worked on any matter for the trust or estate and what that person's responsibility is, and so forth. And given that the Supreme Court in *Knight* acknowledged that some investment advisory fees might not be subject to the 2-percent floor, fiduciaries need guidance on how to determine which of their investment fees are fully deductible and which are subject to the 2-percent floor under IRC § 67. We also recommend that the final regulations clearly articulate any standard of proof that must be met.

For those reasons and for the reasons expressed in the 2008 Report and at the November 14, 2007 hearing, we hope that the Treasury Department will reconsider its proposal to require unbundling of fiduciary fees. If not, we respectfully suggest that another hearing on any unbundling proposal would be helpful.

We thank you for your consideration of our concerns about the proposed regulation. Carol A. Cantrell, Chair of the Individual and Fiduciary Income Tax Committee, supervised the preparation of these comments and participated in their presentation along with Martin M. Shenkman, Robert E. Barnhill, and Robert S. Balter. These comments were reviewed by Jonathan G. Blattmachr on behalf of the Section's Committee on Government Submissions.

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

If you have any questions or if we can be of further assistance, please write or call Carol A. Cantrell at 713-667-9147, or ccantrell@bvccpa.com.

Respectfully submitted,

Steve R. Akers

Steve R. Akers
Section Chair

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