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) Dispute as to Intent. 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) 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 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. Partnership Transfers Preceded Contributions. 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. Contributions Preceded Partnership Transfers; Contributions Allocated to Contributor's Own Capital Account. 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. Uncertain Sequence of Events. 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

August 2009
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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 purchase of the income interest and termination of the trust occur within one tax year, and often within thirty days.

The 2007 Notice specifically notes that transactions fall under the Notice and must be disclosed only if Grantor trust status is terminated and subsequently toggled back to Grantor trust status. The mere termination of Grantor trust status will not attract IRS scrutiny.

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[1] http://www.irs.gov/pub/irs-drop/n-09-55.pdf

[2] http://www.irs.gov/pub/irs-drop/n-08-99.pdf

[3] http://www.irs.gov/pub/irs-drop/n-07-73.pdf

THE TAXPAYER CERTAINTY AND RELIEF ACT OF 2009: A PREVIEW OF PORTABILITY

Timothy J. Vitollo

Portability at Last

For more than twenty years, members of the ABA have been trumpeting the estate planning simplification for modestly wealthy taxpayers that would result from portability of the estate tax exemption. Formally recommended by the ABA Tax Section's Task Force on Transfer Tax Restructuring in 1988 (41 Tax Law. 395), making the estate tax exemption portable would enable a decedent's surviving spouse to take advantage of any remaining estate tax exemption not utilized by the decedent. While the Taxpayer Certainty and Relief Act of 2009 (S. 722, "TCRA") has not yet emerged from the Senate Committee on Finance, it provides the clues as to what the final portability provisions might look like.

Limitations Under the Current Transfer Tax Regime

Under current law, any estate tax exemption that the decedent fails to use is wasted and expires upon the decedent's death. For example, using the 2009 applicable exemption amount of $3,500,000, if a decedent with few assets married to a spouse possessing $7,000,000 in assets died without proper planning, the surviving spouse would be left with an estate of $7,000,000, of which $3,500,000 would potentially be subject to estate tax upon the surviving spouse's death. With proper planning, such as utilizing an inter vivos QTIP trust, the surviving spouse could have avoided any estate tax while ensuring virtually the same ultimate disposition. If TCRA becomes law, the executor of the deceased spouse's estate could elect to allow the surviving spouse to have the unused applicable exclusion amount of the original decedent added to that of the surviving spouse, and still be able to avoid any eventual estate tax without undertaking extensive inter vivos planning, significantly simplifying the estate planning process.

Re-unifying the Estate and Gift Tax Exemptions

Aside from implementing the portability of the estate tax exemption, TCRA would make other significant modifications to the current estate and gift tax structures (as well as provide alternative minimum tax relief and other tax cuts that are not discussed here). First, TCRA would make permanent the $3,500,000 applicable exclusion amount and 45 percent maximum estate tax rate, thereby undoing the estate tax repeal scheduled for 2010 (S. 722, Pg. 17-19). The applicable exclusion amount would also be indexed annually for inflation beginning in 2011 (Pg. 18). Second, TCRA would increase the gift tax exemption amount to $3,500,000 (Pg. 21). When Congress passed the Tax Relief Reconciliation Act of 2001 (EGTRRA), it created a schedule whereby the estate tax exemption of $1,000,000 would gradually increase to $3,500,000 while the gift tax exemption of $1,000,000 remained stagnant, de-unifying the estate and gift tax exemption amounts. Under TCRA, the estate and gift tax exemption amounts would be re-unified. Third, TCRA makes permanent the $60,000 applicable exclusion amount for non-resident aliens and entitles residents of United States possessions to a potential increase in applicable exclusion amount of up to $175,000 (Pg. 19-20). Finally, TCRA repeals code sections 2011, 2057, and 2604, and increases from $750,000 to $3,500,000 the amount by which the fair market value of qualified real property can be reduced for gross estate purposes under the special use valuation rules of code section 2032A (Pg. 22).

The Portability Provisions

The portability provisions of TCRA are highly anticipated. For modestly wealthy married taxpayers whose combined estates are unlikely to exceed the total exemption amount, portability could significantly reduce the complexity and costs of estate tax planning. Taxpayers with estates likely to exceed the applicable exclusion amount, however, are likely to recognize increased tax savings by foregoing the benefits of portability in favor of effective lifetime planning. If the gift tax exemption is made equal to the applicable exclusion amount, as proposed in TCRA, taxpayers could maximize transfer tax savings by making lifetime transfers and thereby shift future appreciation to the next generation. In the alternative, taxpayers can continue to use Credit Shelter Trust planning and remove from estate tax the appreciation occurring between the first spouse's death and the surviving spouse's death.

As expected, the portability rules also contain a number of anti-abuse provisions. To begin, in order for the surviving spouse to use the deceased spouse's unused exclusion amount, the executor of the deceased spouse's estate must timely file an estate tax return whereon the unused exclusion amount is calculated and an irrevocable election is made to make the amount available to the surviving spouse (Pg. 26). Also, while the surviving spouse may take into account the unused exclusion amounts of multiple deceased spouses, the total portable amount available to the surviving spouse is limited to the applicable exclusion amount in effect for purposes other than portability at the surviving spouse's death; in other words, the same amount that would be available if the surviving spouse had only one prior deceased spouse who died earlier in the same year with a gross estate valued at zero (Pg. 25). Finally, the statute of limitations remains open for determining the amount of a deceased spouse's unused exclusion amount even after the statute has expired for purposes of examining the deceased spouse's estate tax return (Pg. 26). As a result, the statutory period for determining the unused exclusion available to the surviving spouse does not expire until the statute has run for purposes of auditing the surviving spouse's estate tax return (thus allowing the Service to undertake an audit of the deceased spouse's return and add any additional tax assessed to the surviving spouse's estate tax liability).

Troublesome Anti-Abuse Provisions

The anti-abuse provisions are likely to be the most controversial. Each of the last two anti-abuse provisions seem logical, except that both could be avoided by resorting to pre-portability estate planning techniques and foregoing the advantages that portability was intended to provide. For instance, under the proposed portability provisions, the total unused exemption amount afforded to a surviving spouse is limited to the full applicable exclusion amount of one prior deceased spouse. At the same time, if a surviving spouse was willing to forego the simplification afforded by portability, the exclusion of each predeceased spouse could be utilized through proper lifetime marital deduction planning. Exhausting the predeceased spouses' estates during lifetime also eliminates the need to make the portability election that extends the statute of limitations. The final anti-abuse provision extending the statute of limitations is particularly disturbing because it reverts back to policy firmly rejected by the substantial disclosure rules for gift tax returns, policy whereby the Service was previously able to re-examine gift tax returns for which the statute of limitations had expired and use any additional tax assessed to reduce a deceased's available exemption, thereby increasing the estate tax owed.

Weighing the Benefits

TCRA provides a number of significant improvements to the current estate and gift tax structures, one of which is the portability of the estate tax exemption. For taxpayers of modest wealth, portability could be utilized to significantly simplify lifetime estate planning. Portability would also provide a safety net for estate plans of taxpayers with modest or significant wealth that are frustrated by unexpected events. At the same time, the portability anti-abuse provisions are likely to discourage taxpayers with gross estates susceptible to valuation disputes from relying on portability as part of their estate planning. As a result, unless Congress is able to come up with other alternatives for preventing the perceived potential abuses, taxpayers will need to weigh the benefits of simplified estate planning provided by the portability of the estate tax exemption against the potential disadvantages created by the anti-abuse provisions.

COMMENTS OF THE

REAL PROPERTY, TRUST AND ESTATE LAW SECTION

OF THE

AMERICAN BAR ASSOCIATION

REG-119532-08 (Graduated Retained Interests)

July 28, 2009

The following is being submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (hereinafter the "Section"). Neither the House of Delegates, nor the Board of Governors of the American Bar Association has approved these comments. Therefore the comments should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Estate and Gift Tax Committee of the Trust and Estate Division of the Section. Principal responsibility was exercised by Thomas M. Sheehan. Also participating in the preparation of the comments were Lisa M. Rico, Laurence G. Constable, Jeffrey L. Carson, Bradley W. Lard, Phillip J. Kenny, Anta Cissé-Green and Brooke A. Everley. The comments were reviewed by a Review Committee of the Section, which Review Committee included Carlyn S. McCaffrey, Milford B. Hatcher, Michael Whitty and W. Birch Douglass III. These comments were reviewed by Steven B. Gorin on behalf of the Section's Committee on Governmental Submissions.

Although the members of the Section 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.

Table of Contents

I. Executive Summary

By notice of proposed rulemaking in Section 2036 – Graduated Retained Interests, 74 Fed. Reg. 19913 (April 30, 2009) (hereinafter the "Notice"), the United States Department of the Treasury (hereinafter the "Treasury") issued Proposed Regulations (hereinafter the "Proposed Regulations") that would amend Treasury Regulation Section 20.2036-1 (hereinafter the "Regulation") to address the following three (3) substantive issues:

> A. how to calculate the amount includible in a grantor's gross estate when the grantor retained the right to receive an annuity or other payment (other than income) after the death of the current recipient of that interest, and
>
> B. how to calculate the amount includible in the grantor's gross estate when the grantor retained the right to receive a graduated retained interest in a trust.
>
> C. clarify whether Internal Revenue Code [1] section 2033 applies in the case of a retained interest that continues past the death of the grantor when Section 2036 applies to the retained interest.

While the Section agrees with the methodology adopted by the Proposed Regulations to value a graduated retained interest in a trust, we think the accompanying explanation needs to be clarified. As explained more fully below, we think the Proposed Regulations, by failing to take into account the depletion of trust principal that occurs when a surviving annuitant receives an annuity greater than the amount earned relative to an investment return equal to the section 7520 rate, attribute to the grantor a greater portion of the value of a trust than is appropriate.

Our comments are divided into two sections: first, the background on Regulation section 20.2036-1 and how it will be impacted by the Notice; and second, the Section's recommendations, along with a detailed discussion of the recommendations and the suggested amendments necessary to implement the recommendations.

II. Background

On June 7, 2007, the Treasury and Internal Revenue Service (hereinafter the "IRS") caused to be published in the Federal Register at 72 FR 31487 Proposed Regulations (REG-119097-05) providing guidance on the portion of trust corpus includible in a grantor's gross estate pursuant to sections 2036 and 2039. In response

[1] Unless otherwise specified, all cites are to the Internal Revenue Code of 1986, as amended.

to numerous comments, the Treasury and IRS determined that certain comments warranted a reply by separate notice of proposed rulemaking, instead of in the final regulations published on July 14, 2008 (73 FR 40173; as TD 9414).

The Section recognizes that re-proposing regulations is unusual, and appreciates the Treasury's and IRS' willingness to accept additional input.

Consequently, on April 30, 2009, the Treasury and IRS caused to be published in the Federal Register at 74 FR 19913 the Proposed Regulations (REG-119532-08) which more specifically addressed the proper amount includible in a grantor's gross estate if the grantor retained the use of the property, the right to an annuity, unitrust, graduated retained interest, or other payment from such property for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death. The Proposed Regulations incorporate the methodology provided in Revenue Ruling 76-273, 1976-2 C.B. 268, and Revenue Ruling 82-105, 1982-1 C.B. 133, which provides that the portion of the corpus of a grantor retained trust or a charitable remainder trust includible in the decedent's gross estate under section 2036 is that portion of the trust corpus necessary to generate a return sufficient to pay the decedent's retained annuity, unitrust, or other payment. On June 22, 2009 the IRS issued IRS Announcement 2009-50 (hereinafter the "Announcement") which revised the Proposed Regulations to correct errors in the chart set forth in Proposed Regulation section 20.2036-1(c)(2)(iii) *Example 7(iii)*.

We respectfully suggest that the Treasury and IRS have not sufficiently clarified expectations the Proposed Regulations place on the taxpayer to ensure compliance with regard to calculation of the retained interest includible in the grantor's gross estate. We do believe the Proposed Regulations support and properly reference a consistent application of the existing methodology as established in the referenced revenue rulings. The greatest area for improvement to assist taxpayer compliance would be in the content and format of the existing explanatory provisions of the Proposed Regulations. Therefore, it is recommended greater emphasis be given to providing clear and consistent, step-by-step analysis and application of the existing methodology.

Further, we believe that the Proposed Regulations fail to take into account the depletion of trust principal that occurs when an annuitant receives an amount that is higher than that that would be earned if the trust assets were invested to produce a return equal to the section 7520 rate. The result is an attribution to the grantor of a greater portion of the value of the trust property. As such, we recommend this issue be addressed in the final regulations.

Finally, we recommend that guidance be provided in the Regulation that would preclude the potential inclusion under section 2033 of a retained interest in property that continues past the death of the grantor and the property that is subject to inclusion as a retained interest under section 2036. If both sections applied under these circumstances, more than 100% of a property would be included in the gross estate. When a decedent has transferred property and has retained an interest in that property that continues past death, section 2033 should not apply to the value of the retained post-death interest (e.g., the right to receive post-death payments of income or annuities) if section 2036 applies to the transferred property itself.

The Section believes implementation of these recommendations will simplify the rules, thus making it easier for taxpayers to follow.

III. Recommendations

This section contains a description and detailed analysis of the Section's recommendations and suggests textual changes to the Proposed Regulations that would implement these recommendations.

A. Summary

1. **Revise Regulation section 20.2036-1(b).** Regulation section 20.2036-1(b) should be limited to its definitional purpose. The explanation of the application of the methodology outlined in romanette (ii) should be moved to Regulation section 20.2036-1(c) where the includibility of other retained interests is handled.

2. **Revise Regulation section 20.2036-1(c)(1).** Regulation section 20.2036-1(c)(1) should be revised to delete the "(i)" following "Example 1" while retaining the text of the example, and the example under romanette (ii) of the same section should be moved to Regulation section 20.2036-1(c)(2). This will achieve organizational consistency.

3. **Revise Regulation section 20.2036-1(c)(2).** Regulation section 20.2036-1(c)(2) should be revised to delete references to retained income or use interests. Again, this will achieve organizational consistency.

4. **Revise Regulation section 20.2036-1(b)(1)(ii).** Regulation section 20.2036-1(b)(1)(ii) should be revised to delete the current steps implementing its computational methodology and add the steps detailed below. Again, this example should be moved to Regulation section 20.2036-1(c) for purposes of internal consistency.

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5. Clarify Proposed Regulation section 20.2036-1(c)(2)(ii). Proposed Regulation section 20.2036-1(c)(2)(ii) should be revised to clarify the explanation of the methodology used to calculate the retained annuity of a graduated retained annuity.

6. Clarify Proposed Regulation section 20.2036-1(c)(2)(iii) *Example 7*. Proposed Regulation section 20.2036-1(c)(2)(iii) *Example 7* should be revised to provide consistent headings in the charts and clarify the discrepancy in the amounts used in subsections (ii) and (iii) of the example.

B. Advantages

The recommendations included herein are intended to: 1) clarify the methodology meant to be employed by the Proposed Regulations; 2) provide a consistent internal structure, and 3) provide examples that properly reflect the computational methodology.

C. Detailed Discussion of Recommendations

1. Regulation section 20.2036-1(b) – Meaning of terms

Regulation section 20.2036-1(b) is a definitional section. In its current form, the function of Regulation section 20-2036-1(b)(ii) is to tell us that the term "for any period not ascertainable without reference to his [the grantor's] death" includes a period of time that has not commenced because another person is enjoying the trust income at the time of the decedent's death. Without this definition, it might be possible to argue that the decedent had not retained enjoyment of the property at all within the meaning of section 2036 because he or she was not receiving anything from the property at death.

The definitional statement in Regulation section 20.2036-1(b)(ii) refers to a decedent who reserved an income interest. The Proposed Regulations appropriately expand this statement to include a decedent who "reserved the right to receive the income, annuity, or other payment from transferred property at the time of the decedent's death."

In addition to the expanded definition, the Proposed Regulations provide a description as to how to determine the portion of the transferred property that should be included in the case of a reserved annuity interest that follows an annuity interest held by another. This is an awkward position for this description because the more basic description of the method of determining portion includibility in the case of a reserved annuity interest that the decedent was entitled to receive at the time of death appears later in the Regulations. We suggest that this inclusion description be moved to Regulation section 20.2036-1(c), which describes how to determine the portion of the transferred property that should be included in a decedent's gross estate in the case of all other reserved interests.

We suggest, therefore, that Proposed Regulation section 20.2036-1(b)(1)(ii) be changed to read as follows:

> "(ii) A decedent reserved the right, to receive the income, annuity, or other payment from transferred property after the death of another person who was in fact enjoying the income, annuity, or other payment at the time of the decedent's death. In such a case, the amount to be included in the decedent's gross estate under this section does not include the value of the outstanding interest of the other person. The methods of accounting for that interest are explained in paragraph (c) of this section. If the other person predeceased the decedent, the reservation by the decedent may be considered to be either for life, or for a period which does not in fact end before death."

2. Regulation section 20.2036-1(c)(1) – Amount included in gross estate

In its current form Regulation section 20.2036-1(c)(1) appears to deal only with the includible portion determination in the case of reserved income and use interests. The method of determining portion includibility in the case of retained annuity and unitrust interests is explained in detail in Regulation section 20.2036-1(c)(2).

The Proposed Regulations would change Regulation section 20.2036-1(c)(1) by adding a two-part example that deals with determining the includible portion in the case of both reserved income interests and reserved annuity interests that follow an income interest or annuity interest held by another. Because we believe that the explanation of the method illustrated in second part of this example should follow the explanation of the method to be used to determine the includible portion in the case of a reserved annuity interest that the decedent was entitled to receive at the time of death, we suggest deleting the "(i)" that follows "Example 1." and adding an example dealing with reserved annuity interests that follow annuity interests held by others to the set of examples in Section 20.2036-(1)(c)(2).

In addition, the Regulation does not address the interaction between sections 2033 and 2036. Many grantor retained annuity trusts and grantor retained unitrusts trusts are established for a term of years, and provide for continuing annuity or unitrust payments to the grantor's estate if the grantor dies during the term, consistent with Regulation section 25.2702-3(e) *Example 5,* and *Walton v. Comm'r,* 115 T.C. 589 (2000), *acq.* IRS Notice 2003-72, 2003-44 I.R.B. 964. The actuarial value of the right to receive post-death annuity or unitrust payments is includible in the grantor's gross estate under section 2033. The interest retained by the grantor would also be includible in the grantor's estate under section 2036(a)(1). We believe the amount includible in the grantor's gross estate under section 2036(a)(1) should be the same whether or not the annuity or unitrust payments terminate at the death of the grantor. This is so because the amount includible in the grantor's gross estate under section 2036(a)(1), as computed under the Regulation, would be that portion of the trust corpus necessary to generate the annuity or unitrust payment in perpetuity as if those payments constituted an income interest in the trust. Accordingly, whether the payments terminate upon the grantor's death or terminate a period of years later should not affect the amount of property included in the grantor's estate under section 2036(a)(1).

For that reason, the Proposed Regulations should include a provision, similar to the provision in Regulation section 20.2039-1(e), providing that, in the case of a retained interest that continues past death of the grantor, section 2033 would not apply to the value of future payments if the retained interest is includible in the grantor's gross estate under section 2036. The application of two different inclusion sections to the same property interests should not result in a double estate tax. In order to avoid this result, and because the amount of trust corpus that is necessary to yield the annual annuity payment to the grantor must always be greater than the actuarial value of the post-death annuity payments, the amount includible should be limited to the value determined pursuant to Section 2036(a)(1).

For organizational clarity and to preclude possible double inclusion under sections 2033 and 2036, we also suggest that Regulation section 20.2036-1(c)(1) be changed to read as follows:

> *"(1) Amount included in gross estate in the case of retained income or use interests.*

(i) In general. If the decedent retained or reserved an income interest in or right to use all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. If the decedent retained or reserved such an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence. An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred. If the reserved right to receive income continues after the death of the decedent, the value of the right to receive post-death payments will not be separately included under section 2033."

3. Regulation section 20.2036-1(c)(2) – Retained annuity, unitrust, and other income interests in trusts.

Despite the caption of this paragraph of the Regulations, its function is to describe the method for determining portion includibility when the grantor has reserved an annuity or unitrust interest. It does not provide any guidance as to the determination of portion includibility in the case of retained income or use interests that is not already provided in Regulation section 20.2036-1(c)(1). For organizational clarity, we suggest that the references to retained income and use interests be deleted from the caption of section 20.2036-1(c)(2) and from section 20.2036-1(c)(2)(i) so that it would read as follows:

"(2) Retained annuity and unitrust interests in trusts. (i) In general. This paragraph (c)(2) applies to a grantor's retained annuity, unitrust, or other interest (other than a retained income or use interest) in any trust (other than a trust constituting an employee benefit) including without limitation the following (collectively referred to in this paragraph (c)(2) as "trusts"): Certain charitable remainder trusts (collectively CRTs) such as a charitable remainder annuity trust (CRAT) within the meaning of section 664(d)(1), a charitable remainder unitrust (CRUT) within the meaning of section 664(d)(2) or (d)(3), and any

charitable remainder trust that does not qualify under section 664(d), whether because the CRT was created prior to 1969, there was a defect in the drafting of the CRT, there was no intention to qualify the CRT for the charitable deduction, or otherwise; other trusts established by a grantor (collectively GRTs) such as a grantor retained annuity trust (GRAT) paying out a qualified annuity interest within the meaning of §25.2702-3(b) of this chapter, and a grantor retained unitrust (GRUT) paying out a qualified unitrust interest within the meaning of § 25.2702-3(c) of this chapter. If a decedent transferred property into such a trust and retained or reserved the right to an annuity or unitrust in such trust with respect to the property decedent so transferred for decedent's life, any period not ascertainable without reference to the decedent's death, or for a period that does not in fact end before the decedent's death, then the decedent's right to use the property or the retained annuity or unitrust (whether payable from income and/or principal) constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036. The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained annuity or unitrust (without reducing or invading principal) as determined in accordance with § 20.2031-7 (or § 20.2031-7A, if applicable). The portion of the trust's corpus includible in the decedent's gross estate under section 2036, however, shall not exceed the fair market value of the trust's corpus at the decedent's date of death. If the retained annuity, unitrust or other interest in any continues after the death of the decedent, the value of the right to receive post death payments will not be separately included under section 2033."

4. Determining Portion Includibility When a Reserved Annuity Interest Follows a Preceding Annuity Interest

Proposed Regulation section 20.2036-1(b)(1)(ii) prescribes the following method for determining portion includibility when a grantor has retained an annuity interest that follows in whole or in part an annuity interest held by another:

"(A) Step 1: Determine the fair market value of the trust corpus on the date of death.

(B) Step 2: Determine, in accordance with paragraph (c)(2)(i) of this section, the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment (determined on the date of the decedent's death) payable to the decedent for the trust year in which the decedent's death occurred.

(C) Step 3: Determine, in accordance with paragraph (c)(2)(i) of this section, the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment that the decedent would have been entitled to receive for each trust year if the decedent had survived the current recipient.

(D) Step 4: Determine the present value of the current recipient's annuity, unitrust, or other payment.

(E) Step 5: Reduce the amount determined in Step 3 by the amount determined in Step 4, but not to below the amount determined in Step 2.

(F) Step 6: The amount includible in the decedent's gross estate under section 2036 is the lesser of the amounts determined in Step 5 and Step 1."

We believe that these steps do not produce an appropriate result when the annuity, expressed as a percentage of the trust property, is higher than the section 7520 rate because they fail to reflect accurately the principal depletion that will occur under these circumstances. The following simple example illustrates this.

D creates an irrevocable trust the terms of which require the trustee to pay C an annuity of $10,000 per year at the end of each year for 12 years. If C dies before the 12 year period is over, the payments will be made to C's estate. At the termination of the 12-year period, the annuity is to be paid to D for the rest of D's life. D dies immediately after C has received her second annuity payment. The trust property is worth $100,000; the Section 7520 rate is 7%.

The Proposed Regulation would require D to include $72,621 of the trust's value in her gross estate calculated as follows:

(A) Step 1: Fair market value of corpus - $100,000

(B) Step 2: Corpus required to produce D's date of death annuity - $0 because D was not receiving an annuity at death.

(C) Step 3: Corpus required to produce D's annuity if D had survived the 12-year term - $10,000/.07 = $142,857

(D) Step 4: Present value of C's interest - $70,236

(E) Step 5: The amount determined in Step 3 reduced by the amount determined in Step 4, but not to below the amount determined in Step 2. - $142,857-70,236 = $72,621.

(F) Step 6: The lesser of the amounts determined in Step 5 and Step 1 - $72,621.

This result is inappropriate because, if the trust earns a 7% investment return and pays out $10,000 per year, only $58,551 of corpus will remain at the end of 10 years to pay the annuity to D, and the present value of that corpus at the time of D's death is only $29,764. This amount, of course, is also equal to the value of the trust property at D's death reduced by the present value of C's annuity interest. Limiting the inclusion to that amount is entirely consistent with the manner in which the regulations have long valued retained income interests that follow the income interests of another.

The portion of the corpus included in D's gross estate should be no greater than the present value of the amount of trust property that will remain after paying C's annuity, calculated in a manner consistent with section 7520.

If, at the time of the decedent's death, decedent is receiving an annuity from a trust fund that will pay her an additional annuity after the termination of an annuity being paid to another, before calculating the amount of the trust to be included as a result of the deferred annuity, the trust fund should be bifurcated into two parts, the first part consisting of the portion of the trust corpus needed to provide the decedent's current annuity and the second part consisting of the balance of the trust corpus. The calculation of the includibility portion with respect to the deferred annuity should be done with reference to the second portion.

We suggest, therefore, adding the following section 20.2036-1(c)(2)(ii):

"(ii) Reserved annuity interests that follow annuity interests held by another.

If the decedent reserved the right to receive an annuity after the termination of an annuity interest held by the current recipient of that interest measured by a term of years or by the recipient's life, then the amount includible in the decedent's gross estate under section 2036 is the lesser of (a) the amount of trust corpus required to produce sufficient income to satisfy the entire annuity the decedent would have been entitled to receive if the decedent had survived the current recipient and (b) the fair market value of the trust corpus on the date of death reduced by the present value of the current recipient's interest.

The following steps implement this computation.

(A) Step 1: Determine the fair market value of the trust corpus on the date of death.

(B) Step 2: Determine, in accordance with paragraph (c)(2)(i) of this section, the amount of corpus required to generate sufficient income to pay the annuity that the decedent would have been entitled to receive for each trust year if the decedent had survived the preceding term.

(C) Step 3: Determine the present value of the current recipient's annuity.

(D) Step 4: Reduce the amount determined in Step 1 by the amount determined in Step 3.

(E) Step 5: The amount includible in the decedent's gross estate under section 2036 is the lesser of the amounts determined in Step 2 and Step 4."

We also suggest adding the following example to the examples in Regulation section 20.2031-1(c)(2):

"*Example (__)(i).* In Year N, D creates an irrevocable inter vivos trust. The terms of the trust provide that D's child C is to receive an annuity of $10,000 per year for 12 years. At the termination of the 12-year period, the annuity is to be paid to D for the rest of D's life. D dies in Year N+2 immediately after C had received the second annuity payment. On D's date of death, the fair market value of the trust is $100,000 and the section 7520 rate is 7 percent. At the date of death, the amount of trust corpus needed to produce C's annuity interest ($ 10,000 per year) is $ 142,857 ($ 10,000/.07). The present value of C's right to receive $ 10,000 annually for the next 10 years is $70,236. The portion of the trust corpus includible in D's gross estate under Section 2036(a)(1) is $29,764, determined as follows:

(A) Step 1: Fair market value of corpus - $ 100,000

(B) Step 2: Corpus required to produce D's annuity if D had survived C ($ 10,000/.07) - $ 142,857

(C) Step 3: Present value of C's interest - $ 70,236

(D) Step 4: Reduce the amount determined in Step 1 by the amount determined in Step 3 - $29,764

(E) Step 5: The lesser of the amounts determined in Steps 2 and 4 ($142,857 or $29,764) - $ 29,764.

5. Proposed Regulation section 20.2036-1(c)(2)(ii) - Clarification of the Explanation of How to Calculate the Retained Annuity For a Graduated Retained Annuity

Proposed Regulation section 20.2036-1(c)(2)(ii) prescribes the method for determining the amount to be included in a grantor's estate when a grantor retains a graduated retained annuity. While we believe the Proposed Regulations adopt an appropriate methodology in calculating the amount to be included in the grantor's estate in this situation, we request that the explanation of the methodology be clarified. For example, we recommend that the last sentence in Proposed Regulation section 20-2036-1(c)(3) be revised to include language that the corpus amount is the present value of the periodic addition. The language could read as follows:

> "(3) For each trust year in which a periodic addition occurs (increase year), the corpus amount is the amount of trust corpus which, starting from the decedent's date of death, is necessary to generate an amount of income sufficient to pay the periodic addition, beginning in the increase year and continuing in perpetuity, without reducing or invading principal. For each year with a periodic addition, the corpus amount required as of the date of death is the present value of the periodic addition for such year determined by taking the product of two factors: the first is the result of dividing the periodic addition (adjusted for payments made more frequently than annually, if applicable, and for payments due at the beginning, rather than the end, of a

> payment period (see Table K or J of §20.2031-7(d)(6)) by the section 7520 rate (periodic addition / rate); and the second is 1 divided by the sum of 1 and the section 7520 rate raised to the T power (1 / (1 + rate)^T)."

Given the complexity of this computation the Section recommends that a step-by-step explanation of the computation be added to Proposed Regulation section 20.2036-1(c)(2)(ii) in addition to the tables currently provided in *Example 7* of Proposed Regulation section 20.2036-1(c)(2)(iii). In this explanation, the names used for each portion of the computation should be made consistent. For example, if the term "present value factor" is used in a table set forth in Example 7, it should also be referred to as the "present value factor" in the step-by-step explanation and in the text of Proposed Regulation section 20.2036-1. We suggest that the following step-by-step explanation be added as Proposed Regulation Section 20.2036-1(c)(ii)(D):

> "(D) *Step-by-Step Computation.* The following is a step-by-step explanation of the computation set forth in paragraph (c)(ii):
>
> Step A: GRAT Year: Determine the remaining GRAT Years for which payment has not been made under the terms of the GRAT.
>
> Step B: Annual Annuity Payment: Determine the amount of the annuity payment in the year of the decedent's date of death and for the remaining GRAT Years by increasing each succeeding annual payment amount, after the first annual payment, by the percentage the annuity is increasing each year.
>
> Step C: Periodic Addition: Determine the periodic addition amount by determining the amount by which the annuity payment for each year would exceed the annuity payment for the year immediately preceding such year.
>
> Step D: First, determine the "base amount" pursuant to (c)(2)(ii)(B)(1) (annuity payment in year of date of death divided by the section 7520 rate). Next, determine the first factor of the "corpus amount" pursuant to (c)(2)(ii)(B)(3) for each year with a periodic addition.

Step E: Determine the deferral period for the years in which there are periodic additions in accordance with (c)(2)(ii)(B)(3)(ii).

Step F: Calculate the present value factor (the second factor of the Corpus Amount) pursuant to the formula set forth in (c)(2)(ii)(B)(3) $(1/(1 + \text{section 7520 rate})^{T}$, where T equals the time period in years from the date of death through the last day of the trust year immediately before the year for which the periodic addition is first payable (Step E)).

Step G: Determine the Base Amount for annuity payment in the year of death and the Corpus Amount for each year with a periodic addition by multiplying the results in Step D and Step F and the Total Corpus by adding the Base Amount and the Corpus Amounts for each year.

6. Proposed Regulation section 20.2036-1(c)(2)(iii) *Example 7* - Clarification of the *Example 7*

We believe that Example 7 is very useful in illustrating how to calculate the amount includible in the grantor's gross estate when the grantor retained the right to receive a graduated retained interest in a trust. However, we believe it would be helpful if Example 7 were further clarified.

First, we recommend that column G of the chart in (ii) of *Example 7* should refer to the Base Amount, as well as the Corpus Amount. We recommend this because the amount set forth for GRAT Year 3 in column G is the Base Amount as defined under Proposed Regulations section 20.2036-1(c)(1)(ii)(B)(1).

Further, we believe that the numbers in the corrected chart in Proposed Regulation section 20.2036-1(c)(2)(iii), *Example 7(iii)* as set forth in the Announcement should be consistent with the numbers set forth in the chart in Proposed Regulation Section 20.2036-1(c)(2)(iii) *Example 7(ii)*. As corrected by the Announcement subsection (ii) and subsection (iii) of *Example 7* have different Corpus Amounts for GRAT Years 4 and 5. This discrepancy should be clarified. Also, we recommend for clarity purposes the label "Additional Annuity" in the corrected chart in section (iii) of Example 7 should be re-labeled as "Periodic Addition" to be consistent with the definition terms used in paragraph (c)(1)(2).

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May 6, 2009

The Office of the Assistant Secretary for Tax Policy
Elizabeth Garrett, Nominee
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: IRS Proposed Regulation 26 CFR 1.67-4, REG-128224-06 Regarding Fees of Trusts and Estates

Dear Ms. Secretary:

The following comments are submitted by the American Bar Association ("ABA") Section of Real Property, Trust and Estate Law. The comments have not been approved by the House of Delegates or the Board of Governors of the ABA and should not be construed as representing the position of the ABA. The comments were prepared by the Individual and Fiduciary Income Tax Committee of the ABA Section of Real Property, Trust and Estate Law ("Committee"). The Committee wishes to express certain of its concerns over a proposed Treasury Department regulation § 1.67-4(c), which would require trustees and executors to "unbundle" their single commission fees and, if made a final regulation, would have a significant adverse impact on fiduciary administration.

Under the proposed regulation, fiduciaries would be required to unbundle or break down their fees to determine the nature of the services rendered and to what extent, if any, the component parts, otherwise deductible under section 212 of the Internal Revenue Code of 1986 as amended ("IRC"), may be subject to reduction by the "2-percent floor" pursuant to IRC Sections 67(a) and 67(e). The ABA Section of Real Property, Trust and Estate Law previously expressed concerns about unbundling to the Internal Revenue Service "IRS") and the Treasury Department in May 2008 ("2008 Report").[1] It pointed out that unbundling is required neither by the statute nor by the Supreme Court's decision in *Knight v. Commissione*[2] and that it would be extremely burdensome and impractical, if possible at all, for trustees and executors to implement and the IRS to enforce.

Recently, new concerns have arisen that we ask the Treasury Department to consider when drafting any final regulations. The requirement to unbundle trustee fees for income tax purposes may have the unintended effect of causing beneficiaries to assert that costs should be consistently allocated under state law. Under the Uniform Principal and Income Act of nearly all states and many trust agreements, trustee fees, custodial fees, and investment management fees are paid equally from the trust's income and principal. But most other administrative costs are often paid entirely from fiduciary accounting income. These costs may include property management, tax preparation, fiduciary bond

[1] ABA Section of Real Property, Trust, and Estate Law comments to IRS and Treasury on REG- 128224-06 dated May 21, 2008, *available at* www.regulations.gov. Similar concerns were also expressed in the November 14, 2007 Treasury Department hearing by many witnesses.

[2] Knight v. Comm'r, 128 S. Ct. 782 (2008).

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
Section Chair

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