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New Year Brings Changes in Estate Tax and Generation-Skipping Transfer Tax

By Richard S. Franklin[1]

Beginning January 1, 2009, the estate and GST exemptions are increased to $3.5 million, a 75% increase over last year's $2 million exemptions. As a result, the number of federal estate tax returns that need to be filed will drop significantly. The Tax Policy Center estimates that about 17,550 taxable returns were filed in 2008, while only about 6,200 are expected to be filed in 2009. The IRS estimated that 17,416 taxable returns were filed in 2007. Of those, 9,892 were for gross estates less than $3.5 million.[2]

A married couple with a combined estate of $7 million or less should now be able to pass the entire amount to family members with no federal estate tax being imposed. To ensure that your clients' estate plans take full advantage of both spouses' $3.5 million federal estate tax exemption consider:

Funding the Family Trust. Ensure that the asset allocation between the spouses is sufficient to allow the "Family Trust" or credit shelter trust of the first spouse to die to be fully funded, preferably without using retirement accounts or other items of income in respect of a decedent. If possible, ensure that both spouses have $3.5 million of assets in their respective names or revocable trusts available to fund the Family Trust. If one spouse's assets are insufficient, consider making gifts from the wealthier spouse (being mindful however of marital law issues) or dividing jointly owned property (being mindful that severing a tenancy by the entirety may be poor planning for asset protection purposes). Another possibility is for the wealthier spouse to create an inter vivos marital trust (QTIP trust) for his or her spouse and make the QTIP election. Upon the donee spouse's death, the QTIP trust will be included in the donee spouse's estate under IRC section 2044 and thereby be available to use the donee spouse's estate tax exemption.

If a client's current will or revocable trust states that the Family Trust is to be funded with a specific amount, such as $2 million, consider updating the provision to reflect the new exemption amount of $3.5 million. If a QTIP trust has been previously established by the wealthier spouse with $2 million or less, consider increasing the funding to $3.5 million.

If the Family Trust is to be funded using a formula clause, check the will/revocable trust to ensure that the surviving spouse will be comfortable with the terms of the Family Trust now that a greater proportion of the estate will pass to the Family Trust rather than the Marital Trust. The terms of the Family Trust and its control by the appointed trustee could be skewed toward or away from the surviving spouse, and in some cases the surviving spouse may have been completely omitted as a beneficiary. For example, ten years ago in 1999, the estate tax exemption was $650,000. At that time, a couple may have reasonably concluded that the Family Trust should benefit just the descendants, since the amount over $650,000 would solely benefit the surviving spouse. However, now diverting a much greater amount - $3.5 million - away from the surviving spouse may not be appropriate.

State Estate Tax Considerations. Many states such as California, Texas, and Virginia do not impose a separate estate tax, but about 15 states, including the District of Columbia, Maryland, and New York, do impose their own estate tax and allow only a $1 million estate tax exemption.

In Maryland, the personal representative of the first spouse to die may qualify a portion of the Marital Trust for the Maryland estate tax marital deduction, but not the federal estate tax deduction. This state-only QTIP allows the full federal estate tax exemption of $3.5 million of each spouse to be used, while deferring all Maryland estate taxes until the surviving spouse's death. The primary reason articulated for using the state-only QTIP is that the surviving spouse may leave the jurisdiction and thereby permanently avoid the state estate tax. However, if complete avoidance of the state death tax is not assured by a change in domicile or otherwise, there are reasons why a state-only QTIP may not be a good idea, including that (1) the lower brackets of the state estate tax table are not used in both estates; (2) when the surviving spouse dies, no federal death tax deduction is available with respect to state death taxes paid on the state-only QTIP;[3] (3) all income of the state-only QTIP trust must be paid to the surviving spouse, the trust cannot have other beneficiaries, and any income paid and not spent or given away would be taxable in the surviving spouse's estate; and (4) there is likely to be less creditor protection compared to a discretionary Family Trust. The chart below illustrates that the state-only QTIP may increase the overall tax liability.

Comparison of Electing or Not Electing the Maryland State-Only QTIP

Year of Deaths	2009
Federal Applicable Exemption	3,500,000
Maryland Exemption	1,000,000
Growth Rate	0.00%

Plan #1 - Pay State Death Taxes on Full Family Trust Upon 1st Spouse's Death		Plan #2 - Pay No State Death Taxes Upon 1st Spouse's Death	
1st Spouse's Death		**1st Spouse's Death**	
Value of Estate	7,000,000	Value of Estate	7,000,000
Value of Family Trust	3,270,800	Value of Family Trust	1,000,000
Value of Federal & MD QTIP	3,500,000	Value MD QTIP	2,500,000
		Value of Federal & MD QTIP	3,500,000
Federal Estate Taxes	-	Federal Estate Taxes	-
Maryland Estate Taxes*	229,200	Maryland Estate Taxes	-
Total Taxes on 1st Death	229,200	Total Taxes on 1st Death	-
2nd Spouse's Death		**2nd Spouse's Death**	
Value of Federal & MD QTIP	3,500,000	Value of MD QTIP	2,500,000
		Value of Federal & MD QTIP	3,500,000
Federal Estate Taxes	-	Federal Estate Taxes	-
Maryland Estate Taxes	229,200	Maryland Estate Taxes	510,800
Total Taxes on 2nd Death	229,200	Total Taxes on 2nd Death	510,800
Total Estate Taxes 1st and 2nd Deaths	458,400	Total Estate Taxes 1st and 2nd Deaths	510,800
Savings of Plan #1 over Plan #2**	52,400		

Notes:
*Assumes the taxes are charged to the Family Trust. If taxes are charged to the Marital Trust, thereby allowing the full $3.5 million to fund the Family Trust, the taxes would increase to $254,910.
**If the value of the 1st spouse's estate were $10 million, the savings of Plan #1 over Plan #2 would be $113,200.

Unfortunately, clients in DC and New York are generally limited to either funding the Family Trust with $1 million and wasting $2.5 million of the federal estate tax exemption, or fully funding the federal estate tax exemption at $3.5 million and paying DC or New York estate taxes on $2.5 million upon the first spouse's death.[4] Prior to the increased federal exemption, the DC or New York estate tax under this latter alternative would have been about $100,000 on the $1 million of federal estate tax exemption exceeding the DC or New York $1 million estate tax exemption. In 2009, the DC and New York estate tax will be about $229,000 on the $2.5 million of federal estate tax exemption exceeding the $1 million DC or NY estate tax exemption. Incurring some state estate taxes upon the first spouse's death in exchange for fully utilizing the federal exemption may provide overall estate tax savings when considering the aggregate taxes payable for both spouses.[5]

Increased GST Exemption. The additional $1.5 million of GST exemption now available may be useful if a client has previously established an irrevocable life insurance trust, dynasty trust, GRAT remainder trust, or other similar types of irrevocable trusts. If such trust is partially exempt from the GST tax or if it includes two subtrusts, one exempt from the GST tax and one subject to it, the additional GST exemption can now be allocated to the partial inclusion ratio trust or nonexempt trust, thereby making it or some portion of it exempt from GST tax. This would be a so-called "late" allocation of GST exemption.[6]

For a client who is not likely to use his or her GST exemption during lifetime, ensure that the testamentary provisions in the will/revocable trust, when appropriate, are properly structured to use the exemption. There could be situations in which a testamentary provision provides for a fixed amount to be set aside in a GST trust, rather than using a formula based on the then GST exemption available. Consideration should be given to adjusting these clauses for the increased exemption.

Opportune Time for Estate Planning. A combination of factors may make this the opportune time to transfer assets to family members. First, recessionary pressures have driven down stock prices and the values of most companies, and volatility in the stock market means that equity interests in private companies may be subject to greater discounts for lack of marketability. Therefore, this is the time to freeze values for gift and estate tax purposes. Second, historically low interest rates are available, thereby (i) increasing the leverage of GRATs and CLATs, (ii) reducing the financing costs of sales and loans, and (iii) making it advantageous to refinance existing notes. Third, Congress is considering legislation that would, among other changes, limit the use of minority interest discounts for lack of control in valuing business interests transferred between family members. The potential loss of this discount would effectively increase federal gift and estate tax burdens.

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2 The IRS statistics are available at: http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html.

3 The federal estate tax deduction under IRC section 2058 for death taxes paid to a state is not applicable to taxes with respect to property not included within the federal gross estate. Some estate tax attorneys may have thought that the higher brackets of the state death tax table applicable to the state-only QTIP when the surviving spouse dies would be offset by the federal deduction for state death taxes – not so!

4 One partial solution is to consider funding the Family Trust with the $1 million gift tax exemption amount before the first spouse's death (but giving due consideration to income tax basis and market risks associated with gifts) as most states do not have a gift tax working in coordination with their estate tax. This allows the funding of the Family Trust with $2 million with no state estate tax (i.e., $1 million during lifetime that escapes state tax because there is no state gift tax and $1 million upon death because of the state estate tax exemption of $1 million). State estate tax would apply on the remaining $1.5 million of the federal exemption upon the first spouse's death.

5 DecoupleCruncher may be useful in modeling scenarios and can be obtained from http://www.leimberg.com/.

6 For the rules governing the late allocation of GST exemption see the regulations under IRC sections 2632 and 2642. A qualified severance may also be advisable.

PENDING LEGISLATION TO CHANGE THE FEDERAL TRANSFER TAXES
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Currently, there appear to be four bills pending in Congress to deal with changes to the federal transfer taxes. Two of them, H.R. 96 and H.R. 173, appear to be focused on issues related to farmland. Another, H.R. 533, aims to repeal the estate tax entirely. But another has drawn more attention because it appears to dovetail with the announced intentions of newly elected President Obama.

That bill is H.R. 436 introduced by Representative Pomeroy [North Dakota] on January 9, 2009. The bill does 6 major things, most of which have to do with modifications of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"):

1. Repeal is Repealed: Title V of EGTRRA, and particularly Subtitle A (included as part of the appendix), provided for the repeal of the estate and generation skipping tax rules for decedents dying December 31, 2009. That provision is to be repealed, and thus estate and GST taxes would continue to be imposed.

2. Carryover Basis is Carted Out: The carryover basis rules would not apply at death, and the provisions of Section 1014 (change in basis at death) would continue to apply. Subtitle E of Title V of EGTRRA provided for carryover basis for assets in the estates of decedents dying after December 31, 2009. This new bill would repeal that section.

3. Unified Rate and Credit: One of the big things EGTRRA did was to disconnect or "un-unify" the unified credit for estate and gift taxes, providing for different "applicable exclusion" amounts and rates. Under this bill, subsections (d) and (e) of section 511 of EGTRRA are repealed. In effect, that would re-unify the estate and gift tax rates and provide for a single credit to applied to both.

4. New Fixed Applicable Exclusion Amount and Rate: All transfer taxes would again have a unified "exemption" of $3,500,000 and a unified tax rate of 45%. The new bill would fix the applicable exclusion about at $3,500,000 and the rate for amounts in excess of that at 45%. The wording of the bill will have to be fixed because it seems to try to alter the first sentence of section 2010(c). But in doing so, it cuts the sentence off and makes it nonsensical. But enough is there to make clear the author's intent.

5. Modification of the Surtax Rate and Amount: The surtax rate for estates over $10 million would still be 5% but the maximum amount of the

addition would be increased. Currently, the amount of the surtax is capped at the difference between tax at the maximum rate less tax computed at the graduated rate structure. The bill would provide a cap equal to “the <u>sum</u> of the applicable credit amount under section 2010(c) and $119,200.” That would appear to be $1,455,800 + $119,200 = $1,575,000.

6. <u>Valuation Rules for Transfers of Entities with Passive Assets</u>: Valuation discounts for entities, such as family limited partnerships, would be lost to the extent those entities have “passive” assets (as defined in the bill). And lack of control would no longer be considered in many cases.

These provisions are an obvious attempt to attack discounts in family limited partnerships and similar entities. The bill eliminates discounts for entities to the extent to which the entity owns “passive” assets. The mechanical application of the statute requires that the passive assets be treated as though they are owned, and transferred, directly by the transferor; and the entity is then valued as though it did not own the passive assets.

Passive assets are defined to include cash, cash equivalents, corporate stock, ownership interests in other kinds of entities, debt instruments, trading devices (options, forward and future contracts, notional principal contracts and derivatives), foreign currency, interests in REITs and RICs, publically traded partnerships, precious metals, annuities, real property (with exceptions), assets which pay royalties (other than patents and trademarks), commodities, collectibles and “any other asset specified in regulations prescribed by the Secretary.”

Pass-through rules add to the above by saying that if the entity in which an interest is transferred in turns owns at least a 10-percent of another entity, then the assets of the subsidiary entity are treated as though they are owned by the entity being transferred, up to the percentage of ownership. In other words, if A transfers an interest in FLP to B, and FLP owns a 10% interest in BigCo which owns $100 in assets, $10 of BigCo’s assets will be treated as though the FLP owned them directly.

And finally, discounts for lack of control are eliminated entirely if the interest is not actively traded and the transferor and members of the family (as defined under section 2032A(e)(2)) have control of the entity. It is interesting to note that the definition of family members referred to is very restricted, and so a wide variety of people normally considered family members in common parlance are not included in the foregoing, such as aunts and uncles.

Currently, the bill is sitting in the House Ways and Means Committee. No action has been taken as of the writing of this note.

APPENDIX

Selected Sections of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

These provisions are reproduced in the order in which they are referred to in HR 436. The result is that the last section copied herein is out of order from the text of EGTRRA.

TITLE V--ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

Subtitle A--Repeal of Estate and Generation-Skipping Transfer Taxes

SEC. 501. REPEAL OF ESTATE AND GENERATION-SKIPPING TRANSFER TAXES.

(a) ESTATE TAX REPEAL- Subchapter C of chapter 11 of subtitle B (relating to miscellaneous) is amended by adding at the end the following new section:

`SEC. 2210. TERMINATION.

`(a) IN GENERAL- Except as provided in subsection (b), this chapter shall not apply to the estates of decedents dying after December 31, 2009.

`(b) CERTAIN DISTRIBUTIONS FROM QUALIFIED DOMESTIC TRUSTS- In applying section 2056A with respect to the surviving spouse of a decedent dying before January 1, 2010--

`(1) section 2056A(b)(1)(A) shall not apply to distributions made after December 31, 2020, and

`(2) section 2056A(b)(1)(B) shall not apply after December 31, 2009.'.

(b) GENERATION-SKIPPING TRANSFER TAX REPEAL- Subchapter G of chapter 13 of subtitle B (relating to administration) is amended by adding at the end the following new section:

`SEC. 2664. TERMINATION.

`This chapter shall not apply to generation-skipping transfers after December 31, 2009.'.

(c) CONFORMING AMENDMENTS-

(1) The table of sections for subchapter C of chapter 11 is amended by adding at the end the following new item:

`Sec. 2210. Termination.'.

(2) The table of sections for subchapter G of chapter 13 is amended by adding at the end the following new item:

`Sec. 2664. Termination.'.

(d) EFFECTIVE DATE- The amendments made by this section shall apply to the estates of decedents dying, and generation-skipping transfers, after December 31, 2009.

* * *

Subtitle E--Carryover Basis at Death; Other Changes Taking Effect With Repeal

SEC. 541. TERMINATION OF STEP-UP IN BASIS AT DEATH.

Section 1014 (relating to basis of property acquired from a decedent) is amended by adding at the end the following new subsection:
`(f) TERMINATION- This section shall not apply with respect to decedents dying after December 31, 2009.'.

SEC. 542. TREATMENT OF PROPERTY ACQUIRED FROM A DECEDENT DYING AFTER DECEMBER 31, 2009.

(a) GENERAL RULE- Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by inserting after section 1021 the following new section:

`SEC. 1022. TREATMENT OF PROPERTY ACQUIRED FROM A DECEDENT DYING AFTER DECEMBER 31, 2009.

`(a) IN GENERAL- Except as otherwise provided in this section--
`(1) property acquired from a decedent dying after December 31, 2009, shall be treated for purposes of this subtitle as transferred by gift, and
`(2) the basis of the person acquiring property from such a decedent shall be the lesser of--
`(A) the adjusted basis of the decedent, or
`(B) the fair market value of the property at the date of the decedent's death.
`(b) BASIS INCREASE FOR CERTAIN PROPERTY-
`(1) IN GENERAL- In the case of property to which this subsection applies, the basis of such property under subsection (a) shall be increased by its basis increase under this subsection.
`(2) BASIS INCREASE- For purposes of this subsection--
`(A) IN GENERAL- The basis increase under this subsection for any property is the portion of the aggregate basis increase which is allocated to the property pursuant to this section.
`(B) AGGREGATE BASIS INCREASE- In the case of any estate, the aggregate basis increase under this subsection is $1,300,000.
`(C) LIMIT INCREASED BY UNUSED BUILT-IN LOSSES AND LOSS CARRYOVERS- The limitation under subparagraph (B) shall be increased by--
`(i) the sum of the amount of any capital loss carryover under section 1212(b), and the amount of any net operating loss carryover under section 172, which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent, plus
`(ii) the sum of the amount of any losses that would have been allowable under section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death.
`(3) DECEDENT NONRESIDENTS WHO ARE NOT CITIZENS OF THE UNITED STATES- In the case of a decedent nonresident not a citizen of the United States--
`(A) paragraph (2)(B) shall be applied by substituting `$60,000' for `$1,300,000', and
`(B) paragraph (2)(C) shall not apply.
`(c) ADDITIONAL BASIS INCREASE FOR PROPERTY ACQUIRED BY SURVIVING SPOUSE-
`(1) IN GENERAL- In the case of property to which this subsection applies and which is qualified spousal property, the basis of such property under subsection (a) (as increased under subsection (b)) shall be increased by its spousal property basis increase.
`(2) SPOUSAL PROPERTY BASIS INCREASE- For purposes of this subsection--
`(A) IN GENERAL- The spousal property basis increase for property referred to in paragraph (1) is the portion of the aggregate spousal property basis increase which is allocated to the property pursuant to this section.

`(B) AGGREGATE SPOUSAL PROPERTY BASIS INCREASE- In the case of any estate, the aggregate spousal property basis increase is $3,000,000.

`(3) QUALIFIED SPOUSAL PROPERTY- For purposes of this subsection, the term `qualified spousal property' means--

`(A) outright transfer property, and

`(B) qualified terminable interest property.

`(4) OUTRIGHT TRANSFER PROPERTY- For purposes of this subsection--

`(A) IN GENERAL- The term `outright transfer property' means any interest in property acquired from the decedent by the decedent's surviving spouse.

`(B) EXCEPTION- Subparagraph (A) shall not apply where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail--

`(i)(I) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse), and

`(II) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse, or

`(ii) if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust.

For purposes of this subparagraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.

`(C) INTEREST OF SPOUSE CONDITIONAL ON SURVIVAL FOR LIMITED PERIOD- For purposes of this paragraph, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if--

`(i) such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event, and

`(ii) such termination or failure does not in fact occur.

`(5) QUALIFIED TERMINABLE INTEREST PROPERTY- For purposes of this subsection--

`(A) IN GENERAL- The term `qualified terminable interest property' means property--

`(i) which passes from the decedent, and

`(ii) in which the surviving spouse has a qualifying income interest for life.

`(B) QUALIFYING INCOME INTEREST FOR LIFE- The surviving spouse has a qualifying income interest for life if--

`(i) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and

`(ii) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Clause (ii) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

`(C) PROPERTY INCLUDES INTEREST THEREIN- The term `property' includes an interest in property.

`(D) SPECIFIC PORTION TREATED AS SEPARATE PROPERTY- A specific portion of property shall be treated as separate property. For purposes of the preceding sentence, the term `specific portion' only includes a portion determined on a fractional or percentage basis.

`(d) DEFINITIONS AND SPECIAL RULES FOR APPLICATION OF SUBSECTIONS (b) AND (c)-

`(1) PROPERTY TO WHICH SUBSECTIONS (b) AND (c) APPLY-

`(A) IN GENERAL- The basis of property acquired from a decedent may be increased under subsection (b) or (c) only if the property was owned by the decedent at the time of death.

`(B) RULES RELATING TO OWNERSHIP-

`(i) JOINTLY HELD PROPERTY- In the case of property which was owned by the decedent and another person as joint tenants with right of survivorship or tenants by the entirety--

`(I) if the only such other person is the surviving spouse, the decedent shall be treated as the owner of only 50 percent of the property,

`(II) in any case (to which subclause (I) does not apply) in which the decedent furnished consideration for the acquisition of the property, the decedent shall be treated as the owner to the extent of the portion of the property which is proportionate to such consideration, and

`(III) in any case (to which subclause (I) does not apply) in which the property has been acquired by gift, bequest, devise, or inheritance by the decedent and any other person as joint tenants with right of survivorship and their interests are not otherwise specified or fixed by law, the decedent shall be treated as the owner to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants with right of survivorship.

`(ii) REVOCABLE TRUSTS- The decedent shall be treated as owning property transferred by the decedent during life to a qualified revocable trust (as defined in section 645(b)(1)).

`(iii) POWERS OF APPOINTMENT- The decedent shall not be treated as owning any property by reason of holding a power of appointment with respect to such property.

`(iv) COMMUNITY PROPERTY- Property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State or possession of the United States or any foreign country shall be treated for purposes of this section as owned by, and acquired from, the decedent if at least one-half of the whole of the community interest in such property is treated as owned by, and acquired from, the decedent without regard to this clause.

`(C) PROPERTY ACQUIRED BY DECEDENT BY GIFT WITHIN 3 YEARS OF DEATH-

`(i) IN GENERAL- Subsections (b) and (c) shall not apply to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of the decedent's death.

`(ii) EXCEPTION FOR CERTAIN GIFTS FROM SPOUSE- Clause (i) shall not apply to property acquired by the decedent from the decedent's spouse unless, during such 3-year period, such spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth.

`(D) STOCK OF CERTAIN ENTITIES- Subsections (b) and (c) shall not apply to--

`(i) stock or securities of a foreign personal holding company,

`(ii) stock of a DISC or former DISC,

`(iii) stock of a foreign investment company, or

`(iv) stock of a passive foreign investment company unless such company is a qualified electing fund (as defined in section 1295) with respect to the decedent.

`(2) FAIR MARKET VALUE LIMITATION- The adjustments under subsections (b) and (c) shall not increase the basis of any interest in property acquired from the decedent above its fair market value in the hands of the decedent as of the date of the decedent's death.

`(3) ALLOCATION RULES-

`(A) IN GENERAL- The executor shall allocate the adjustments under subsections (b) and (c) on the return required by section 6018.

`(B) CHANGES IN ALLOCATION- Any allocation made pursuant to subparagraph (A) may be changed only as provided by the Secretary.

`(4) INFLATION ADJUSTMENT OF BASIS ADJUSTMENT AMOUNTS-

`(A) IN GENERAL- In the case of decedents dying in a calendar year after 2010, the $1,300,000, $60,000, and $3,000,000 dollar amounts in subsections (b) and (c)(2)(B) shall each be increased by an amount equal to the product of--

`(i) such dollar amount, and

`(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year, determined by substituting `2009' for `1992' in subparagraph (B) thereof.

`(B) ROUNDING- If any increase determined under subparagraph (A) is not a multiple of--

`(i) $100,000 in the case of the $1,300,000 amount,

`(ii) $5,000 in the case of the $60,000 amount, and

`(iii) $250,000 in the case of the $3,000,000 amount,

such increase shall be rounded to the next lowest multiple thereof.

`(e) PROPERTY ACQUIRED FROM THE DECEDENT- For purposes of this section, the following property shall be considered to have been acquired from the decedent:

`(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.

`(2) Property transferred by the decedent during his lifetime--

`(A) to a qualified revocable trust (as defined in section 645(b)(1)), or

`(B) to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

`(3) Any other property passing from the decedent by reason of death to the extent that such property passed without consideration.

`(f) COORDINATION WITH SECTION 691- This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

`(g) CERTAIN LIABILITIES DISREGARDED-

`(1) IN GENERAL- In determining whether gain is recognized on the acquisition of property--

`(A) from a decedent by a decedent's estate or any beneficiary other than a tax-exempt beneficiary, and

`(B) from the decedent's estate by any beneficiary other than a tax-exempt beneficiary,

and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded.

`(2) TAX-EXEMPT BENEFICIARY- For purposes of paragraph (1), the term `tax-exempt beneficiary' means--

`(A) the United States, any State or political subdivision thereof, any possession of the United States, any Indian tribal government (within the meaning of section 7871), or any agency or instrumentality of any of the foregoing,

`(B) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter 1,

`(C) any foreign person or entity (within the meaning of section 168(h)(2)), and

`(D) to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance.

`(h) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.'.

(b) INFORMATION RETURNS, ETC-

(1) LARGE TRANSFERS AT DEATH- So much of subpart C of part II of subchapter A of chapter 61 as precedes section 6019 is amended to read as follows:

* * *

TITLE IX--COMPLIANCE WITH CONGRESSIONAL BUDGET ACT

SEC. 901. SUNSET OF PROVISIONS OF ACT.

(a) IN GENERAL- All provisions of, and amendments made by, this Act shall not apply--

(1) to taxable, plan, or limitation years beginning after December 31, 2010, or

(2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

(b) APPLICATION OF CERTAIN LAWS- The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

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Subtitle B--Reductions of Estate and Gift Tax Rates

SEC. 511. ADDITIONAL REDUCTIONS OF ESTATE AND GIFT TAX RATES.

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(d) MAXIMUM GIFT TAX RATE REDUCED TO MAXIMUM INDIVIDUAL RATE AFTER 2009- Subsection (a) of section 2502 (relating to rate of tax) is amended to read as follows:

`(a) COMPUTATION OF TAX-

`(1) IN GENERAL- The tax imposed by section 2501 for each calendar year shall be an amount equal to the excess of--

`(A) a tentative tax, computed under paragraph (2), on the aggregate sum of the taxable gifts for such calendar year and for each of the preceding calendar periods, over

`(B) a tentative tax, computed under paragraph (2), on the aggregate sum of the taxable gifts for each of the preceding calendar periods.

`(2) RATE SCHEDULE-

`If the amount with respect to which the tentative tax to be computed is:

The tentative tax is:

Not over $10,000

18% of such amount.

Over $10,000 but not over $20,000

$1,800, plus 20% of the excess over $10,000.

Over $20,000 but not over $40,000

$3,800, plus 22% of the excess over $20,000.

Over $40,000 but not over $60,000

$8,200, plus 24% of the excess over $40,000.

Over $60,000 but not over $80,000

$13,000, plus 26% of the excess over $60,000.

Over $80,000 but not over $100,000

$18,200, plus 28% of the excess over $80,000.

Over $100,000 but not over $150,000

$23,800, plus 30% of the excess over $100,000.

Over $150,000 but not over $250,000

$38,800, plus 32% of the excess over $150,000.

Over $250,000 but not over $500,000

$70,800, plus 34% of the excess over $250,000.

Over $500,000

$155,800, plus 35% of the excess over $500,000.'.

(e) TREATMENT OF CERTAIN TRANSFERS IN TRUST- Section 2511 (relating to transfers in general) is amended by adding at the end the following new subsection:

`(c) TREATMENT OF CERTAIN TRANSFERS IN TRUST- Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.'.

(f) EFFECTIVE DATES-

(1) SUBSECTIONS (a) AND (b)- The amendments made by subsections (a) and (b) shall apply to estates of decedents dying, and gifts made, after December 31, 2001.

(2) SUBSECTION (c)- The amendment made by subsection (c) shall apply to estates of decedents dying, and gifts made, after December 31, 2002.

(3) SUBSECTIONS (d) AND (e)- The amendments made by subsections (d) and (e) shall apply to gifts made after December 31, 2009.

Determining the Income Tax Basis of Property Gratuitously Transferred to Grantor Trusts

Margery J. Schneider, Esq.

[i]In the current financial climate, where it is not uncommon that the fair market value of assets held by a grantor trust has fallen below the grantor's basis, the determination of the income tax basis of property gratuitously transferred to grantor trusts has taken on renewed importance. Specifically, the question is whether the grantor trust rules of I.R.C. §§ 671-679 (the "grantor trust basis rules") or the basis rules for gifts in I.R.C. § 1015 (a) and (b) (the "gift basis rules") are applicable. With the exception of Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984) and Revenue Ruling 85-13, 1985-7 I.R.B. 28, 1985-1 C.B. 184, the I.R.S.'s response to Rothstein, this question has received little attention since the 1940's. This article presents a rationale for the application of the grantor trust basis rules to the exclusion of the gift basis rules.

Example:

A simple example demonstrates how the application of the grantor trust basis rules differs from that of the gift basis rules.

> *A owns property in which A's basis is $50,000 (the Property). A is the Grantor of a grantor trust ("GT"). A transfers the Property to the trustee of GT. The fair market value of the Property at the time of the transfer is $30,000. One year later, the property is distributed from GT to B, the remainder beneficiary of GT. B is unrelated to A.*

The following questions arise from the example:

(1) What is the basis of the Property in the hands of the trustee of GT?
(2) What is the basis of the Property in the hands of B?

The answer to the first question is uncontroversial. Because GT is a grantor trust, under both the grantor trust basis rules and the gift basis rules the basis of the property in GT is $50,000, the same as its basis in the hands of A.

The answer to the second question depends on whether the grantor trust basis rules or the gift tax basis are utilized.

> Grantor Trust Basis Rules. If the grantor trust basis rules apply, the basis of the property in B's hands is determined at the time it is distributed to B. At that time, for income tax purposes, B's basis in the Property is the same as A's, or $50,000. The transfer from A to B through GT is not treated as a gift from A to B for income tax purposes.

> Gift Basis Rules. If the gift basis rules apply, the transfer from A to B would be treated as a gift from A to B. B's basis in the property would not be determined until B disposes of the property. B's basis would be $50,000 for purposes of determining gain and $30,000 for purposes of determining loss. If B sells the property for $40,000, B would realize neither gain nor loss.

Fundamental Principles of Grantor Trusts:

The analysis of the problem properly begins with a review of some of the fundamental principles of the income taxation of grantor trusts:

1. Because the grantor has powers allowing him to exercise “dominion and control” over the property in a grantor trust, the grantor is taxed as the owner of income accruing to the trust. A beneficiary to whom such income may be distributed is not taxed. Treas. Reg. § 1.671-2(b).

2. The grantor of a grantor trust is treated as actual owner of the trust property for all income tax purposes. Treas. Reg. § 1.671-2(c). In computing grantor’s tax liability, the grantor “takes into account all items of income, deduction and credit … to which he would have been entitled had the trust not been in existence during the period he is treated as owner.” Treas. Reg. § 1.671-3(a)(1). [ii]

3. The grantor is treated as the owner of "any portion of a trust ... where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both." I.R.C. § 676(a).

4. By attributing the income of a grantor trust to the grantor, the Code effectively disregards the trust entity. Estate of O'Connor v. Commissioner, 69 T.C. 165, 174 (T.C. 1977).

5. A grantor is defined as a person who makes gratuitous transfers to a grantor trust. A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer is for fair market value “only to the extent of the value of the property received from the trust, services rendered by the trust, or the right to use property of the trust. Treas. Reg. § 1.671-2(e)(2)(ii). A person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust. Treas. Reg. §1.671-2(e)(1).

6. The Treasury Regulations distinguish between the income taxation and the gift taxation of transfers to grantor trusts. The transfer of property to a grantor trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes. Treas. Reg. §1.671-2(e)(2)(i).[iii] The transfer of property from a grantor to a grantor trust is not treated as a transfer of property by gift. I.R.C. § 2511(c). I.R.C. § 2511 (c) provides that "a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under [the grantor trust rules in Code Sections 671 to 679]" (*emphasis added*).

Principles of Taxation of Transfers to Grantor Trusts

The principles of the income taxation of transfers to grantor trusts are most clearly set forth in Rev. Rul. 85-13, 1985-7 I.R.B. 28, 1985-1 C.B. 184, which holds that property transferred gratuitously to a grantor trust retains the grantor’s cost basis. Rev. Rul. 85-13 was issued by the I.R.S. in direct reaction to Rothstein v. U.S., 735 F.2d 704, which remains the only unreversed case ruling that a grantor trust has a separate taxable existence, enabling a grantor to receive a basis equal to the purchase price in stock he purchased from a grantor trust.

Rev. Rul. 85-13 states that a transaction such as an asset sale between the grantor and a grantor trust cannot give rise to any taxable income because the transaction is treated as a transfer between the grantor and him/herself. *See generally* Dobson v. Commr, 1 B.T.A. 1082 (1925); PLR 9230021; PLR 9535026; PLR 9525032; PLR 9519029; and PLR 9345035 (all concluding that no gain or loss is realized on transfers by a grantor to a grantor trust and that transfers are disregarded for income tax purposes). There is no change in the adjusted basis and holding period of stock "sold" by a grantor to a grantor trust. PLR 9508007; PLR 9535026. *See also* Rev. Rul. 88-103, 1988-2 C.B. 304 (grantor trust's purchase of replacement property can qualify the individual's gain for nonrecognition treatment under I.R.C. § 1033) and Rev. Rul. 87-61, 1987-2 C.B. 219 (transfer of appreciated property to foreign trust is not subject to the tax under I.R.C. §1491 (1954) (repealed 1997) when grantor treated as the owner of the trust under I.R.C. §§ 671-679).

Similarly, no gain or loss is realized on sales between trusts that are treated under the grantor trust rules as owned by the same grantor. Rev. Rul. 2007-13, 2007-11 I.R.B. 684.

It follows, then, that property which had been gratuitously transferred to grantor trust can take on a new basis for income tax purposes only at the time when the grantor gives up dominion or control over the property, or when the property is no longer held by trust.[iv] The relinquishment of dominion and control can be a realization event for the grantor. For example, if the property is sold, the gain on the sale is taxed to the grantor. Rev. Rul. 85-13. When the property is no longer taxable to the grantor, it must assume a new basis in the hands of its current owner. In the case of a gratuitous transfer, where there has been no sale, the property retains the grantor's basis in the hands of the new non-grantor owner. Here are some examples of when and how the new basis is determined:

1. Change in status of the trust.

   When the grantor of a trust renounces the power that causes the trust to be a grantor trust, the grantor is deemed to have transferred the assets and liabilities in the trust to the trust, for income tax purposes. The grantor has given up dominion and control, and the trust is now a separate taxable entity. Madorin v. Commr., 84 T.C. 667 (1985). *See also* Treas. Reg. 1.1001-2(c), Example 5 (1980), Rev. Rul. 77-402, 1977-2 C.B. 222 and TAM 200011005, G.C.M. 37228 (Aug. 23, 1977). (Note that the transfer is deemed to occur only for income tax purposes and does not result in a taxable gift to the trust.)

2. Distribution of property from an irrevocable grantor trust to a non-grantor beneficiary.

   The basis of property distributed to a beneficiary is the grantor's basis, rather than the fair market value at the time of distribution. Newman v. Commr.., 4 T.C. 226 (1944) (distribution from grantor trust to grantor's child is not to be viewed as effecting a gift to the child on the date of distribution). This holding was based on I.R.C. § 113(a) (3) (1938).[v]
   Newman, whose explanation of the grantor trust basis rules remains the most expansive in the case law, cites Regulations 103, sec. 19.113(a) (3) (1), which states that the grantor's basis "applies whether the property be in the hands of the trustee or the beneficiary and

whether prior to the termination of the trust and distribution of the property or thereafter." 4 T.C. 228. The facts that the income of the trust may be taxable to the grantor and that the gift is not complete for gift tax purposes does not enter into the determination of the proper basis.

3. Transfer of appreciated property to a foreign trust.

The transfer of appreciated property to foreign trust results in deemed sale of property for its fair market value. I.R.C. § 684; Treas. Reg. 1.684-2(e)(2), Example 1 (ii) and Example 3 (ii).

4. Reversion of property to the hands of the grantor.

When property transferred to a grantor trust is reconveyed to the grantor under the terms of the trust instrument at the termination of the trust, its basis for gain or loss is the same as the cost basis of the property in the hands of the grantor upon the original conveyance to the trust. Rev. Rul. 72-406, 1972-2 C.B. 462; Pierre S. DuPont v. Commr., 18 B.T.A. 1028 (1930).

To be sure, these examples do not cover the universe of possible transfers from grantor trusts to non-grantors. Nevertheless, they serve to confirm the nonrecognition treatment of property gratuitously transferred to a grantor trust that is set forth in Rev. Rul. 85-13. They also confirm that this treatment is consistent with the treatment of grantor trust basis questions since the early decades of the twentieth century. Although the holding of Rothstein still stands in the Second Circuit, it has been ignored by other circuits and sidestepped by the I.R.S.

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[ii] Note also that the income of a grantor trust is not taxed to the grantor if it is taxable to the grantor's spouse under IRC § 71 (alimony and separate maintenance) or IRC § 682 (income of estate or trust payable to spouse in case of divorce or separate maintenance).

[iii] The common law definition of a "gift" to a grantor trust is limited to gratuitous transfers to irrevocable trusts: where the settlor of an irrevocable inter vivos trust reserves an interest in him/herself, the trust is not a "gift" for income tax purposes, but where the settlor does not reserve any interest in him/herself, the trust is a "gift." Russell v. Bowers, 27 F. Supp. 13 (D.C. New York, 1939).

[iv] This is consistent with the rules defining the time of a donee's acquisition of gifted property in I.R.C. 1015. The time of acquisition is defined as the date "when the donor relinquishes dominion over the property." Treas. Reg. §1.1015-1(c). The loss of dominion or control over property also determines the completion of a gift and the donor's concomitant liability for gift tax. A gift is completed "when the donor has so parted with dominion and control as to leave him no power to change its disposition whether for his or her own benefit or for the benefit of another." Treas. Reg. §§ 25.2511-2(b); *see also* Burnet v. Guggenheim, 228 U.S. 280 (1933).

[v] "Transfer in trust after December 31, 1920 – If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made."

Estate of Hurford, T.C. Memo 2008-278

Aggressive Private Annuity Sales of Interests in FLP Not Successful; Section 2036 Applied to Creation of FLP

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Synopsis:

The Tax Court rejected an overly aggressive estate plan for a surviving wife who had been diagnosed with stage three cancer. The plan involved the contribution of all assets owned by Wife (and even assets that belonged to her predeceased husband's estate) into FLPs, and selling the partnership interests to two of her three children for private annuities (with the two children agreeing to share the eventual value with her third child). Wife died only about 10 ½ months after the private annuity transaction. The estate was worth $14 million when Husband died and Wife's estate tax return several years later reported a total gross estate of only $847,000. The court addressed (1) whether §2036 and §2035 applied to the creation of the FLPs (to bring all of the contributed assets back into Wife's estate without a discount) and (2) whether the transfer of partnership interests to the children in return for a private annuity similarly should be disregarded under §§2036 or 2038. The court concluded that the bona fide sale for full consideration exception to §§2036 and 2038 did not apply to the creation of the partnership or the private annuity transaction. Section 2036(a)(1) coupled with §2035 required the inclusion in Wife's estate of all assets that Wife contributed to the FLPs without a discount because there were various reasons to believe that there was an implied agreement that Wife would continue to enjoy benefits of the contributed assets. Furthermore, the assets would have been included in Wife's estate because the private annuity transaction did not pass muster under §2036 or §2038. In light of the extreme facts in the case, the IRS alleged penalties, but the court held that the executor reasonably relied on professional advice and refused to apply penalties.

Basic Facts:

1. Husband died on April 8, 1999, owning assets worth about $14 million including (1) a portfolio of stock and bonds, (2) real estate (farms and ranches and two residences), and (3) an interest in the Hunt Oil Company phantom stock plan. His will left his estate to a bypass trust and a QTIP trust. It is not clear when the trusts were funded, but the estate tax return for Husband's estate claimed a marital deduction for a lump sum amount — without itemizing what property was included in that number.
2. After Husband's death, Wife met with her attorney (Sandy Bisignano, a respected estate planning attorney in Dallas) to discuss the administration of Husband's estate and her own estate planning concerns. Mr. Bisignano "took a conservative and thoughtful approach" and recommended outright cash gifts to her three children (Michael, David and Michelle) to utilize Wife's gift tax exemption amount, creating an FLP to hold the farm and ranch properties, and creating a second FLP to own Wife's financial assets.
3. Wife and Michelle took detailed notes during all meetings, which were turned over to the IRS. The court viewed Michelle's actions as a "strong indicator of her honesty."
4. Wife was diagnosed with cancer in January, 2000, and cancer surgery confirmed that she had stage three cancer. The surgery did not cure the disease but reduced the cancer's size.
5. One of the sons (Michael) looked for a new attorney, and eventually Wife selected an attorney who apparently had a great "bedside manner." Wife's notes indicate that she "thought him one of the most agreeable men (or, at least lawyers) that she had ever met." [Perhaps that is faint praise; in any event, the eventual result suggests this is not the primary factor one should use in selecting an attorney.]
6. The new attorney suggested a much more aggressive plan to transfer all of the assets of the Wife, the Family Trust and the Marital Trust into three FLPs, one for each of the three groups of assets, and then transferring all of these interests to the children in return for a private annuity for the

balance of her lifetime. (Eventually, the interests were sold to just two of the children [Michael and Michelle]. Because of some "personal problems" of David, Wife wanted to limit his control, but trusted Michael and Michelle eventually to transfer to him his equal value. This ended up causing significant legal issues, as discussed below.)

7. The structure of each of the FLPs was similar. The general partner of each FLP was an LLC (a separate LLC for each FLP) owned one-fourth each by Wife and the three children. The limited partners of each of the three FLPs were Wife (48%), "Gary T. Hurford Trust" (48% — even though this trust did not exist), and 1% each for the three children.

8. The three FLPs were purportedly funded in March 2000. The opinion goes into great detail describing the funding of the partnerships and pointing out the attorney's "unsteady drafting ability" and "sloppy … paperwork." Among some of the problems: incorrect pagination on the partnership agreements table of contents; granting partnership interests to a trust that did not even exist; signature pages showing an incorrect entity as the general partner of two of the partnerships; all assets of the Family Trust, Marital Trust and Husband's estate investment accounts were transferred to the investment FLP listing Wife as the "Primary Client;" delays in providing documentation to Hunt Oil Company to support the transfer of the right to the phantom stock plan until January 2001 (nine months after Wife sold her limited partnership interests in return for the private annuity); mistakes in the deeds to the farm and ranch properties, and delays in preparing deeds to some tracts until April 10, 2000 (after the private annuity sale). Also, Wife was the sole signatory on the partnership accounts, and she made deposits to and withdrawals (to pay Wife's estimated income tax payments) from the accounts even after she had sold the partnership interests to her children for the private annuity.

9. The attorney designed the FLPs so that the children did not make any contributions, even though they initially were each 1% limited partners. The plan was to show them as owning a 1% ownership interest but a zero capital account. The attorney did this "to avoid gift taxes."

10. On April 5, 2000, about two weeks after the FLPs were purportedly funded, Wife signed documents transferring a 96.25% interest in the three FLPs to Michael and Michelle for a private annuity. How did Wife own a 96.25% interest to sell? The explanation was that Wife transferred the Family Trust, Marital Trust and Estate assets to herself and contributed them to the FLPs. (Even so, that would seem to leave her owning 96% of the limited partnership interests, not 96.25%.) The attorney attempted to value the partnership interests in order to determine the appropriate monthly annuity amount (eventually determined to be $80,000 per month). The court goes to lengths to point out the valuation mistakes made in valuing the assets in the partnerships (as well as noting that the attorney merely estimated lack of control and marketability discounts). The assets in all three of the partnerships were substantially undervalued.

11. The $80,000 monthly payments were made to Wife by making a transfer directly from the investment FLP's account into Wife's personal accounts. (Assets in the other two partnerships were not used to make the private annuity payments.)

12. Wife filed the estate tax return for Husband's estate and filed income tax returns for all of the various LLCs and FLPs. The court points out various discrepancies between the positions taken on the returns and the actual facts. For example, the partnership and LLC returns showed the three children as making substantial capital contributions (over $4 million) when they actually made no capital contributions at all.

13. Wife's cancer never went into remission and she died on February 19, 2001 (about 10 ½ months after entering into the private annuity sale).

14. Michael was the executor of Wife's estate and he filed an estate tax return reporting total assets of $846,666. He also filed a gift tax return reporting the direct cash gifts that she made in 2000. The IRS asserted a $9.8 million deficiency and $2.0 million of penalties for Wife estate tax return and an $8.3 million deficiency and $1.7 million penalty for Wife's gift tax return.

Issues:

1. Are the assets contributed to the FLPs includable in Wife's estate under §§ 2036(a)(1) and 2035 (to the extent that interests causing the inclusion of assets under §2036 were relinquished within three years of death)?
    a. Were the transfers to the FLPs bona fides sales for full and adequate consideration?
    b. Did the decedent retain a beneficial enjoyment in the assets (triggering §2036(a)(1)) or relinquish such an interest within three years of death (triggering §2035(a)). [The IRS argued that §2036(a)(2) or §2038 applied to the creation of the FLPs, but the Tax Court did not address that argument in light of the fact that it found §2036(a)(1) to apply. (See footnote 21.)]
2. Were the limited partnership interests that were transferred in return for the private annuity includable in Wife's estate under §§2036(a)(1), 2036(a)(2) or 2038?
    a. Were the transfers in return for the private annuity bona fides sales for full and adequate consideration?
    b. Did the decedent: retain a beneficial enjoyment in the assets (triggering §2036(a)(1)); retain the right to designate who could enjoy the transferred assets (triggering §2036(a)(2)); or have the right to alter, amend, revoke or terminate the transfer (triggering §2038)?

Holdings:

The court addressed these issues in reverse order.

1. The transfers of limited partnership interests in return for the private annuity were includable under §§2036(a)(1), 2036(a)(2), and 2038, and the bona fide sale for full consideration exception did not apply.
2. The assets transferred to the FLPs were includable in the estate under §2036(a)(1) and the bona fide sale for full consideration exception did not apply.
3. Even assets of the Husband's bypass trust, which Wife purportedly transferred to herself from the trust (albeit in violation of the standards stated in the trust) and contributed to the FLPs, were included in Wife's estate.
4. Penalties were not applied because the estate relied on professional advice, and it reasonably relied on that advice (in part because the prior attorney had also introduced the family to the concept of family limited partnerships, albeit in a much more conservative manner).

Analysis:

1. <u>Private Annuity Transaction: Was the Transfer for the Private Annuity Bona Fide and For Full Consideration</u>?
    a. <u>Bona Fide: Disguised Gift or Sham</u>. The court concluded that the transfer was not bona fide but was a disguised gift or sham, pointing to two key facts. First, Wife transferred her limited partnership interests to only two of her three children (because she was concerned

with giving David too much control over the assets), trusting them to ignore the documents and instead carry out Wife's true intentions to ultimately include David. Second, the annuity payments came directly from assets transferred to the investment FLP; the children did not use their own assets and collectively they could not have afforded to pay $80,000 per month to wife. "What Thelma's children did … was to hold the assets in the exact same form that they were in before the private annuity and then slowly transfer bits and pieces of them back to her, planning to divide what was left over (including a share for David), after she died. Again, this makes the private annuity look much more like a testamentary substitute than a *bona fide* sale."

b. Bona Fide: Arm's Length Parties Test. A transaction need not be between strangers to be bona fide, but "there must be some objective proof that the transaction would not materially differ if the parties involved were negotiating at arms' length."

c. Bona Fide: Transfer From Estate Assets Disregarding Formalities. The transfer of assets from Husband's estate to Wife and from Wife to the FLP, with the subsequent transfer of the FLP interests in return for the private annuity is especially suspect as a bona fide sale. The transfers from the estate disregarded formalities.

d. Full Consideration: Depletion Approach; Partnerships Undervalued. The test stated by the court adopts a depletion approach:

> "'[U]nless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no "adequate and full consideration"'."

The court detailed how the assets in each of the FLPs were substantially undervalued, so the private annuity was not equal in value to the amount transferred. "It is on this point that the private annuity is most vulnerable." [The annuity amount was determined using the Treasury actuarial tables for valuing annuities. The court addressed (in footnote 8) that those tables cannot be used for an individual who has a terminal illness as described in regulations, but the court did not address whether that limitation would apply on the facts of this case.]

e. Summary: Exception Does Not Apply. Having determined that the bona fide sale for full consideration exception in §§2036 and 2038 did not apply, the court then proceeded to determine if the transfers in return for the private annuity violated the substantive provisions of §2036 and §2038.

2. Private Annuity Transaction: Did Wife Retain a Prohibited Interest in the Transferred Property Through the Private Annuity?

a. Section 2036(a)(1); Retained Beneficial Enjoyment of Transferred Assets. Section 2036(a)(1) applies if there was an express or implied agreement that the transferor retains present economic benefits of the transferred property.

1. Payments from transferred assets. The court emphasized that the annuity payments were made to Wife with the "very assets she supposedly sold." The payments came directly from the investment FLP account, "meaning that she retained a present economic benefit from her assets after she 'sold' them."

2. Continuing to treat transferred assets as her own. Wife continued to make deposits into the FLP accounts, shifted assets between the accounts, withdrew money to pay her income taxes, and otherwise treated them as if they were her own.

3. Control. Wife continued as president of the LLCs (which were the general partners), remained a party to the farm leases held in a real estate partnership, and had ongoing signature authority over the investment partnerships accounts.

b. Sections 2036(a)2) and 2038; Power to Designate Who Could Enjoy Assets and Power to Alter and Amend. David was not included in the private annuity transaction; however, Wife made clear to the other two children that while she did not want David to have managerial signature rights, he was to receive one third of the property in the FLP's. The court viewed this as an exercise by Wife of the right to designate persons who possess or enjoy the transferred property under §2036(a)(2) and as an exercise of the power to alter or amend the transfer under §2038.

[It seems somewhat ironic that if Wife had included David directly in the private annuity transaction, the court's rationale to apply §2036(a)(2) or §2038 would not apply. However, this fact anomaly is not determinative to the results, because the court held that §2036(a)(1) applies, making it generally immaterial that §2036(a)(2) and §2038 also applied, although this fact was also highlighted as one of the reasons for the conclusion that the bona fide sale exception did not apply.]

3. Transfer to FLPs: Does the Bona Fide Sale for Full Consideration Exception to Section 2036 Apply?

a. Bona Fide: Absence of Legitimate and Significant Nontax Reason. The partnership agreements listed 10 purposes (numbered incorrectly in the agreements). The estate relied primarily on asset protection and asset management purposes. The court observed that prior cases have rejected asset protection as a significant nontax purpose (citing Bongard, Korby cases, and Rosen). The concluded that "placing the assets in FLPs provided no greater protection than they had while held by the Family or Marital Trusts, or in Thelma's own name." The court also rejected the asset management purpose, because the partners' relationship to the assets did not change after the formation of the partnership.

b. Bona Fide: Relevant Factors Recognized in Prior Cases. The court observed that "we have developed in our case law a longer list of factors that, if present, will incline us to find that the transferred property to a FLP was not motivated by legitimate and significant nontax reason." Factors listed by the court include:

- Financial dependence on distributions from the partnership (the decedent transferred nearly all of her liquid assets to the partnership);
- Commingling personal funds with the partnership (the decedent made personal contributions to and withdrawals from the partnership accounts);
- Delay or failure to transfer property to the partnership (many assets remained in the individual and trust accounts for several months after the FLP were formed);
- Old age or poor health;
- Functioning business or meaningful economic activity (an investment manager, Chase, made all investment decisions of the investment partnership; the only decision for the phantom stock partnership was whether to hold or sell; and there was no management of the real estate other than merely collecting rent). [*Observe: The court did not suggest that there must be a functioning business; "meaningful economic activity" is sufficient.*]

The court concluded that obtaining discounts was the only reason for creating the FLPs:

> "This leaves only the Hurfords' drive for a discount as a reason for creating the FLPs. And we do find that their purpose was nothing more than allowing the Hurfords to claim a discount… Michelle's notes from one of the initial meetings with Garza confirm this. She wrote, "have kids own 1% of everything to maximize discount advantage." We thus find that Thelma's transfers to the FLPs were not *bona fide* sales."

c. Full Consideration Test. The court observed the three-part test articulated in Bongard and Kimbell: (1) partnership interests credited to partners are proportionate to the fair market value of assets contributed by each partner; (2) assets contributed are properly credited to capital accounts of the partners; and (3) on termination or dissolution of the partnership, the partners are entitled to distributions equal to their respective capital accounts. However, the court preferred the "short-hand" test described at another place in the Bongard case: "All partners in each partnership received interests proportionate to the fair market value of the assets they each transferred, and partnership legal formalities were respected."

The court emphasized that, in the unusual facts of this case, the 48% partnership interests credited to Wife were far less than the proportionate fair market value of assets that she contributed to the FLPs. That alone would seem sufficient to establish that the full consideration test was not satisfied. However, the court went on to make the statement that "[f]or a FLP to work, the minority interest holders must at a minimum receive their interests either by gift or by contributing their own assets or services," citing the regulations under §704(e). The court suggested that requirement was not met because the children contributed nothing to the partnership and Wife did not report the creation of the partnership as an indirect gift to the children. [*That analysis seems inapplicable. The court relied on regulations dealing with recognizing allocations of income to donee partners under the Section 704(e) "family partnership" limitations, which would seem to have no relevance to whether the full consideration exception of §2036 applie*s.]

4. FLPs: Did Wife Retain Present Economic Benefits From Property Transferred to FLPs in Violation of §2036(a)(1)? The court pointed to three factors that prior cases have recognized as indicative of an implied agreement of retained enjoyment:

- Using FLP assets to pay personal expenses (Wife used partnership assets to pay some of her expenses during the several weeks before the private annuity transfer);
- Transferring nearly all assets to the FLP (Wife transferred nearly all of her property to the FLPs); and
- No change in relationship to assets after transfer to the FLP (annuity payments to Wife came directly from assets that she contributed to the FLPs and Wife's relationship to her assets did not change after the transfer to the FLPs or the private annuity transaction).

The court observed that Wife transferred her limited partnership interests in the private annuity transaction, and that she may have severed her ties to the FLP interest. However Section 2035(a) requires estate inclusion of property that would have been included in the estate under §§ 2036, 2037, 2038, or 2042, but for the decedent having made a transfer of an interest in such property within three years of death. Therefore, even aside from the private annuity transaction, assets that Wife contributed to the partnership are included in her estate under §2036(a)(1) — by way of §2035(a) — without a discount.

5. Family and Marital Trusts. The sad effect of this case is that even assets contributed to the Family Trust from Husband's estate are subject to estate taxation at Wife's subsequent death. Wife's estate argued that the Family Trust imposed a "health, education, support or maintenance" standard on distributions by Wife as trustee to herself, and that her purported transfer of Family Trust assets to herself should be ignored. The court did not agree:

> "But the Hurfords cannot qualify for the exception merely by stating it in the will and avoiding it in practice. Thelma exercised a general power by "distributing" all of the Family Trust to herself and "selling" those assets in the private-annuity agreement, and so they became subject to her full control and individual ownership. Since Thelma used all the Family Trust's assets as her own in the private annuity, we disregard the fact that they at one time could have been sheltered from any estate tax under the plan designed by [the prior attorney]."

As to the Marital Trust, the court pointed out that there were many assets from Husband's estate that apparently were never transferred to the Marital Trust. The court noted that if it were to construct an alternative approach for including the assets in Wife's estate under §2044 as QTIP property, other issues would arise. Was Wife's "handling of that property… a conversion and disposition of the QTIP property under sections 2511 and 2519." (Footnote 24 highlights the §2519 issue that is before the Tax Court in another case involving an investment by a Marital Trust in an FLP: "For example, does a transfer of QTIP into a FLP terminate the qualified income interest, that the Code requires Thelma to have from the time she receives the interest until death? Sec. 2044; sec. 25.2519-1(f), Gift Tax Regs.")

6. Negligence Penalties: Reasonable Reliance on Advice of Professionals. The court first noted that all parties agree that the actions of Wife's executor (her son, Michael) are determinative — not the actions of Wife. The negligence penalty can be rebutted by showing reasonable cause and good faith. Cases have recognized that reliance on professional advice can establish reasonable cause if three factors are present: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the advisor; and (3) the taxpayer actually relied in good faith on the advisor's judgment. The advisor's recommendations, if successful, would have resulted in paying no estate taxes on an estate worth $14 million at Husband's death, and while one might question if Michael could reasonably rely on this advice under a "too good to be true" concern, the court nevertheless found Michael's reliance on the attorney's advice reasonable. The court interestingly pointed to the fact that the prior estate planning attorney had previously introduced the family to the concept of using FLPs. Michael is a child psychiatrist and not sophisticated in tax and business matters. Also, Michelle's notes of the various meetings "show constant questioning of their advisors about what was going on and whether it would work."

Observations:

1. Application of §2036 to FLPs Not Surprising; Terrible Facts. The facts were rather ugly, and the result of including the assets contributed to the FLPs in Wife's estate under §2036 is not surprising.

2. Creditor Protection Not Sufficient; Operating Business Not Required to Satisfy "Bona Fide" Exception to §2036. The opinion, like various prior opinions, concluded that the taxpayer did not show that contributing assets to an FLP increased the protection from creditors' claims, without any analysis of the underlying substantive law. It is not unreasonable that a court would conclude that asset protection is not a significant reason in a particular case, but to just state summarily

that there are no asset protection advantages of contributing assets to FLPs ignores the growing extensive body of discussion about the extent of creditor protection from FLPs and LLCs.

Some planners have been concerned that statements in some of the FLP cases requiring an active "business purpose" might mean that some judges require that an FLP have an operating business in order to be recognized for purposes of §2036. The opinion clarifies that an active business operation is not required — there just must be "meaningful economic activity."

3. Dictum Regarding Section 2519 Issue If Marital Trust Invests in FLP. Another unrelated case pending in the Tax Court (Estate of Samuel Black) addresses whether an investment by a Marital Trust in an FLP constitutes a deemed disposition of the surviving spouse's interest in the FLP under §2519. Footnote 24 raises this issue, while noting that it does not apply in this case, because the Marital Trust was found to have distributed its assets to Wife. It is certainly clear that the Tax Court is aware of the issue.

4. Structure of Awarding Partnership Interest But No Capital Account to Children Not Recommended. The children did not make any contributions to the FLPs, even though they initially were each 1% limited partners, but they were credited with a zero capital account. The attorney designed the FLP structure in this manner "to avoid gift taxes." This approach is not recommended, and it raised various "red flags" to the court. For example, the court stated: "We have found no legal authority for [the attorney's] position that partners can have a partnership interest with nothing more than a shuffle of paper."

5. Sections 2036(a)(2) and 2038 Considered for Private Annuity Transaction But Not for FLP Contributions. There is an interesting difference in the court's treatment of the §2036(a)(2) and §2038 arguments by the IRS in the FLP vs. the private annuity analysis. The court did not address the §2036(a)(2) and §2038 arguments by the IRS regarding the contribution of assets to the FLPs, because it had held that §2036(a)(1) applied, so there was not need to address the other arguments. However, the court did address §2036(a)(2) and 2038 as to the private annuity transaction, even though it had already held that §2036(a)(1) applied to the private annuity transaction.

6. What Was the Added Impact of the Private Annuity Discussion? There were two major transactions addressed by the court; whether §2036 should cause estate inclusion of all assets contributed by Wife to the FLPs, and whether §2036 applied to cause estate inclusion of estate assets sold to the children in the private annuity transaction. The court ultimately held that §2036 caused estate inclusion of all assets contributed to the FLPs. Even though the decedent arguably relinquished any retained beneficial enjoyment (by selling the partnership interests in the private annuity transaction), the court made clear that estate inclusion would still result under §2035 because the relinquishment occurred within three years of death. If the assets contributed to the FLPs were included in Wife's estate without a discount under §2036, what is the impact of the extended discussion of the private annuity? The court seemed to acknowledge this in noting that "[o]f course, [the assets contributed to the FLPs] are already included because of the problems with the private annuity." The FLP analysis seems very straightforward; does this mean that the extended discussion of the private annuity transaction is unnecessary dictum?

Section 2035 has its own "bona fide sale for full consideration" exception (§2035(e)), but the court did not address that exception. However, it clearly would hold that the exception did not apply because it found that the assets transferred in return for the private annuity were undervalued substantially, so there was not an "adequate and full consideration" when the limited partnership interests were transferred in return for the private annuity.

7. Application of §2036 to Private Annuity Transaction. The Hurford case is consistent with other cases that have applied §2036 to transfers of assets in return for a private annuity in certain situations. The primary suspect transaction is one in which the annuity payments are made directly with income or other portions of the transferred assets, and if the purchasers did not have the ability to make the annuity payments apart from the assets that were sold to the purchasers in the private annuity transaction. This is particularly sensitive for sales to a trust in return for a private annuity, but has been applied to sales directly to individuals as well. E.g., Estate of Alma W. Mitchell, T.C. Memo 1982-185 (§2036 applied where children had no financial ability to make annuity payments and never intended to make annuity payments).

8. Why Is the Value of the Private Annuity Not Allowed as a Consideration Offset Under §2043? On the facts of this case, all of the FLP assets are included in the estate under the analysis dealing with the contribution of assets to the FLP and the relinquishment of the beneficial interest within three years other than for adequate and full consideration. However, if the case had just dealt with the direct transfer of undervalued assets in return for a private annuity, and if the court similarly found that the assets were included under §2036, it would be very important whether a "consideration offset" reduction is allowed under §2043 for the value of the annuity. Section 2043 provides generally that if assets are included in an estate under §§2035-2038 or §2041, the amount included in the estate is reduced by "the value of the consideration received therefore by the decedent." The purpose is to avoid double inclusion of the assets brought back into the estate by reason of §§2035-2038 as well the consideration paid to the decedent in return for transferring those assets.

   That analysis would seem to apply to private annuity transactions. For example, under the facts of this case, Wife transferred assets to her children in return for a private annuity from them. If §2036 applies, are the value of the transferred assets at the date of death included in her estate, but offset under §2043 by the value that she received (i.e., the value of the private annuity at the time of the sale transaction) in return for transferring the assets to her children? While this issue would seem to be important in any case involving the application of §2036 to a private annuity, the private annuity cases involving §2036 rarely address §2043. The IRS has addressed the application of §2043 in several private annuity cases. In Estate of Marie A. De Foucaucourt, 65 T.C. 485 (1974), the IRS position was to include the value of transferred property less the value of periodic annuity payments *actually received* by the decedent. The taxpayer agreed with the IRS's position as to the application of §2043 and the court made no finding regarding the appropriate application of §2043 to a private annuity.

   The IRS continued that approach, of allowing an offset only for the value of annuity payments actually received by the decedent, in Estate of Gordon B. McLendon. In the initial Tax Court case, the court concluded that an offset should be allowed under §2043 only for the amount of annuity payments actually made to the decedent. T.C. Memo 1993-459.

   > "Petitioner maintains that if section 2036(a) applies, then the estate is entitled to an offset under section 2043(a) in the amount of the value of the annuity promised Gordon under the private annuity agreement. Respondent determined that petitioner is entitled to an offset for the $250,000 actually paid to Gordon on the date the private annuity agreement was executed. The parties have not cited any case law in support of their respective positions.
   >
   > Section 2043(a) was first enacted into law as section 302(i) of the Revenue Act of 1926… While we observed in Estate of Frothingham v. Commission, 60 T.C. 211, 216 (1973), that legislative history on the provision is nonexistent, we nonetheless concluded that:

> It was plainly designed to deal with the situation where the decedent has received some, but not 'adequate and full' consideration for the transfer. In providing that there shall be included in the gross estate 'only the excess of the fair market value at the time of death of the property … over the value of the consideration *received* therefore by the decedent" (emphasis supplied), Congress was obviously attempting merely to provide a measure of relief from double taxation of the same economic interest…

Consistent with the foregoing, we hold that section 2043(a) provides for an offset limited to the $250,000 amount actually transferred to Gordon pursuant to the private annuity agreement. We have already concluded that the annuity promised to Gordon in exchange for the remainder interest was wholly illusory. It would defy logic to allow petitioner an offset for such a meaningless promise. Further, such an offset would run contrary to the policy underlying section 2043(a) — to provide a measure of relief from double taxation of the same economic interest. Because the promised annuity payments were not intended to make their way into Gordon's gross estate, there is no risk that petitioner will be subjected to double taxation on the value of the property in question."

The Fifth Circuit remanded to the Tax Court for clarification as to how the court viewed the valuation of the private annuity in light of Revenue Ruling 80-80. 77 F.3d 477. The Tax Court, on remand, concluded that the Treasury actuarial tables should not be used to value the annuity even though the requirements of Rev. Rul. 80-80 were satisfied. T.C. Memo 1996-307. The Fifth Circuit subsequently held that the Tax Court was incorrect to ignore a Revenue Ruling when the Commissioner was making an argument inconsistent with a Revenue Ruling, and reversed and held for the estate. Because the assets were not brought back into the estate under §2036, the Fifth Circuit did not address how §2043 would be applied — whether to the entire value of the annuity at the time of the sale transaction or only to the amount of annuity payments actually made to the decedent.

Finally, the IRS addressed the §2043 issue regarding private annuities in <u>Estate of Rose D'Ambrosio</u>, 105 T.C. 252. The taxpayer sold a remainder interest in a trust in return for a private annuity. The IRS initially included the full value of the trust assets less the annuity payments received by the decedent. However, the IRS subsequently (before trial) conceded that the maximum amount includable in the gross estate was the value of the trust assets less the present value of the annuity at the time of the sale transaction.

Section 2043(a) itself makes reference to including the value "at the time of death" of property that was transferred, but allowing an offset for "the value of consideration received" without referring to "at the time of death" as to the consideration. It would seem that a strong argument could be made that §2043 should apply, whenever §2036 is applied to property conveyed in return for a private annuity, for the full value of the annuity at the time of the sale transaction. However, a court might conclude that the private annuity has zero value if the facts indicate that the buyers never intended to make the annuity payments (which was the result in <u>Estate of Musgrove</u>, 76 AFTR2d 95-5276 (Fedl. Ct. Cl. 1995)). Query whether a court might reach that same result if the facts reflected that the parties intended that the payments would be made solely from assets that were transferred from the decedent in the private annuity transaction, and if the buyers had no ability to make the payments independent of the transferred assets.

9. <u>Inclusion of Assets That Wife Transferred to Herself As Trustee of Family Trust in Violation of Distribution Standards</u>. The court refused to ignore the purported transfer of assets from the Family Trust to Wife (by herself as trustee) because the distribution was not permitted under the

stated distribution standards for the trust in Husband's Will. The court stated that the ascertainable standard exception in §2041 does not apply by merely stating it in the will and avoiding it in practice. "Since Thelma used all the Family Trust's assets as her own in the private annuity, we disregard the fact that they at one time could have been sheltered from any estate tax…"

Some cases and rulings have held that transfers made in violation of fiduciary duties would be ignored for tax purposes. E.g., Estate of Vak, T.C. Memo 1991-503 (court did not recognize purported cancellation of trust beneficial interest certificates by trustees where not authorized by original trust agreement or amendment of trust), rev'd and remanded 973 F.2d 1409 (8th Cir. 1992) (agreeing with Tax Court as to this narrow issue in the case); Tech. Adv. Memo. 9337001 (unauthorized distributions from marital trust to persons other than surviving spouse not recognized even though the spouse acquiesced to the improper distributions). Other cases have concluded that a decedent retained control over trust assets despite trust provisions to the contrary. E.g., Estate of Wedum, T.C. Memo 1989-184 (decedent retained dominion and control over trust assets throughout his lifetime, thus causing estate inclusion, despite restrictions in the trust agreements and despite the decedent's purported resignation as trustee). Hurford was an extreme situation in which the beneficiary-trustee distributed the entire trust to herself, apparently in violation of the standards in the trust instrument. How would the court's statement be applied in less extreme situations? The potential ramifications of the court's statements are rather scary for the typical situation where beneficiaries serve as trustees. What if a surviving spouse serving as trustee makes distributions of trust principal to herself when she is only authorized to make discretionary distributions of income to herself? Would the amounts distributed to her nevertheless be included in her estate even though trust beneficiaries would have a claim against her estate for the violation of her fiduciary duty? Could the court's reasoning be extended to hold that a beneficiary-trustee has a general power of appointment over all of the trust assets if the beneficiary has repeatedly made distributions beyond the ascertainable standards specified in the instrument?

Charitable Developments- 2008 in Review

Legislation

The **Heartland, Habitat, Harvest and Horticulture Act of 2008**, enacted on May 22, 2008, amends IRC section 170(b)(1)(E)(vi) to extend, through 12/31/09, **incentives for qualified conservation easements** or other qualified conservation contributions.

On October 3, 2008, Congress passed the **Emergency Economic Stabilization Act of 200**8, which includes a provision extending for 2009 the ability of IRA owners age 70 ½ and older to make **IRA distributions to qualified organizations** of up to $100,000 per year (H.R. 1424).

Under the **Heartland Disaster Tax Relief Act** (Pub. L. No. 110-343), a part of the Emergency Economic Stabilization Act of 2008, an individual taxpayer who itemizes deductions can choose to **deduct qualifying cash contributions up to 100%** of his or her adjusted gross income, reduced by deductions for other charitable contributions. Likewise, an electing corporation may deduct qualifying cash contributions up to 100% of its taxable income, reduced by deductions for other charitable contributions. Cash contributions qualify for this special treatment if they are **made to a public charity for disaster relief efforts** related to certain areas of Arkansas, Illinois, Indiana, Iowa, Missouri, Nebraska, or Wisconsin.

Regulations

Final regulations were released clarifying the **substantive requirements for tax exemption under IRC section 501(c)(3) and the relationship between IRC sections 501(c)(3) and 4958** and how the IRS will determine whether excess benefit transactions penalized under section 4958 could jeopardize an organization's tax-exempt status (T.D. 9390).

Treas. Reg. Sec. 1.664-1, which implements the statutory change providing that **charitable remainder trusts with unrelated business taxable income** remain exempt from federal income tax but are subject to a 100% excise tax on their unrelated business taxable income, was finalized. The final regulations adopted the proposed regulations, issued on March 7, 2008, without substantive change.

Final amendments were made to Treas. Reg. Sec. 20.2036-1 and Treas. Reg. Sec.20.2039-1, which address the **inclusion in a grantor's gross estate of a charitable remainder trust, pooled income fund** or grantor retained trust.

Proposed regulations on **supporting organizations** were not issued in 2008, as initially expected. The **donor-advised fund study** will be done subsequent to the issuance of the proposed regulations.

Proposed regulations reflecting **changes to gift substantiation rules** contained in the American Jobs Creation Act of 2004 and the Pension Protection Act of 2006 were issued on August 7, 2008 (REG-140029-07). The regulations address cash, check or monetary gifts, noncash contributions and the definitions of qualified appraiser and qualified appraisal, the timing of appraisals, and deductions for used clothing and household items. Notice 2006-96, 2006-46 IRB, issued on November 13, 2006 and addressing the **definition of qualified appraiser**, remains effective until the issuance of final Treasury Regulations.

Proposed regulations providing the **income ordering rules for distributions to charity** were issued on June 18, 2008. Prop. Treas. Reg. Sec. 1.642(c)-3 and 1.643(a)-5.

The IRS issued proposed regulations that confirm the **economic effect requirement** of existing regulations on the treatment of amounts paid to the charitable beneficiary of a trust or estate under sections 642 and 643. (REG-101258-08, released on June 18, 2008). Professor Christopher Hoyt points out that language typically used to ensure a 642(c) deduction, such as "I instruct that all of my charitable gifts, bequests, and devises shall be made, to the extent possible, from property that constitutes income in respect of a decedent as that term is defined…." will no longer work. Instead, there must be an economic effect.

Temporary regulations **implementing the revised Form 990** and **eliminating the advance ruling period** for publicly supported organizations were issued in September 2008 (REG-142333-07; T.D. 9423). The new regulations also **change the public support period for exempt organizations from four years to five** and clarify that **support must be reported using the organization's overall method of accounting**. Exempt organizations whose advance rulings expired on or after June 9, 2008 do not need to file Form 8734 at the end of the advance ruling period.

The IRS issued temporary regulation 1.6033-6T implementing the **e-Postcard (Form 990-N) filing requirement for small tax-exempt organizations** (T.D.9366).

Revenue Rulings, Procedures and Notices

Rev. Rul. 2008-41 provides guidance for the **division of a charitable remainder trust** pursuant to a divorce.

The IRS has announced that it will no longer rule on whether the **early termination of a CRT** and a division of the trust assets between the noncharitable beneficiary and the charitable remainder beneficiary based on the actuarial values of their interests will cause the trust to lose its qualification as a CRT (Rev. Proc. 2008-3, §5.10 (area under study)).

The IRS released **sample documents for charitable lead unitrusts**, which complete the forms for split-interest trusts. Rev. Procs. 2008-45, 2008-46.

Notice 2008-6, 2008-3 IRB, provides transitional relief and filing procedures for certain **charitable trusts that fail the responsiveness test for Type III supporting organizations.** The procedures are intended for (1) charitable trusts that received a determination recognizing their tax-exempt status under 501(c)(3) and that met the requirements of section 509(a)(3) until August 17, 2007, and (2) non-exempt charitable trusts described in section 4947(a)(1) that are treated for certain purposes as organizations described in section 501(c)(3) and that met the requirements of 509(a)(3) until August 17, 2007.

Notice 2008-49 implements a technical correction to the Pension Protection Act regarding **public disclosure of Form 990-T**.

Notice 2008-99, issued on October 31, 2008, identifies as a **"transaction of interest"** subject to disclosure and list maintenance requirements, a **transaction involving the sale of all interests of a charitable remainder trust.**

The IRS issued Notice 2008-108, which sets forth a list of changes referred to in Rev. Proc. 2007-44 pertaining to the statutory, regulatory, and guidance changes needed for certain **requests to the Service for opinion, advisory, and determination letters** for the 12-month period beginning February 1, 2009.

Miscellaneous

The IRS mailing **address for EO determinations** has been changed. The new mailing address is Internal Revenue Service, P.O. Pox 12192, Covington, KY 41012-0192. Forms 1023, 1024, 8734 and 8718 should be mailed to this new address.

On May 12, 2008 (published in the Federal Register on May 14, 2008), comments were requested on Rev. Proc. 2005-24 and Notice 2006-15 (**spousal election for CRTs**).

The IRS has extended the due date for responding to the **university and college compliance questionnaire** to February 6, 2009.

The IRS issued **Guide Sheets i**n 2008 on the following topics: IRC 509(a)(3) Supporting Organizations, Type I and II, IRC 509(a)(3) Supporting Organizations, Type III, and Donor Advised Funds.

Charitable Developments- 2009

Rev. Proc. 2009-2 outlines **procedures for issuance of determination letters and rulings** on the tax-exempt status of organizations.

Rev. Proc 2009-4 contains **revised procedures** for the issuance of ruling letters, information letters, etc. on matters related to code sections under the jurisdiction of the Commissioner, Tax Exempt and Government Entities.

Rev. Proc. 2009-5 contains **revised procedures** for furnishing technical advice to area managers and appeals offices by the Commissioner, Tax Exempt and Government Entities regarding exempt organizations matters.

Rev. Proc. 2009-8 contains **new user fees** for exempt organizations matters.
Until a new Form 1023 is issued to comply with the regulations that eliminated the advance ruling process, applicants should follow certain new instructions for completing **Part IX and Part X of Form 1023.** The IRS posted these instructions in two notices on its website in January.

The **Texas Attorney General's Office** has rolled out a **new online resource** that allows charitable donors to research how nonprofit organizations are spending their donor dollars. Interested parties can log onto the website at www.texasattorneygeneral.gov and click on the "Charity Search" function.

New York State Department of Taxation and Finance Advisory Opinion on the New York estate taxation of non-resident owned S Corporations and single member LLCs which own New York Real Estate

Robert D. Steele

The New York State Department of Taxation and Finance issued an advisory opinion on whether a non-resident decedent's interest in either an S corporation or a single member LLC owning real property in the State of New York is considered an intangible asset and therefore not included in the non-resident decedent's estate for New York estate tax purposes, or whether the entities are considered New York property included in the non-resident decedent's New York Estate, TSB-A-08-(1)M, Estate Tax, October 24, 2008. http://www.tax.state.ny.us/pdf/advisory_opinions/estate_&_gift/a08_1m.pdf

A non-New York domiciliary petitioned the state concerning the proposed purchase of a condominium apartment. The petitioner was considering the purchase of a condominium apartment either by a Florida S corporation or by a single member LLC. Under Section 960(a) of the New York State Tax Law, the gross estate of a non-resident includes real and tangible personal property having an actual situs in New York State, but does not include intangible property.

The New York State counsel assumed that the petitioner's S corporation referred to a non-New York corporation that qualifies for and makes the election to be treated as an S corporation under IRC section 1362(a). The opinion concluded that since "stock in an S corporation is an intangible, that interest in property is not subject to the estate tax imposed on the estate of a non-resident decedent under Tax Law section 960(a)." In so concluding it was assumed that the S corporation is entitled to be recognized as a corporation for tax purposes. For the S corporation to be so recognized, its purpose had to be the equivalent of business activity or followed by the carrying on of business by the corporation. So, in holding that the interest in the S corporation was an intangible, New York State determined that the corporation's owning and maintaining of the condominium is the required "equivalent of business activity."

The Internal Revenue Code does not define a single member LLC. Usually, a single member LLC is a disregarded entity. It is possible, however, to elect treatment as an association under the "check-the-box" regulations. If this is elected, a single member LLC will be treated as an association taxable as a corporation and therefore as a C corporation for income tax purposes.

If a single member LLC is taxed as a C corporation, it will be recognized as a corporation for the purposes of New York estate tax. Therefore, a condominium apartment in New York owned by a non-resident decedent in a single member LLC which is treated as a C corporation will be intangible property under the New York estate tax law and excluded from the New York estate.

In sum, a non-resident decedent owning an S corporation which owns a condominium will be deemed to be intangible property in the State of New York unless the S corporation fails the business activity or carrying on of business test. A single member LLC that has elected to be treated as an association under the check-the-box regulations also will be treated as an intangible and, therefore, not subject to New York estate tax. A single member LLC that has not so elected will be "disregarded" and subject to New York estate tax.