ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

eReport

A Bi-Monthly Electronic Publication for Section Members

October 2009

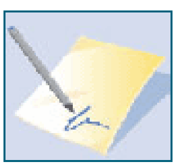
Section News

A Message from the RPTE Chair, Roger D. Winston
Click here to read Roger's first *eReport* communication of the new bar year.

The Joint Fall CLE Meeting in Chicago Was a Success
Thank you to those of you who attended the Joint Fall CLE Meeting in Chicago, September 24-26, 2009. If you were unable to attend, look for program materials soon on the RPTE website. To find out more about the Joint Fall CLE Meeting, click here.

Section Nominations Committee
For a list of the Section's 2009-2010 Nominations Committee members and the Section officer and council positions that are to be elected at the 2010 Section Annual Meeting, please click here.

Trust and Estate News   Real Property News



Trust and Estate News

Split-Dollar Insurance and the Closely Held Business
Larry Brody, Richard Harris and Martin M. Shenkman

The Disposition of Digital Assets: Estate Planning Potential NOT Just Propaganda
Karin Prangley

Final IRC Section 2053 Regulations
Jim Roberts

Steve Akers summarizes and analyzes three recent decisions concerning the transfer of partnership interests in varying circumstances and the interpretation of IRC section 2036 in all three cases and valuation discounts in two of the cases. Estate of Malkin v. Commissioner, T.C. Memo 2009-12,

Technology and Law Practice Management

Top Ten Twitter Tools
Tonya Johnson

Nearly 500 individuals participated in the free webinar, "Why Twitter Matters to Lawyers," part of the *ABA Journal's* Legal Rebels series. Often referred to as a microblogging tool, Twitter has steadily increased in popularity, even among lawyers, a typically wordy group. Click here to see the Top Ten Twitter Tools.

CLE Spotlight

Trust and Estate CLE
Passwords and Personalty: Planning and Pitfalls in the Disposition of Tangible and Quasi-Tangible Property
Webcast/ Teleconference
Date: November 10, 2009
Time: 12:00 P.M. - 1:30 P.M. Central

Real Property CLE
Wind Energy Development: Real-Estate Related Legal Issues with Wind Energy
Webcast/ Teleconference
Date: November 18, 2009
Time: 12:00 P.M. - 1:30 P.M. Central

Group & Committee News

Charitable Planning and Organizations Group

Estate of Murphy, W.D. Ark, and Keller v. U.S., S.D. Tex. In a fourth decision, he summarizes and analyzes Pierre v. Commissioner, 133 T.C. No. 2, which concerns the issue of whether the transfers, for gift tax purposes, of interests in a single member LLC to trusts are transfers of the entity or transfers of the underlying assets.

Real Property News

A lender holding two mortgages or deeds of trust on the same property may face some difficult issues on foreclosure. Brian Hulse previews a much longer article that will appear in the December issue of the *Real Property, Trust and Estate Law Journal*. Read more here.
Brian Hulse

Marlene S. Gomez analyzes recent legislation and varying approaches to address environmental contamination left over from former methamphetamine laboratories. Click here to read.
Marlene S. Gomez

MERS' Standing to Foreclose Upheld in Rhode Island State Court Challenge
Jeffrey H. Gladstone and David J. Pellegrino

Separate Property v. Property of the Estate: Determination of Rights in Funds When a 1031 Intermediary Exchange Files Chapter 11
Katie Graves Williams

Congress Passes Tax Relief through 2010 for Solvent Debtors Holding Real Estate
Mark Stone

Join a Committee Today!

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

Would you like to write an article for the eReport?

If you have something to say, and would like your article

The Group is working on comments in response to the Treasury Department's proposed regulations governing supporting organizations. This project will focus on the proposed regulations' effectiveness and thoroughness in bringing clarity to the significant changes made to supporting organizations by the Pension Protection Act of 2006. Please contact any of our Group's leadership to become involved in this project. To read more on the Group, click here.

TRUST AND ESTATE

Litigation, Ethics and Malpractice Group
The Group concentrates its efforts on issues involving trust, estate and fiduciary litigation matters. To read more about this Group's activities, click here.

REAL PROPERTY

Hospitality, Timesharing and Common Interest Development Group
The Group continues its quarterly Hot Topics conference calls and education efforts. Click here to find out more information. Read more here.

The Special Investors and Investment Structure Group
The Group's focus this year is on providing value to its committee members. To this end, the Group has instituted several communication initiatives and has planned substantive conference calls and programs. Click here for more.

Young Lawyers Network

Get Published in Your Field

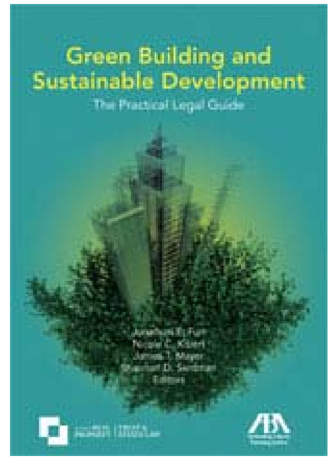
A great benefit to being a member of the Young Lawyers Network is the chance to be published and gain visibility in your field. You could be chosen to write a column for the RPTE Section's flagship magazine, *Probate & Property,* or the *eReport*. Click here for more information.

Law Students

Student liaison, Will Hudson, has posted a message on real estate law societies. For more click here.

considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

New Book from RPTE



Green Building and Sustainable Development: The Practical Legal Guide
Jonathan E. Furr, Nicole C. Kibert, James T. Mayer and Shannon D. Sentman

In today's legal and economic landscape, all development professionals -- including attorneys -- are realizing that they need to fully understand sustainable development and green building concepts, requirements, and policies in order to meet their clients' expectations and to operate successfully in the evolving economic and regulatory environment. **Green Building and Sustainable Development: The Practical Legal Guide** gives lawyers the necessary information to understand and assist their clients in establishing themselves as leaders in the area, helping them meet growing customer demand, take advantage of government incentive programs, enhance marketing opportunities, and lower operating expenses in anticipation of rising utility costs.

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

About RPTE eReport

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

ABA Defending Liberty Pursuing Justice

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

	Edward T. Brading	Yes
	Elizabeth C. Lee	Yes
Trust and Estate Division		
	David J. Dietrich	No
	Bernard V. Kearse	No
	Steven B. Gorin	Yes
	John W. Porter	No

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

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October 2009

Section News

Chair's Message

As I write my first *eReport* communication to our members for the new bar year, I realize that my challenge for the year will be to keep these messages short and concise. This is not because, as lawyers we always have a lot to say (or at least think we do!), but rather because the Section is engaged in so many significant activities. Thus, my goal with each of these bi-monthly updates will be to merely give you a glimpse of some of our current activities. To learn more about the many other things the leaders within your Section are doing, I encourage you to visit our robust website regularly at www.abanet.org/rpte.

Let me start by telling you a little about who your leaders are within the Section. As chair of the Section I am honored and privileged to have the support of an outstanding and dedicated staff, as well as a ten-member Executive Committee with over 150 years of RPTE experience. The Executive Committee is, in turn, supported by a Council of 30 members as well as 9 real property substantive groups, 43 real property substantive committees, 7 trust and estate groups and 26 trust and estate committees. We also have 13 standing committees, 5 task forces and many persons who serve as liaisons to various organizations. Most of these groups, committees and task forces have chairs and vice-chairs (and many, many members). Together, those dedicated volunteers constitute the leadership of the Section of Real Property, Trust and Estate Law. If you are not actively involved in the Section, you are missing the opportunity to work with many wonderful people who continue to stay on the cutting edge of developments in their respective practice areas. Getting involved in one or more of our committees is painless and the level of commitment is entirely your decision. Visit out website for more details on what these committees are doing and how you can get involved.

One very exciting thing that many of our committees are doing is holding periodic substantive and informative teleconferences. These are free and are presently open to members of the Section and those who are not. Eight such teleconferences are scheduled for October alone on subjects such as (1) Rev. Rul. 2009-25 (September 21, 2009) dealing with non-deductibility of interest on a loan to purchase insurance, (2) unique issues involved with the leasing of medical offices and facilities, (3) dealing with lenders in today's real estate climate, (4) estate planning for clients with chronic illnesses, and much more. These teleconferences are informal and interactive and are designed for the participants to learn, as well as to share their knowledge with others. Further details and dial-in instructions are available and regularly updated on the Section website.

Our website also includes many other timely and important resources. We have an "Economic Recovery Resource Web Portal" with materials on job searching, personal development and career transition. There are also links to "CLE Now!" which provide many complimentary CLE programs. We are well aware of the impact the current recession has had on our profession and our practices and these resources provide many useful tools for confronting these challenges. The website also includes information on the "Red Flag Rule." As you may know, the ABA has sued the Federal Trade Commission because the FTC sought to impose significant burdens on lawyers by classifying them as "creditors" who must then develop and implement plans to detect and respond to possible identity theft. Our website is also regularly updated to include recent government submissions and reports by our groups and committees.

As you can see from this brief snapshot, your Section is fully engaged and committed to providing outstanding materials and resources for all of its members. We welcome the opportunity to continue to serve you as well as for your continued or future involvement.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

eReport

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Section News

2009 RPTE/Taxation Joint Fall CLE Meeting

The Joint Fall CLE Meeting, held by the Trust and Estate Law Division of ABA RPTE Section and the ABA Section of Taxation was a success. This year's meeting took place in Chicago on September 24-26, 2008. At the meeting, the country's leading estate planning and tax lawyers and government officials discussed the latest federal tax policies, initiatives, regulations, legislative forecasts and planning ideas.

Meeting attendees had opportunities to network with leadership from the RPTE Section and the Section of Taxation. Also, the first time attendee dinner drew a large turnout.

The Saturday afternoon programs were very well attended:
"News from the Benches" panel discussed tax cases in each of the three fora, with hints for estate and gift practitioners.

"Unholy Matrimony: Tax & Planning Aspects of Divorce" had a panel discussion of tax planning and asset protection aspects of divorce and how to structure settlements to achieve the most advantageous tax consequences for the mutual benefit of both parties.

Section Nominations Committee

Pursuant to §6.1(f) of the Section Bylaws, the names of the Section's 2009-2010 Nominations Committee and the Section officer and council positions to be elected at the 2010 Section Annual Meeting are set forth below. Any Section member wishing to suggest a nomination should send the suggested nomination to one of the Nominations Committee members listed below.

Nominations Committee

Chair:	Kathleen M. Martin, Malkerson Gunn Martin LLP, Suite 1900, 220 S. 6th Street, Minneapolis, MN 55402, kmm@mgmllp.com
Vice-Chair:	Stephen R. Akers, Bessemer Trust, Suite 800, 300 Crescent Court, Dallas, TX 75201-1800, akers@bessemer.com
Members:	Gwendolyn C. Allen, Ballard Spahr, 1225 17th Street, Suite 2300, Denver, CO 80202-5535, alleng@ballardspahr.com
	Linda S. Whitton, Valparaiso University, School of Law, 656 S. Greenwich, Valparaiso, IN 46383-4945, linda.whitton@valpo.edu
	Christopher B. Hanback, Holland & Knight LLP, 2099 Pennsylvania Avenue NW, Suite 100, Washington, D.C. 2006-6801, christopher.hanback@hklaw.com

Positions to be Elected, August 2010

Office	Incumbent	Eligible for Re-nomination?
Officers		
Chair-Elect	Alan F. Rothschild, Jr.	No. Automatic ascension to
Section		
		Chair
Real Property Division		
Vice-Chair	Andrew F. Palmieri	Eligible to become Chair-Elect
Trust and Estate Division		
Vice-Chair	Tina H. Portuondo	Yes
Finance & Corporate Sponsorship Officer	Gideon Rothschild	No
Secretary	Susan G. Talley	Yes
Assistant Finance & Corporate Sponsorship Officer	Jo Ann Engelhardt	Eligible to become Finance & Corporate Sponsorship Officer
Section Delegate	Leopold Z. Sher	No
Council Members		
Real Property Division		
	Orlando Lucero	Yes
	Stephen R. Romine	Yes

	Edward T. Brading	Yes
	Elizabeth C. Lee	Yes
Trust and Estate Division		
	David J. Dietrich	No
	Bernard V. Kearse	No
	Steven B. Gorin	Yes
	John W. Porter	No

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Technology and Law Practice Management

Top Ten Twitter Tools

The June 2009 issue of *Law Practice* magazine asks "Are You Considering Twittering?". Increasingly, lawyers are saying yes. Twitter was originally created as a way to keep in touch with friends by answering the question, "What are you doing?" in 140 characters or less. In January 2009, however, the *ABA Journal* reported Twitter Becoming 'Incredibly Mainstream' for Blogging Lawyers, and followed with Much Chatter About Twitter in April 2009. As Twitter has increased in popularity, so have the number of tools available to increase its usefulness. The following tools are free and cross platform (Mac and Windows compatible) unless otherwise mentioned.

- Be Twittered (http://tinyurl.com/4cnb7g) is a Twitter application (gadget) for your iGoogle homepage. It shows recent posts from the people you follow and has a box where you Tweet. For mobile lawyers, there is Be Twittered Mobile for mobile devices and phones with "proper" web browsers like Internet Explorer, Opera and Safari.

- PowerTwitter (https://addons.mozilla.org/en-US/firefox/addon/9591) is a Firefox add-in that adds features to the Twitter Web interface. Power Twitter brings Twitter Search , located on a different subdomain, right into the Twitter site itself. It also de-mystifies those tiny urls with -url expansion and -url translation to page titles.

- TweetDeck (http://tweetdeck.com/beta/) bills itself as your personal browser for staying in touch with and connecting you with your contacts across Twitter, Facebook and more. TweetDeck is a standalone program that runs on Macs as well as PCs and allows you to customize your Twitter experience with columns, groups, saved searches and automatic updates to stay updated with your chosen people and topics.

- TweetGrid (http://www.tweetgrid.com) does not require a Twitter account to start. If you want to see what all the fuss is about, consider this application created by developer Chad Etzel. Unlike many other Twitter tools, you do not need a Twitter account to use TweetGrid. It allows you to create a dashboard to follow multiple conversations for multiple keywords in real time. Just open TweetGrid and choose a grid layout to get started. You will need a twitter account to tweet if you decide you want to join in.

- Tweet Law (http://www.tweetlaw.com), developed by Westin Consulting, LLC, is a Twitter application that improves the utility of Twitter for legal professionals. Create a free profile using your Twitter username and password and pick up to 4 categories that describe what you do. TweetLaw displays the tweets of its 470+ members and allows you to filter them based on over 30 categories.

- Tweet Scan (http://www.tweetscan.com) sends you an email when keywords you specify are mentioned on Twitter, and you do not have to have a Twitter account to use it. Tweet Scan makes narcisurfing easy by searching the "Twitterverse" to see when anyone mentions your name, firm name or other keywords. It then sends you the results via email or RSS for a $20 annual fee after the 30-day free trial.

- Twhirl(http://www.twhirl.org) **is a social software desktop client that allows** users to access Twitter accounts without a web browser. Twhirl enables you to **cross-post** your updates to Facebook, MySpace, LinkedIn and more. Other features include the ability to search **tweets** using Twitter Search and TweetScan*, and follow topics in ***near***-real time with **saved searches.**

- Twittelator (http://www.stone.com/Twittelator/Pro_versus_Lite_Features.html) by Stone Design is a twitter client for your iPhone/Touch. The Free Lite version is a popular, feature rich download that supports conversations and nearby search for tweeters. TwittelatorPro supports multiple accounts, sub groups of friends and high-resolution photo uploads. It retails for $4.99 but includes support and free upgrades for life.

- TwitterBerry (http://www.orangatame.com/products/twitterberry/) by Orangatame Software is a free BlackBerry mobile client for posting updates to Twitter. It works over the data network, so you don't need to use SMS. TwitPic (http://www.twitpic.com/), a picture sharing utility, is integrated into the application so you only have to snap a quick photo with your device, select that picture in your media file and choose "send with TwitterBerry."

- Twitterrific (http://iconfactory.com/software/twitterrific) is a Macintosh only Twitter client created by The Iconfactory. Features include the ability to manage multiple accounts, search and see trends, email tweets, link to individual tweets and filter the timeline so you can see only replies, direct messages or favorites. The free version is ad supported but $14.95 removes all advertising and supports future improvements.

Did we miss a great Twitter tool? Follow the Legal Technology Resource Center (LTRC) on Twitter at http://twitter.com/ltrc and let us know your favorites.

Additional Resources

- Twitter Alert: Be Careful Who You Follow - ABA Site-tation
- Lawyers and Twitter - ABA Site-tation
- Get Started with Twitter from the Legal Know How Wiki at LegallyMinded
- Twitter Resources The *ABA Journal April 2009*
- Tools on the Web to Let Twitter Sing by Robert J. Ambrogi for *Law Technology News*
- Marketing Your Practice in 140 Characters or Less by D. Todd Smith for *Texas Lawyer*
- Lawyers (and Legal Professionals) to Follow on Twitter Posted on September 9, 2008 by Adrian Lurssen
- Attorney Marketing on Twitter: Valuable or Waste of Time? Posted on June 5, 2009 by Cordell Parvin
- 22 Tweets - Real-time Twitter interviews with practicing lawyers who tweet by David Barrett, Boston business litigation attorney and author of the law blog "The Linkedin Lawyer"

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Committee Spotlight

The Charitable Planning and Organizations Group

The Charitable Group consists of three separate committees: Charitable Planning, Charitable Organizations, and Legislative and Regulatory Issues. The Charitable Group tends to operate more as a group than within our separate committees, because our committees overlap so much. We have group phone calls once a quarter, and we try to have an educational topic for the call - or sometimes several presentations. We post the call-in information and the agenda for the call on the group website, so it's good to check a week or two before the call to see whether it will be of interest.

The group has been active in presenting programs at both the RPTE Spring CLE meeting and the fall joint meeting with the Tax Section. We also have time to gather as a group at those meetings in order to talk about the other projects we are working on.

The group has written comments when the Treasury Department requests comments on proposed regulations. Usually a subcommittee within the group works on comments, gets input from group members, and then sends the comments to the leadership of the RPTE Section for approval. The Section then submits the comments to Treasury.

Group members write articles for *Probate & Property* and the *Real Property, Trust and Estate Law Journal* and we can post short articles on *eReport*, the electronic newsletter produced by the Section. http://www.abanet.org/rpte/publications/ereport/ In fact, *eReport* is a great way for a new member to get involved and have something published. Articles can be short, need not be heavily footnoted, and will be published relatively quickly (as compared with print publications).

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Group and Committee News

Litigation, Ethics and Malpractice Group

The Litigation, Ethics and Malpractice Group concentrates its efforts on issues involving trust, estate and fiduciary litigation matters. These issues include probate disputes, will and trust construction proceedings; fiduciary accountings; breach of fiduciary duty claims; and other disputed issues involving the disposition and administration of individual and charitable estates and trusts. In addition, the group addresses ethics concerns faced by trust and estate lawyers and malpractice issues (including malpractice avoidance) that may affect them. The group works to educate its members on recent developments and national trends in these areas. They do this through educational efforts such as CLE programs and articles. Where appropriate, the group assists other RPTE Section groups in analyzing litigation, ethics or malpractice issues as they may related to estate planning, administration or any other litigation or controversy matter germane to the Section's mission. Quarterly conference calls are listed on the Section Website (They are scheduled for January 13, April 14 and July 14, all at 1:30 EDT). The group urges it members to come to the Section's meetings, including the Spring Symposia (May 2010 in Philadelphia) and the Fall Joint Meeting with the Section on Taxation. In the coming year, the Group plans to continue to address ethical issues involving estates and trusts. One of the Spring 2010 Symposia programs will involve a hypothetical meeting of partners at a law firm confronting ethical dilemmas that often arise in estate administrations. The group will also seek to present an update on the ever-changing world of trust reformation and modification, recognizing that our clients sometimes encounter the need for relief from provisions of an otherwise irrevocable estate plan. Gerard Brew is the group Chair; Matt Matiasevich is group Vice-Chair; Steven Mignogna chairs the Litigation Committee; and Pat Char chairs the Ethics and Malpractice Committee.

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Group and Committee News

The Hospitality, Timesharing and Common Interest Development Group

The Hospitality, Timesharing and Common Interest Development Group continues its efforts to provide outstanding and detailed information concerning matters of interest for all RPTE members as well as Group members. The Group is comprised of three committees: Common Interest Ownership Development; Hotels, Resorts and Tourism; and Timesharing and Fractional Uses. The Group holds quarterly Hot Topics calls; the next one will be held in December, and further information will be posted on the Group's webpage - http://www.abanet.org/dch/committee.cfm?com=RP266000. The subject matter of these Hot Topics calls generally rotates among the committees. Recent topics have included HUD requirements for condominium project approval, distressed hotel projects, international fractional programs and interstate land sales cases and strategies. Upcoming topics will include continued discussions on the financing of common interest communities and the anatomy of condo-hotels and their future viability. Several articles have been published following the Group's CLE programs, and the Common Interest Ownership Development Committee is presently working to catalog the myriad case law concerning alleged violations of the Interstate Land Sales Full Disclosure Act. We welcome your ideas for programming or topics which need to be addressed by our Committees; please contact Jay Zschau, Group Chair (jayz@penningtonlawfirm.com) or Rob Freedman, Group Vice-Chair (rfreedman@carltonfields.com) with your thoughts and suggestions.

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Group and Committee News

The Special Investors and Investment Structure Group

The Special Investors and Investment Structure Group addresses specialized investments in real estate, including pension plan investments, insurance company investments and foreign investment in U.S. real estate. The Group also addresses specialized structures for investment and financing, including limited liability companies, partnerships, REITs, land trusts and real estate investment funds. To address these matters, the Special Investors and Investment Structure Group has seven committees: Partnerships and Limited Liability Companies, Pension Plan Investments, Life Insurance Company Investments, Land Trust, International Investment in Real Estate, Real Estate Investment Funds (in combination with the Pension Plan Investments Committee) and Federal Taxation of Real Estate.

The Group holds monthly leadership calls to coordinate our activities and is planning to launch a Group blog and a Group newsletter. The objective is to inform our members of timely issues in the investment field, publish articles written by our members and coordinate our presentations. We also encourage lawyers who may not yet be active in the Group or in the Section to join one of the Group's committees.

The Group also has an active calendar of substantive programs. We hold quarterly Hot Topics calls. The subject matter of these Hot Topics calls generally rotates among the committees. Recent topics have included the global financial crisis, and how the crisis has affected international investments in real estate. The next call is scheduled for Tuesday, October 27th, at 11:00 A.M. Eastern and is entitled "Levin Bill v. NCCUSL: The Lesser of the Two Evils?" Further information is already posted on the Group's webpage - http://www.abanet.org/dch/committee.cfm?com=RP289000.

The Group is already planning on its Group Program at the 2010 Spring Symposia, in Philadelphia. The Group's Partnerships and Limited Liability Companies Committee is working to put on a joint program with the Real Estate Financing Group and the Business Law Section on the General Growth case and its impact on SPE entities and securitized debt.

We welcome your ideas for programming or topics which need to be addressed by our Committees. Please contact Dennis Horn, Group Chair (dennis.horn@hklaw.com) or Luis Moreno, Group Vice-Chair (luis.moreno@haynesboone.com) with your thoughts and suggestions.

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Young Lawyers

YLN Writing Opportunities

Being published is one of the best ways to gain visibility among your colleagues and within your practice specialty. The RPTE Section offers a number of writing opportunities for young lawyers, including writing the YLN column for the *eReport* or *Probate & Property* and making contributions to the RPTE website. Please contact members of the YLN leadership for more information. Their contact details are below.

Elizabeth Lindsay-Ochoa, Chair
AXA Equitable
1290 Ave. of the Americas, 13th Floor
New York, NY 10104
Elizabeth.Ochoa@axa-equitable.com

Jasleen K. Anand, Co-Vice Chair
Law Office of Jasleen K. Anand
500 Old Country Road, Suite 316
Garden City , NY 11580
jasleen@jasleenanand.com

Rana H. Salti, Co-Vice Chair
Kinship Trust Company, LLC
400 Skokie Boulevard, Suite 300
Northbrook , Illinois 60062
rana.salti@kinshiptrustco.com

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Law Student News

As fall draws near, law students prepare for endless activities that will consume their time, including long nights studying, mid-terms, on-campus interviews, symposia and conferences. These activities take on a whole new meaning when forming a new student organization. No matter how much planning is involved, there is a moment where you wonder if others will take an interest in your vision. Adding to the anxiety is finding speakers who will bring much needed attention to your new organization.

This is exactly what happened to me when forming the West Virginia University Real Estate Law Society (RELS) this fall. RELS was created to bolster communications between real estate practitioners and students interested in the real estate field. Although starting RELS was extremely time consuming and stressful, having a first meeting where people actually attended, made the whole endeavor worthwhile.

If any one has any ideas or is interested in speaking to West Virginia Real Estate Law Society, please do not hesitate to contact me. Also, let me know if your law school has a similar real estate organization that would be interested in exchanging ideas, or if you are interested in forming a real estate law society at your law school.

Will Hudson,
West Virginia University College of Law
whudson3@mix.wvu.edu

Real Property Student Liaison and
President of the West Virginia University Real Estate Law Society

Split-Dollar Insurance and the Closely Held Business

By: Larry Brody, Esq., Richard Harris, CLU and Martin M. Shenkman, Esq.

Introduction

Split-dollar is a mechanism for owning and paying for life insurance that can provide considerable flexibility when planning for closely held businesses. Split-dollar arrangements can be used for a variety of business related purposes that can aid in succession planning for closely held businesses. For example, split-dollar can be used:

- As a means of providing compensation to a key employee. In the context of planning for the succession of a closely held business this can be used as a financial incentive to entice a key employee to continue to perform after the demise of the business founder.
- To fund certain buyout arrangements.
- For estate and succession planning purposes for the business owner.

Tax Framework for Business Split-Dollar

The general manner in which a split-dollar arrangement will be evaluated from a tax perspective will depend on the characterization of the capacity of the individual involved with the business.

- If the insured/employee is also a shareholder the determination as to whether the benefits the employee/shareholder/insured are receiving are in the context of being an employee or rather of being a shareholder, are fundamental to the determination of the tax consequences of the split-dollar arrangement.
- If the insured receives benefit in his or her capacity as an employee, that benefit will be taxed as compensation income.
- If he or she receives benefit in his or her capacity as a shareholder, that benefit will be treated as a distribution that might be taxed as a dividend, return of capital, etc. With the tax rate on dividend income presently at 20% and that on compensation nearly double, there can be substantial advantages to documenting the shareholder connection as predominant over the employee connection. See Rev. Rul. 79-50, 1979-1, CB 138. In one case the court rejected the conclusion that the benefits were taxed to an employee/shareholder as compensation. Johnson v. Comr., 74 T.C. 1316 (1980). The above tax relationships may change substantially when tax rates are increased and other changes made to address federal budget deficits.

Decisions to Make in Structuring Business Split-Dollar Arrangements

There are several broad categories of issues to address in structuring a business split-dollar arrangement: (1) premiums, (2) cash values, (2) death benefits, and (4) other issues. Each of these must be addressed.

With respect to the payment of insurance premiums there are a number of options. The employer/business can pay the entire insurance premium on the policy subject to the split-dollar arrangement. The employee/insured would then contribute nothing to the cost of the insurance coverage. Another option would be for the employee to pay the cost of term coverage for the insurance policy. If a permanent policy is involved this could be substantially less than the actual premium. These term costs are presently estimated using Table 2001 rates or qualifying alternative term rates. However, the Service may issue a different updated rate schedule in the future in which case that would be the means of calculating the payment. If the employee pays the 2001 term cost, the employer/business pays the balance of the premium cost. Another approach is for the employer/business to pay the premiums up to the amount of the increase in the cash value of the policy each year. Under this approach, which is not commonly used, the employer/business would pay a small portion in early years, but a growing portion as the cash value grows in later years.

Cash values and death benefits must be addressed in planning the split-dollar arrangement. The employer/business could be entitled to receive the greater of the premiums actually paid, or the cash surrender value of the policy. Another option is for the employer/business only to receive back the premiums advanced, and the employee/insured to receive the cash value in excess of this amount (this excess constitutes the “equity” in the policy).

Other contractual issues should also be addressed in structuring the split-dollar arrangement. Which party will have the authority to make the investment selection decisions if the policy is a variable policy? Which party will determine the amount of premiums to pay each year if a universal life insurance policy is involved? Which party pays the interest on any policy loans?

How Benefits under Business Split-Dollar Arrangements are Treated

The status and nature of the relationship of the individual involved in the split-dollar arrangement with the employer/business determines the income tax consequences. Unfortunately, while the categories are easy to identify, characterizing the relevant relationship in any actual situation can be subject to considerable uncertainty. The individual can be characterized as an employee. If, as an employee, the individual receives benefit under a split-dollar arrangement that benefit will generally be treated as compensation income. If the individual is characterized as a C corporation shareholder the benefit received under a split-dollar arrangement should be treated as a C corporation distribution. This will generally be taxed as a dividend to the extent that the corporation has earnings and profits. IRC Sec. 301(c); Treas. Reg. 1.66-22(d)(1). If the individual is characterized as an S Corporations shareholder the tax treatment will be similar to that of a C corporation shareholder, but there are important differences. Because S corporation shareholders report earnings of the S corporation on their personal tax returns as a result of the conduit nature of S corporation taxation, S corporation payments towards the split-dollar arrangement will effectively made with post-tax dollars. This negative, however, may not offset the estate planning benefits of using a split-dollar arrangement with an S corporation.

If the individual is characterized as a partner the tax treatment remains uncertain. There are no regulations for split dollar life insurance arrangements involving partnerships. The only mention is in Treasury Regulation §1.61-22(c)(1)(iv) indicates “Reserved”. One approach for the tax treatment of a partner receiving a benefit under a split-dollar arrangement, might be for that benefit to be treated as a guaranteed payment to the partner under the concepts of Rev. Rul. 91-26. The IRS has permitted a partnership to be a party to a split-dollar arrangement in which the insured is a partner, but not an employee, of the partnership. PLR 9204041 and PLR 9639053.

Finally, if the individual is a member of a limited liability company (“LLC”) there is even more uncertainty than for a partner. No rules have been provided for LLCs. The determination as to how an LLC member will be treated will not necessarily follow from the paradigm of how a partner should be treated even if rules governing partners are eventually issued. If the LLC member is a mere passive owner, the tax treatment might be as a partnership distribution. If the member is also active in the management of the LLC, or is also a manager, the treatment as a guaranteed payment analogous to a partner might be appropriate.

Endorsement and Collateral Assignment

There are two common forms of structuring the ownership of a split-dollar insurance arrangement: endorsement or collateral assignment. Each has potentially important implications to the consequences of the plan.

When an endorsement split-dollar arrangement is used in a business context the employer typically pays the premiums on a life insurance policy on the life of the employee. The employer/business owns the life insurance policy and endorses the excess death benefit (this is the amount of death benefit which exceeds the greater of the premiums paid or cash surrender value of the policy) to the employee’s designated beneficiary. An advantage of using the endorsement approach (in contrast to the collateral assignment approach discussed below) is that the endorsement approach enables the employer/business to retain control over the ownership of the insurance policy. A disadvantage to the use of the endorsement approach in the context of a closely held corporation is that incidents of ownership held by the corporation may be attributed back to a controlling shareholder, thereby triggering estate tax inclusion. Treas. Reg. Sec. 20-2042-1(c)(6). This refers to incidents of ownership in a policy in which the corporation has an interest under a split-dollar arrangement that is not payable to the corporation and for which the corporation is not the beneficiary. Similarly, it follows that if a partner controls a partnership that owns the policy under an endorsement arrangement, the proceeds could be included in the partner's estate. Rev. Rul. 83-147. Remember that regulations governing split-dollar life insurance arrangements with partnerships is "reserved".

Another approach to structuring the split-dollar arrangement is to use a collateral assignment. When a collateral assignment split-dollar arrangement is used in a business context the employee (or an irrevocable life insurance trust established by the employee) typically owns the policy. The employer pays for the policy and retains a security interest in the policy to protect its right to be repaid. This can be structured in one of three ways:

- Non-equity. The employer receives the greater of the premiums it paid on the policy, or the policy's cash surrender value.
- Equity. The employer receives the premiums it paid (if the cash surrender value is greater that excess over premiums paid inures to the benefit of the employee (or the employee's beneficiary).
- Loan. The employer is lending the employee premiums to pay for the policy with or without AFR interest..

A key advantage of a collateral assignment approach, in contrast to the endorsement approach above, is that the life insurance can be owned by an irrevocable life insurance trust ("ILIT") established by the employee. The use of an ILIT can facilitate the proceeds not being included in the employee's estate even if the employee is a controlling shareholder or partner of the employer/business involved. Another advantage of the collateral assignment as compare to the endorsement approach is that with a collateral assignment arrangement the policy is not owned by the employer entity and therefore should not be subject to the reach of the employer entity's creditors.

Despite the confusing language in the Regulations about collateral assignments being treated as loans under the loan regime, an economic benefit arrangement between an employer/employee will be treated as such even if the policy is collaterally assigned, if both parties to the arrangement consistently treat it as an economic benefit arrangement.

Pre-2003 Regulations Employee/Close Business Split-Dollar Arrangements

What happens to employee/employer split-dollar arrangements that pre-date the final 2003 Regulations? Employee split-dollar arrangements that were in existence prior to the September 18, 2003 effective date of the 2003 Regulations and were not materially modified thereafter are governed by Notice 2002-8. Under these rules, taxpayers could have elected on the policy anniversary after December 31, 2003 to apply a loan treatment, or if they did not, then the economic benefit treatment under Notice 2002-8 (not the 2003 Regulations) governs.

An economic benefit arrangement created prior to the 2003 Regulations may have been for an employee to own an insurance policy, and the employer to pay the premiums for the policy. The employer may have been assigned, pursuant to a collateral assignment agreement, an interest in the policy to secure the repayment of the premiums advanced. v If this arrangement is unwound (e.g., via a rollout to a loan arrangement) the transfer for value rules should be considered to avoid tainting the insurance proceeds as taxable. IRC Sec. 101(a)(2). This tax taint may be avoided, for example, if the transferee is the insured. Also, the repayment of the employer, and the release of the collateral assignment, should generally not constitute a transfer for value. Treas. Reg. Sec. 1.101-1(b)(4).

Alternatively, the pre-2003 Regulation arrangement could have been characterized as a loan, however this is more a theoretical matter since few if any were. With loan treatment was elected then interest is imputed under IRC Sec. 7872. If the imputed interest exceeded the actual interest the employee/insured paid, that excess was taxable as income to the employee.

Employee/Employer Economic Benefit Regime Post-2003 Regulations

The post 2003 Regulations’ economic benefit regime applies to all employer/employee non-equity split-dollar arrangements. These are arrangements in which the employee/insured does not share in the policy cash surrender value. It also applies to an all equity split-dollar arrangement if, for example, an employer owns the policy, and the employee shares in the policy cash surrender value.

When the employer owns the policy the “endorsement method” is typically used. This is the paradigm of the 2003 Regulations. With the endorsement method the employer as policy owner endorses over to the employee (or a beneficiary designated by the employee) the policy death benefit in excess of the premiums advanced by the employer.

Each year the employee, under an economic benefit regime, must include in taxable income as compensation the sum of the following:

- The value of the term insurance benefit provided by the employer. This is reduced by any premiums paid for by the employee. If the employee pays the Table 2001 amount, or the qualifying alternative term rate, for the insurance involved he or she will be deemed to have paid the full value of the term insurance benefit and thereby avoid any income imputation under this criteria.
- Any cash surrender value to which the employee had "access" (i.e., provided to the employee) during that tax year. The term "access" is broadly defined. If the employee has a current, or even future, right to the cash value of the policy, that is not available to the employer, or creditors of the employer, it could be deemed sufficient "access" to trigger current income taxation. If the employee can realize economic benefit from the cash value, by making a withdrawal, borrowing, using the policy as collateral, or surrendering part or all of the policy, the employee will be deemed to have access to the policy thus triggering taxation of the entire value, not merely the portion of the value that can be accessed.
- If the life insurance policy is transferred to the employee, the employee must recognize compensation income equal to the cash surrender value of the policy. This amount is reduced by amounts payable by the employee to the employer, or previously reported in income by the employee.

If the employee has a third party, such as an ILIT, own the policy, there will be a deemed indirect gift from the employee to the ILIT upon the employer's payment of the policy premiums. However, it is not the actual premium cost that constitutes the gift, but rather the measure of the insurance value under the Table 2001 (or the insurance company term rates if applicable) that is the measure of the gift. If the insurance trust benefits skip persons (e.g., grandchildren) then GST exemption would have to be allocated to the ILIT in order to assure that it remains GST exempt. The correct amount of exemption needed to keep the trust GST exempt is the Table 2001 calculated insurance amount (or the insurance company term rates if applicable). Tremendous GST leverage can be obtained using this mechanism. If the employee's health is such that the actual cost of the policy exceeds the Table 2001 rate this could provide a more valuable benefit to the employee as the Table 2001 rate could be substantially lower than the actual insurance cost.

If the employer corporation held rights in the policy that rose to the level of incidents of ownership, and the employee owned more than 50% of the voting stock in the corporation, the employee could be deemed to have held the incidents of ownership in the insurance policy causing estate tax inclusion. Treas.

Reg. Sec. 20.2042.1(c)(6). This can be avoided by using a restricted collateral assignment arrangement.

Corporation/Cross-Purchase Arrangement-Economic Benefit Regime

In a simple cross-purchase buyout arrangement, shareholder 1 buys life insurance on shareholder 2, and vice versa. Whichever shareholder dies first the surviving shareholder collects life insurance proceeds and is obligated under the buyout agreement to repurchase the shares of the deceased shareholder with those proceeds. If this common arrangement is structured with a split-dollar overlay, the corporation could pay for a substantial portion of the premiums on each shareholder's life, while retaining the right to recover the cumulative premiums paid. To implement this type of plan the shareholders would each execute an endorsement providing the corporation with the right to an interest in the policy each holds on the other shareholder equal to the greater of aggregate premiums paid or cash surrender value. If there are age and/or health differences between the insured employees/owners employing a split-dollar approach can provide a mechanism to make the purchase of the cross-purchase insurance policies more palatable. This issue can be avoided by having a partnership own the insurance, with one policy per insured.

The use of split-dollar to fund a cross-purchase agreement does have a special risk that needs to be addressed. Cross-purchase buyouts are simplest to use when there are only two shareholders of the corporation. In such cases, each shareholder owns a policy on the other, with both policies being subject to a split-dollar agreement with the corporation. If there are three shareholders, each shareholder needs to own a policy on the other two shareholders, so a total of six policies are needed. As the number of shareholders increases beyond two, the number of policies required to fund the cross-purchase buyout quickly becomes unwieldy. One approach to dealing with this dilemma that is sometimes used is to utilize a first-to-die insurance policy that pays on the death of the first of the participating shareholders to die. However, there are no rulings supporting the application of first to die insurance under a split-dollar arrangement. The only rulings pertain to survivorship insurance. PLR 974019.

Stock Redemption Funded with Reverse Split-Dollar

In a reverse split-dollar arrangement the shareholder/employee/insured would own the life insurance policy (or perhaps a trust for the employee's benefit) and the employer/corporation would receive the death benefit. The corporation would enter into a redemption agreement with the insured shareholder providing that in the event of his or her death the corporation would use the insurance proceeds (received under the reverse split-dollar agreement) to fund the repurchase or redemption of that shareholder's shares. Assuming the shareholder/employee/insured survived until retirement, the plan would be unwound. Following retirement, the corporation would no longer require the use of the death benefit for key man coverage so that the corporation could relinquish its rights in the policy. In this context some corporations have tried to use an artificially high (rather than a low) term rate. The use of as higher rate could, if successful, would permit the corporation to effectively fund a large cash value in the policy that following retirement would inure to the benefit of the employee/insured. The IRS responded with Notice 2002-59 expressing its disapproval with these types of abuses.

S Corporations/Family Trust-Economic Benefit Regime

S Corporations present special split-dollar considerations. An S corporation shareholder/employee a split-dollar agreement provides no income tax benefit since any premiums paid for by the S corporation are paid with the shareholders' after-tax dollars because of the conduit nature of an S Corporation. However, a split-dollar arrangement within an S corporation can still provide gift and estate planning benefits, as illustrated below.

The more significant concern in structuring split-dollar arrangements with an S corporation is not violating the single class of stock requirement that could jeopardize S corporation status. S corporations are only permitted to have one class of stock. IRC Sec.1361(b)(1)(D). If the split-dollar arrangement results in dividend treatment to one shareholder, and there are two or more shareholders, the arrangement could be treated as a second class of stock thereby disqualifying the corporation from “S” status.

When properly structured this issue can be avoided. See PLR 200914019. In this Ruling the split-dollar arrangement between the S corporation and the third party trust required each to contribute an amount, each tax year, equal to the economic benefit generated by the coverage provided under the plan. Under this paradigm, the trust paid its fair share as did the S corporation. Thus, under the split-dollar construct no incremental economic benefit could have inured to the particular shareholder from this arrangement. So the single class of stock status was protected, and the amount the trust had to pay was significantly lower than the entire premium would have been without this arrangement. If the S corporation shareholder who is a party to the split-dollar arrangement pays for the entire economic benefit received in any tax year, this issue may be obviated. PLR 9331009, 9413023, 9651017.

When the agreements were between the S corporation and life insurance trusts created by its shareholders, and the trusts (or the trust grantors) or the beneficiaries were required to reimburse the S corporation to the extent of the economic benefit to the trusts, no second class of stock was found to exist. PLRs 9709027 and 9735006. If the shareholder/employee’s policy is owned by a trust so that the life insurance proceeds would not be included in the shareholder/employee’s estate, the transfer of the funds necessary to pay the annual premium to the trust by the shareholder/employee/insured would generate a taxable gift if in excess of the annual gift exclusion. The S corporation split-dollar arrangement could substantially reduce or eliminate that potentially negative gift tax consequence.

In a closely held business organized as an S corporation a split-dollar arrangement can be used to fund insurance for succession planning and estate tax purposes. This can be illustrated in an example.

Example. Mother and Father own the stock in a family business organized as an S corporation and both are employees (if not, the arrangement illustrated will have a different result). They have utilized their lifetime $1 million gift exclusion. Assume further, that the annual premium for a $12 million survivorship policy is $94,000/year. There would be a substantial gift tax cost incurred for them to make cash gifts to an irrevocable life insurance trust (“ILIT”) to pay for the premiums. Instead the ILIT and Corporation enter into a non-equity split-dollar arrangement. Pursuant to this arrangement, on termination, Corporation will receive the greater of the aggregate premiums paid or the policy cash surrender value. Although Corporation does not own the policy, this arrangement is taxed under the economic benefit paradigm of the 2003 Regulations. The payment of the insurance policy premiums in this example consists of two components: Corporation pays for the value of a joint and survivor term insurance policy under Table 2001 that is about $850.00. This amount is treated as taxable income to Mother and Father, perhaps as a dividend distribution from Corporation. Then this amount would be a deemed gift by Mother and Father to the ILIT. Corporation pays the balance of the premium $93,250, to the ILIT directly as an investment in the policy. Because the corporation is entitled to receive back the premiums paid or cash value in the policy, there is no indirect gift to the ILIT by the Mother or Father as a result of this payment.

Corporation/Family Trust-Loan Regime

In a closely held business organized as a corporation a split-dollar loan arrangement can be used to fund insurance for succession planning and estate tax purposes (compare to the example above of the application of the economic benefit regime to a family succession planning situation).

Example. Mother owns the stock in a family business organized as a corporation. Mother has utilized all of her lifetime $1 million gift exclusion so further taxable gifts would generate a significant gift tax. Assume further, that the annual premium for a $10 million insurance policy is $200,000/year. There would be a substantial gift tax cost incurred for her to make cash gifts to an irrevocable life insurance trust (“ILIT”) to pay for the premiums. Instead the ILIT and the Corporation enter into a loan split-dollar arrangement. Pursuant to this arrangement, the premium payments by the Corporation to/for the benefit of the ILIT will be for a 12 year term. The applicable federal long term interest rate applies. Assume that the applicable federal rate is 5%. Interest will be due the first year is $10,000 ($200,000 x 5%). If Mother gifts the $10,000 to the ILIT which in turn pays it to the corporation, the transaction will be disregarded and treated as an interest-free loan. If instead Mother makes gifts to the ILIT over the course of the year of varying amounts, and the ILIT uses $10,000 of those gifts to pay the interest due to the corporation, that arguably, according to some practitioners, should not trigger the same consequences. However, there is no authority for this conclusion.

Key Employee/Employer Loan Regime Post-2003 Regulations

If a key employee owns the life insurance policy that is subject to a split-dollar arrangement, and the employer pays for any portion of the premiums on the policy, and the arrangement is not an economic benefit arrangement, the loan regime will govern. As the premiums (or a portion of them) are paid by the employer, they will be treated as a series of loans to the employee. These loans will be tested under the below market loan rules to determine if the interest charged is adequate. There is no de minimus exception for the imputation of interest under these rules. If the employee is either not obligated to repay the premiums advanced by the employer, or this obligation is terminated, the amount forgiven must be treated as compensation income to the employee. This might be a hybrid loan under IRC Sec. 7872.

Code Section 409A and Split-Dollar

Code Section 409A was enacted in 2004 to provide strict rules governing nonqualified deferred compensation. Generally, if the requirements of Code Section 409A are not satisfied any compensation otherwise deferred will be taxable to the participant if not subject to a substantial risk of forfeiture. Split-dollar life insurance arrangements are not subject to the reach of Code Section 409A if:

- They only provide death benefits for an employee. Notice 2007-34
- Loan split-dollar arrangements if there is no agreement for the employer to forgive the loan. However, if there is an arrangement to forgive the loan, Notice 2007-34 provides that the split dollar loan can be subject to Code Section 409A. Note that the proposed Regulations provide that the corporation can continue to advance premiums without charging a market rate of interest.
- Split-dollar arrangements wherein the employer owns the policy and endorses a portion of the death proceeds in excess of the premiums advanced to the employee (the "endorsement method) may be subject to Code Section 409A if the employee has a legally enforceable right to

compensation that will be included in the employee's income in a tax year after the substantial risk of forfeiture lapses.

- Modifications of a pre-2003 Regulation split-dollar arrangement to comply with Code Section 409A may not constitute a material modification that would subject an otherwise grandfathered arrangement to the 2003 Regulations.

In most split-dollar situations the employer entity is a beneficiary of the life insurance policy subject to the split-dollar arrangement. Therefore, the employer entity is generally not entitled to an income tax deduction for the portion of premiums it pays on the policy. This result occurs even if the employee has to report some portion of the payments as income. IRC Sec. 264(a); Rev. Rul. 64-328.

Split-Dollar and Corporate Owned Life Insurance and Code Section 101(j)

Business owned life insurance contracts issued after August 17, 2006 must meet certain requirements to exclude the proceeds of an employer-owned life insurance contract from income. Employer-owned life insurance is a policy of life insurance on the life of certain employees that are owned by the employer (or a party related to the employer). An "employee" includes an officer, director, and highly compensated employee. See IRC Sec. 414(q). The employer (or the related party) is directly or indirectly, a beneficiary.

The IRC Sec. 101(j) rules are not applicable if the individual employee involved is not a U.S. citizen or resident. The rules affect businesses that enter into redemption agreements (where the business itself buys the interest of a former owner) and purchase insurance on the owners' lives to fund its obligation under the agreement. If the 101(j) requirements for tax free treatment are not met only that portion of the life insurance proceeds from an employer-owned life insurance policy equal to premiums and other amounts paid for the policy can be excluded from income. Proceeds above this amount are taxable. If the IRC Sec. 101(j) requirements are met, then the entire proceeds from the employer-owned life insurance will be excluded from income.

The employee must be notified in writing of the employer's plans to insure the employee's life and of the maximum face value of the policy's when it is issued. The employee must be informed in writing that the employer will be a beneficiary of any death proceeds. The employee must consent in writing to be insured, and to the coverage continuing after termination of the employment arrangement. A statement on Form 8925 "Report of Employer-owned Life Insurance Contracts" must be filed with the income tax return for each year that policies subject to IRC Sec. 101(j) are owned. IRC Sec. 6039I(a). This filing must report the total number of employees at the end of the year, the number of employees insured under employer-owned life insurance ("EOLI"), the face amount of life insurance in force under EOLI contracts at the end of the year, the name, address, and taxpayer identification number of the policyholder, the type of business of the policyholder, and a statement that the business has a valid consent for each insured employee, or the number of insured employees for which the proper consent has not been obtained.

If the notices and consents are provided, the death benefit will not be taxable if the insured was an employee at any time during the 12-month period before his or her death. At the time the contract was issued, the employee was a director, a highly compensated employee under IRC Sec. 414(q), or a highly compensated individual under IRC Sec. 105(h)(5) (except that 35% under IRC Sec. 105(h)(5)(C)).

If the notice and consent requirements are complied with, the life insurance proceeds will be tax free if it is paid to a member of the insured's family, any individual other than the employer (or a related party to the employer) who is the designated beneficiary of the policy, the estate of the insured, or a trust established for the benefit of a family member. It is also tax free if it is used to purchase equity in the employer from a family member, estate, or trust.

Mere administrative changes won't cause an insurance policy issued prior to the effective date to be subject to the IRC Sec. 101((j) rules. Unfortunately, there is little latitude in what is considered administrative (e.g.,, changes from a general to a separate account). A policy issued after August 17, 2006 as a result of a Section 1035 exchange for a policy issued on or before that date is not considered a material modification.

Employer-owned life insurance ("EOLI") is subject to stringent rules for death benefit proceeds payable to the entity. The overlay of a split-dollar regime on the insurance does not necessarily avoid the applicability of the EOLI rules. A split-dollar arrangement may provide that if the employee dies while the split-dollar agreement is in effect the employer will be repaid the premiums advanced or cash value. This payment of a portion of insurance proceeds might be subject to the IRC Sec. 101(j) rules, although, it is not fully clear that this situation is intended to be covered by EOLI.

If any one of the following requirements are met the corporation can avoid the taxable income re-characterization of 101(j):

- The insured had to be an employee of the corporation during the 12 month period prior to death.
- The insured was a highly compensated employee or director when the insurance contract was issued.
- The insurance proceeds are payable to the insured's family, a designated beneficiary of the insured, a trust for the benefit of the family of the insured, or to the insured's estate. In a split-dollar arrangement a portion of the proceeds are in fact payable to the insured's family, etc. However, a portion is also payable to the employer so that it would appear that this could be at most a partial exclusion. However, if the portion payable to the employer only equals the premiums paid the issues sought to be addressed by IRC Sec. 101(j) don't seem to be applicable to a split-dollar arrangement. However, what if the employer receives the cash surrender value which exceeds the amount of premiums paid? This could be viewed as insurance proceeds under a IRC Sec. 101(j) paradigm.
- The proceeds are part of a buyout used to purchase the equity interests of the insured's estate, a family member or trust.

Income Tax Treatment of Employee

Employees are generally taxed, as compensation income, on the value of what would be current term life insurance protection in the amount of coverage provided, to the extent that value exceeds payments made by the employee. Rev. Rul 64-328; Rev. Rul. 66-110.

The measure of this value that is taxable to the employee was determined:

- Pre-2001 using the PS 58 table rates, Rev. Rul 55-747, or the insurance company rates for a standard risk one year term policy if lower.
- 2001 and forward Table 2001 rates had to be used instead of the PS 58 rates or lower insurance company rates for new arrangements or materially modified existing ones.
- In 2002 Notice 2002-8 was issued which provided rules for determining the value to an employee. Under this paradigm the employer/employee can treat the insurance arrangement as either a loan to the employee or an economic benefit to the employee. If loan treatment is used then the tax consequences of a low or below market interest loan may apply. Below market interest loans are addressed in IRC Sec. 7872. If economic benefit regime is chosen the employee treats the value of the term insurance coverage generally determined under Table 2001, or qualifying alternative

term rates, in excess of any payments, as income in the year of payment and the value of any cash surrender value of the policy as income in the year it becomes available to the employee.

- Post-2003 Regulations, the provisions in the Regulations should be used to determine the amount taxable to the employee. These rules generally apply to policies issued after September 17, 2003, or policies issued earlier that were materially modified.

Payroll Tax Treatment of Split-Dollar Arrangements

To the extent that a split-dollar arrangement results in taxable compensation income to an employee that amount is also subject to federal withholding tax. Rev. Rul. 64-328; Rev. Rul 66-110. The compensation component is not subject to FICA or FUTA taxes. IRC Sec. 3121(a)(2)(C).

Conclusion

Split-dollar arrangements can offer a valuable planning technique to address a number of different aspects of succession planning for the closely held business. Creatively applied split-dollar can address gift tax issues, asset protection concerns, provide a means of motivating a key employee and more. There are a range of complications and ancillary issues to address in this type of planning including transfer tax issues, income and payroll tax issues, and more.

There has been a small flurry of attention in the media recently addressing the disposition at death of so-called "digital assets" (i.e, email accounts, social networking profiles, webpages, blogs and domain names). Despite this clamor, most estate planners still do not address the disposition of a client's digital assets in the estate planning process. Wrong move.

<u>The Disposition of Digital Assets: Estate Planning Potential NOT Just Propaganda</u>

Karin Prangley, Attorney
Krasnow Saunders Cornblath, LLP Chicago, Illinois

Many estate planning attorneys would be surprised to learn the value (both emotional and monetary) of certain "digital assets" such as email accounts, websites, social networking profiles, online store credits and other digital media.

For example, when a family member who operated a small business suffered a stroke earlier this year, I learned first-hand how valuable his email account was to his business. He maintained contact with his customers and suppliers solely through email, and when his family and business partners could not access his email account during his disability, a significant amount of business was lost. The sophisticated business succession plan that his estate planning attorney had created did not help to resolve that problem.

When we contacted the internet service provider, we still did not get the information we needed. Many internet service providers (such as Yahoo) will refuse to share an individual's password absent a court order. This policy is understandable in light of the stringent privacy laws imposed on such companies. Other internet service providers such as Gmail (Google) require a copy of a death certificate prior to turning over a decedent's email password. But even these less stringent procedures can lead to an unnecessary and costly delay.

As more and more people move the important components of their lives onto the computer, it becomes necessary to devise a safe and secure method for a person's loved ones to access digital information in the event of death or disability. This we know, we've heard it all before. Despite these warnings, it appears that most estate planners are doing little or nothing to address the disposition of digital assets with their clients. Perhaps because estate planners don't believe there is yet a fail-safe solution to this problem. I've heard several concerns discussed by estate planners. Easy solutions like giving passwords and other digital information to a trusted individual have their obvious shortcomings – the information could be (even accidentally) misappropriated or misplaced. I have heard several estate planners express reluctance to hold the client's passwords themselves, believing that doing so could expose the estate planning attorney to undeserved blame in the event that information is stolen or misappropriated by a third party. It also appears that many estate planners shun the use of paid service providers such as legacylocker.com and assetlock.net (formerly known as youdeparted.com) that store passwords and other digital information online for a small fee, perhaps because they are not yet confident that these sites appropriately safeguard the information.

While there may be no perfect solution to this problem, for many individuals, especially those that are technologically oriented, doing nothing is the least perfect solution of all. The true monetary cost of doing nothing may only be that a few thousand dollars of online store credits, pay pal monies and similar value is lost forever. However, the much greater cost may be that many of the decedent's precious memories (e.g., photos, email messages and social networking profiles) are inaccessible to those left behind. Even worse, as my family recently discovered, the cost of failing to address a client's digital assets may be devastating for a small or family owned business.

There may be no way to know if your client is a "techie" unless you address the topic directly with the client. If it becomes clear that the client prefers to keep all his or her important information off-line and insists that he has no digital assets of value, then the conversation can end there. However, if many of the important elements of the client's financial and personal life reside online, then the client deserves some guidance. Perhaps the client is married and would feel comfortable creating a list of his passwords for his spouse. Even better, the client and the attorney may find (as I have) that some websites that store passwords and other digital information have state-of-the-art security and can effectively make relevant information quickly and readily accessible to trusted persons in the event of death or disability.

Just as the estate planner would not hesitate to address a complicated generation-skipping transfer tax problem staring him in the face (and may be liable for malpractice for failing to do so), he should also not hesitate to find an appropriate method for the client to dispose of his valuable digital assets at the time of this death. After all, many everyday estate planning techniques such as GRATs and sales to grantor trusts have inherent risks and are not perfect solutions to the tax problems faced by clients. But estate planners nonetheless readily employ these techniques to assist their clients. I am not suggesting that estate planners recommend that clients post their passwords on a billboard or engage in any other unnecessarily risky technique. However, many viable options are available for disposing of digital information in the event of death or disability that do not place the client in an inordinate amount of danger.

As with many problems created by advances in technology, further technological developments may come along to provide a perfect solution to this problem. While we wait for these developments, the best solution for now may be to have an open and honest discussion with your client about the solutions available, rather than remaining silent on the issue, and to encourage the client to select the most appropriate method for storing digital information.

FINAL IRC SECTION 2053 REGULATIONS

By Jim Roberts[1]
Glast, Phillips & Murray, PC.
Dallas, Texas

Effective October 20, 2009, the Internal Revenue Service issued and finalized regulations determining the amount deductible from a deceased individual's gross estate for claims against the estate under Section 2053.[2] These regulations were first proposed in April of 2007.[3] The fundamental issue addressed by the proposed regulations, and now these final regulations, is whether post-death events can be taken into account in evaluating and deducting claims made against the estate. In short, claims have to be paid before they can be deducted, and protective claims for refund have to be filed to make sure refunds can be gotten once the claims are actually paid. The final regulations are 1/3rd longer than the proposed regulation, with the added text being much needed clarifications and amplification.

Snapshot Date of De ath vs. Post-Death Developments. The primary debate over these regulations had been over the issue of whether claims should be treated like assets, which are valued as of the date of death. Assets are appraised. They may ultimately sell for more or less, but post-death events are not taken into account in their valuation (except for the alternative evaluation date). Many courts have followed that approach in dealing with claims.

In 1929, in the *Ithaca Trust* case[4], Justice Holmes, writing for the court, determined that the date of death was the appropriate point in time for evaluating claims against the estate. In that case, the decedent left a life interest to one person, and the remainder interest to a charity. The life interest owner's death was premature, and the issue was whether the life expectancy of the life tenant, as of the original decedent's death, should inform the value of the charitable remainder interest, or whether the untimely death should be taken into account. The court rejected the latter and adopted the former approach.

Since *Ithaca Trust* was decided, the Circuits have split on which approach to take. The Fifth Circuit, in the 1999 *Algerine Smith* case[5], the Ninth Circuit, in the 1971 *Propstra*[6] and 1983 *Van Horne*[7] cases, the Tenth Circuit in the 2001 *McMorris* case[8], and the Eleventh Circuit in the 1999 *O'Neal* case[9], have followed the *Ithaca Trust* approach.

Following the opposite approach and incorporating post-death events have been the Eighth Circuit decisions in the *Jacobs*[10] and in the *Sachs*[11] case, and also in a 44-year-old decision out of the Fifth Circuit in the *Shedd*[12]case. Another decision following this path is the *Cafaro*[13] case from the Tax Court out of Illinois (Seventh Circuit). But see the Tax Court's decision in the *May*[14] case, a 1947 decision out of Pennsylvania (Third Circuit) using a date-of-death approach.

The split among the Circuits was a problem, but it was not the whole problem. Going deeper reveals unevenness in the handling of Section 2053, especially where contingent and immature claims exist. Drill down into Tax Court and district court decisions and you will find that they stir the mix with a variety of different interpretations of the subsets of issues within the main categories laid out by Section 2053.

Based on that background of conflicting and confusing cases, Treasury and the Internal Revenue Service attempted to bring order and uniformity across the different Circuits. Rather than following the majority of the Circuits, instead Treasury opted to follow the minority view. And thus in the final regulations the fundamental rule that will be that claims may be deducted when they are actually paid.

Exceptions. There are some important exceptions prompted by Treasury's careful consideration of the comments to the proposed regulations. In the final rules, Treasury has attempted to deal with practical issues and difficulties. For example, while most claims are deductible when paid, the new rules contain an exception for claims against the estate that do not exceed $500,000 in the aggregate. As for those claims, the date-of-death snapshot rule applies, provided that the claims are valued by a qualified appraiser who produces a qualified appraisal of the claims.

Another major concern expressed by many commentators was the disconnect in situations where the estate might be in a lawsuit where there were claims and counterclaims. In the proposed regulations, claims against the estate would not be deductible until paid, but the claims by the estate by the other side would have to be valued at date of death and tax paid on them. In this regard, Treasury changed its mind. The final regulations provide that the current value of a claim against the estate with respect to which there is one or more substantially related claims or integrally related assets that are included in a decedent's gross estate may be deducted, provided that the related claim or asset constitutes at least 10% of the decedent's gross estate. Again, there must be a qualified appraisal performed by a qualified appraiser.

Protective Claims for Refund. An important and integral part of these regulations is the ability of the taxpayer to file a protective claim for refund to cover the claims that are pending but not paid by the time the 706 and tax are due.

Change in Dealing with Family Members. Also, Treasury appears to have taken to heart the criticism of its proposed rebuttable presumption that claims by, or settlements among, certain related individuals and entities are not legitimate and bona fide and, therefore, not deductible. Treasury has removed the presumption from the final regulations and, instead, has continued to include the generally applicable requirement that any claim or expense must be bona fide in nature. It has added a paragraph that provides a non-exclusive list of factors indicative of (but not necessarily determinative of) the bona fide nature of a claim or expense involving a family member, related entity or a beneficiary of the estate.

Clarification. Treasury has been careful in the final regulations to make clear that the regulations dealing with claims do not affect mortgages, which are the subject of existing regulations. It cross-references the existing regulations on mortgages and clears up perceived confusion on the latter. And language in the original regulations essentially saying "the executor may" has been removed so that the regulations can be applied to trustees and others who may be filing the estate tax return or dealing with issues of deductibility.

Court Orders. Executors can rely on court orders regarding the payment of amounts if the court addressed the merits of the claim, and, if the court did, the regulations presume an active and genuine contest, and the claim has been or *will be* paid. The final regulations removed the language in the proposed regulations which appeared to have given the Service the ability to second guess the court's decision[15]. Revised and helpful language related to consent decrees and settlements has been added. And the final regulations add language that clarifies the ability of an executor to take deductions that are otherwise permissible where the executor is in a state in which the obtaining of court orders is difficult or impossible.

Examples. Treasury has added more examples. Most notable is the one dealing with a claim by a family member. It spotlights a claim by a niece who is a CPA performing accounting services for her uncle. If the charges are the normal types of charges incurred in the ordinary course of business, they are deductible. A list of factors relevant to the example is given to show how the factors in the regulations would be applied.

Reimbursements. The section on reimbursements has been expanded from a one-liner to an expansive paragraph explaining how the possibility of insurance coverage or other reimbursement works. The original language could have been read to say that no deduction would be available if any reimbursement "could" exist. The added language clarifies that a partial deduction still may be allowed if the executor can establish only partial coverage. And the new language clarified that the executor can show that the reimbursement is not collectible or otherwise worthy of pursuit.

Ascertainable Amounts. The regulations have re-titled the former section denominated “estimated amounts” to “ascertainable amounts,” adds an embedded example and expands the guidance on what is or is not ascertainable. It also removes the duty imposed on the executor to notify the Service if an amount is claimed but later not paid.

Protective Claim for Refund. The proposed regulations talked about filing a protective claim for refund where a deduction for a claim was not allowable, but provided no guidance on what a protective claim for refund should say or when it would be processed by the Service. The new language sheds some light on those issues.

Charitable and Marital Deductions. The final regulations add language addressing charitable and marital deductions. If they might be affected by the size of a claim, the claim is still valued and deducted (or not) under the other rules, and if there is no deduction, the estate gets the charitable or marital deduction in full. Once the claim is finally settled and paid, then an adjustment to the charitable and marital deductions will be made. And an example has been added to show how the rule works.

Executor Commissions and Attorney’s Fees. The section on commissions has been rewritten to cross-reference another regulation and to add language addressing compensation when the will sets a standard that is different from the state law default rule. The proposed regulation on attorney’s fees was modified to shorten it considerably, removing troublesome language about what would happen on audit, and discussing the filing of a protective claim for refund.

Expenses. Additional language has been added to modify some provisions of existing regulations that the proposed regulations had not addressed. And the proposed provisions related to costs of defending claims were carried forward, without the sentence, "Expenses incurred merely for the purposed of unreasonable extending the time for payment, or incurred other than in good faith, are not deductible." Several commentators had objected to that.

Other Provisions. A number of other provisions in the proposed regulations have been carried forward, some without significant change and some in ways that may not have broad impact. The reader is directed to the regulations themselves for further detail.

Criticism. The final regulations are already drawing severe criticism. In a commentary in Tax Notes Today written by Sam Young[16], Robin Klomparens and Douglas Youmans "provided a long list of what they see as flaws in the final regulations and even questioned their legality." The regulations "are contrary to express statutory language, they do not interplay well with the estate tax provisions of the Internal Revenue Code, and they are unreasonable, arbitrary and capricious." In the same article, Kenneth H. Ryesky, a former IRS attorney, now a professor at the Queens College of the City University of New York, said that the final regulations address some of the concerns expressed in comments and that "the IRS and the Treasury are to be thanked and applauded for the deliberation and effort behind the new regulations, and the dispatch with which this project was handled."

Ronald Aucutt, a partner with McGuire Woods of McLean, Virginia, probably has the best ultimate description of the new regulations. He is quoted in the Daily Tax Report[17] published by BNA, as saying, "this is an area where it is very difficult to achieve fundamental fairness." Situations may occur where the estate tax may be overpaid or underpaid. Mr. Aucutt said there was "no perfect solutions," but that the proposed rules were a good approach at "rough justice."

Conclusion. Without regard to whether the regulations will withstand any test, in the interim they certainly change how claims will have to be handled. At a minimum, the time for administration of estates will be extended until all of the protective claims for refund are determined. That factor may force changes in the handling of claims unrelated to the tax issues simply to avoid that prolonged window of time. The ultimate chapter on this area of the law certainly has not yet been written. Quoting a phrase often used by my estate tax professor in law school, "stay tuned."

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[1] James V. Roberts is board certified in Texas as an estate planning attorney. Jim is the Co-Vice-Chair of the Estate & Gift Tax Committee in the Income and Transfer Tax Planning Group inside the Real Property, Trusts and Estates Section of the ABA, sits on the standing CLE Committee, is an associate editor of eReprt and assists in producing eCLE for the Section. Jim Roberts is also the outgoing chair of the Estate & Gift Tax Committee of the Tax Section of the State Bar of Texas, and sits on Council for the Tax Section of the Dallas Bar Association. With regard to Section 2053 and these regulations, Jim spoke about the proposed regulations as part of the Hot Topics Roundtable at the 2007 Spring Symposium in Washington, DC, and worked with others to prepare the Section's comments to Treasury on those regulations.

[2] T.D. 9468, 74 FR 53652

[3] IRS REG-143316-03, 72 FR 20080

[4] *Ithaca Trust v. Commissioner*, 27 US 151, 157 [7 AFTR 8856] (1929)

[5] *Algerine Smith v. Commissioner*, 198 F.3d 515, 84 AFTR 2d 99-7393 (1999)

[6] *Propstra v. United States*, 680 F.2d 1248, 50 AFTR 2d 82-6153, 82-2 USTC P 13475 (9th Cir. 1971)

[7] *Estate of Van Horne v. Commissioner*, 720 F.2d 1114, 53 AFTR 2d 84-1549, 83-2 USTC P 13548 (9th Cir. 1983)

[8] *Estate of McMorris v. Commissioner*, 243 F.3d 1254, 87 AFTR 2d 2001-1310 (10th Cir. 2001)

[9] *O'Neal v. United States*, 258 F.3d 1265, 88 AFTR 2d 2001-5248 (11th Cir. 2001)

[10] *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 US 603 (1929)

[11] *Estate of Sachs v. Commissioner*, 856 F.2d 1158, 62 A.F.T.R.2d 88-6000, 88-2 USTC P 13,781 (8th Cir. 1988)

[12] *Estate of Shedd v. Commissioner*, 320 F.2d 638, 12 AFTR 2d 6221 (9th Cir. 1963)

[13] *Estate of Cafaro v. Commissioner*, TC Memo 1989-348, PH TCM P 89348, 57 CCH TCM 1002

[14] *Estate of May v. Commissioner*, 8 TC 1099 (1947)

[15] For example, in the proposed regulations, Treasury used language such as "the [settlement] is within the reasonable range of outcomes under applicable state law governing the issues resolved by the [settlement]." That language has been removed.

[16] 2009 TNT 200-2

[17] October 19, 2009, issue

Estate of Malkin v. Commissioner, T.C. Memo. 2009-212 (September 16, 2009)

IRS Defeats Aggressive FLP Planning; Issues Involving §2036, Indirect Gifts, and Sham Sales and Loans

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Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Synopsis

The case involves the creation of and sales of interests in two different FLPs to two different sets of trusts for decedent's son and daughter. Decedent was the sole general partner of both FLPs. The decedent contributed about $16.8 million worth of "D&PL" shares to the first FLP ("MFLP"). After the partnership was funded and limited partnership interests were sold to trusts for the children, decedent was diagnosed with pancreatic cancer. About one year after funding the FLP, the partnership pledged almost all of its assets toward a personal debt of decedent, and decedent paid a small fee to the partnership (0.75%) for doing so. Those shares were included in the estate under §2036; the pledging was evidence of an implied agreement of retained enjoyment, and the purported non-tax purposes did not meet the bona fide sale exception to §2036.

Contributions of some D&PL stock and various LLC interests to the second FLP ("CRFLP") were also subjected to transfer tax without a partnership level discount. The D&PL shares were contributed subject to a personal liability of decedent, and that evidenced an implied agreement of retained enjoyment under §2036. Contributions of decedent's interests in the LLCs to CRFLP were treated as indirect gifts of the LLC interests themselves (with no FLP level discount). The trust partners were deemed to be partners before the funding. The court viewed purported sales of limited partnership interests to the trusts as sham transactions and treated the transfers as gifts; therefore the LLC interests were treated as indirect gifts to the trusts. Subsequent contributions to the LLCs (in which the decedent no longer owned a direct interest) were treated as indirect gifts to the decedent's children.

Various cash loans to decedent's children were treated as gifts because there was no expectation of repayment. The estate was insolvent at decedent's death, and deductions were allowed only up to the amount of assets subject to claims. (For purposes of determining the assets subject to claims, the court made clear that there should be no "double inclusion" and that decedent's interest in CRFLP that he retained at his death should be determined without including any of the D&PL stock in that partnership that was included in the estate under §2036.)

Basic Facts

(1) Decedent had been Chairman and CEO of Delta & Pine Land Co. ("D&PL"). He held substantial stock and options and wanted to transfer over $16 million worth of shares to his son and daughter.

Facts Related to MFLP and D&PL Stock

(2) Decedent created trusts for each of his two children and gave $500,000 collectively to the trusts.

(3) On August 31, 1989, the Roger D. Malkin Family Limited Partnership ("MFLP") was formed. Decedent contributed D&PL shares worth about $16.8 million in return for a 1% general partnership ("GP") and a 98.494% limited partnership ("LP") interest. The two trusts collectively contributed $50,000 for 0.506% LP interests collectively.

(4) The same day, decedent sold 88.594% LP interests to the two trusts, collectively, for approximately $880,000 cash and 9-year $7.96 million secured SCINs (reflecting a discount of about 40%). The sale transactions were structured with consideration consisting of 10% downpayments and 90% notes.

(5) At the end of each of the first two years (before decedent died), decedent appeared to make gifts of cash to the children, which they loaned to their respective trusts, and which the trusts used to make the interest payments to decedent. (Footnote 17 says this definitely happened both years for the son and at least one year for the daughter.)

(6) In May 1999, decedent was diagnosed with pancreatic cancer [one of the most lethal cancers].

(7) On September 24, 1999, decedent, as GP of MFLP, pledged almost all of the partnership's D&PL shares to Bank of America to secure decedent's personal debts. (Decedent and two trusts had signed a resolution authorizing the pledge.) Over two months later, decedent gave the partnership a personal guaranty and agreed to pay the partnership a fee of 0.75 percent for the $4,345,000 pledge. [Observe, the value of the D&PL shares appear to have dropped in value from $16.8 million to $4.3 million in a little over a year. The opinion does not describe the value of decedent's other assets at that time, but when he died several years later, he had an insolvent estate.]

(8) Apparently, decedent refinanced his personal debt with Morgan Guaranty, and in April and June, 2000, all of the partnership's D&PL shares were pledged to Morgan Guaranty to secure decedent's personal debt. Decedent again gave a personal guaranty to the partnership and paid a 0.75% fee to the partnership for its pledge.

Facts Related to CRFLP and LLC Units

(9) Decedent and the son owned various interests in five LLCs (Malkin I, Malkin II, Malkin III, Malkin IV, and Malkin V) that owned interests in private equity ventures and interests in a partnership.

(10) On February 29, 2000 (almost a year after decedent was diagnosed with pancreatic cancer), three events occurred:

a) Decedent and two new trusts for son and daughter [although the trusts had not yet been formed] signed the partnership agreement for Cotton Row Family Limited Partnership (CRFLP);

b) Decedent transferred all of his interests in the LLCs to CRFLP in exchange for 1% GP and 99% LP interests [observe: decedent was initially the purported sole partner of the partnership — which, of course, does not create a valid partnership]; and

c) Decedent contracted to sell about 89% of his LP interests in CRFLP to the two trusts, for combined cash downpayments of $80,100 and 9-year secured notes totaling $721,000. (SCINs were not used because at the time of this sale, the parties knew of decedent's cancer and that using SCINs "would not [have been] appropriate." Footnote 17.)

(11) The next day (March 1), decedent signed documents creating the two new trusts.

(12) A week later, decedent gave about $81,000 to the trusts, and two days later, the trusts paid decedent the $81,000 as the cash downpayment and signed the promissory notes. (The court observed the $900 discrepancy between the downpayment amount under the agreement and the amount actually paid)

(13) In November 2000, decedent transferred 80,000 D&PL shares to CRFLP. Decedent had previously pledged the shares as collateral for his personal debt, and the shares were contributed encumbered by the pledge.

Basic Facts Related to Various Loans and Indirect Gifts

(14) In 1998, decedent paid a $64,760 debt of Malkin I (when he owned 30% and his son owned 70% of Malkin I).

(15) In May 2000, after decedent no longer owned any interest in the LLCs, he paid various debts of the LLCs, including a capital call.

(16) In June and November of 2000, decedent transferred various amounts to son and daughter in return for promissory notes (which both later testified they did not remember signing).

Decedent's Death and Estate Tax Return

(17) Decedent died on November 22, 2001.

(18) On March 1, 2002, the estate tax return was filed by the son and daughter as executors of the estate. [The filing was late; with a 6-month extension, the return was due on February 22, 2002. The opinion does not address late filing penalties.] The return reflected an insolvent estate. It reported assets of about $15.5 million to satisfy debts, and there were also two accounts of about $1.25 million that were omitted from Schedule C. The return claimed Schedule J, K, and O deductions of about $18.3 million, the largest claims being a $12.9 million loan secured by D&PL stock worth $10.475 million and a $2.3 obligation to Malkin IV.

Holdings

(1) All of the D&PL shares contributed to MFLP and CRFLP are included in the estate under §2036(a)(1).

(2) The contribution of LLC units to CRFLP by decedent was an indirect gift (i.e., no FLP level discount) "to his children of his interests in the Malkin LLCs". [As discussed below, it seems that the transfers should be indirect gifts to the trusts only to the extent of their interests in CRFLP.]

(3) Decedent's payment of debts of the LLCs (including a capital call) constituted indirect gifts to the children.

(4) The purported cash loans to the children were gifts; the purported loans were a sham because there was no intent to repay the loans.

(5) The estate did not present proof that decedent was personally liable for the loan secured by D&PL stock; the note is treated as a non-recourse note and is deductible only to the extent of the value of the collateral (which was included in the estate under §2036 even though the collateral was owned by MFLP and CRFLP).

(6) Schedule J, K, and O deductions are allowed to the extent they are actually paid and do not exceed the value of property in the estate subject to claims.

Analysis

(1) Burden of Proof. The estate had the burden of proof and did not argue that the burden shifted to the IRS under §7491(a). The court concluded that §7491(a) does not apply "because petitioners have not produced any evidence that establishes the preconditions for its application." It is hard to tell if the burden of proof was the key to any of the holdings, but it is interesting that the court concluded the discussion of each issue by stating that the estate had failed to satisfy its burden of proof.

(2) Section 2036 Inclusion of D&PL Shares.

(a) Bona Fide Sale Exception Did Not Apply. The estate offered three nontax reasons for the partnerships, which the court rejected.

(i) Providing for children and keeping growth in the children's hands, not the decedent's hands — The court responded by quoting from Bongard:

"a 'good faith' transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form."

(ii) Preventing the sale of the family's D&PL shares — The court observed:

"Had decedent wanted to prevent the sale of any D&PL stock his family owned, he would have demanded (or at least requested) that his son contribute his own D&PL stock. He did not. Obviously, decedent did not need the FLPs to control his own D&PL stock; he already controlled it."

[**Observe:** This argument is similar to the rationale in the <u>Schutt</u> case where the purpose was to preserve the family's duPont stock held in various trusts. In that case, all of the trusts' and decedent's shares were transferred to a Delaware Business Trust — unlike this case where only decedent's shares were transferred to the partnership. The opinion does not cite the <u>Schutt</u> case.]

(iii) Centralized management — The court rejected this because there was no pooling of assets: "[t]he property the FLPs passively held, i.e., the D&PL stock, was simply decedent's wealth."

The court's conclusion as to the bona fide sale exception:

"Favorable estate tax treatment was the aim of the change in form. We are unable to identify a legitimate and significant nontax reason for the transfers...We find that decedent's transfers of D&PL stock to the FLPs achieved nothing more than testamentary objectives and tax benefits, and thus those transfers do not qualify for the bona fide sale exception in section 2036(a)."

(b) <u>Retained Interest</u>. The pledge of the D&PL shares held by MFLP to secure D's substantial personal debt [observation: at a time that his estate appeared to be in severe financial trouble] reflects at least an implied agreement of retained enjoyment. The estate argued that this was just an investment decision by MFLP. The court concluded that the estate failed to show that the decision to pledge the partnership's shares was made at arm's length. (i) The estate offered no evidence to prove that the 0.75% fee the decedent paid to MFLP was a reasonable fee. (ii) The estate did not explain "what business purpose of MFLP" the pledge served.

CRFLP did not pledge its D&PL shares, but they were encumbered by a pledge at the time they were contributed to the partnership (similar to the situation in <u>Bigelow</u>). The court concluded that

"we see no relevant distinction between CFLP's pledging shares itself and receiving previously pledged shares. See <u>Estate of Bigelow v. Commissioner</u>, <u>supra</u>. In either case, CRFLP holds property pledged to discharge a personal obligation of decedent."

Because the court concluded there was an implied agreement of retained enjoyment under §2036(a)(1), it did not address the IRS's argument that there was also an express agreement of retained enjoyment. Also, it did not address the IRS's arguments for inclusion of the D&PL shares under §§2035 and 2036(a)(2).

(3) <u>Indirect Gift of LLC Units Contributed to CRFLP</u>. The court reasoned that the facts "are indistinguishable" from the facts in <u>Shepherd</u>. In that case, a father deeded land to a partnership, but his sons did not sign the partnership agreement until the next day. The partnership agreement

was only effective after one of the sons had signed the agreement because state law did not recognize a "one person partnership," and the deed was not effective until the partnership existed. The creation of the partnership preceded the effectiveness of the deed, and the transfer of land to the partnership was treated as an indirect gift to each son of an undivided 25% interest in the land. While LLC interests were purportedly transferred to CRFLP before the trusts acquired interests in CRFLP, the case is similar to Shepherd.

> "Only after CRFLP was validly formed on March 1, 2000, could decedent transfer his interests in the Malkin LLCs to it. Thus, at the time of that transfer, the CRFLP trusts were already limited partners, and they acquired interests in the Malkin LLCs by virtue of their status as limited partners."

A difference from Shepherd is that the trusts purportedly acquired their interests by purchase rather than by gift. However, the court viewed the purported purchase as a sham and treated the transfer as a gift. (i) At the time of the "sale," the decedent was terminally ill; (ii) the decedent provided all the cash for the downpayment even though the children both had the ability to pay a downpayment, so the decedent's actions do not reflect an arm's length sale; and (iii) there is no evidence that decedent expected the trusts (or the children) to pay the notes, particularly in light of the fact that decedent gave his children the money for the first set of trusts to make the interest payments on the notes for purchasing the MFLP interests. [Observe: the fact that the children did not make the downpayments from their own funds may be explainable — if the purchasing trusts were grantor trusts, they would no longer have been wholly grantor trusts as to decedent if the children made contributions to the trusts to make the downpayments. The children could have loaned the amounts to their trusts, but that would have left the trusts with almost no "equity cushion" let alone having equity of 10% following the purchase of CRFLP LP interests.]

[**Observe:** It would seem that there could still have been an indirect gift even if the sale had been respected. The contribution to the partnership was effective only after a partnership existed, and that occurred only after the transfers to the trusts. Therefore, the conclusion may still have been that the contribution was an indirect transfer to the other partners at that time, however they acquired their interests. The effect would be that the purchase price would not have equaled the fair market value of the indirect transfers, determined without an FLP level discount, so a gift would have resulted only to the extent of the difference in value. Under the court's reasoning, the entire value of the LLC interests transferred to CRFLP was treated as a gift.]

[Observe that an appropriate discount would be allowed for the value of the LLC interests; the indirect gift holding just precludes an additional level of discount for the LP interests.]

(4) Cash Loans Treated as Gifts. Decedent's various loans to his children were not respected as loans but were treated as gifts.

Loans to the daughter of $68,000 and $149,000 in 1998 and 1999 were not evidenced by promissory notes, and the daughter "never repaid a dollar on the alleged debt." The daughter's testimony that she offered to repay the debt but decedent told her to keep it in her company was not credible because the daughter closed her company in 1999 to take care of decedent. The court viewed the transfers as decedent's attempt, after almost a decade of estrangement, to reconcile with his daughter.

Loans to the son and daughter of $830,000 and $100,000 in 2000 also were not respected. While there were notes, the son testified that he did not recall signing a note and that a portion of the advanced funds were to pay his family's travel expenses while visiting decedent during his illness. The daughter testified that she did not recall the transfer at all. Decedent never demanded any payments, and neither child made any note payments. The court quoted Rosen (which discussed when notes would be respected in the context of §2036):

> "Security, adequately stated interest, and repayment arrangements (or efforts to secure the same) are important proofs of intent, and such proofs are notably lacking here."

(5) Transfers to LLCs as Indirect Gifts. Decedent's transfers to the LLCs (most of which were made when he no longer owned *any* direct interest in the LLCs) were treated as indirect gifts to his children. [Observe: This is confusing. The second set of trusts, not the children, were the 89% limited partners of CRFLP, which owned what had previously been decedent's interests in the LLCs. Decedent retained an 11% interest in CRFLP. It would seem that the gifts should be to the trusts, but only to the extent of their 89% ownership interests in CRFLP. The opinion says that the gifts were made "to the beneficial owners of Malkin I and Malkin IV (i.e., his children)."] The estate argued that decedent was personally liable for debts "by virtue of his having made capital commitments to two of the LLCs." However, the court reasoned that the estate did not satisfy its burden of proof "to explain how decedent could be obligated to contribute capital to an LLC of which he was no longer a member."

(6) Deductions. The largest claim was a $12.9 million debt secured by $10.48 million of D&PL stock. The IRS allowed that as a deductible expense only to the extent of the value of the collateral, in effect treating the debt as a nonrecourse debt. The court concluded that the estate failed to satisfy its burden of proof: "The several exhibits petitioners cite relating to the debt fail to show decedent was personally liable for it." [Observation: That does not make sense. Presumably the actual notes signed by decedent were offered as evidence and they would seemingly clearly specify if they were nonrecourse. However, the treatment of the debt as nonrecourse does not seem to impact the ultimate result, because there are not sufficient assets in the estate subject to claims to cover all of the deductions, even without adding the additional $2.4 million of purported personal liability on this debt.]

Various other debts, administration expenses and a charitable transfer are allowed as deductions only to the extent actually paid and only to the extent of the value of property in the estate subject to claims. [Observe: The charitable deduction must have been generated by something other than a charitable bequest since this is an insolvent estate.] (For purposes of determining the value of the estate subject to claims, the value of decedent's 11% interest in CRFLP must be adjusted by disregarding the D&PL shares as assets of CRFLP. Those shares are included in the estate under §2036 and there should not be double inclusion by also including them indirectly as assets of CRFLP.)

Planning Implications

(1) Bad Facts. In a variety of ways, this case illustrates how "not to plan" FLP and loan transactions. Having an FLP pledge almost all of its assets for a personal debt of decedent a year after the FLP is created and after substantial interests were transferred to trusts is highly indicative of an implied agreement of retained enjoyment. Perhaps there was an explanation — the D&PL stock appears to have cratered in value during that year and perhaps all of the financial difficulty was totally unanticipated. Even so, such unusual actions seem consistent with the finding of an implied agreement that decedent could enjoy use of the partnership assets if needed. Furthermore, the court never had to get to the §2036(a)(2) inclusion argument based on the fact that decedent was the sole GP.

(2) Shifting Burden of Proof to IRS is Important. Judge Halpern appears to have viewed this as an egregious situation and it is impossible to know if any of his conclusions would have been

different had the burden of proof been shifted to the IRS under §7491(a). There is no explanation of why the estate failed to make the argument to shift the burden. There are no indications in the opinion that the estate failed to reasonably cooperate during the estate tax audit to be able to comply with the requirements of §7491(a)(2)(b), but the opinion concluded that the estate had not "produced any evidence that establishes the preconditions" for the application of §7491(a). It is clear, however, that the court many times in the opinion concluded its discussion of issues by observing that the estate did not satisfy its burden of proof.

(3) Pledge of All FLP Assets For Personal Debt. Pledging all of the FLP's assets to satisfy a personal obligation of the parent creates a huge red flag of an implied agreement of retained enjoyment.

(4) Contribution of Encumbered Property to FLP. This is the second case (the other being Bigelow, a 9th Circuit Court of Appeals case) that has treated a contribution of property, encumbered to satisfy a continuing personal debt of the parent, as retained enjoyment under §2036(a)(1).

(5) Bona Fide Sale Exception.

- This case, like most of the cases (other than Mirowski) have refused to recognize the facilitation of making gifts or estate planning transfers as a legitimate nontax reason to satisfy the "bona fide" requirement of the exception to §2036.
- If preserving the family's stock in a certain corporation is important, consider also having other family members (or trusts) transfer their stock to the partnership as well.
- Similarly, to support a centralized management claim, have other family members also contribute assets, so that centralized management of family assets results. However, some cases have not required "pooling" to support a centralized management nontax reason, including situations in which the partnership will be able to provide centralized management on a long term basis, after transfers are made to other family members. Furthermore, a partnership with contributions by parents and trusts for children may permit the trusts to invest in venture investments requiring a qualified purchaser and accredited investor where the trusts might not otherwise qualify. (If that is the nontax reason for the partnership, it is important to implement such an investment program under the actual operation of the partnership.)

(6) Respecting Sales — Ability to Make Cash Downpayment. The sales were planned to have a 10% downpayment, apparently to satisfy the common practice of having a 10% "equity cushion" to support the bona fides of a purported sale transaction. However, it seems suspicious in the case of the sale of CRFLP interests to the new trusts that the trusts had no ability to make the cash downpayment at the time of the sale and decedent made a cash gift to the trusts, after entering into the sale transaction, to permit the trusts to make the cash downpayments. (For MFLP, the trusts held about $450,000 cash before the sale, but not enough for the entire $880,000 downpayment. The validity of that sale transaction was not addressed, because the court found that the decedent had a §2036(a)(1) retained enjoyment of all assets in the partnership. The note was a SCIN, so the issue of double inclusion of partnership assets and the note did not arise for that partnership.) At a minimum, make a gift to the trust of cash sufficient to make required cash downpayments *before* entering into the sale transaction, so that the trust has the 10% equity value at the time of the sale transaction. [Query whether the IRS will make a step transaction argument if the gift is made soon before the sale?]

(7) Respecting Sales — Ability to Make Note Payments. The court specifically observed that decedent made cash gifts to the children, which they loaned to their respective trusts, in order for the trusts to make required annual interest payments on the MFLP sale transaction. The court concluded

that those actions suggested that decedent did not expect repayment of the loans in the subsequent CRFLP transaction. At the time a sale transaction is structured, the planner should consider how the purchaser will be able to make note payments.

(8) Follow Formalities to Assure Existence of Partnership Before Contributions to Partnership and Consider Step Transaction Doctrine. The indirect gift issue arose in this case because only one "partner" signed the partnership agreement before contributions were made. The partnership did not really exist until there were other partners, so the contributions were determined to have been made after the other partners held their interests. First, make sure there are multiple partners who have signed the partnership agreement and that all state formalities for creating a partnership are satisfied before making initial contributions to the partnership. Planning Tip: Do not structure the partnership (like the CRFLP Agreement) to reflect parent as the initial sole GP and LP owner with an agreement to sell LP interests to trusts. The partnership agreement should list some at least two partners at the outset. Second, include provisions in the partnership agreement clearly stating that if any partner makes a contribution to the partnership, it increases the capital account and sharing ratio of only that partner rather than being allocated pro rata to the capital accounts of all partners.

Furthermore, under the step transaction analysis of Holman, Gross, Linton, and Heckerman, there should be some appropriate lapse of time between the time of funding the partnership and making transfers of partnership interests. In Malkin, even if the contributions to CRFLP of LLC interests had clearly been effective before the transfers of LP interests to the trusts, the court may have still treated the transfers as indirect gifts of the contributed LLC interests under the step transaction doctrine if the transfers were made soon after the contribution. This is true particularly in light of Judge Halpern's reasoning in Holman and Gross that the step transaction doctrine applies if there is not a "real economic risk of a change in value" between the time of funding and a gift of partnership interests.

(9) Cash Advances; Respect Loans and Make Payments. Cash advances should be documented with formal promissory notes, and the borrower should actually make at least some payments on the notes. During the current economy with very low interest rates, simple loan transactions with interest at the AFR can be powerful transfer planning strategies. However, keep in mind that the formalities of arm's length loans transactions should be followed, including having solvent borrowers who can repay the loans (and having security arrangements if there are any questions about the borrowers' abilities to repay the notes.)

(10) Sole General Partner. Decedent in this case was the sole GP. That was not an important factor in this case because of the court's finding of a §2036(a)(1) retained enjoyment of the D&PL stock in MFLP and CRFLP and of an indirect gift of LLC interests in CRFLP. However, having a decedent as sole GP raises the specter of possible inclusion of all partnership assets (even following transfers of partnership interests) under §2036(a)(2); the taxpayer's defense would be that the GP's fiduciary duties would preclude §2036 inclusion under the reasoning of the Byrum U.S. Supreme Court case, but that defense was rejected by Judge Cohen in a controversial opinion in Strangi. In addition, having the decedent as sole GP seems to have assisted some courts in finding an implied agreement of retained enjoyment under §2036(a)(1), where there is a heightened suspicion that the GP has the ability to access the partnership assets personally if needed. Having the decedent as sole GP also raises the question of whether any (or much discount) is available for LP interests owned at death if the sole GP has the power to withdraw and force the dissolution of the partnership under the laws of many states.

(11) No Double Inclusion. The court observes that there should be no double inclusion of partnership assets both under §2036 and §2033, at least for purposes of determining the assets of the estate subject to creditors' claims. However, the court's language is broader than just determining the value of property subject to claims — footnote 23 says that "the value of the estate's Schedule F property" should be adjusted because the D&PL stock is included under Schedule G. Some commentators have suggested that when §2036 applies, the partnership assets would be included on Schedule G, the full value of the partnership interest would be included on Schedule F, and a "§2043 offset" reduction would be allowed for the value of assets contributed to the partnership at the time of the contribution. However, this court suggests that the same assets should not be included under both the "string" statutes and under §2033 for directly owned assets.

Estate of Murphy vs. United States, U.S. Dist. Ct. W.D. Ark. El Dorado Division, Case No. 07-CV-1013 (October 2, 2009)

Total Taxpayer Victory in FLP Case Involving §2036, Rule 144/Blockage Discounts, FLP Discounts, and Graegin Loan

October 2009
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com
www.bessemertrust.com

Synopsis

Among other assets, decedent owned substantial interests in a publicly traded oil company (he served as CEO and Chairman of the Board), a timberland and farmland company, and a bank. Decedent formed an FLP to centralize management and protect against dissipation of those family assets, and transferred his interests in the three companies (worth about $90 million) to the FLP (directly or through the LLC that was the general partner). (The concern about dissipation arose because two of decedent's four children had pledged and sold many of the family assets that had previously been given to them. The other two children shared decedent's philosophy and participated in the FLP planning and operations.) Decedent retained assets worth about $130 million. Decedent, individually and as trustee of several revocable trusts, acquired a 96.75% limited partnership interest. A new LLC, owned 49% by decedent and 51% by two of his children, held a 2.25% general partnership interest. At decedent's death, he owned a 95.25365% limited partnership interest in the FLP, and the LLC owned a 2.28113% general partner interest.

The transfer to the FLP satisfied the bona fide sale exception to §2036.

The value of the limited partnership interest is calculated by first determining the net asset value of the stock in the three companies owned by the FLP, taking into consideration Rule 144 and blockage discounts (applying the taxpayer's expert's discounts of 5%, 10.6%, and 1.3% for the three corporations) and of a timber and farm plantation. Second, the value of the 95.25365% limited partnership interest is determined by applying a 12.5% lack of control and 32.5% lack of marketability discount, for an overall combined discount of about 41% of the net asset value. The value of decedent's 49% interest in the LLC, which is the general partner of the FLP, is determined by applying two levels of discounts; (i) the LLC's 2.28113% general partner interest is valued with a 20% lack of control/lack of marketability discount, and (ii) the estate's 49% interest in the LLC is valued with a lack of control discount of 11.1% and a lack of marketability discount of 32.5%. The overall discount of the tiered entity is 52% of the net asset value.

The estate is allowed an estate tax deduction for all of the interest on a 9-year Graegin note for amounts borrowed from the FLP and for the interest actually paid on another note. The proceeds of the loans were used to pay federal and state estate taxes.

Basic Facts

(1) Decedent served as the CEO and Chairman of the Board of Murphy Oil Corporation, a publicly traded company, and owned significant shares in the company. He also owned about 3% of the stock of Deltic Timber Corporation (another NYSE corporation), which operates farm, timber and real estate businesses. In addition, he owned about 0.37% of a bank (that later merged with Bancorp South, Inc.). He was involved in the management of all three companies. (Decedent's interests in those three companies are referred in the opinion as the family's "Legacy Assets.")

(2) Two of decedent's four children had sold and pledged various family assets previously given to them or to trusts for their benefit. Decedent's attorney recommended that he transfer the family's Legacy Assets to an FLP "to accomplish his goal of pooling the family's Legacy Assets together under centralized management and to protect those assets from being dissipated."

(3) On February 19, 1998, after various planning sessions with his other two children (one of whom was represented by an attorney), decedent contributed his interests in the three companies (held individually and as trustee of several revocable trusts) worth about $89 million to an FLP, for a 96.75% limited partner interest (and an additional 1% limited partnership interest that he allocated to a college as a charitable gift). The 2.25% general partner interest was owned by an LLC that was owned 49% by decedent and 51% by two of his children. (Decedent and the

children contributed about $2 million of the Legacy Assets to the LLC, which it contributed to the FLP for its general partner interest.)

(4) This planning was part of a process of decedent turning over management of family assets to the next generation. The two children who shared his business/investment philosophy (i.e., a buy and hold philosophy) became actively involved with the management of the FLP and its employees. The youngest son continued serving on the Board of Directors of the three corporations comprising the family's Legacy Assets. The FLP purchased timberland and farmland (and the two children prevailed in a disagreement with decedent over how many acres to purchase) and made significant capital improvements to the plantation. The partners met six to eight times a year to discuss partnership business.

(5) The FLP made only two distributions during decedent's life: (1) a pro rata distribution to partners in one year to cover the partners' federal taxes attributable to the FLP; and (2) a distribution to decedent of stock in another company (so the company could convert to an S corporation), which distribution reduced decedent's percentage interest and capital account in the FLP.

(6) Decedent made annual exclusion gifts of FLP interests to his children, their spouses, and eight grandchildren until his death.

(7) Decedent died on March 20, 2002. By that time, the assets in the FLP had grown from $91 million to about $131.5 million.

(8) The estate tax return reported decedent's 95.25365% limited partner interest in the FLP at $74,0082,000 (using a 41% discount).

(9) The estate sold its shares in a bank, but because the stock had declined substantially in value (and assets in the FLP had appreciated substantially), the estate had a $16 million shortfall to pay estate taxes. The estate borrowed funds to raise needed cash, including an $11 million 9-year "Graegin note" from the FLP, secured by a 14.36% limited partner interest in the FLP. (The estate also borrowed $5.4 million from a Family Trust but did not claim an estate tax interest deduction with respect to that loan.)

(10) About three years after the estate tax return was filed, the IRS issued a Notice of Deficiency for $34 million, alleging that the estate undervalued various assets, and that the FLP assets were includable in the estate under §§2036(a)(1) and 2036(a)(2). The estate borrowed $41 million from trusts created in 1956 to pay the added tax and interest (this was documented by a note with a variable interest rate that could be prepaid — so it was not a Graegin note). The estate paid the added tax and interest on December 20, 2002 and filed a Claim for Refund the same day.

Holdings

(1) The transfers to the FLP qualified for the bona fide sale for full consideration exception to §2036.

(2) The FLP is valued based on net asset value with appropriate lack of control/marketability discounts. The net asset value of the interests in the three corporations is determined with Rule 144/blockage discounts of 5%, 10.6% and 1.3%. The estate's 95.25365% limited partnership interest is valued by applying a 12.5% lack of control discount and a 32.5% lack of marketability discount, for a combined seriatim discount of 41% (the discounts used by the estate's expert).

(3) The estate's interest in the LLC is determined after applying two levels of discounts: (1) a 20% lack of control/marketability discount for the general partner interest owned by the LLC, and (2) a 11.1% lack of control and 32.5% lack of marketability discount (a combined discount of 40%)

for valuing the estate's interest in the LLC. The overall combined discount was 52% (again, being the discount used by the estate's expert).

(4) Interest on the full term of the 9-year Graegin note is deductible and interest paid to date on the other note is deductible.

Analysis

(1) Section 2036 Bona Fide Sale For Full Consideration Exception.

(a) Bona Fide Sale. The bona fide sale element of the exception in §2036 requires a transfer in good faith with "some potential benefit other than the potential estate tax advantages that might result from holding assets in the partnership form" (quoting Estate of Korby and Estate of Thompson). The court lists the following factors in concluding that the bona fide sale requirement is met.

- Purpose — Purposes of the FLP included pooling "the family's Legacy Assets into one entity to be centrally managed in a manner that was consistent with Mr. Murphy's long-term business/investment philosophy." (The IRS argued that holding assets long term without active management is not a legitimate non-tax purpose. The court responded that the Estate of Schutt case held that implementing a buy and hold investment strategy is a legitimate non-tax purpose, and that the youngest son was actively involved in management of the three Legacy Asset companies.)
- Management and Operation — The youngest son was actively involved in the management of the Legacy Assets, and the FLP purchased and managed property consistent with the goal of acquiring and maintaining the family's historical assets.
- Retained Assets — Decedent retained $130 million of assets to support his lifestyle.
- Formalities — Decedent did not treat the FLP assets as his own and did not commingle his assets with FLP assets.
- Not "Standing on Both Sides" — The two children involved with the FLP took an active role in the formation of the FLP, with the daughter being represented by her own attorney, so decedent "was not effectively standing on both sides of the transaction."

(b) Full Consideration. The case followed the Kimbell analysis of the full consideration requirement. It is met because 1) the interest in the FLP was proportionate to the value of the assets contributed, 2) the value of each partner's contribution was credited to the partner's capital account, and 3) on termination or dissolution of the partnership, the partners are entitled to distributions from the partnership in amounts equal to their respective capital accounts. The IRS argued that the Kimbell test is not the appropriate test. The court rejects that argument, simply saying that it is "not persuaded."

(c) §§2036(a)(1) and 2036(a)(2). Because the §2036 exception applies, the court does not discuss whether §2036(a)(1) or 2036(a)(2) would have applied, but for the exception. The opinion does not disclose why the IRS reasoned that §2036(a)(2) would apply in this case when decedent only owned 49% of the LLC that was the sole general partner.

(2) Value of Limited Partner Interest.

(a) General Approach. The net asset value approach is used to value the estate's limited partner interest. First, the net asset value of the interests in the FLP's assets is determined.

Second, appropriate lack of control and lack of marketability discounts are applied to determine the value of the estate's 95.25365% limited partnership interest.

The estate's primary expert was Donald Barker (Howard Frazier Barker Elliott, Inc.) and the IRS's primary expert was Francis Burns (CPA International).

[**Observation:** Interestingly, as to each separate value issue, the court considers the positions of the estate's and IRS's experts and picks the expert opinion that it finds the most credible. Unlike many Tax Court cases, the court does not perform its own appraisal analysis to arrive at a value somewhere between the experts' values. Also, it is interesting that for many of the issues, the court concludes which expert's opinion is more credible as to each issue without any explanation of why that that expert's opinion was more credible than the other.]

[**Observation:** It is also interesting that the court uses the estate's expert's opinion for every one of the many valuation issues considered except for one minor net asset value (i.e., the value of timberland in the plantation owned by the FLP).]

(b) Overall Value of Limited Partner Interests. The overall values proposed by each party and the value determined by the court are:

Estate's expert:	$ 74.15 million
IRS's expert:	$106.24 million
Court:	$ 74.50 million

(c) Rule 144/Blockage Discount. Both the estate's and the government's experts agreed that a Rule 144/blockage discount would apply in the valuing the FLP's stock in the three Legacy Asset companies, but they disagreed on the amount of the discount. The court finds the estate's expert more credible because it considered not only the size of the block relative to the daily trading volume, but also (unlike the government's expert) "the volatility of the stock, the actual price change in the stock under recent and preceding market conditions, the company's current economic outlook, the trend of the price and the financial performance of the stock, the trend of the company's earnings and the existence of any resale restrictions on the stock." In addition, the government's expert did not consider SEC sales restrictions on the Murphy Oil stock.

(d) Timberland and Farmland. The one area where the court sides with the IRS is on the value of timberland in the plantation. However, the court finds the estate's expert's valuation of farmland in the plantation to be more credible because the government's appraisal used one comparable that was 75 miles away from the estate's property and because it did not apply a "downward size adjustment" in comparing the estate's farmland (13,481 acres) to the much smaller comparables (1,233 to 4,786 acres).

(e) Lack of Control Discount — 12.5%. Both appraisers determined appropriate lack of control discounts using data from closed-end equity funds. The court finds that the estate's appraiser (who applied an 11% discount) screened the funds and used funds that were most similar to the FLP's equity category. In addition, the estate's appraiser applied a 5% discount even for the large cash/cash equivalents holdings, reasoning that the large cash balance "would be invested in equities or real estate in lieu of the partnership's long-term goals." The estate's appraiser applied a weighted average lack of control discount of 12.5%, and the government's appraiser calculated a 10% lack of control discount. The court applies a 12.5% discount, finding the estate's expert to be more credible.

(f) Lack of Marketability Discount — 32.5%. Both experts used restricted stock studies, but they applied different approaches. The estate's expert calculated a 32.5% lack of marketability discount and the IRS's expert applied a 10% discount. The court prefers the estate's expert's approach, which compared the data "from three studies (FMV Opinions, Management Planning (MPI), and Silber)… to the holding period, relative risk, distributions policy, and transfer restrictions of Mr. Murphy's partner interest. In doing so, Barker realized that the 'holding period' for Mr. Murphy's partner interest was substantially longer than that of restricted stock (one to two years)."

(g) Combined Seriatim Discount — 41%. The combined seriatim lack of control and lack of marketability discount is about 41% (i.e., the value is 87.5% x 67.5%, or 59.0625% of net asset value, representing a discount of 40.9375%).

(3) Value of 49% Interest in LLC General Partner. The estate's 49% interest in the LLC that served as the sole general partner of the FLP is determined using a tiered entity approach. [**Observation:** This is consistent with the result in the 2008 Astleford case, which allowed multiple levels of discounts for a tiered entity. The court does not cite Astleford, or discuss the allowance of the two levels of discounts, but both appraisers agreed with this approach. This seems appropriate particularly in light of the fact that the "subsidiary entity" (i.e., the FLP) was not wholly owned by the "parent entity" (i.e., the LLC).]

First, the LLC's 2.28113% general partner interest is determined and the court without explanation adopts the estate's expert's 20% lack of control/lack of marketability discount (rather than the IRS's expert's 14.5% discount). Second, the court determines the value at the "parent" level of the estate's 49% interest in the LLC. Again, without explanation, the court adopts the estate's expert's conclusion of an 11.1% lack of control discount and a 32.5% lack of marketability discount. (The IRS's expert's same respective discounts were 5% and 10%.) The combined seriatim lack of control and lack of marketability discount is about 40% (i.e., 88.9% x 67.5%, or 60.0075% of net asset value, representing a combined discount of 39.9925%).

The combined two-level discount for the two entities (i.e., the 2.28113% general partner interest inside the LLC and the 49% interest in the LLC) is 52.02%.

In summary:

LLC's 2.28113% general partner interest: 20% discount

49% interest in LLC: 11.1% lack of control discount

32.5% lack of marketability discount

Combined two-tier overall discount: 52.02%

(4) Interest Deduction for Graegin Note and Other Note. The estate borrowed $11,040,000 from the FLP on a 9-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The estate sought to deduct the interest on these loans for estate tax purposes.

(a) Graegin Note. "Borrowing money to pay the estate tax of an illiquid estate is a 'necessarily incurred' administrative expense under section 2052" (citing McKee, 72 T.C.M. 324 and Estate of Todd, 57 T.C. 288 (1971)). The full amount of interest over the 9-year period of the Graegin note (i.e., though December 2011) is deductible, based on the 1988 Graegin case, because the total amount of interest is "not vague or uncertain but instead is capable of calculation." The IRS argued that the interest should not be deductible for two reasons.

(i) Self-Created Illiquidity. The interest was not necessarily incurred "because it was the result of an unnecessary estate-tax avoidance transfer" that drained decedent's estate of liquid assets. The court rejects this reasoning, because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes.

(ii) Sale and Distribution from FLP. The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejects this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment. *McKee*, 72 T.C.M. at 333."

(b) Regular Note. Because of the floating interest rate and the possibility of early payment of the loan, only the amount of interest paid to date is deductible. [**Observe:** Perhaps the estate has filed a protective claim for refund so that it can deduct any additional interest as it is paid.]

(5) Bench Trial in District Court. The case was tried in a five-day bench trial in El Dorado, Arkansas without a jury. The two recent FLP district court refund cases, Keller and Murphy, (which were both huge taxpayer victories) have both involved non-jury trials. The excellent trial attorneys in both cases chose to proceed with bench trials and avoid jury trials. (It is also interesting that the Murphy family is from El Dorado, Arkansas, where Murphy Oil Corporation is headquartered and where the trial was held. Query whether there was some "home town" advantage of trying this tax case in the community where decedent and his family were prominently known?)

Another interesting trend is that a number of the recent cases involving FLPs have been district court decisions. This may suggest a trend of taxpayers choosing to avoid the Tax Court regarding FLP matters, particularly for §2036 issues, by paying the deficiency assessed in the audit and filing a Claim for Refund. The obvious downside is that the estate must come up with cash to pay the deficiency, but as evidenced in Murphy, the estate may be able to pick up a significant estate tax deduction for the interest that is paid on loans to secure the cash to make the tax payment.

(6) "Scorecard" of §2036 FLP Cases. Of the various FLP cases that the IRS has chosen to litigate, nine have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — Church (preserve family ranching enterprise, consolidate undivided ranch interests); Stone (partnerships to settle family hostilities); Kimbell ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); Bongard (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); Schutt (maintaining buy and hold investment philosophy for family du Pont stock); Mirowski (joint management and keeping a single pool of assets for investment opportunities); Miller (continue investment philosophy and special stock charting methodology); Keller (protect family assets from depletion in divorces); and Murphy (centralized management and prevent dissipation of family "legacy assets"). In every FLP case resulting in taxpayer successes against a §2036 attack the court relied on the bona fide sale exception to §2036.

Interestingly, four of those nine cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the Miller case and authored the Tax Court's opinion in Bongard. Judge Chiechi decided both Stone and Mirowski. (Judge Wherry decided Schutt. Church and

Kimbell were federal district court opinions ultimately resolved by the 5th Circuit. Keller and Murphy are federal district court cases.)

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

Keller v. U.S., Civil Action No. V-02-62 (S.D. Tex. August 20, 2009)

$40 Million Taxpayer Victory; Partnership Recognized Although Not Formally Funded Before Decedent's Death; 47.5% Discount Allowed For Assignee Interest in Limited Partnership Holding Bond Portfolio; Bona Fide Sale Exception to Sections 2036 and 2038 Applied; Interest on Loan to Borrow Money From Partnership After Death to Pay Estate Taxes and Other Obligations Is Deductible For Estate Tax Purposes

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Steve R. Akers

Bessemer Trust

300 Crescent Court, Suite 800

Dallas, Texas 75201

214-981-9407

akers@bessemer.com

Synopsis

In this estate tax refund case (published about 2 ½ years after a four-day trial), the decedent signed a partnership agreement and expressed the intent to fund the partnership with a specifically identified bond portfolio and cash, but the funding did not formally occur before her death. The decedent died unexpectedly, so the planner put the funding on hold for about a year until one of the planners heard about the Church case, which had recognized a partnership that similarly had not been formally funded at the decedent's death. The planners completed the formal funding transfers and the estate filed an estate tax return reporting the partnership interests (without a discount) and reporting about $143 million of estate tax. The estate later filed a claim for refund for about $40 million of estate tax. The court concluded that the decedent had expressed the clear intent to fund the partnership with the identified assets, and under Texas law that caused the assets to become partnership assets. The bona fide sale exception to §§2036 and 2038 applied because the partnership was genuine, there was a legitimate business purpose for the partnership (protecting family assets from divorce proceedings and facilitating the administration of family assets) and because she retained significant assets outside the partnership. The taxpayer's valuation expert's value was accepted, representing a 47.5% discount. (The IRS's expert's opinion was rejected because it violated several of the tenets of the hypothetical willing buyer-willing seller valuation principle, including considering the true identities of the buyer and seller, speculating as to future events, and aggregating the interests of the various owners.) The estate borrowed $114 million from the partnership to pay estate taxes and other debts. The interest on the 9-year loan was deductible for estate tax purposes because the interest expense was actually and necessarily incurred in the administration of the estate.

Basic Facts

(1) Mr. Williams died in January 1999. He and Mrs. Williams ["Wife"] had created a "Family Trust" which at his death was to be distributed into Trust M (a QTIP trust) and Trust A (containing Wife's separate property and one-half of community property). Wife was trustee of both trusts. Apparently, there were about $300 million of liquid assets and considerable land and mineral holdings. (The QTIP trust and Trust A apparently were not funded before Wife's subsequent death about 16 months later; that became relevant because it became necessary to fund those trusts before the partnership at issue in this case could be funded.)

(2) Wife was "an impeccably shrewd businesswoman and frugal heiress — with annual living expenses of about $60,000."

(3) Wife was particularly concerned as she worked to protect the family's interests with the risk of losing control of significant family assets through divorces. One of her daughters had gone though a quite lengthy and expensive divorce.

(4) Planners (including Rayford Keller, and his son, Lane Keller, who had been longtime accountants for the family) discussed with Wife creating a series of family limited partnerships for the different classes of assets.

> "It is clear to the Court that the primary purpose of these partnerships was to consolidate and protect family assets for management purposes and to make it easier for these assets to pass from generation to generation. Any estate tax savings that resulted from these partnerships were, in the court's view, merely incidental. It is therefore, clear to the Court that the primary purpose of these partnerships was not federal estate tax avoidance, and the actions taken to form these partnerships were not done so to create a disguise gift or sham transaction as those terms are used in estate taxation." [**Observation**: That finding of fact very early in the opinion clearly telegraphs the court's ultimate resolution of the case.]

(5) There were various meetings in the summer of 1999 and Wife was particularly interested in creating an Investment Partnership to own the community property bonds. The plan was for the QTIP Trust and Trust A to contribute the bonds in return for limited partnership interests (49.95% each). A corporation initially owned entirely by Wife would be the general partner (0.1%). There was oral agreement that she would immediately sell her stock to one of her daughters and two of her grandchildren. In September 1999, the Kellers prepared a spreadsheet describing the funding of the partnership from the QTIP Trust and Trust A, reflecting funding of about $250 million (municipal bonds, treasury securities and cash). The spreadsheet was discussed with Wife in a meeting in September 1999, and her instructions were to proceed with forming the partnership and funding it in accordance with the numbers in the spreadsheet. She did not sign anything evidencing those oral instructions.

(6) A well respected Dallas attorney (Sandy Bisignano) prepared drafts of the partnership agreement before the end of September 1999. The various planners were involved in drafts and redrafts through the fall of 1999, and the drafts were discussed with Wife in January 2000 and she suggested further changes to further restrict the potential of interests passing to non-blood relatives. In January 2000, Lane Keller produced a flowchart and a set of notes laying out the plans for funding the partnership. He tried on

several occasions to convince Wife to contribute other assets to the partnership, but she rebuffed those efforts.

(7) Wife retained assets at her disposal totaling in excess of $110 million.

(8) Wife was diagnosed with cancer in March 2000.

(9**)** Final drafts of the partnership and corporate documents were discussed with Wife on May 9, 2000, and she signed the documents creating the partnership (as trustee on behalf of the trusts) and the corporation. The partnership agreement stated that each partner would contribute assets described on Schedule A, and a separate Subscription and Acceptance by Limited Partners Section also referenced Schedule A. Schedule A had blanks for the amounts to be contributed by each partner. The accountant said the dollar amounts were left blank because he did not have a firm market value of the bonds or the interest accrued on the bonds as of that date. The amounts were to be filled in when the values were finalized.

(10) The following day (May 10), the accountant took steps to request tax identification numbers for the partnership and trusts and spoke with the Vanguard Group (where the investment assets were kept) about creating new accounts for the partnership assets when the tax identification numbers were obtained. The accountant also cut a check for $300,000 to be contributed by Wife to the LLC. The accountant planned to complete the funding after the tax identification numbers were received and the accounts could be opened and planned to have Wife sign the $300,000 check the following week, when Wife was expected to be home from the hospital. The partnership and LLC articles and certificate were filed with the Secretary of State.

(11) Before the funding could be completed, Wife died unexpectedly on May 15 (before the accountant received the tax identification numbers, before he could open the Vanguard accounts, and before he could present the $300,000 check to Wife for her signature). Rayford Keller was one of the co-executors of Wife's estate [hence, the name of the case].

(12) After Wife's death, all activity regarding the partnership (including transferring the bonds to the partnership) was put on hold. No assets were transferred to the partnership and the Schedule A remained blank.

(13) About nine months after the date of death (on February 12, 2001), the estate filed with the IRS an extension request for filing the estate tax return together with "a check in the amount of $147,800,245 … drawn from accounts relating to the Family Trust and made payable to the United States Treasury."

(14) About one year after Wife's death (on May 17, 2001), Lane Keller heard a discussion of the <u>Church</u> case (which had recognized a partnership that similarly had not been formally funded at the decedent's death) at an estate planning seminar. The planners quickly moved forward with formally funding the partnership.

(15) Wife's estate filed an estate tax return on August 14, 2001 reporting a gross estate of about $380.7 million including the interests in the partnership owned by the QTIP Trust and Trust A of about $260.8 million, determined without any discount, and reflecting an estate tax liability of about $143.5 million. (The gross estate and partnership values are described in the summary judgment case described in Item 17 below.) Three months later, the estate filed a Claim for Refund, requesting a refund of about $40 million "or

such other amount as is legally and/or equitably refundable, together with interest thereon."

(16) After funding the partnership, "with an eye towards preserving the liquidity of Mrs. Williams' estate," the estate (and the Family Trust) borrowed $114 million from the partnership to pay federal estate taxes, state inheritance taxes and other debts and obligations arising from the partnership. The $114 million debt was evidenced by a 9-year note with annual interest payments based on a 5.07% rate. The principal is due at the end of 9 years. The estate had paid about $30 million of interest payments to the partnership by the time of trial; the partners paid income taxes on this flow-through interest income from the partnership.

(17) The court rejected the IRS's arguments to dispose of major issues in the case on summary judgment, including that the trusts did not exist for want of a corpus, that the corporate general partner was not authorized to conduct business, that the partnership never came into existence, that there were no assets in the partnership at decedent's death, and that the partnership assets would be included in the estate in any event under §§ 2036(a) and 2038(a). Keller v. U.S., 96 AFTR 2d 2005-6736 (S.D. Tex. 2005).

Holdings

(1) Wife had expressed the clear intent to fund the partnership with particular assets, and under Texas law that caused the assets to become partnership assets even though they had not been formally transferred into the partnership by the time of Wife's death. The interests in the partnership owned by the QTIP Trust and Trust A are included in the estate rather than the underlying assets in the partnership attributable to those interests.

(2) Sections 2036 and 2038 do not apply to include the assets contributed to the partnership in the estate because the transfers to the partnership satisfied the bona fide sale for full consideration exception to §§2036 and 2038.

(3) The estate's interest in the partnership was valued as an assignee interest. The court accepted the taxpayer's valuation expert's opinion, resulting in a discount of 47.5% with respect to the bonds and cash in the partnership.

(4) The interest on the amount that the estate and an includable trust borrowed from the partnership to pay estate and state estate taxes and other debts was deductible for estate tax purposes because the interest expense was actually and necessarily incurred in the administration of the estate. In addition, attorney's fees and miscellaneous administrative expenses such as court costs, accountants' fees, executor and trustee fees, and appraisers' fees are deductible for estate tax purposes.

Analysis and Observations

(1) Assets Treated as Partnership Assets Even Though Not Formally Transferred to Partnership Before Decedent's Death. As evidenced by the "basic" description of the facts, this was a very fact-intensive oriented decision. There was a four-day trial, and the Finding of Facts section comprises about two-thirds of the opinion. The decedent never signed any written document indicating an intent to convey her bond portfolio (and some cash to bring the total to $250 million) to the partnership and to sell her stock in the corporate general partner. Nevertheless, the court was persuaded by the very careful and detailed planning steps of the planners (including detailed spreadsheets and documentation of individual meetings, etc.) that the decedent in fact had the intent to

convey those assets to the partnership, to capitalize the corporate general partner with the $300,000 check waiting for her signature, and to sell her stock in the corporation. In light of the decedent's unexpected death, there were understandable reasons for why the partnership did not get funded prior to her death. Reminiscent of the Church decision (a 2000 case from the Western District Texas Federal Court), the court found that under Texas law, "the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership…This is the case whether or not legal or record title to the property has yet been transferred." (numerous case citations omitted).

The court addressed and rejected various evidentiary objections raised by the government, including (1) the Fifth Circuit rule imposing a qualified ban on parol evidence in federal tax cases, (2) various hearsay objections, and (3) the Texas "Dead Man's Rule."

Observe: The decedent never signed a funding document, and the Schedule A on the partnership agreement was never completed. Nevertheless, the court found that the decedent had expressed the intent to fund the partnership with specifically identified bonds and cash. The accountants' very careful planning and documentation of their various meetings and planning discussions were critical in convincing the court of the decedent's expressed intent to fund the partnership. The accountants' professionalism and high sense of ethics were no doubt important in convincing the court of their credibility and that they were trying to do the right thing. For example, it might have been tempting to fill in Schedule A after the decedent's death to reflect her expressed intent. Furthermore, the case suggests that the planners' (and executor's) testimonies never wavered from admitting that at the date of the decedent's death, they did not realize that the partnership had been funded under applicable state law. The estate's trial lawyer obviously did an excellent job presenting the case to the court in the four-day trial.

(2) Bona Fide Sale Exception to §§ 2036 and 2038 Applies.

There is an exception in §§2036 and 2038 for bona fide sales for full and adequate consideration. The bona fide sale test was analyzed under the rationale of the Fifth Circuit's Kimbell case rather than the "legitimate and significant non-tax purpose" test used by the Tax Court since the time of the Bongard case. Applying the Kimbell analysis, the court found that the estate satisfied the bona fide sale requirement for the following three reasons.

- Genuine Transaction. "[T]he lengthy discussion that went into creating the Partnership Agreement, which Mrs. Williams signed, provides sufficient objective evidence that the Partnership transaction was "real, genuine, and not feigned."
- Legitimate Business Purpose—Divorce Protection; Administration of Family Assets. "[T]he primary purpose underlying the Partnership's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This was accomplished by creating an entity that, by altering the legal relationship between Mrs. Williams and her heirs, could facilitate the administration of significant family assets. In other words, the creation and funding of the Partnership was undertaken for a legitimate business purpose and not the mere 'recycling' of wealth." (A Finding of Fact found that the primary purpose of the partnership in the initial planning stage

was "to consolidate and protect family assets for management purposes and to make it easier for these assets to pass from generation to generation." The Conclusions of Law did not restate those particular reasons.) [**Observe**: Very few prior cases have given much weight to asset protection or divorce protection aspects of limited partnerships as business purposes of the partnerships. Perhaps it is very significant that there had actually been a "quite lengthy and expensive" divorce with one of the decedent's daughters. Interestingly, another daughter fared much better in a divorce after that time because of various trusts that had been created after the first daughter's divorce. The court did not address why the additional protection from the partnership planning was significant. Also, very few prior cases have given much weight to "facilitating gift-giving" as a legitimate non-tax purpose with respect to the bona fide sale exception to §§2036 and 2038. This court seemed to give weight to facilitating passing assets from generation to generation in the Findings of Fact in finding that the primary purpose of the partnership was not federal estate tax avoidance.]

- Retained Significant Assets. "[T]he fact that Mrs. Williams had a significant collection of assets outside of the Partnership — well over $100 million — further supports the conclusion that the transfer was made pursuant to a bona fide sale."

The court also found that the transfers to the partnership satisfied the "full and adequate consideration" requirement in the §§2036 and 2038 exception, again applying the test announced in Kimbell. (1) The interests credited to the partners were proportionate to the fair market value of assets contributed by each partner, (2) assets contributed to the partnership were properly credited to the respective capital accounts of the partners, and (3) on termination or dissolution of the partnership the partners were entitled to distributions in amounts equal to their respective capital accounts.

The court distinguished the Strangi Fifth Circuit case, which had found that the bona fide sale test was not satisfied, because in that case the decedent "transferred his entire accumulated wealth to the partnership, relied on partnership funds to satisfy his various post-transfer financial needs, and continued to live in the residence that comprised a portion of the partnership's corpus."

Observe: This is now the eighth case in which taxpayers have survived a §2036 attack (at least as to part of the assets contributed to an FLP). All eight cases have found that the bona fide sale exception applies. The other seven cases are Church, Stone, Kimbell, Bongard, Schutt, Mirowski, and Miller.

(3) Valuation of Interests in the Partnership. The court valued the interests as assignee interests (without much discussion as to why they were valued as assignee interests rather than full limited partnerships interests; the prior cases have split on this issue, sometimes valuing interests as assignee interests and sometimes valuing them as full limited partnership interests.) The court accepted the opinion of the taxpayer's valuation expert. The court rejected the government's valuation expert because it violated several of the tenets of the hypothetical buyer and seller standards, including considering the true identities of the buyer and seller, speculating as to future events (citing Estate of Simplot), and aggregating the interests of the various owners (citing Estate of Bonner). The fair market value of the partnership assets was $261,042,664, and the value of the QTIP Trust and Trust A's assignee interests collectively was

$136,878,000. Taking into account that the trusts held a 99.9% interest in the partnership, this reflects a 47.5% discount.

Observe: The court's objection to the government's appraiser's analysis is reminiscent of the Holman case, where the court concluded that only a 12.5% lack of marketability discount should apply in valuing assignee interests for gift tax purposes, reasoning in part that the partners could agree to dissolve the partnership at any time and there would be an economic interest to both a limited partner wanting to exit the partnership and the remaining partners "to strike a deal at some price between the discounted value of the units and the dollar value of the units' proportional share of the partnership's NAV." The taxpayers have appealed the valuation portion of that case to the Eighth Circuit Court of Appeals on the basis that the analysis violates the basic hypothetical willing buyer-willing seller valuation principle.

Observe: A 47.5% discount for an assignee interest in a limited partnership holding bonds and cash seems to be a high discount as compared to discounts allowed in most of the prior cases. The opinion does not discuss how much of the 47.5% discount is attributable to the fact that the interest was valued as an assignee interest rather than as a full limited partnership interest. The judge clearly picked one appraisal or the other, and was concerned with the errors mentioned above with the government's appraisal. The high discount may be primarily attributable to a lack of evidence from the government supporting a lower discount. Tax Court judges seem more inclined to do their own valuation analysis and arrive at a value different than any of the experts' conclusions. I suspect that some Tax Court judges would have concluded that a lower discount should apply.

(4) Interest on Post-Death Borrowing From Partnership Deductible. The estate made an estimated federal estate tax payment on February 21, 2001 of almost $148 million (from assets in the Family Trust). That was before the accountant learned of the Church case and funded the partnership. After the partnership was funded (sometime in the late spring or early summer of 2001), the estate and the Family Trust borrowed $114 million from the Partnership "with an eye toward preserving the liquidity" of the estate. The note is due in February 2010, or about 9 years after the borrowing. The estate had actually made $30 million of interest payments to the partnership at the time of the trial. (At a 5.07% interest rate, the interest is almost $5.8 million a year, resulting in a very large deduction over nine years of interest payments; however, the estate tax savings due to the interest deduction for estate tax purposes is partially offset by large income taxes paid on these amounts by the partners of the partnership over the nine-year period.) The court concluded that the "estate lacked sufficient liquid assets to pay its necessary taxes and obligations without forcing the sale of its illiquid properties." The court concluded that the interest on the borrowing was "actually and necessarily incurred in the administration of the decedent's estate," Reg. §20.2053-3(a), and therefore deductible as an administration expense under §2053.

Observe: The opinion does not clarify whether the interest deduction is allowed for the full 9-year term of the note, even before the interest payments have actually been made (in accordance with the Graegin case, which addressed payments under a note with a fixed interest rate for a fixed period of time that does not allow prepayment). Interestingly, the court cites the Graegin case as support for allowing the interest deduction. At this point, there is not much difference whether the interest is deductible upfront, or only as it is paid, because the estate is fairly close to the end of the 9-year term of the note and most of the interest payments have been made.

Observe: The opinion does not clarify why there were insufficient liquid assets to pay the estate taxes when the $148 million tax payment had already been made. The opinion also does not clarify how the Family Trust raised the $148 million that was paid in February 2001. Perhaps the Family Trust had borrowed the money from a bank, or perhaps the estate had used liquid funds in the Family Trusts, not yet realizing in February, 2001 that under Texas law those funds legally belonged to the partnership.

Observe: The opinion does not suggest that the IRS made arguments similar to its conclusion in Technical Advice Memorandum 200513028, where the interest deduction was denied regarding amounts that an estate borrowed from a partnership created by the decedent. In that TAM, the IRS took the position that the deduction was disallowed because the loan was not necessary because the partners were the same as the estate beneficiaries (which appears not to be the situation under the Keller facts), one of the sons was both a co-executor and a general partner of the partnership, the partnership was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor’s ability to access the partnership funds. In addition, the IRS reasoned in the TAM that the repayment of the loan had no economic impact on the parties, but just represented a circular flow of funds.

(5) Post-Death Use of Partnership Assets as a Factor in Applying §2036. A number of cases have looked to the post-death use of partnership assets to pay estate taxes as evidence of retained enjoyment of assets to trigger §2036(a)(1). That is not relevant in this case, because the exception to §2036 applies, so the court never had to address whether there was an implied retained enjoyment of partnership assets within the meaning of §2036(a)(1). If an estate must utilize partnership assets in some way in order to pay estate taxes, tax litigation attorneys generally prefer accessing partnership funds by borrowing rather than having the partnership directly paying estate taxes or making distributions to the estate to pay estate taxes. The estate in this case followed the preferred route of borrowing rather than making direct payments of taxes or making distributions to the estate to pay taxes.

Pierre v. Commissioner, 133 T.C. No. 2
(August 24, 2009)

Transfers of Interests in Single-Member LLC Treated as Transfers of Interests in the Entity Rather Than as Transfers of Proportionate Shares of the Underlying Assets (Without a Discount)

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Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Synopsis

Gifts and sales of interests in a single-member LLC to two trusts (12 days after the LLC was created) are treated for federal gift tax purposes as transfers of interests in the entity (with the possibility of discounts) rather than as transfers of proportionate shares of the underlying assets owned by the LLC, even though the single-member LLC is treated as a disregarded entity pursuant to the check-the-box regulations. This conclusion came from a rather divided Tax Court (with 10 judges joining the majority and 6 judges dissenting).

Basic Facts

(1) Mother wanted to provide for her son and granddaughter, but was concerned about keeping her family's wealth intact. A plan was developed for her to fund an LLC and make transfers of interests in the LLC to trusts for her son and granddaughter.

(2) On July 13, 2000, Mother organized a single-member LLC. She did not elect to treat the LLC as a corporation for federal tax purposes by filing Form 8832, so by default it was treated as a disregarded entity.

(3) On September 15, 2000, Mother transferred \$4.25 million in cash and marketable securities to the LLC.

(4) Twelve days later, on September 27, 2000, Mother transferred her entire interest in the LLC to two separate trusts, one for her son and one for her granddaughter. This happened in two steps. First, she gave a 9.5% interest to each trust. Then she sold a 40.5% interest to each trust for a secured note, with the face amount determined by an appraisal that applied a 30% discount (although a mistake in valuing the underlying assets resulted in a 36.55% discount.)

(5) Mother filed a gift tax return for 2000 reporting the gifts. The IRS took the position that the transfers made by gift and sale should be valued as a proportionate share of the underlying assets (without a discount).

Issue

"The issue to be decided is whether certain transfers of interests in a single-member limited liability company (LLC) that is treated as a disregarded entity pursuant to sections 301.7701-1 through 301.7701-3, Proceed. & Admin. Regs., known colloquially and hereinafter referred to as the check–the-box regulations, are valued as transfers of proportionate shares of the underlying assets owned by the LLC or are instead valued as transfers of interests in the LLC, and, therefore, subject to valuation discounts for lack of marketability and control." (A separate opinion will address "(1) Whether the step transaction doctrine applies to collapse the separate transfers to the trusts and (2) the appropriate valuation discount, if any.")

Holding

"[T]ransfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC."

Analysis of Majority:

(1) IRS Position. Mother elected to treat the LLC as a disregarded entity separate from its owner "for federal tax purposes" under the check-the-box regulations. Regulation §301.7701-3(a) provides that "[w]hether an organization is an entity separate from its owners *for federal tax purposes* is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." (emphasis added) Because the LLC is treated as a disregarded entity, the transfers of interests in the LLC should be treated as transfers of cash and marketable securities, i.e., proportionate shares of the LLC's assets, rather than as transfers of interests in the LLC for purposes of valuing the transfers to determine federal gift tax liability.

(2) Taxpayer Position. State law, not federal tax law, determines the nature of a taxpayer's interests in property transferred and the legal rights inherent in that property interest. Under New York law, a member has no interest in specific property of the LLC. Accordingly, the transfers of interests in the LLC were properly valued as interests in the LLC with appropriate lack of control and lack of marketability discounts.

(3) Historical Gift Tax Valuation Regime. The U.S. Supreme Court has clarified that the federal gift tax is constitutional as an excise tax rather than a direct tax (which must be apportioned proportionately by population) because it is a tax on the power to give property to another. "A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights." The conclusion to be drawn from the general principles is that "there was no State law 'legal interest or right' in [the LLC assets] for Federal law to designate as taxable, and Federal law could not create a property right in those assets. Consequently, pursuant to the historical Federal gift tax valuation regime, petitioner's gift tax liability is determined by the value of the transferred interests in Pierre LLC, not by a hypothetical transfer of the underlying assets of Pierre LLC."

(4) Check-the-Box Regulations Merely Intended to Cover Classification of Entities. The "Kintner Regulations," in place since 1960, addressed the classification of entities for federal tax purposes and they became "unnecessarily cumbersome to administer." To simplify the classification of hybrid entities, such as LLCs, the check-the-box regulations were promulgated. Regulation §301-7701-1(a)(1) provides:

> "The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners *for federal tax purposes* is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." (Underlined emphasis supplied by court; italicized emphasis added).

Regulation §301.7701-3(a) provides that

> "[a] business entity … can elect its classification for federal tax purposes as provided in this section. An eligible entity … with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." (Emphasis supplied by court).

"There is no question that the phrase 'for federal tax purposes' was intended to cover the classification of an entity for Federal tax purposes, as the check-the-box regulations were designed to avoid many difficult problems largely associated with the classification of an entity as either a partnership or a corporation…"

Section 7701, which is the underpinning of the check-the-box regulations, defines entities for purposes of the Internal Revenue Code, but §7701(a) makes clear that the definitions in that section apply "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." In any event, §7701 does not make clear whether an LLC falls within the definition of a partnership, a corporation, or a disregarded entity taxed as a sole proprietorship.

(5) Check-the-Box Regulations Do Not Alter Historical Federal Gift Tax Valuation Regime. The issue is whether the check-the-box regulations require disregarding a single-member LLC, validly formed under state law, in deciding how to value and tax a donor's transfer of an ownership interest in the LLC under the federal gift tax regime. The IRS suggested several precedents for ignoring state law restrictions. None of those precedents are applicable. McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007) held that state law cannot abrogate the federal employment tax obligations of the owner of a disregarded entity under the check-the-box regulations; it did not hold that an entity is to be disregarded in deciding what property interests are transferred under state law. Similarly, Littriello v. United States, 484 F.3d 372 (6th Cir. 2007) and Med. Practice Solutions, LLC v. Comm'r, 132 T.C. No. 7 (March 31, 2009) merely involved the classification of a single-member LLC for purposes of liability for employment taxes, not transfers of interests in a single-member LLC for gift tax purposes. Shepherd and Senda held that a transfer of assets to a partnership already owned by other partners (or where it cannot be determined whether the contribution preceded the transfer of partnership interests) may represent an indirect gift to the other partners. That is distinguished from the current situation in which the taxpayer clearly contributed assets to the LLC before transfers of ownership interests in the LLC to the trusts.

(6) Conclusion. Congress has enacted several provisions that explicitly disregard valid State law restrictions in valuing transfers (§§2701 and 2703), but when Congress has determined that the "willing buyer, wiling seller" and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses (see

chapter 14 of the Code). By contrast, Congress has not acted to eliminate entity related discounts for LLCs or other entities generally, or for single-member LLCs specifically.

> "In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC."

The reviewed majority opinion, written by Judge Wells, was joined by nine other judges (Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison).

Brief Overview of Concurring and Dissenting Opinions

(1) Concurring Opinion by Judge Cohen. The check-the-box regulations were a targeted substitute to the complexity of the Kintner regulations, and a targeted solution to a particular problem should not be distorted to achieve a comprehensive overhaul of a well-established body of law.

The majority opinion does not disregard the plain meaning of the phrase "for federal tax purposes" in the check-the-box regulations. First, the regulation does not provide that an entity is disregarded "for all federal tax purposes," but the regulation implements a statute that by its terms applies except where "manifestly incompatible with the intent" of the Internal Revenue Code. "The language of the regulation requires a determination of which 'federal tax purposes' are implicated and whether a given purpose might be manifestly incompatible with the Internal Revenue Code." Second, the statement that an entity will be "disregarded as an entity separate from its owner" is ambiguous and the regulation must be interpreted in light of the other principles of the Internal Revenue Code, including the historical valuation principles. The IRS's proposed application of the regulation is manifestly incompatible with those principles.

The majority opinion does not involve the issue of deference to the Commissioner's interpretation of a statute. Nothing in the check-the-box regulations or in the cases cited requires disregarding a "single–owner LLC where, as is the case here, to do so would be 'manifestly incompatible' with the intent of other provisions of the Internal Revenue Code."

The court has never accorded deference to the Commissioner's litigating position, as contrasted to (1) contemporaneous expressions of intent when the regulations were adopted and (2) consistent administrative interpretations before the litigation.

(This concurring opinion was joined by eight other judges (all of the judges that joined the majority opinion except Judge Morrison).)

(2) Dissenting Opinion by Judge Halpern. Express language in the check-the-box regulations seems to apply. Regulation §301-7701-2(a) says that when an entity with only one owner is disregarded "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." Therefore, the LLC's activities are

treated in the same manner as those of a sole proprietorship. A sole proprietorship is generally understood to have no legal identity apart from the proprietor.

If the "activities instruction" regulation is ambiguous, it must be construed, and an agency's interpretation of its own regulation must be considered and the courts will ordinarily show deference to such construction and give it controlling weight. The government's position is consistent with the Commissioner's administrative position for at least 10 years, evidenced by Rev. Rul. 99-5, and cannot be dismissed as a mere litigating position. Rev. Rul. 99-5 treated a sale by the owner of a single-member entity of a 50% ownership interest in the entity as converting the entity to a partnership and treated the purchaser as purchasing a 50% interest in each of the LLC's assets, "which are treated as held directly by [the original single-member owner] for federal tax purposes." Granted, that addresses sales for income tax purposes, and the Commissioner has made no interpretation specifically for gift tax purposes, but "a gift is the functional equivalent of a below-market sale."

As to the deference issue, the majority opinion does not merely reject the IRS's interpretation of the regulation but actually accepts that meaning and rejects the activities instruction itself as an invalid construction of the statute. McNamee, Littriello and Med. Practice Solutions, LLC have all recognized the validity of the check-the-box regulations as applied to single-member disregarded entities.

Judge Halpern's dissent was joined by Judges Kroupa and Holmes.

(3) Dissenting Opinion by Judge Kroupa. The majority fails to apply the plain meaning of the regulation, which requires that a single-member LLC be disregarded for "federal tax purposes." The check-the-box regulations are not simply rules of classification, but apply to the entire Code. The regulations do not just apply for "federal *income* tax purposes," and the drafters could have specifically excluded gift tax from the regulations' scope had they intended to do so. The regulations consistently treat single owners who choose noncorporate status for their LLCs as holding the property of their disregarded entities.

Other guidance from the IRS treats the owner of a single-member LLC as the owner of its underlying property, including Rev. Rul. 99-5 and numerous private letter rulings (for example, such as the applicability of like-kind exchange treatment).

The majority invalidates the check-the-box regulations for federal gift tax purposes to the extent that the term "federal tax purposes" encompasses federal gift tax.

The majority opinion's reliance on the gift tax regime and valuing interests that are recognized by state law is misplaced. The regulations provide the federal tax consequences of what is, in effect, an agreement between the taxpayer and the Commissioner to treat an entity in a certain way for federal tax purposes despite the entity's state law classification. Three cases have confirmed that the owner of single-member LLC is liable for federal employment taxes even though state law provides that the owner is not personally liable for the LLC's debts. McNamee, Littriello, and Med. Practice. "Determining an owner's liability for employment taxes is as far removed from determining the owner's income tax liability as is determining the owner's gift tax liability."

The majority overlooks the broad scope of the gift tax statutes in concluding that the check-the-box regulations are manifestly incompatible with the gift tax regime. The gift tax regime includes indirect gifts (citing Dickman). Substance over form principles have been used by the courts to get to the true nature of a gift (citing Kerr, Astleford, and Estate of Murphy). The courts have also used the step transaction doctrine in the area of gift tax where intra-family transactions often occur (citing Senda and Commissioner v. Clark, 489 U.S. 726, 738 (1989)).

> "Conclusion The plain language of the regulations requires Pierre LLC to be 'disregarded as an entity separate from its owner.' Unlike the majority, I give meaning to these words. I do not minimize this language by labeling it a classification. A plain language interpretation of the check-the-box regulations must prevail. It is an interpretation of relevant regulations. It is not manifestly incompatible with the gift tax statutes."

Judge Kroupa's dissent was joined by five other judges (Judges Colvin, Halpern, Gale, Holmes, and Paris).

Observations

(1) Case of First Impression; Discounts May Be Allowed for Single-Member LLCs. The issue of how the disregarded "for federal tax purposes" regulation will be applied for gift and estate tax purposes has been an open issue since the check-the-box regulations were issued. This is the first opinion addressing the valuation issue for a transfer of an interest in a single-member LLC. It seems to be a rather close call, with six Tax Court judges joining the dissent. The dissents make interesting arguments. Nevertheless, in this case of first impression, the court decides that discounts are not automatically disallowed for federal gift tax purposes when the interests in a single-member LLC are transferred.

(2) Different Possible Approach: Focus on What Is Transferred to Hypothetical Willing Buyer. The judges obviously struggled with how the regulation saying that the entity is disregarded for federal tax purposes applies in the context of gift (and presumably estate) tax purposes. However, the regulation applies during the time that the entity is a single-member entity. For gift (and estate) tax purposes, the key is what is transferred. At the instant a transfer is made, the entity is no longer a single-member entity (unless it is transferred entirely to a single transferee). In this case, there were multiple transfers (i.e., by gift and sale) to multiple transferees. The gifts occurred first. After the initial transfers, the entity clearly was not a single-member entity, and the value of the interests subsequently sold do not seem to be affected by the regulation, which only applies to single-member entities, unless the step transaction doctrine somehow aggregates the gift and sale transactions.

In addition, the transfers in this case are to multiple transferees. Under the principles of Rev. Rul. 93-12, the transfers to each separate transferee are valued separately. In that context, the transfer to each necessarily will not be interests in a single-member LLC.

One possible way of approaching the issue is to focus on the particular interest being transferred, and whether it can possibly be treated as an interest in a single-member entity. The answer for estate tax purposes may be that it would be — that the focus would be on the single-member interest owned by the estate, rather than focusing on who are the legatees of the interest (and in particular, whether there are multiple transferees). Even for gift tax purposes, if the court applies a step transaction doctrine to join all of the different transfers into a single transfer, the issue of how the regulation applies might arise. Aside from those situations, the niceties of whether the regulation applies would be avoided under this alternate possible analysis. But — that was not the court's approach.

This suggests a planning consideration. In the event that future cases may resolve this issue differently (indeed, this was a very divided court), consider first making a transfer of a very small interest in the entity (for example, 1% or lower), in case a future court were to treat the transfer of an interest in a single-member LLC as a proportionate transfer of the underlying assets (without a discount). If the client later decides to transfer further interests in the entity, it would no longer be a single-member entity, so the regulation would not apply, unless the IRS were able to apply the step transaction doctrine. How long of a delay would be necessary to avoid the step transaction doctrine? If future courts were to apply an analysis similar to Holman, the focus might be on whether there was a real risk of an economic change in value during the intervening time period. Of course, there may be important reasons for keeping the entity as a single-member disregarded entity rather than having it convert to a partnership for income tax purposes. If that were important, the transfers would typically be made to grantor trusts, and it is not clear how the single-member LLC regulations would apply in this context if there were various transfers to a single grantor trust. During the time that the original grantor and the grantor trust each held interests in the LLC, those interests are recognized as separate ownership interests for estate and gift tax purposes, but it is not clear how the single-member entity regulations would apply for estate and gift tax purposes. On the other hand, if there were transfers to multiple grantor trusts for differing beneficiaries, it would be harder for the government to maintain that the entity is still a single-member entity for estate and gift tax purposes.

(3) Step Transaction Doctrine; Aggregation. The step transaction doctrine is arising with increasing frequency. At one time, many planners argued that the step transaction doctrine was an income tax doctrine that did not apply at all to the estate and gift tax. Now, it seems to be a rather commonplace argument in gift and estate tax cases (and the very broad reasoning in the Litton and Heckerman cases is quite troubling — suggesting that the doctrine might apply almost whenever an individual has an intent to transfer assets to children while minimizing transfer taxes).

Footnote 1 indicates that there will be a separate opinion addressing "whether the step transaction doctrine applies to collapse the separate transfers to the trusts." Footnote 4 indicates that the IRS did not argue that the step transaction doctrine should be applied to disregard the LLC entirely. Instead, the IRS argues that the step transaction doctrine should apply to the gift and sale transfers, but "explicitly limits the proposed application of the step transaction doctrine to the events of Sept. 27, 2000." That is the date the gifts and sales occurred with the two separate trusts. Will the IRS argue that all four transactions (i.e., gift to Trust 1, sale to Trust 1, gift to Trust 2, and sale to Trust 2) should be treated as one transaction? That would involve the collapse of the multiple transactions with each transferee as well as the transactions of one transferee with the other transferee.

What if the two transferee trusts are each grantor trusts? Does that change the analysis? For income tax purposes, the grantor is treated as the owner of the assets of the grantor trust, so the owner may still be treated as the owner of the interests, but for estate and gift tax purposes, the trusts are separate legal entities and should not be deemed to be owned by the grantor of the grantor trust. Even if the trusts are grantor trusts, they should not be treated as being a single member (i.e., Mother in this case) for estate and gift tax purposes.

The IRS is not arguing that the funding of the LLC and the subsequent transfers of interests in the LLC should be treated as transfers of assets contributed to the LLC under the step transaction doctrine as discussed in the Holman, Senda, Gross, Linton, and Heckerman cases. (That would involve applying the step transaction doctrine to the events of Sept. 15-27, 2000, not just to the events of Sept. 27.) Footnote 12 specifically made the observation that the subsequent transfers were made 12 days after the funding of the LLC and that Holman had refused to apply the indirect gift analysis "where assets were transferred to a partnership 5 days before the gifts of the partnership interests." [Observe: The Holman facts indicate that the gift of partnership interests in the partnership holding Dell stock was made 6 days after funding in that case and the Gross case involved contributions of marketable securities 11 days before the transfers of partnership interests.]

The step transaction issue obviously involves an aggregation issue, as to whether transfers to multiple recipients should be aggregated. That would seem to be a very difficult argument for the IRS in light of its position in Rev. Rul. 93-12. The aggregation issue is important because if a transfer is made to a single member, even if it is treated as an interest in an entity rather than as a transfer of all of the assets, if the single member could dissolve the entity at any time under state law, the IRS would likely argue for very low (if any) discounts. If the transfers to multiple transferees are not ignored under the step transaction doctrine, it would generally no longer be possible for any single recipient to have the power to force the liquidation of the entity, so avoiding aggregation of the interests held by the separate transferees is very important.

How will the court apply the step transaction doctrine? Planners were generally very surprised with the way that the Tax Court chose to apply the step transaction doctrine in Holman (followed by Gross). If the court applies a similar analysis, i.e., whether there is a real risk of an economic change in value between the different steps in the transaction, it would seem that the gifts and sales made on the same day may be aggregated. However, that would not address combining the transfers to the separate trusts as a single transfer. If the transfers to the multiple recipients are respected, it would seem that the interests actually transferred would be entitled to entity level discounts under the reasoning of Rev. Rul. 93-12.

(4) Estate Tax Implications. The analysis presumably would be the same for estate tax purposes as to whether the interest in a single-member LLC is valued as an interest in the entity or valued at an amount equal to the value of the underlying assets. Even if the decedent is treated as holding an interest in the entity rather than the underlying assets, the IRS may argue that no discount should be appropriate if under state law the decedent could unilaterally control when the entity would be liquidated and receive the underlying assets, and could transfer that right to another single recipient. While the focus would still be valuing an interest in an entity, very low discounts may be applied if the decedent or the decedent's estate has the ability to reach the underlying assets at any time.

If that is the analysis that emerges in future estate tax cases involving interests in single-member LLCs, the primary importance of this case will be its direct application for gift tax purposes rather than possible ancillary effects for estate tax purposes.

In Mirowski, the IRS made its typical argument that the bona fide sale exception to §2036 did not apply, in part because "Ms. Mirowski sat on both sides of Ms. Mirowski's transfers" to a single-member LLC. The court rejected that argument, because it would mean that the bona fide sale exception to §2036 could never apply to the creation of a single-member LLC, and the court would not read out of the statute an exception that "Congress expressly prescribed when it enacted that statute."

This summary reflects the views of Bessemer Trust and is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current opinions only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

THE LENDER WITH TWO MORTGAGES ON THE SAME PROPERTY
Risks and Strategies

Brian D. Hulse

The Fall 2009 issue, Vol. 44, Issue No. 3, of the *Real Property, Trust and Estate Law Journal* will include an article entitled *The Lender With Two Mortgages on the Same Property: Risks and Strategies*, by Brian D. Hulse. The article will explore some difficult and little-known issues facing lenders holding two or more mortgages or deeds of trust on the same property. The most fundamental of these issues is the risk that, by foreclosing one of the two mortgages, a court will deem the debt secured by both mortgages to have been satisfied. If the lender does not anticipate these issues in planning its realization strategy, it can severely impair its rights.

The case law in this area is inconsistent and has created unpredictability and unnecessary variations in outcomes from state to state. This is an undesirable situation in the modern world of real estate finance where lenders and the secondary markets deal with a national lending market and unnecessary local variations only add additional costs to the lending process, which are ultimately passed on to borrowers.

Most cases hold that, if the lender forecloses the more senior mortgage, while that foreclosure will wipe out the junior mortgage as a lien on the property, that foreclosure will generally not operate to extinguish the debt secured by the junior mortgage. *See, e.g., Urbach v. Monchamp Corporation*, 110 Or. App. 275, 821 P.2d 1116 (1991); *United Bank of Lakewood National Association v. One Center Joint Venture*, 773 P.2d 637 (Colo. App. 1989). Notwithstanding this general rule, there are situations and states in which such a foreclosure will be held to have extinguished the junior debt. *See, e.g., Iwan Renovations, Inc. v. North Atlanta National Bank*, 296 Ga. App. 125, 673 S.E. 2d 632 (2009); and *Simon v. Superior Court*, 4 Cal. App. 4th 63, 5 Cal. Rptr. 2d 428 (1992).

Oregon recently retreated somewhat from the ruling in *Urbach* in the case of residential foreclosures by a 2009 amendment to its trust deed statute. The amendment amends the state's antideficiency law, to provide that, where a residential trust deed is foreclosed judicially or nonjudicially, no deficiency or other judgment may be entered on any "other note, bond or other obligation" where that other obligation is secured by another residential trust deed or mortgage on the same property if (i) the two obligations were "created at the same time" and (ii) the other obligation is "owed to the beneficiary in the residential trust deed that was subject to the trustee's sale or the foreclosure."

The law is somewhat different where the junior mortgage is foreclosed. In that case, "if the holder of both a junior and senior mortgage forecloses the junior and buys at the foreclosure sale it is generally held that, in the absence of an agreement to the contrary, the mortgagor's personal liability for the debt secured by the first mortgage, or for a deficiency, is extinguished." *See*, 1 NELSON AND WHITMAN, REAL ESTATE FINANCE LAW § 6.16 (5th ed. 2007) and cases cited therein. The cases have reached this result by a variety of theories, some of which are of questionable merit. Further, courts have too often applied technical legal theories, such as the doctrine of merger, in mechanical ways that do not address the underlying equities of the case.

The article will explore all of these issues in detail, will discuss state variations in the law and will propose strategies for the secured creditor to employ, at both the documentation stage and at the foreclosure stage, to minimize the risks. These issues have heightened importance in the current environment of greatly increased numbers of foreclosures after a long period of a buoyant real estate market with a very low foreclosure rate.

Brian D. Hulse is a partner in the Seattle office of Davis Wright Tremaine LLP. He can be reached at brianhulse@dwt.com.

Speed Kills:

Buyers Risk Liability and Physical Harm for Former Meth Labs

By Marlene S. Gomez[1]

The contamination left over from former methamphetamine laboratories ("meth labs") can wreak havoc on unsuspecting home buyers. Widespread and numerous meth lab seizures in areas not usually associated with drug activity have led to an increasingly familiar story: after being plagued by mysterious illnesses ranging from nausea and dizziness to chemical burns, severe migraines and respiratory ailments, the unwary homeowners discover that their family has been living in a house that was a former meth lab.[2] The acids, solvents, volatile organic compounds and other toxic chemicals that were used to "cook" the meth have been lurking in the walls, carpets, counters, air ducts and appliances that surround them. The hazardous wastes produced from the manufacturing process were poured down drains or directly onto the ground and may persist for years in the soil and groundwater. These are not the threats that most people think of when they think of meth labs – such as fires and explosions. Rather, the invisible contamination left over from a former meth lab can be just as harmful. Adding insult to injury, the affected homeowners are financially responsible for the remediation of the contamination at their home which will carry the stigma of being a former "meth house."

The federal government defers meth lab cleanup to the states. Pursuant to the Methamphetamine Research and Remediation Act of 2007, however, the Environmental Protection Agency (EPA) has been working on model, health-based clean-up guidelines for states and localities with the goal of ensuring former meth lab sites are safe and livable. EPA is still revising a draft version of the guidelines. Because each state has been affected by meth use to different extents, a myriad of different approaches has developed. Western states, such as Washington and Oregon, tend to have the most comprehensive programs requiring cleanup of contaminated property, establishing cleanup standards and mandating disclosure to prospective purchasers. But a growing number of meth lab incidents in the South and Midwest,[3]

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1 Marlene S. Gomez is an associate in the Philadelphia office of Ballard Spahr, LLP, and a member of the firm's Environmental Group. Her practice involves a range of environmental litigation, transactional and regulatory counseling, and compliance matters, including representing lenders, developers and other clients who are involved in projects that carry risk arising from the presence of contamination or environmentally-sensitive features such as wetlands or endangered species. Ms. Gomez is admitted to practice in Pennsylvania. She serves on the board of the Hispanic Bar Association of Pennsylvania, and is President of the Hispanic Bar Association of Pennsylvania Legal Education Fund. Ms. Gomez is a graduate of Princeton University (A.B. 2000) and the University of Pennsylvania Law School (J.D. 2004), where she served as a senior editor of the Journal of Constitutional Law.

2 Take a look at websites like www.methlabhomes.com for examples of the increasing frequency with which meth contamination has brought physical and financial ruin to innocent homebuyers.

3 Missouri State Highway Patrol, *2009 Meth Lab Incidents*, at http://www.mshp.dps.mo.gov/MSHPWeb/DevelopersPages/DDCC/methLabDisclaimer.html. Missouri far

have prompted a number of states to begin enacting laws to address the problem. Nationally, meth lab seizures reached a high in 2003 and 2004 when there were over 17,000 meth lab incidents in the U.S. for two years in a row.[4] The number of incidents fell steadily after that due to the enactment of federal legislation, but the number of incidents rose again in 2008. Despite the high numbers of meth lab seizures over the past few years and the fact that many labs are often found in dwellings like houses or apartments, almost half of the states do not have any meth cleanup or disclosure laws in place.

Washington was one of the first states to have a comprehensive meth cleanup program in place and enacted legislation in 1989.[5] The Washington initiative has since been used as a model by a number of other states that have created their own programs. Some key provisions of Washington's program are as follows:

- The current owner of the contaminated property is held financially liable.

- The responsible health official must determine whether property containing an illegal drug lab is "fit for use" or "unfit for use." Any property deemed "unfit for use" will be reported to the state health division and a copy of the "unfit for use" order will be filed with the county auditor meaning that anyone who conducts a title search on the property will find a notice that the property was used as a meth lab in the land records. The decision may be appealed or the owner may choose to decontaminate the property and seek certification that the property has been properly decontaminated.[6]

- Regulations and guidelines have established decontamination standards. These include numeric remediation levels for hazardous chemicals.[7]

- The seller always retains the option not to decontaminate the property, but the property may only be sold with full written disclosure to the prospective buyers. Even if the property is decontaminated, sellers must still disclose to potential buyers that the property was once used as an illegal drug-manufacturing site.[8]

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surpasses any other state for meth lab incidents in 2009. "Incidents" include labs, dumpsites and chemical and glassware seizures.

4 U.S. Drug Enforcement Agency, *Maps of Methamphetamine Lab Incidents*, at http://www.usdoj.gov/dea/concern/map_lab_seizures.html.

5 *See* WASH. REV. CODE § 64.44 (2009).

6 *Id.* § 64.44.030.

7 WASH. ADMIN. CODE § 246-205-541 (2009).

8 WASH. REV. CODE § 64.46.020 (2009).

The cleanup standards that states have put in place throughout the U.S. range from enforceable regulations to more general guidelines that do not have numeric remediation levels. Some states have cleanup guidelines but do not have any laws requiring disclosure of the property's use as an illegal drug manufacturing site. The absence of meth cleanup or disclosure laws in many states does not mean that those states are necessarily insulated from the meth problem. For example, Nebraska does not have cleanup standards in place or meth disclosure laws, despite the fact that meth lab incidents, after dropping sharply in 2007, doubled from 2007 to 2008.[9] Reasons for the delay by states appear to include questions about the legality of requiring home owners to disclose the history of their home to a potential buyer. There are also concerns in a number of states with the lack of data analyzing the effects of long-term exposure to meth contamination and the resulting inability to devise health-based standards.

In the absence of meth cleanup standards, the presumption should be that the environmental laws of the state control. In addition to providing cleanup standards (although maybe not meth-specific) some states have environmental laws with deed notification requirements that are triggered when hazardous substances have been released into the environment. Depending on the particular substances and quantities involved, meth lab contamination may constitute a release under state laws, which raises a broader question: does the failure to disclose meth contamination in the deed constitute a defect in title and implicate a claim against the title insurer? But it may not be true in all states or under federal environmental laws that a spill inside a building would be subject to the same environmental regulations as a spill in the yard or a release to groundwater. Environmental laws have been developed to address different types of threats and are not typically set up to address indoor pollution. And even if meth contamination would technically qualify as a release under federal or state environmental laws, it is also unlikely that smaller operations typically found in homes would receive any enforcement action under those laws.

Some states have chosen to take an approach that uses real estate disclosure laws to put prospective buyers on notice before sale. Most states already have laws that require disclosure of everything from water in the basement to environmental contamination. In such cases, it would be quite simple to add a provision that alerts sellers that environmental contamination includes meth labs or to create a separate provision for illegal drug manufacturing. Illinois is an example of one state that has taken this route. It has thus far declined to devise clean up standards, but just recently amended its Residential Real Property Disclosure Act to require the disclosure by a seller of real property if the property is "known" to be used for the manufacture of methamphetamine. The Illinois legislation, Public Act 96-232, was signed and became effective on August 11, 2009.

Nevertheless, the "disclosure-law-only" approach suffers from the glaring defect that it relies on the knowledge and honesty of those making the disclosures.

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[9] U.S. Drug Enforcement Agency, *supra* note 4.

Depending on the language of the statute, the responsibility to disclose the property's history may fall on the seller and the realtor, or just the seller, who may have incentive to lie or may not have known the extent of the activities conducted on the property (for example – the activities of former tenants). Of course, this is always the case with disclosure forms, which is why testing or a comprehensive program like Washington's which raises red flags in the land records, may be the way to go. Even more troubling is that disclosure laws may be rendered practically worthless without cleanup standards in place. States may choose to exempt from disclosure properties that have been "cleaned up," but without enforceable standards and certification methods, how does one know what is "clean"?

Questions may then arise if misrepresentations are made in the disclosure statement, the answers to which will depend on the particular real estate laws of individual states. Is it possible that a misrepresentation could render the transaction voidable? Or will the only recourse be trying to recover through the legal process cleanup costs from the seller, who may or may not have any assets?

The risks of severe health effects from exposure to residual contamination from meth labs are serious enough to warrant state laws that are designed to protect the public from exposure to meth contamination. States have taken a variety of approaches, ranging from establishing comprehensive cleanup programs to doing nothing. If the country really is facing a "meth epidemic", is doing nothing the right policy?

MERS' Standing to Foreclose Upheld in Rhode Island State Court Challenge

by

Jeffrey H. Gladstone, Esq.
David J. Pellegrino, Esq.

Rhode Island is the most recent state in a long line of jurisdictions to rule that Mortgage Electronic Registration Systems, Inc. (“MERS”) has standing to foreclose. The Rhode Island court further ruled that MERS, as mortgagee and nominee for the mortgagee, may exercise the statutory power of sale in its own name.

The case of *Bucci v. Lehman Brothers Bank, et al.,* C.A. No. PC 09-3888, was filed in the Providence County Superior Court. The facts of the underlying action are typical of many foreclosure scenarios occurring across the country. A loan was originated and the borrower executed a promissory note made payable to the lender. Contemporaneously, as security for the repayment of the promissory note, the borrower granted a mortgage on the residential property to MERS. The mortgage was granted by the borrower/mortgagor to MERS as nominee for the Lender, granting all the rights and privileges of a mortgagee to MERS, including the statutory power of sale.

As with many non-judicial jurisdictions, Rhode Island’s legislature enacted a statutory process allowing a mortgagee to foreclose on its mortgage following a borrower’s default. Rhode Island General Laws § 34-11-22 codifies the statutory power of sale, which many, if not all MERS originated mortgages incorporate by reference (“Statutory Power of Sale”).

The borrower eventually defaulted on its repayment obligations under the terms of the promissory note. The loan was accelerated and the borrower failed to cure. Non-judicial foreclosure proceedings were commenced whereby, pursuant to Rhode Island’s statutory scheme, a notice of foreclosure was sent to the borrower and foreclosure notices were published in the statutorily prescribed form and manner.

In this case, prior to the scheduled foreclosure date, the borrower filed a complaint seeking injunctive relief to enjoin the foreclosure sale. The complaint alleged, *inter alia*, that: the Rhode Island statutory scheme does not allow MERS to exercise the Statutory Power of Sale in the mortgage because Rhode Island does not recognize a “nominee mortgagee”; MERS, because it is not the Lender, does not have standing to foreclose; and MERS is precluded from foreclosing because it is not the owner of the promissory note. The Court granted the initial request for relief pending a substantive hearing on the issues. In an unusual procedural move, the Court administratively consolidated dozens of other cases raising similar issues throughout Rhode Island. Five days later, a preliminary injunction hearing was held and, pursuant to Rule 65(a)(2) of the Rhode Island Rules of Civil Procedure, the Court consolidated the preliminary injunction hearing with the trial on the merits.

Following the full hearing, on August 25, 2009, the Court issued its decision denying the borrower’s requests for relief. In so ruling, the Court “specifically [held] that MERS, in the case at bar, has standing to and may foreclose the mortgage granted to it by the Plaintiffs utilizing the Statutory Power of Sale referenced therein.”

After a brief description of MERS' functions, the Court first considered MERS' contractual right to foreclose pursuant to the mortgage document. Citing directly to the mortgage, the Court noted that the borrower granted "the Statutory Power of Sale to MERS, as nominee for Lender, its successors and assigns." The Court went on to quote the mortgage which stated that: "if necessary to comply with law or custom, MERS (as nominee for Lender and Lender's successors and assigns) has the right to exercise any or all of those interests, including, but not limited to, the right to foreclose and sell the Property[.]" (Emphasis in decision). In addition, the Court, rejecting certain of the borrower's other contentions, found that the "fact that paragraph twenty-two of the mortgage states that the Lender 'may invoke the STATUTORY POWER OF SALE' does not negate the previous language in the mortgage directly granting MERS, as mortgagee in a nominee capacity, the right to invoke the Statutory Power of Sale." Accordingly, MERS has the contractual right to exercise the Statutory Power of Sale because it is the named mortgagee and nominee of the Lender, and its successors and assigns, and MERS was acting on behalf of the beneficial owner of the promissory note.

Next, the Court tackled the borrower's assertion that MERS does not have the statutory authority to foreclose. First, the Court determined that there is no express statutory prohibition impacting MERS' ability to foreclose. Next, citing the Statutory Power of Sale, the Court determined that because the "mortgagee or his, her or its executors, administrators, successors or assigns" can exercise the power of sale, so too can MERS as the mortgagee. Simply put, the Court found that MERS "is the mortgagee because the mortgage executed by the [borrower] so states." "The fact that MERS acts in a nominee capacity for the lender . . . does not diminish MERS' role as the mortgagee nor is there created a new legal term 'nominee mortgagee.'" Therefore, not only is there "[n]othing in the Rhode Island statutes prohibit[ing] MERS, as mortgagee in a nominee capacity, from foreclosing under the Statutory Power of Sale," MERS "may invoke the Statutory Power of Sale as the mortgagee."

Through its decision, the Court, in the clearest language addressed the various challenges that have been asserted against MERS' authority to foreclose under Rhode Island law. As a result, the multitude of pending cases seeking to enjoin Rhode Island foreclosures by attacking MERS' standing will most likely be resolved in a perfunctory and consistent manner in favor of MERS. An appeal by the borrowers is anticipated.

Jeffrey H. Gladstone *(jhg@psh.com) is a partner of the firm and co-chair of the Litigation Group. He oversees the Creditors' Rights Litigation and is lead trial attorney for the group. For more about Jeffrey and his practice, please click on this link: http://www.psh.com/jeffrey-gladstone*

David J. Pellegrino *(djp@psh.com) is an associate of the firm and a member of the Creditors' Rights Practice group. He concentrates his practice in representing the interests of creditors and mortgage servicers in bankruptcy and foreclosure proceedings, as well as tax takings, eminent domain and condemnation. For more about David and his practice, please click on this link:* http://www.psh.com/david-pellegrino

Separate Property v. Property of the Estate:
Determination of Rights in Funds When a 1031 Intermediary Exchange Files Chapter 11

INTRODUCTION

In three separate decisions, the U.S. Bankruptcy Court for the Eastern Division of Virginia decided whether or not funds held by a Qualified Intermediary in connection with a tax-deferred exchange under IRC Section 1031 were deemed to be property of the bankruptcy estate. Upon joint motions brought forth in the Chapter 11 Bankruptcy filing of Land America Financial Group, Inc.[1], an order was entered that set forth five "lead cases" to be heard on an accelerated schedule. On January 16, 2009, these "lead cases" were identified, specifically due to their fact patterns, which were representative of the adversary proceedings filed to date. All other adversary proceedings seeking a determination as to whether taxpayer funds are deemed separate property versus property of the estate were stayed until the lead cases reached a determination. This article will discuss the outcome of three of the five lead cases, two of which deemed the exchange funds to be property of the bankruptcy estate while the other decision deemed such funds to be the property of the taxpayer.

In *Health Care REIT, Inc. v LandAmerica 1031 Exchange Services, Inc*.[2], the Court ruled in favor of the taxpayers by approving a stipulation and settlement agreement set forth by the parties on February 22, 2009. In *Health Care*, the taxpayer's funds were kept in a segregated account with an escrow agreement. However, in the two other cases, *Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.* and *Frontier v. LandAmerica 1031 Exchange Services, Inc*.,[3] the taxpayers' funds were deemed to be property of the bankruptcy estate. No escrow agreement was in place for either of these cases. Moreover, in *Frontier*, the funds were co-mingled. The outcomes of these three "lead cases" will undoubtedly shape future adversary proceedings brought forth that share similar fact patterns. More importantly, the outcomes will shape the planning and drafting of all future Exchange Agreements.

I. Health Care REIT, Inc. v. LandAmerica 1031 Exchange Services, Inc.

Plaintiff Health Care REIT, Inc. filed its complaint in this adversary proceeding seeking return of its funds totaling around $137 million. The facts show two "Exchange Agreements" designating Centennial Bank as an escrow holder. In addition, all three parties involved –

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[1] *In Re LandAmerica Financial Group, Inc.*, Case No. 08-35994 (KRH). Shortly after the proposed merger between Fidelity National Financial Group, Inc. and LandAmerica Financial Group, Inc. fell through, LandAmerica 1031 Exchange Services, Inc., a LandAmerica owned entity providing tax exchange intermediary and related services, posted on its website that it was closing business operations. Reports began to surface that suggested the 1031 Company was unable to liquidate certain invested customer funds to meet necessary exchange deadlines. On November 26, 2008, LandAmerica Financial Group, Inc. as well as its wholly owned subsidiary, LandAmerica 1031 Exchange Services, Inc., each filed a Chapter 11 petition in the Richmond, Virginia Bankruptcy Court. These cases are being administrated together for procedural purposes.

[2] *Health Care Services, Inc. v. LandAmerica 1031 Exchange Services, Inc*. Adv. Pro. No. 08-03149

[3] *Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.*,

Adv. Proc. No. 08-03147, *Frontier Pepper's Ferry LLC v. LandAmerica 1031 Exchange Services,*

Inc., Adv. Proc. No. 08-03148

LandAmerica 1031 Exchange Services, Health Care and Centennial Bank – entered into two "Qualified Escrow Agreements."[4] On February 23, 2009, the U.S. Bankruptcy Judge Kevin Huennekens granted a joint motion to approve stipulation and settlement agreement which provided for the return of Health Care REIT's exchange funds and approved the release of the Exchange Funds from the bankruptcy estate.[5]

Even though a Memorandum Opinion was not entered along with the order in this case, it is evident that the parties availed themselves of the safe harbors provided by the Treasury Regulations by not only using a Qualified Intermediary but also utilizing a Separate Qualified Trust.[6]

II. Millard Refrigerated Services, Inc. v LandAmerica 1031 Exchange Services, Inc.

In *Millard*, Plaintiff Millard and LandAmerica 1031 Exchange Services, Inc. entered into an Exchange Agreement. No separate trust agreement existed. The court entered a Memorandum Opinion and Order that determined the Exchanged Funds to be property of the bankruptcy estate.[7] The Exchange Funds were held in a segregated account in which LandAmerica was the only named account holder and the only named signatory. This created a presumption that the Exchange Funds were indeed funds of the bankruptcy estate. In order to determine whether Millard retained some rights to the funds, the Court looked to state law to see if an express or resulting trust was created by the intent of the parties.

Upon review, the Court noted that nowhere in the Exchange Agreement could the words, "trust", "trustee" or "beneficiary" be located.[8] Despite Millard's arguments that it maintained equitable ownership of the Exchange Funds; the Court determined no such intent could be found. Indeed, the Court found an express intent *not* to create a trust because Millard conveyed their "exclusive possession, dominion, control and use of the Exchange Funds to [LandAmerica]".[9] Moreover, the Exchange Agreements contained a merger clause which prevented either party from relying upon representations and warranties not contained in the agreement itself. Therefore, the Court maintained that Millard's argument that LandAmerica had a fiduciary duty towards Millard was unfounded and unsupported by the agreement's plain statements. Moreover, the Court determined that each party was represented by experienced legal counsel and financial professionals. Considering all these factors, the Court found the Exchange Funds to be part of the bankruptcy estate.

III. Frontier Pepper's Ferry, LLC v. LandAmerica 1031 Exchange Services, Inc.

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[4] *See generally, footnote 2*

[5] *Id.*

[6] *See* Treasury Reg. 1.1031 (k)-1(g).

[7] *See Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.*, Adv. Proc. No. 08-03147

[8] *Id.* at 16.

[9] *Id.* at 17.

As in *Millard*, the Court entered a Memorandum Opinion and Order in the *Frontier* adversary proceeding.[10] Frontier executed an Exchange Agreement with LandAmerica 1031 Exchange Services. Similar to Millard, no separate trust agreement existed. The funds from the sale of the taxpayer's relinquished property were deposited directly into LandAmerica's *commingled* account. The Court found that, absent any trust agreement, a presumption existed deeming the Exchange Funds to be property of the bankruptcy estate. Again, without any express language contained in the exchange agreement creating a trust, the Court looked to Virginia's state law to see if the *intent* to create a trust existed.

After examining the facts of the case, the Court determined that Frontier conveyed exclusive control and use of the exchange funds over to LandAmerica 1031 Exchange Services. *Frontier*, similar to *Millard*, held that Frontier maintained equitable ownership of the Exchange Funds at all times. However, as pointed out by the Court, at no point was Frontier allowed to withdraw the exchange funds after the funds were directly deposited from the third party purchasers of the relinquished properties into the commingled account. Moreover, Frontier specifically disclaimed "any right, title or interest in and to the Exchange Funds" per the Exchange Agreement.[11] Therefore, the Court found that it was the intention of the parties to the Exchange Agreement *not* to create a trust. Noting that the Exchange Agreements were fully documented commercial transactions and that the parties were represented by financial and legal professionals, the Court entered an order on May 7, 2009 that determined the Exchange Funds to be part of the bankruptcy estate.

CONCLUSION

It is clear that failing to utilize the Qualified Trust safe harbor provision, in addition to the Qualified Intermediary provided for in the Treasury Regulations, has proven to be fatal to the taxpayer's position that it retains equitable ownership in the Exchange Funds. The Treasury Regulations permit the use of multiple safe harbors to secure a transferee's obligation to deliver replacement property which include the use of a separate Qualified Trust. Although the terms and conditions of the safe harbors must be satisfied separately, they are not mutually exclusive.

In determining whether or not an implied trust exists, a bankruptcy court will look towards the controlling state law for guidance. Unfortunately for the taxpayer, in two of these lead cases, their own Exchange Agreements prevented such intent from being detected. These lead cases will no doubt enable a speedy outcome for the remaining 100 or so adversary proceedings in the LandAmerica Chapter 11 bankruptcy proceeding. More importantly, they should serve as guidelines for the planning and drafting of Exchange Agreements going forward.

[10] The remaining two of the five "lead cases", *Howard Finkelstein v LandAmerica 1031 Exchange Services, Inc.* Adv. Pro. No. 08-03171 and *Matthew B. Luxenberg, Trustee of the Matthew B. Luxenberg Revocable Family Trust v LandAmerica 1031 Exchange Services, Inc.* Adv. Pro. No. 09-03023 were combined in this memorandum opinion and order because all five fact patterns dealt with commingled account agreements. For purposes of this article, these two cases will not be discussed in detail.

[11] *See Frontier Pepper's Ferry LLC v. LandAmerica 1031 Exchange Services, Inc.*, Adv. Proc. No. 08-03148 at 8.

Katie Graves Williams, Esq.
CODILIS & ASSOCIATES, P.C.
15W030 North Frontage Road
Burr Ridge, Illinois 60527
katie.williams@il.cslegal.com
(630)-230-2616

Education: B.A. DePaul University, 1997; The John Marshall Law School JD with Distinction for Outstanding Achievement in Real Estate, 2005; The John Marshall Law School LL.M in Real Estate Law, 2007.

Admitted to practice in the State of Illinois and an American Bar Association Fellow 2008-2010 for the Real Estate Property Division. Member of the Illinois State Bar Association, Chicago Bar Association - Real Property Divisions, Chicago Real Estate Council, and the Real Estate Finance Forum. Prior to joining her current Firm, Katie was employed by Barclays Capital Commercial Mortgage Backed Securities division.

Congress Passes Tax Relief through 2010 for Solvent Debtors Holding Real Estate

Mark Stone[1]

We are all aware of the economic crisis affecting real estate and other businesses. Many in the real estate bar are also somewhat or passingly familiar with tax issues that can arise from restructuring, retiring or otherwise modifying the underlying debt of an enterprise favorable to the debtor. In short, we have to deal with aspects of cancellation of indebtedness income ("COD") at the time of such event, i.e. does it apply, if it applies are there any exemptions or other rules to lessen the tax impact.[2] The American Recovery and Reinvestment Act of 2009 (the "2009 Act"), signed into law by President Obama on February 17, 2009, includes a provision that adds tax relief for the solvent real estate debtor (and in certain circumstances the insolvent debtor) for COD realized in 2009 and 2010. Thus, there is a short window of opportunity presently available to use this new tool.

Background

COD in General

So what exactly is COD and how is it taxed for federal income tax purposes? Section 61(a)(12) of the Internal Revenue Code of 1986, as amended (the "Code") provides that gross income includes income from discharge of indebtedness. It is treated as ordinary income and not capital gains. COD is generally equal to the excess of the adjusted issue price of the debt being satisfied (in general, for debt without original issue discount ("OID"), the current outstanding principal balance amount or, if there is OID, the original issue price plus accrued unpaid interest less payments of principal) over the amounts paid to satisfy such debt.[3]

> **Example 1** – Assume that a limited liability company ("LLC") held equally by five U.S. resident members owns a single rental building acquired in 2003 for $90 million with its sole mortgage of $80 million outstanding. Two of the members are insolvent to the extent of $5 million each and the other three are very solvent. Assume further the property has dropped in value to $55 million today and that the lender agrees with the owner to reduce the principal amount of the loan to $60 million.

As real estate counsel for the LLC in Example 1, you may be feeling great about the debt restructuring you have negotiated for your client. That is, until you speak with your tax

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[1] Mark is a partner in the New York Office of Holland & Knight LLP. He is Vice-Chair of the Federal Taxation of Real Estate Committee of the American Bar Association, Section of Real Property, Trust & Estate Law and immediate past chair (2005-2008) of the Committee on Taxation of Business Entities of the New York City Bar. I want to thank my partner Marty Miner for his review and very helpful comments from the perspective of a transactional real estate lawyer.

[2] This report does not consider tax consequences to the debtor arising from foreclosure, deed in lieu, or similar transactions which are very different from those arising from COD (where the debtor remains owner).

[3] For simplicity, unless otherwise noted, this report assumes that non-publicly traded debt arising from a third party loan and not seller financing is: (a) retired for cash or, (b) reduced in principal amount without other economic changes to the terms of the debt instrument. Such other economic changes (interest rates, payment dates, security, etc.) favorable to the debtor arising from the restructuring or modification of the debt increase the complexity as to the amount of the COD. Whether the debt that is considered retired or reissued is publicly offered within the meaning of section 1273 of the Code also affects the amount of COD.

partner. In Example 1, the LLC would recognize $20 million of COD ($80 million former principal amount less $60 million revised principal amount), allocated among its owners in 2009 unless exemptions or other rules come into play. It is worth noting that this diminution in value likely corresponds to reduced income from the property and an otherwise distressed financial situation in the company, although it may also arise from cap rate changes at maturity of a balloon instrument. Nonetheless, the company, or since it is an LLC, its owners, will have to pay tax on $20 million of income ($4 million for each member) without generating any corresponding funds from the transaction to pay such taxes.[4]

Is there any relief to the owners of the LLC from the recognition of $20 million in income in 2009 in Example 1?

Section 108 of the Code in General

Section 108 of the Code is designed to ameliorate some of the harsh effects of COD recognition, particularly when the taxpayer is in a troubled economic condition. Section 108(a)(1)(A) of the Code provides that COD does not arise if the taxpayer is under the jurisdiction of the court in a U.S. Title 11 bankruptcy case. Section 108(a)(1)(B) of the Code provides that COD does not arise to the extent the taxpayer is insolvent (the excess of taxpayers' liabilities over the fair market value of their assets just prior to the debt release).[5] Another rule provides that in determining whether the taxpayer is under the jurisdiction of a court or insolvent, ownership of the property by a partnership is disregarded and the determination is made at the partner level.[6]

In Example 1, the LLC is clearly insolvent (debt of $80 million exceeds the fair market value of the assets $55 million, by $25 million). But the insolvency of the LLC is not relevant to the COD analysis. Three of its members, on the other hand, are not under the jurisdiction of a court in a Title 11 case and are solvent, so the two main exemptions are not applicable to such members. Prior to the 2009 Act, and still remaining in the Code, other exemptions include: qualified farm indebtedness (not relevant in Example 1), qualified real property business indebtedness (relevant and discussed below), qualified principal residence indebtedness (not relevant in Example 1), interest indebtedness of a cash basis taxpayer (not relevant in Example 1), seller financing indebtedness (not relevant in Example 1), and contribution of indebtedness to corporate capital (not relevant in Example 1).[7]

> **Example 2** – We change the facts of Example 1 to provide that the loan is made to an LLC whose business is not the ownership, operation or development of real property; such as to a wholesaler of goods whose $80 million loan is secured by its receivables.

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[4] An LLC is treated as a partnership for federal income tax purposes unless it has made an election to be treated as a corporation. We assume, consistent with the great majority of LLCs, that the LLC has not made the corporate election and is treated as a partnership. Thus, it is a nontaxable "flow-through" entity and its members are taxed on their distributive share of its income.

[5] Establishing insolvency and its extent typically requires a competent appraisal. There is no guarantee that the IRS will agree with the appraisal or taxpayer's independent evaluation.

[6] Section 108(d)(6) of the Code.

[7] The bankrupt, insolvent and farm exemptions are not pure exemptions in the sense that they come with a tax cost. The tax cost is loss of certain future tax benefits of the taxpayer, in the amount of such COD, such as net operating loss carryovers ("NOLs") and reduction in basis in property, in a prescribed order. Section 108(b) of the Code.

In Example 2, the three solvent owners, prior to the 2009 Act, would be required to include $4 million each of the $20 million COD into income in 2009. However, the 2009 Act, establishing section 108(i) of the Code, could provide some welcome relief to the owners of such wholesale enterprise.[8] The two insolvent owners, on the other hand, would receive tax protection under the insolvency exemption (they are insolvent to the extent of $5 million each in our example) and would not need any further tax relief.

Section 108(i) Deferral Relief

The LLC in Example 2 may elect under section 108(i) of the Code to defer the owners' share of the 2009 COD income to 2014 and to include such income ratably over the five year period 2014 to 2018 ($800,000 per year). Thus, the owners get a ten year interest free deferral of their tax obligations.[9] While this looks attractive to the solvent members, the insolvent members may object to any such election since all of their COD income is excluded under the insolvency exemption on a permanent basis.[10] Let us take a look in more detail at how section 108(i) of the Code works.

Section 108(i) of the Code permits a taxpayer to elect to defer the recognition of COD income from the reacquisition of an applicable debt instrument in the years 2009 and 2010 only. Thus, it has a very limited life. The election is made (on a debt by debt basis) by the issuer of the debt, in this case by the LLC. The COD income is deferred until the year 2014 and included in income ratably over the five year period 2014 to 2018.[11] A reacquisition includes any acquisition of the debt instrument for cash, the exchange of the instrument for a new instrument favorable to the debtor (including a deemed exchange resulting from a reduction in the principal amount of the debt and other modifications), and certain restructuring changes. An applicable debt instrument is any debt instrument issued by a C corporation, and any other person (which would include an individual or an LLC) but such other person must hold the debt in connection with the conduct of a trade or business. If the taxpayer dies, the business is terminated, or the taxpayer terminates its interest in a partnership or other pass-through entity, the balance of any deferred amount not yet included in income is accelerated to the year of such termination.

We have posited in Example 2 that the LLC taxpayer debtor is engaged in a wholesale business, which would constitute the conduct of a trade or business within the meaning of section 108(i) of the Code. In the real estate setting, operating the rental business of a large commercial or residential office building, as in Example 1, would likely qualify as the conduct of a trade or business, although there is some question whether an owner's building operations under a triple net lease rise to the level of the conduct of a trade or business or merely

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[8] We are digressing from the focus of this report, tax relief for debtors holding real estate, to provide background on the COD tax relief for debtors in most other businesses. Such background will aid in understanding the relief provided to real estate concerns.

[9] Although the election appears to make sense for the three solvent owners, there are a number of factors to consider, one of which is whether one anticipates that tax rates will be significantly higher in the out years. As discussed further, the election generally makes no sense for the two insolvent owners.

[10] The insolvent members must take into account loss of any NOLs or depreciable tax basis in their properties arising under the statute from the insolvency exemption, but in most cases the trade-off for loss of these tax benefits is outweighed by permanent avoidance of the COD.

[11] For fiscal year taxpayers, the COD is includable in the fifth taxable year following the taxable year in which the reacquisition occurs for reacquisitions occurring in 2009 and the fourth taxable year following the taxable year in which the reacquisition occurs for 2010 reacquisitions.

constitute a passive investment activity. It seems unlikely that a debt reacquisition arising from the ownership of undeveloped land would qualify.[12]

The section 108(i) election trumps the other section 108 exemptions so that any bankruptcy or insolvency protection a taxpayer may otherwise be entitled to is lost. In a nutshell, this means that such persons must include COD in income in the sixth through tenth year following reacquisition when they may never have had to include such amounts into taxable income in the first instance because of the insolvency or bankruptcy exemption in the year of reacquisition or in any of the years six through ten. Once the election is made, it is irrevocable.

On August 17, 2009 the IRS issued Rev. Proc. 2009-37 (the “2009 procedure”) to flesh out the taxpayer election procedure. Under the statute, the election is made, in our examples, by the LLC in its 2009 annual tax return filed on partnership Form 1065. The election must contain the identity of the specific applicable debt instruments,[13] and the amount of the related COD. The 2009 procedure thankfully avoids some of the rancor that might arise from an election at the LLC level otherwise applicable to all members by permitting the LLC to effectively elect on a member by member basis. So in Example 2, the election would be made for the three solvent members only. Detailed information must be included on the K-1 of each member and detailed information must be filed with each subsequent year of the LLC until all the deferred income has been recognized. The election concerns at the LLC level, while abated somewhat by the 2009 procedure, raise interesting questions about the LLC manager’s obligations to the company and its members that may not be addressed in the company operating agreement and is beyond the scope of this report.

Section 108(c) Real Estate Special Exemption

In Example 2 a wholesale operation debt discharge is described giving rise to COD income to its solvent owners. In Example 1, however, the debt arises from a real estate transaction. Unlike most other business activities which have no specific section 108 exemptions available,[14] there is an exemption for distressed real estate at the enterprise level, termed the qualified real property business indebtedness (“QRPBI”) exemption, similar in nature to the insolvency exemption at the owner level. If applicable, it provides tax relief to the solvent owners.[15]

QRPBI (applicable to solvent individuals and solvent individual owners or beneficiaries of trusts, S corporations and other entities, but not C corporations, holding distressed real estate) arises when the following factors are present: (1) the debt was incurred or assumed in connection with real property used in a trade or business and is secured by the realty; (2) the

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[12] There are also rules under section 108(i) of the Code dealing with any OID that might arise from the reacquisition and with certain esoteric provisions applicable to C corporations known as the AHYDO rules that are not applicable to our fact patterns.

[13] As indicated, the taxpayer can elect to defer COD on some debt instruments but not others that may have been discharged or otherwise adjusted.

[14] The other business which enjoys a COD exemption is farming. It may be applicable to certain of your real estate clients so engaged, but applies to far fewer taxpayers than the general real estate exemption and is not discussed. Section 108(a)(1)(C) and (g) of the Code.

[15] The insolvent owners must rely on the insolvency exemption to avoid recognition of COD. Section 108(a)(2)(B) of the Code.

debt was incurred or assumed to acquire, construct, reconstruct or substantially improve such real estate or to refinance such debt (debt raised to cash out partners would not qualify) and subject to the following limitations: (3) on a property by property basis it applies only to the extent of the excess of the outstanding principal amount of the debt over the fair market value[16] of the property (that is, only to the extent the property is "under water") and further limited to (4) the aggregate tax basis of any depreciable real property, including the secured realty subject to the debt discharge to the extent it constitutes depreciable property, held by the member or other owner immediately prior to the debt discharge.[17]

In Example 1 the debt exceeds the value of the LLC real estate by $25 million ($80 million debt less $55 million fair market value). The LLC's tax basis in the depreciable property is well in excess of the $20 million being discharged (assuming most of the $90 million original cost is attributable to the building and not the land), so each member should have sufficient tax basis in the secured depreciable property alone to meet tests 3 and 4 above. Therefore, an election by a solvent member of the LLC[18] can be made under section 108(c) of the Code to have the QRPBI exemption apply. The election would result in complete exemption of such member's $4 million share of COD in 2009 at a loss of only $4 million in future tax depreciation deductions in this or other properties held by the member. Loss of tax depreciable deductions in Example 1, if a commercial building, with 33 years to run on its depreciable life means that the $4 million in income will eventually be reported to the IRS, but over 33 years. In the tax field, we call this a pretty good deal.

By contrast, if the solvent members permit the LLC to make a section 108(i) election on their behalf, they must include $800,000 in income in each of the years six to ten. This is not nearly as good as the QRPBI election under these facts.

Why Make the Section 108(i) Election?

Since real estate has its own favorable debt relief provision in the tax Code which is superior in many respects to the new 2009 Act provision, why would any real estate related concern make the new election and why did I bother you with all this discussion?

As noted, not all real estate debt relief transactions will qualify.

> **Example 3** – We change the facts of Example 1 to provide that the loan on the building was used to cash out prior members and not for acquisition, construction, reconstruction or substantially improving such property.

The QRPBI exemption does not apply in Example 3 because of the impermissible use of the borrowed funds.

> **Example 4** – We change the facts of Example 1 to provide that the project is for the sale of condominium units[19] rather than commercial rental property, and that the members do not own any depreciable real property.

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[16] Less, in effect, any other mortgage on the property meeting these QRPBI requirements.

[17] Thus, if the business consists of selling condominiums (nondepreciable assets) and the partner has no depreciable real property assets, the QRPBI election provides no tax relief from COD. Section 108(c)(2)(B) of the Code.

[18] The election is made on a partner by partner basis on IRS Form 982.

[19] See footnote 17.

Example 4 will fail to qualify for the QRPBI exemption because it fails test 4 of the rules above (the aggregate tax basis in depreciable real property).

> **Example 5** – We change the facts of Example 1 to provide that the owner of the realty is not an LLC, but rather is a C corporation.

Example 5 fails to qualify for the QRPBI exemption because real estate held by a C corporation, whether publicly or privately held,[20] is not eligible for the QRPBI exemption. The section 108(i) provision, moreover, expressly permits C corporations to make the election. The C corporation can make the election regardless whether it conducts a trade or business within the meaning of the tax law.

> **Example 6** – We change the facts in Example 5 and Example 1 to provide that the underlying real estate held by the corporation consists of undeveloped land.

In Example 6 the C corporation should be able to make the election for section 108(i) debt relief in connection with undeveloped land, whereas the LLC could not.

There may be other instances where the technical rules of the QRPBI provisions can not be met, or its use is not very favorable,[21] and a section 108(i) 10 year deferral option is available and advisable.

The QRPBI election assumes a distressed real estate situation. It is clear that the new section 108(i) deferral election can be made for the solvent owner and the solvent real estate enterprise. But what lender is providing debt relief to a solvent debtor with solvent property unless the debt is a balloon instrument that can not be renewed at maturity due to interest or cap rate changes?

The legislative history to the 2009 Act provision indicates that it was primarily designed to assist companies that can otherwise deleverage by reacquiring their debt at a discount. It was also designed to give financial firms holding such debt more liquidity. The assistance, as discussed in this report, is in the form of the five year deferral and the subsequent five year pay-out of taxes. In effect, the discount may arise not necessarily because the debtor is delinquent in payments or otherwise in default, or is insolvent, or the property has lost value, but rather the market is concerned about the issuer's ability to pay and is willing to take a haircut to get its cash back. Alternatively, the lender in today's economic climate may simply prefer to be bought out and is prepared to take a significant discount to get cash back, even though it may not be concerned about the issuer's ability to pay. Where might a repurchase arise in a non-public company setting?

> **Example 7** – $200 million of debt of an LLC is privately placed with institutional lenders in 2005 for the purpose of acquiring and enlarging by new construction a large residential rental development project. In 2009, as a result of the economic downturn and after a number of the new residential buildings are constructed and rented and the

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20 Yes, there are still a few privately held C corporations out there holding real estate. The C corporation can take advantage of the insolvency exemption, however, if applicable to its financial condition. Under Example 1, as revised in Example 5, the corporation would be insolvent.

21 If the debt discharge occurs toward the end of the life of the building, the loss of tax depreciation arising from the insolvency exemption may have to be recovered over a shorter period than the ten year period under section 108(i) of the Code, for example.

existing buildings remain rented, the development is downsized and $50 million of the funds are no longer needed for the revised new construction project. The borrower is otherwise fully capable of meeting its loan obligations. The project has not lost value, or at least has not lost value beyond the equity put into the deal. The institutional lenders are willing to accept $40 million for the $50 million piece of the loan.

In Example 7 the QRPBI exemption is not available since the property is not under water. The section 108(i) election should provide a welcome 10 year relief to the solvent members of the LLC on their share of the $10 million of COD generated by this transaction.

There are doubtless variations on these examples where new section 108(i) of the Code comes into play. As with any new statute, there will be issues raised concerning its application not expressly covered by the statutory language, such as the proper withholding obligation of an LLC on the COD deferred amounts attributable to a foreign member. We can expect further guidance from the IRS and Treasury Department soon, given the short life of this statute. For now, I simply want to make the reader aware of the limited time availability of, and the potential tax benefits derived from, new section 108(i) of the Code.

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