Garnett v. Comm'r., 132 T.C. No. 19 (2009)
Thompson v. United States, [2009-2 USTC ¶50,501] (Fed. Cl. 2009)

By C. Fred Daniels and William S. Forsberg

The Tax Court and the Court of Federal Claims recently addressed whether members of limited liability companies ("LLCs") or partners in limited liability partnerships ("LLPs") should be treated as limited partners in limited partnerships for purposes of the § 469 passive activity income tax rules. Both cases held that the respective taxpayers should not be treated as limited partners in limited partnerships notwithstanding their limited liability. [1]

Passive Activity Losses and Credits

Section 469(a) disallows losses and credits from passive activities except to the extent of passive activity income. A passive activity is defined as an activity (i) which involves the conduct of a trade or business and (ii) in which the taxpayer does not materially participate. § 469(c)(1). The issue in *Garnett v. Comm'r.* and *Thompson v. United States* focused on whether the taxpayers materially participated in activities conducted through limited liability companies and limited liability partnerships.

The temporary regulations set forth seven alternative tests for determining material participation. [2] They are:

> (1) The individual participates in the activity for more than 500 hours during such year;
>
> (2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
>
> (3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not

> less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
>
> (4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
>
> (5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
>
> (6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
>
> (7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Temp. Reg. § 1.469-5T(a).

Irrespective of the foregoing material participation tests, a taxpayer is treated as not participating in an activity if the taxpayer's participation is based upon an interest as a limited partner in a limited partnership, except as provided in regulations. § 469(h)(2). The temporary regulations provide as an exception that the limited partner limitation does not apply if the taxpayer would be treated as materially participating under material participation test (1), (5), or (6) (quoted above) if the taxpayer was not a limited partner. Temp. Reg. § 1.469-5T(e)(2).

The passive activities temporary regulations do not explicitly refer to LLCs or LLPs. However, LLCs and LLPs are generally treated for Federal income tax purposes

as partnerships. *See McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007); *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007); *Med. Practice Solutions, LLC v. Commissioner*, 132 T.C. (2009); Reg. § 1.761-1, Reg.; § 301.7701-2(c)(1). The check-the-box regulations permit certain eligible business entities, including domestic LLCs and LLPs, to elect to be treated as corporations rather than partnerships. Reg. § 301.7701-3(b)(1)(i).

In addition, there is no general definition of "limited partner" in the Code or regulations, although regulations were proposed in 1997 with respect to § 1402(a)(13) to define the term "limited partner" for self-employment tax purposes.

Similarly, there is no general definition of "general partner" in the Code or the regulations, although the term "general partner" is used multiple times in the Code and the regulations. In certain contexts, the term refers specifically to a general partner in a limited partnership. *See, e.g.*, § 2701(b)(2)(B)(ii); Prop. Reg. § 1.280G-1, Q&A-7(e), Example (3); Prop. Reg. § 1.368-2(m)(5), Example (8). Most often, however, "general partner" seems to refer broadly to any partner (whether or not in a limited partnership) other than a limited partner. *See, e.g.*, §§ 465(c)(7)(D)(ii)(I), 736(b)(3)(B), 988(c)(1)(E)(v), 6231(a)(7); Reg. §§ 1.42-2(d)(3)(i), 1.904-4(e)(3)(iv), Example (4); Temp Reg. §§ 1.367(a)-1T(c)(3)(i)(A), 1.367(a)-2T(c)(2)(ii).

Notwithstanding the lack of a general definition of limited partnerships, the passive activity temporary regulations provide that a partnership interest is treated as a limited partnership interest if (A) "the interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partner-

ship is limited under the applicable State law; or (B) [t]he liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount…." Temp. Reg. § 1.469-5T(e)(3)(i).

Garnett v. Comm'r.

Garnett involved activities in seven limited liability partnerships, two limited liability companies, and two ventures characterized as tenancies in common but argued to be *de facto* partnerships. The LLPs and LLCs engaged in agribusiness operations, primarily the production of poultry, eggs, and hogs. In addition to the above entities, there were five "holding LLCs" that owned interests in the LLPs, LLCs and ventures. The entities were organized or registered under Iowa law.

General summaries of the relevant facts concerning the entities, other than the holding LLCs, are as follows:

Seven limited liability partnerships—
- One owned by the taxpayer directly.
- Six owned indirectly through holding LLCs.
- Each Schedule K-1 identified either the relevant holding LLC or the taxpayer as a "limited partner."
- The LLP agreements generally provided that each partner would participate in control, management and direction of the partnerships' business.
- The LLP agreements generally provided that no partner was liable for partnership debts or liabilities.

Two limited liability companies—
- One LLC interest was held directly by the taxpayer as well as through a holding LLC.
- The second LLC interest was held through a holding LLC.
- Each Schedule K-1 identified the relevant holding LLC or the taxpayer as a "limited liability company member."
- The manager was to be selected by a majority vote of the members.
- The taxpayer was not a manager of either LLC, but he was a manager of two of the five holding LLCs.

Two ventures characterized as tenancies in common but argued to be de facto partnerships—
The interests were held indirectly through a holding LLC.
The holding LLC was identified as a general partner of one of the tenancies in common and as a limited partner of the other.

The IRS asserted that the intervening interests of the holding LLCs should be disregarded, and the taxpayer did not dispute the IRS' assertion. Accordingly, the Tax Court did not address the impact of the holding LLCs.

Principal arguments made by the taxpayer:

The taxpayer argued that the term "limited partnership" should be literally interpreted and limited to entities that are actually limited partnerships under state law. The court observed, however, that Congress likely did not have LLCs in mind when § 469 was enacted, because only Wyoming had an LLC statute at that time. Similarly, LLPs did not exist when § 469(h)(2) was enacted. The legislative history, however, contemplated regulatory authority to treated "substantially equivalent entities" as limited partnerships for purposes of § 469(h)(2).

The taxpayer also argued that he should be treated as a general partner. The taxpayer was not precluded from actively participating in the management and operations of the entities, and the IRS did not dispute that the taxpayer was given at least some role to play in the management of the LLPs and LLCs. The IRS countered that the agreements did not give authority to the taxpayer to take action on behalf of the entities in the capacity of a general partner, and the taxpayer did not function like a general partner. The court observed that the factual inquiry into the taxpayer's authority suggested by the IRS seemed to be akin to the inquiries to be made under the general tests for material participation, and that type of inquiry would blur the rules.

Principal arguments made by the IRS:

The IRS argued that the sole relevant consideration is whether the taxpayer had limited liability with respect to the entities, and thus the interests are limited partnership interests under the temporary regulations. The court observed that the operative condition is not merely that there be an interest in a limited partnership but that the interest be as a limited partner. § 469(h)(2).

The IRS further argued that the general partner exception depends of the extent of the LLP or LLC member's authority and control. A general partner, the IRS argued, means someone who has actual or apparent authority to act for and bind the entity.

The Tax Court's decision:

The Tax Court held that limited liability is not the sole or determinative consideration, although it is one characteristic of limited partners. The rule is not whether there is an interest in a limited partnership, but it is whether there is an interest in a limited partnership *as a limited partner*.

Of greater importance, the court observed that general partners usually have the powers of management as well as personal liability. Most often, limited partners are passive investors, and they lose their limited liability if they participate in management. Thus, the limitation on their participation in a limited partnership's business justifies the presumption that limited partners do not materially participate, and that rationale does not extend to interests in LLCs and LLPs.

As regards LLPs, they are general partnerships that obtain limited liability by filing a registration. Other than the limited liability, applicable general partnership law applies to LLPs. Thus, the Tax Court did not believe that the limited liability rationale

should extend to interests in LLPs or LLCs because their members are not barred by state law from materially participating.

The court concluded that, in the case of an LLC or LLP, the general tests for material participation under § 469 are the tests to be applied. LLC and LLP members should be treated as general partners for § 469 purposes, which means that the remaining question was whether the taxpayer materially participated based upon the seven material participation tests.

As regards the tenancies in common, the IRS made no express argument that they should be treated as limited partnership interests, nor did the IRS make an argument that their liability was limited within the meaning of the temporary regulations.

As regards the descriptions of the taxpayer on the K-1's, the IRS argued that the taxpayer obtained a self-employment tax benefit by not being listed as a general partner, but the IRS conceded that the K-1's did not conclusively establish that the interests were limited partnership interests. The IRS did not argue collateral estoppel or the duty of consistency. Neither the notice of deficiency nor the IRS' answer asserted underpaid self-employment taxes. Therefore, the Tax Court held that the inconsistencies were not material under these circumstances.

Thompson v. United States

The taxpayer in *Thompson* formed a Texas LLC to own and operate a single aircraft for air charter services. The taxpayer directly owned 99% of the LLC, and he held the remaining 1% indirectly through an S corporation. The taxpayer was the sole manager.

Principal arguments made by the taxpayer:

Because the LLC is not actually a limited partnership, the taxpayer argued that his interest cannot be that of a limited partner.

Even if the LLC is treated as a limited partnership, his interest was more akin to that of a general partner due to the high degree of control he exercised as its sole manager.

Also, limited partnership statutes generally provide that a limited partner is liable as a general partner if he takes part in the control of the business.

Principal arguments made by the IRS:

The IRS argued that, when the passive activity loss rules were adopted, there was universal agreement among the states that the *sine qua non* of a limited partnership interest was limited liability. Because the taxpayer had limited liability as an LLC member, the taxpayer's interest was identical to that of a limited partnership interest.

The IRS also argued that the LLC should be treated as a partnership because it elected to be taxed as a partnership under the check-the-box regulations.

The decision of the Court of Federal Claims:

The temporary regulations defining an interest in a limited partnership literally requires that the entity be a limited partnership under state law, and the statute applies only to limited partners. § 469(h)(2); Reg. § 1.469-5T(e)(3). Thus, an LLC cannot be treated as a limited partnership, and a member of an LLC cannot be treated a limited partner for passive activity purposes.

The court held that limited liability is not the *sine qua non* of a limited partnership interest for passive activity purposes. The terms "material participation" and "passive activity" demonstrate that Congress' concern related to the taxpayer's level of involvement in the activity. For example, S corporation shareholders also enjoy limited liability and pass-through taxation, but they are not treated as limited partners for material participation purposes.

Also, LLCs are not "substantially equivalent" to limited partnerships. Unlike limited partnerships, LLCs allow all members to retain limited liability while participating in the business.

The court stated that limited partners are treated differently under the Code because they do not materially participate in their limited partnerships.

As in *Garnett*, the taxpayer's interest in the LLC was not an interest held as a limited partner in a limited partnership.

---

[1] An earlier case, *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Or. 2000), previously held that a member of an LLC formed under Oregon law was not a limited partner for purposes of determining material participation. There, the taxpayer was allowed to combine his participation in the LLC with his participation in a predecessor entity to determine whether he materially participated.

[2] The temporary regulations were promulgated on February 19, 1988, but they have never been made final. The requirement in § 7805(e)(2) that temporary regulations shall expire within three years after the date of issuance only applies to temporary regulations issued after Nov. 20, 1988.

IRS NOTICE 2010-19
GUIDANCE FOR PERSONS MAKING TRANSFERS IN TRUST
AFTER DECEMBER 31, 2009
or
"What Rath Has Estate Tax Repeal Raught!"

By William S. Forsberg

On February 2, 2010, the Internal Revenue Service (IRS) issued Notice 2010-19, Guidance for Persons Making Transfers in Trust after December 31, 2009. After it become clear that estate tax repeal would be with us in 2010 everyone starting taking a hard look at the Internal Revenue Code (IRC) and the estate tax repeal provisions. In particular, there was a focus on IRC Section 2511(c), which was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub.L. 107-16, 115 Stat. 38, June 7, 2001), (EGTRRA) and reads as follows:

> **Treatment of certain transfers in trust.**
>
> Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, **unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1** ***(emphasis added)*** .

The first sentence was not controversial—gifts to trusts in 2010, even non-wholly owned grantor trusts, would always be completed gifts for federal gift tax purposes, unless the IRS regulations said otherwise. The last sentence of IRC Section 2511(c), however, was very alarming and concerning to the government and to trust and estate

practitioners. IRC Section 2511(c) is a federal gift tax provision. Read literally, the last sentence could reasonably be interpreted to mean that **any** transfer in 2010 to a wholly owned grantor trust was not a gift for federal gift tax purposes, which alarmed the government. The issue that alarmed some trust and estate practitioners was whether the government might promulgate regulations to the effect that the passing of assets outside the wholly owned grantor trust (or turning off the grantor trust powers) would be a gift at that later event. If so, any transfer in 2010 to a grantor retained annuity trust (GRAT), an intentionally defective grantor trust (IGIT), or other wholly owned grantor trust would, arguably, not be counted for gift tax purposes until that later event. This would effectively eliminate the estate and transfer tax planning benefits of these types of trusts and transactions.

The legislative history of IRC Section 2511(c) suggests that this was not the intended result or meaning. Rather, the intent was to address perceived income and income tax shifting abuses that might occur because of federal estate tax repeal in 2010. With no federal estate tax after 2009, Congress felt that there might be heightened interest in avoiding federal gift tax, and more importantly, federal income tax through the use of certain income tax "shifting" techniques. If one could create a trust whereby all transfers to it were incomplete for federal gift tax purposes but complete for federal income tax purposes, one could, it was thought, manipulate the federal and state income and transfer tax systems[i]. By "threading the trust needle" in this way there would be no federal gift tax (because the transfer was incomplete for federal gift tax purposes), no federal estate tax (because of federal estate tax repeal after 2009) and, in some cases, no state income tax (because the trust or the trust beneficiaries were located in a state

with no state income tax system (e.g. Florida). The overall effect would be that all federal gift and estate tax (and in some cases all state income taxes) would be avoided, and federal income tax would be minimized by shifting the income tax burden to a trust or trust beneficiary in a lower federal and state income tax bracket than that of the trust grantor.

IRC Section 2511(c) was, many thought, simply poorly drafted. However, its intended meaning and purpose could not easily be deciphered from a quick read of the statute. Many thought it simply could not mean what it apparently said, and chose to ignore it and create GRATs and IGITs and other wholly owned grantor trusts in 2010 as they had done in 2009. Many others, however, felt uncomfortable taking such a big risk, and temporarily suspended planning in these areas. To resolve this dilemma, the IRS issued Notice 2010-19, which reads as follows.

> Notice 2010-19 applies to taxpayers making gifts in trust during 2010. Under section 2511(c), a transfer of property to a non-wholly-owned grantor trust is a transfer by gift of the entire interest in the property. **To determine whether a transfer to a wholly-owned grantor trust constitutes a gift, the gift tax provisions in effect prior to 2010 apply.**

Notice 2010-19 makes it clear that the gift tax consequences of a transfer to a wholly-owned grantor trust in 2010 are determined under the old rules in place before 2010. Therefore, transfers to GRATs and IGITs in 2010 should be fine and are not *per se* incomplete by reason of IRC Section 2511(c).

Finally, Code Section 2511(c) may also have an unintended and negative impact on certain inter vivos charitable trusts. The Charitable Planning Group of the ABA Real Property Trusts & Estate (RPTE) Section is currently in the process of drafting comments to the IRS on the charitable planning concerns surrounding Code Section 2511(c).

Below is a link to IRS Notice 2010-19. Also, below is a link to a memorandum submitted to the IRS by attorney Steve Gorin, Thompson Coburn LLP, St. Louis, MO, on December 20, 2009 addressing this issue.

1. Link to IRS Notice 2010-19. http://www.irs.gov/pub/irs-drop/n-10-19.pdf

2. Link to Steve Gorin memorandum on IRC Section 2511(c)

Special thanks to Steve Gorin of Thompson Coburn LLP who allowed me to submit his memorandum on IRC Section 2511(c) with this eReport.

[i] **See**: PLR 200502014 (Jan. 14, 2005); Settlor created a non-grantor trust that shifted taxable income to trust distributees, without removing assets from settlor's gross estate and without a taxable gift.

"Montana Becomes Third U.S. State To Allow Physician Aid In Dying"

By Kristine S. Knaplund
Co-Chair, ABA Committee on Bioethics
Professor of Law, Pepperdine University School of Law

Synopsis

On December 31, 2009, the Montana Supreme Court issued its decision in *Baxter v. State of Montana*, 2009 MT 449, regarding physician aid in dying (PAD). While the lower court had found a state constitutional right for such aid, a majority of the Supreme Court expressly declined to reach the constitutional issue. Rather, the majority found that the consent of a terminally ill, competent adult to lethal medication would protect the physician from liability for homicide. Montana joins Oregon and Washington in legalizing PAD, but is the only state to do so by judicial decision. Oregon's statutory scheme, the Death With Dignity Act, has been in place for over ten years; Washington's statute, modeled on Oregon's, was passed by the voters last year. Montana's recent decision leaves open serious questions regarding the use of PAD.

Basic Facts

The lead plaintiff in the case, Robert Baxter, was a 75-year-old retired truck driver with lymphocytic leukemia, a terminal form of cancer. He was treated with multiple rounds of chemotherapy which typically become less effective as time passes. Suffering from anemia, chronic fatigue, nausea, night sweats, infections, massively swollen glands, significant digestive problems, and pain, he wanted the option of assisted death when his suffering became unbearable. Other named plaintiffs were board certified physicians who frequently treat terminally ill patients, and a national non-profit group, Compassion and Choice.

Plaintiffs sued the state of Montana and Attorney General Mike McGrath to declare the homicide statutes unconstitutional as a denial of their right to aid in dying.

The trial court's opinion

Both sides filed motions for summary judgment in the trial court. Judge Dorothy McCarter first determined that the plaintiff doctors had standing, and then reviewed federal and state cases on the issue of PAD and assisted suicide. In *Washington v. Glucksberg*, 521 U.S. 702 (1997), the United States Supreme Court held that a Washington statute criminalizing assisted suicide did not violate the Due Process clause because, while terminal patients have a cognizable interest in obtaining relief from suffering, that interest is met with palliative care. A companion case to *Glucksberg*, *Vacco v. Quill*, 521 U.S. 793 (1997), held that New York's prohibition against assisted suicide did not violate the Equal Protection clause of the Fourteenth Amendment. Cases from Florida, Alaska and California all held that statutes prohibiting assisted suicide were constitutional, and did not violate state (as opposed to federal) rights to privacy, liberty and equal protection.

Judge McCarter then turned to the plaintiffs' claims based on equal protection, personal dignity and individual privacy found in the Montana constitution. For the equal protection claim, the classes asserted in *Baxter* were the same as those in *Vacco v. Quill*: terminally ill patients who wish for aid in dying through lethal medication, and terminally ill patients who seek aid in withdrawing life sustaining measures. As in *Vacco*, the Montana trial court found

that the two groups were not similarly situated. The manner of death was different: with PAD, the patient dies from the lethal medication, not from the underlying disease as is the case when life sustaining measures are withdrawn. Second, the doctor's intent in the two situations is different: lethal in writing the prescription, but palliative in carrying out the patient's request to withdraw treatment. The trial court next turned to the individual dignity clause and the right to privacy in the Montana constitution, finding that these two rights were "intertwined" and holding that, "Taken together, this Court concludes that the right of personal autonomy included in the constitutional right to privacy, and the right to determine 'the most fundamental questions of life' inherent in the state constitutional right to dignity, mandate that a competent terminally ill person has the right to choose to end his or her life." 2008 Mont. Dist. LEXIS 482, paragraph 47. This right "necessarily incorporates the assistance of his doctor, as part of a doctor-patient relationship, so that the patient can obtain a prescription for drugs that he can take to end his own life, if and when he so determines." Because the right is fundamental, the state was required to show a narrowly tailored compelling state interest. While the state's interest in preserving human life was found to be compelling, it was overcome by the terminal patients' rights of privacy and dignity. Two other compelling state interests, protecting vulnerable groups, and protecting the integrity and ethics of the medical profession, could be accomplished by legislation. Plaintiff Robert Baxter died the same day the trial court issued its opinion.

Montana Supreme Court opinion

On appeal, the Montana Supreme Court noted the judicial principle that cases should be resolved on a statutory basis, not on constitutional grounds, if possible, and thus framed the issue as "whether the consent of the patient to the physician's aid in dying could constitute a statutory defense to a homicide charge." Montana law codifies four exceptions to the defense of consent, only one of which is relevant here: "it is against public policy to permit the conduct or the resulting harm, even though consented to." MCA Section 45-2-211)(2)(d). The court reviewed the sole Montana case addressing the public policy exception to consent, and found that the exception applies to "conduct that disrupts public peace and physically endangers others." The court surveyed similar cases from the state of Washington with the same result. As opposed to defendants who committed violent acts that directly caused harm, in PAD the patient himself, not the doctor, administers the lethal dose, and every step in PAD is private. Thus the court found no parallel to the "bar brawler, prison fighter, BB gun shooter and domestic violence aggressor" who previous cases had found to come within the public policy exception. In addition, the court found evidence that prescribing lethal medication did not violate Montana public policy by looking at the state's Terminally Ill Act, which allows terminally ill patients to withdraw life sustaining treatments and immunizes doctors from liability for the patients' deaths when the directives are followed. Because the Terminally Ill Act gives patients the right to have their end-of –life wishes followed even where it requires direct participation

by a doctor in withdrawing treatment, the court found no violation of public policy by a doctor following end-of-life wishes through prescribing lethal medications.

The Montana Supreme Court also examined the Terminally Ill Act's prohibition on mercy killing and euthanasia, noting that "Physician aid in dying is, by definition, neither of these." As the court stated, "Neither [mercy killing nor euthanasia]… is consent-based, and neither involved a patient's autonomous decision to self-administer drugs that will cause his own death."

Finally, the court reversed the award of attorneys' fees.

In a concurring opinion, Justice Warner emphasized the wisdom of avoiding the constitutional issue, and noted that the majority's opinion "is not necessarily limited to physicians." He urged the legislature to act on the matter. A second concurrence, by Justice Nelson, concluded that physician aid in dying is protected by the provisions on privacy and individual dignity in the Montana constitution. Justice Rice, dissenting,

would find no statutory or constitutional basis for physician aid in dying.

<u>What's next for Montana?</u>

Amednews.com has reported that Montana Democratic State Representative Dick Barrett plans to propose a statute based on Oregon's "Death with Dignity Act" when the legislature reconvenes in January 2011. Until then, what questions remain as to criminal liability for PAD, and who will be able to use it? The questions arise because, unlike Oregon and Washington, no statutory provisions are in place to determine how and when PAD may occur.

The Montana Supreme Court repeatedly referred to two parties in its analysis: a terminally ill, mentally competent adult who requests medication to aid in dying, and a physician who prescribes but does not administer the drug. Thus, as long as the state agrees with the doctor that the patient is competent and terminally ill, and the patient herself takes the lethal dose, it appears that the defense of consent is available to the Montana physician who wrote the prescription. But what if we go slightly beyond these facts? Can a resident of another state travel to Montana to get the prescription, for example? The Oregon statute limits requests to its residents as demonstrated by such things as an Oregon driver license, registration to vote in Oregon, evidence that the person owns or leases property in the state, or filing an Oregon tax return in the most recent tax year. ORS Section 127.860.3.10. In addition, Oregon defines "attending physician" as the physician who has "primary responsibility for the care of the patient and treatment of the patient's terminal disease." ORS Section 127.800 Sec. 1.01(2). Thus, an out-of-state resident would not be able to demand a lethal prescription from an Oregon physician, as the patient would not qualify as a resident, and the doctor would not qualify as his or her attending physician. (In addition, Oregon requires multiple requests for the medication, concurrence by a second physician, and waiting periods before the prescription can be written or filled). With none of these statutory provisions in Montana, what about the out-of-stater seeking a prescription? The answer may turn on how willing the Montana medical profession is to write these prescriptions. Four physicians were named plaintiffs in *Baxter,* but the position of most Montana

doctors is at present unknown. While the American Medical Association has adopted Opinion E- 2.211, stating that physician assisted suicide is "fundamentally incompatible with the physician's role as healer, would be difficult or impossible to control, and would pose serious societal risks," the Montana Medical Association has taken no position on PAD, and did not file an amicus brief in *Baxter*.

Other scenarios for Montana residents:

Oregon law includes as one of the duties of the attending physician to "Counsel the patient about the importance of having another person present when the patient takes the medication … and of not taking the medication in a public place." ORS 127.815.3.01(1)(g). What might happen if a terminally ill Montana patient follows this advice? What if the Montana patient *doesn't* follow it? First, suppose the terminally ill patient takes the advice, and a friend or family member (not a physician) is present when he or she takes the lethal dose in a private place. Could the friend or family member be charged with homicide if he or she assisted the patient in any way? *Baxter* held that the physician could claim the defense of consent, but it is not clear that others could claim it as well. In contrast, the Oregon statute states that "No person shall be subject to civil or criminal liability… for participating in good faith compliance with [the Death with Dignity Act]. This includes being present when a qualified patient takes the prescribed medication to end his or her life in a humane and dignified manner." ORS 127.884 Sec. 4.01(1).

Alternatively, suppose the terminally ill Montanan does not follow Oregon's advice, and takes the medication in a public place, or privately with no one else present. If taken in a public place, two dangers potentially emerge. First, the Montana Supreme Court emphasized the private nature of physician aid in dying in finding that the conduct does not disrupt public peace. The court therefore concluded that the patient's consent to the prescription would immunize the doctor. What if the manner of carrying out the death does disrupt public peace? It is out of the physician's control where the patient takes the medication. Should the physician's defense of consent turn on where the patient administers the drug? The other potential danger is to the patient. If the patient takes the drug in a public place, strangers not aware of the plan might intervene to try to save him or her. The same result could occur if the patient is alone; someone encountering the patient could summon emergency help and the patient's wishes would not be carried out. Oregon's statistics indicate that, while death generally occurred within 25 minutes of ingestion and sometimes as quickly as one minute, in a few cases death occurred as much as 48 hours after ingestion, thus increasing the likelihood in Montana that a stranger might intervene.

What about a terminally ill patient who is not physically capable of administering the medication himself or herself? Picture a person with Amyotrophic Lateral Sclerosis (ALS, or "Lou Gehrig's disease"), a progressive disease which usually has no effect on the ability to think or reason, but can make it increasingly difficult to swallow and breathe. (30 of the 401 Oregon patients who have died after ingesting lethal medication were diagnosed with

ALS). If the terminally ill patient is unable to swallow and uses a feeding tube, would a friend or family member be liable for homicide if s/he were the one to place the lethal medication in the feeding tube? The Montana Supreme Court emphasized the importance of the terminally ill patient taking the medication him- or her-self; would this count?

Would a terminally ill patient who takes the medication be classified as a suicide, or would the person be deemed as dying from the underlying disease? Oregon has clarified the matter by statute, especially for life, health or accident insurance or annuity policies. ORS 127.875 Sec. 3.13. Section 3.14 makes clear that ingesting a lethal prescription under Oregon's Death With Dignity Act "shall not, for any purpose, constitute suicide, assisted suicide, mercy killing or homicide."

These are a few of the questions that Montana doctors and the terminally ill must face in the next year. Once the legislature reconvenes, other questions arise, such as whether to declare PAD as against the public policy of the state of Montana, or to expand PAD to include those who are not terminally ill but wish to die, those who are mentally competent but unable to make a written request for the medication or unable to take it themselves, plus whether to enact the procedural safeguards (written and oral requests, two physicians, right to rescind, and so on) found in the Oregon and Washington statutes.

A Matter of Trust
by: Sharon L. Klein

The root of the word "trustee" is trust. In this article we will examine the critical importance of communication when serving in the trusted role of fiduciary. We will also look at the unfortunate set of circumstances that can arise when a supposedly trusted family member or friend is appointed as trustee, but turns out not to be so trustworthy…

Finally, we will take a look at the issue of attorney-client privilege. If the interests of the trustee and beneficiary diverge, can the trustee trust that communications with the trustee's attorney will be protected by the privilege?

Communication is Key

Communication is an integral part of the relationship between trustee and beneficiary; its importance cannot be over-emphasized. In fact, oftentimes trustees have been criticized not for taking or failing to take an action, but for the failure to communicate with the beneficiary.

In *Rollins v. Branch Bank and Trust Co. of Virginia*, 56 Va. Cir. 147 (2001), the grantor created trusts for family members, which were funded predominately with the stock of one company. Investment responsibility was bestowed exclusively on family members, the trust agreement providing: "Investment decisions as to the retention, sale, or purchase of any asset of the Trust fund shall…be decided by…living children or beneficiaries…"

When the stock plummeted in value, the beneficiaries sued the bank for breach of duty for the failure to diversify assets and the failure to communicate with the beneficiaries. The bank claimed that the language of the trust agreement insulated it from liability, by conferring investment responsibility on family members alone.

Additionally, the Bank relied on Virginia statutory law, which provided: "Whenever the instrument under which…fiduciaries are acting…vests in…a co-fiduciary…to the exclusion of one or more of the fiduciaries, authority to direct the making or retention of investments…the excluded fiduciary or co-fiduciary…shall not be liable…for any loss resulting from such authorized directions."

The court agreed that the language of the trust agreement and the statute protected the trustees from liability for failure to diversify. However, the court held, the trustee has a duty to (1) keep beneficiaries informed as to the conditions of the trust and (2) fully inform them of all facts relevant to the subject matter of the trust and material for a beneficiary to know for the protection of his interests. A trustee, said the court, cannot rid itself of this "duty to warn".

Lack of communication has been a key component in establishing trustee liability in a number of high profile stock concentration cases. Typically in these cases, a large single stock concentration has been held in a trust portfolio, the value of the concentrated position has plummeted, and the trustees have successfully been sued for failure to diversify.

These cases usually involve a complete failure to communicate, as well as a failure to perform other fiduciary responsibilities (no monitoring of the concentrated position, no documentation of the reasons for the concentration), coupled with reliance on a clause in a document purportedly allowing retention of the concentration.

Under these circumstances, the courts have held that the trustees could not rely on the retention clause.[1]

The theme from these cases is very clear: Trustees will not be permitted to abdicate their fiduciary responsibilities and blindly rely on a retention clause to insulate them from liability. If, however, a trustee actually fulfills its fiduciary responsibilities and communicates with the beneficiaries, there is some hope for the proposition that a trustee can rely on the provisions of an instrument.

In *Americans for the Arts v. Ruth Lilly Charitable Remainder Annuity Trust #1*, 855 N.E. 2d 592 (Ind. Ct. App. 2006), the court actually honored the trust language and found that it was sufficient to exempt the trustee from the duty to diversify when the trustee openly communicated with the beneficiaries and acted properly and responsibly.

Margesson v. Bank of New York, 738 N.Y.S. 2d 411 (3rd Dept. 2002), involved a trust, the assets of which were composed predominantly of large concentrations of four stocks. Because sale of the highly appreciated stocks would result in substantial tax liability, there was a long-standing understanding that the trust would be managed to avoid their unnecessary sale.

Without communicating with the trust's administrative officer or the income beneficiary, the trust's investment officer sold a portion of the stock holdings, which resulted in the income beneficiary being personally liable for over $22,000 in capital gains. When he sued the trustee for breach of fiduciary duty, the trustee claimed it was merely complying with the prudent investor rule and that the sale was made for the purpose of diversifying the trust's investments.

The Third Department, however, found that, although the Bank complied with the prudent investor rule, a triable issue of fact existed as to whether it breached its fiduciary duty by failing to communicate in light of the long-standing understanding to avoid unnecessary sales:

> "She [the administrative officer] had no conversation with [the investment officer] regarding this sale or the plaintiff's needs as income beneficiary. [The investment officer] has a responsibility to communicate with [the administrative officer]…to ensure his understanding of the investment objectives."

In *McGinley v. Bank of America*, 279 Kan. 426 (2005), the settlor created a revocable trust, which provided she was to be consulted by the trustee as to any purchase or sale, and that the trustee had to abide by her decision. The trust was funded with Enron stock and other assets.

Seven months later, she signed a letter directing the trustee to retain the Enron stock. The letter exonerated and indemnified the bank for all losses as a result of the retention and relieved it from responsibility for analyzing and monitoring the stock. By the end of 2000, Enron stock comprised 77% of the trust assets.

After Enron stock plummeted in 2001, the settlor brought suit against the trustee, claiming that it failed to comply with the prudent investor rule. The court rejected the arguments of the settlor because

> (1) the applicable state law specifically provided that a trustee who followed the written directions of a settlor of a revocable trust was deemed to have complied with the prudent investor rule and was authorized to follow such written instructions, and
>
> (2) pursuant to the terms of the trust instrument itself, the settlor retained investment control.

The Court did note, however, that even in these circumstances, the better practice of the trustee would have been to communicate the effects of the letter and to have notified the settlor of the significant decreases in the value of the Enron stock.

Fiduciary Self-Dealing

When appointing a trusted family member or friend to the ultimate position of trust as a fiduciary, that individual is typically chosen precisely because she or he is expected to act in accordance with the highest code of honor, and in the best interests of the beneficiaries. Betrayal of trust in that setting is all the more crushing, as the following cases demonstrate.

In *Estate of Hester v. United States*, 2007 U.S. Dist. LEXIS 14834 (W.D. Va.), *aff'd*, 2008 U.S. App. LEXIS 21971 (4th Cir.), *cert. denied*, 129 S. Ct. 2168 (2009), the decedent established a trust, naming her surviving husband as income beneficiary and trustee, with their two children as remainder persons. At the time of the testator's death, the trust was valued at $3.2 million.

The husband transferred all of the trust's liquid assets into his own brokerage account and commingled the funds. Over the next several months, he lost $2 million from day-trading, withdrew over $450,000 in cash, and collected $280,000 on a promissory note held by the trust.

When the husband later died, the funds had become so commingled that it was impossible to distinguish trust funds from the individual brokerage funds. The estate tax return for the husband included the misappropriated funds in his gross estate, and over $2.7 million was paid in estate taxes.

The children did not assert a claim against the father's estate, probably because the same individuals were beneficiaries of both estates. The estate later claimed an estate tax refund on two alternative grounds:

(1) as the widower had possessed no interest in the misappropriated assets, he was merely holding them in a constructive trust for the benefit of the remainder persons and the misappropriated funds were not includable in the decedent's gross estate, and alternatively,

(2) if the misappropriated assets were includable in the estate, the estate should be awarded an offsetting deduction for claims against the estate.

However, in a double whammy, the court confirmed that the children were obligated to pay estate taxes on the assets their own father misappropriated (the decedent "exercised dominion and control over the assets as though they were his own without an express or implied recognition of an obligation to repay," such that the misappropriated funds were properly includable in the gross estate), and also rejected the argument that there should be an offsetting deduction (the remainder persons had never asserted a claim against the estate and the statute of limitations for asserting such a claim had expired).

In *Davis v. Davis*, 889 N.E. 2d 374 (Ct. App., IN 2008), the settlor named one of her three sons, a former bank president, as trustee of her revocable trust and her attorney-in-fact. During his mother's lifetime, the trustee/son made gifts to himself and his children, invested trust assets in the bank where he was employed, made zero-interest loans to himself, and commingled trust funds with assets subject to a different trust.

After his mother died, the trustee/son did not respond to requests for an accounting of the trust.

The Court found that the trustee committed repeated instances of self-dealing and breach of fiduciary duty including failure to account, making loans to himself and commingling of funds between separate trusts. Indeed, at his deposition, the son/trustee was asked:

> "Q: You don't understand that you have to keep…as a…former bank president, you have to keep the assets straight in one trust…and the assets straight in the other…account?

A: I…I can see…in retrospect that, uh, from a record keeping standpoint, it…it should've been done differently." 889 N.E. 2d at 381.

In *Mary and Emanuel Rosenfeld Foundation Trust*, 2006 Phila. Ct. Com. Pl. LEXIS 394, *aff'd in part* and *rev'd in part*, *remanded*, without opinion, 953 A.2d 849 (2008), Emanuel Rosenfeld, the founder of Pep Boys, established a charitable trust funded entirely with Pep Boys stock in 1952. He named a corporate trustee and three individuals co-trustees: his son Lester, his daughter Rita, and Lester's son Robert. Lester had worked for Pep Boys all his life. After his retirement in 1980, he continued to serve as a consultant and board member.

Beginning in 1997, Rita and the corporate trustee both urged diversification of the trust assets. Lester and Robert both opposed diversification, and the trustees were deadlocked. The court found that Lester's obdurate refusal to diversify stemmed from his own position with the company, the interests of which he put above those of the charitable beneficiaries.

The court also found that Robert abdicated any responsibility as trustee by inattention, his supine submission to his father's presumed inside knowledge of the company and his fear of the personal financial repercussions of failing to follow his father's lead (i.e., being disinherited by his father). The following excerpts from Lester's deposition transcript graphically illustrate the point that Lester was oblivious to the obligation of a trusted fiduciary to refrain from acting in his own self-interest:

"Q: Do you consider yourself a trustee of the foundation to have any duties to beneficiaries of the foundation…?
A: No."

That response prompted the attorney deposing Lester to re-ask the question, probably incredulously, not believing his good fortune, as he could not have scripted better answers to his questions:

"Q: You have no duty to the beneficiaries?
A: No." Id. at 7.

Both Robert and Lester were surcharged for breaches of fiduciary duty.

The much-publicized story of Brooke Astor exemplifies the hostilities that can arise between family members.

Socialite Brooke Astor died in August 2007 at the age of 105, leaving an estate valued at approximately $130 million. In 2002, Ms. Astor executed a will under which her son, Anthony Marshall, received significantly more assets outright than under her prior will, which was executed in 1997. Mr. Marshall was appointed sole executor and trustee.

In July 2006, Ms. Astor's grandson Phillip Marshall filed a petition in New York State Supreme Court accusing his father Anthony Marshall of neglecting Ms. Astor's care while enriching himself with her fortune. In November 2007, Mr. Marshall was indicted on multiple criminal charges stemming from his handling of Ms. Astor's finances during her lifetime. In October 2009, he was convicted of fourteen of the sixteen counts against him, including first-degree grand larceny in connection with a retroactive salary increase of about $1 million dollars that Mr. Marshall gave himself for managing his mother's finances.

In December 2009, Mr. Marshall was sentenced to 1-3 years in prison, but is currently free while an appeal is pending.

Perhaps the best way to prevent these tragic abuses by friends or family members is to appoint a trusted professional advisor that is involved in the day-to-day trust management. The appointment of a trusted professional advisor brings neutrality and accountability to the relationship. It can alleviate the pressure on a family member trustee, circumvent intra-family suspicion and prevent perceived or actual impropriety.

Attorney-Client Privilege

Effective April 1, 2009, the Code of Professional Responsibility was replaced with the Rules of Professional Conduct ("RPC") in New York.

Pursuant to Rule 1.6 of the RPC, a lawyer is prohibited from revealing confidential information, absent informed consent of the client, or in other limited circumstances.

The rule defines confidential information as:

> …information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential.

Under New York law, the attorney-client privilege extends to fiduciary relationships. Civil Practice Law and Rules § 4503(2) provides that a beneficiary is not entitled to access privileged communications made between a personal representative and the personal representative's attorney, solely by virtue of his or her position as a beneficiary. However, a "fiduciary exception" to the privilege may apply. In other words, in the context of a fiduciary relationship, the privilege is not absolute and a showing of "good cause" may trump it.

The controlling feature for the applicability of the fiduciary exception is whether the advice sought was for the benefit of the beneficiary, as a result of the fiduciary relationship. See *Stenovich v. Wachtell, Lipton, Rosen & Katz*, 756 N.Y.S. 2d 367 (Sup. Ct. N.Y. Cty. 2003). Factors to be considered in determining whether the fiduciary exception applies are:

(1) whether the beneficiaries may have been directly affected by a decision the fiduciary made on the attorney's advice,
(2) whether the communications are the only evidence available regarding whether the fiduciary's actions furthered the interests of the beneficiaries,
(3) whether the communications relate to prospective actions and not advice on past actions, and
(4) whether the communications sought are highly relevant and specific.
Hoopes v. Carota, 531 N.Y.S. 2d 407 (3d Dept. 1988), *affirmed*, 544 N.Y.S. 2d 808 (1989)

Note, however, that inter vivos trusts are excluded from CPLR § 4503(2) and communications with counsel may be accessible by beneficiaries of such trusts. Perhaps one factor that might weigh on the side of upholding of the privilege is whether the advice has been paid for out of the fiduciary's own pocket, as opposed to having been funded with trust assets.

Trust(ee) Selection

At its core, the selection of a trustee involves a judgment decision regarding the trustworthiness of the individual selected.

Diligence on the part of the settlor/testator in the trustee selection process, coupled with the guidance of trusted professional advisors in the trust management arena, are key to insuring that the trust reposed is not misplaced.

Sharon L. Klein is currently a Managing Director and Head of Wealthy Advisory at Lazard Wealth Management LLC in New York. She can be reached at 212-332-4504 or sharon.klein@lazard.com.

[1] *In Re Charles G. Dumont*, 791 N.Y.S.2d 868 (Surrogate's Court, Monroe Cty. 2004), rev'd in part, 809 N.Y.S.2d 360 (App. Div. 4th Dep't 2006), appeal denied, 813 N.Y.S.2d 689 (App. Div. 4th Dep't 2006), appeal denied, appeal dismissed, 855 N.E.2d 1167 (2006), *Wood v U.S. Bank*, 828 N.E.2d 1072 (Ohio Ct. App. 2005), appeal denied, 835 N.E.2d 727 (Ohio 2005); *Fifth Third Bank v. Firstar Bank, N.A*,. 2006 Ohio 4506, appeal denied, 860 N.E.2d 768 (Ohio 2007)

IRS Chief Counsel Advice 200937028
Released September 11, 2009

Recent Developments

American Bar Association
Section of Real Property, Trust and Estate Law
Leadership Meeting
Laguna Beach, California
November 20, 2009

James D. Spratt, Jr.
The Bowden Spratt Law Firm, P.C.
Atlanta, Georgia

IRS Chief Counsel Advice 200937028

On September 11, 2009, the IRS released Chief Counsel Advice 200937028 (the "CCA"), which consists merely of a copy of a redacted email dated November 18, 2008. A copy is attached. Because of the redaction, we do not know who it is from or to whom it was directed. Few facts are disclosed in the CCA, but it appears that a taxpayer was taking the position that the assets of a grantor trust should receive a basis adjustment under Section 1014 of the Code, presumably a step-up, equal to their fair market value as of the grantor's death. The CCA states that the taxpayer transferred assets to the trust and reserved the power to substitute assets. It does not say whether the transfer was a gift or a sale or a combination of the two or whether there was a note outstanding on the grantor's death. What is clear is that the chief counsel "strongly disagree[s]" with the taxpayer's contention that the assets of the trust are entitled to a basis adjustment under Section 1014 of the Code.

Section 1014(a) provides that the basis of property acquired from a decedent is the fair market value of the property on the date of the decedent's death. Section 1014(b) describes the circumstances under which property is considered to be acquired from a decedent.[1] Section 1014(b)(1) provides that property acquired by bequest, devise, or inheritance is considered to have been acquired from the decedent. The chief counsel concludes that Section 1014 does not apply because the decedent made a lifetime transfer of property to the trust and the trust property was not included in the decedent's gross estate for federal estate tax purposes.

[1] See Section 1014(b)(1)-(10).

The chief counsel's analysis is simple, and it reaches a logical conclusion. So why would the taxpayer take a contrary position? Perhaps it is not so simple. In 2002 Jonathan Blattmachr, Mitchell Gans, and Hugh Jacobson published an article in the ***Journal of Taxation***[2] that discussed the income tax consequences of the death of a grantor with a purchase money promissory note outstanding from a grantor trust. After concluding that the grantor's death does not trigger gain and that post-death payments on the promissory note are not income in respect of a decedent, the authors explore the issue of how the trustee of the once grantor trust determines the basis of assets purchased from the decedent. There are three possible ways to characterize the trustee's acquisition of the assets—a bequest or devise, a purchase, or a gift. If the acquisition is viewed as a bequest or devise, then basis is determined under Section 1014. If it is characterized as a purchase, then basis is determined under Section 1012. If it is deemed to be a gift, then basis is determined under Section 1015.

The authors concede that at first blush it seems implausible that the transfer of assets to an inter vivos trust the assets of which will not be includible in the transferor's gross estate could be considered a bequest or devise for purposes of Section 1014(b)(1). They observe, however, that although certain provisions of Section 1014(b)[3] would require or result in estate tax inclusion, there is no such requirement for Section 1014(b)(1). If a grantor trust's assets are deemed to be owned by the grantor for income tax purposes, the authors state that "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a

---

[2] Income Tax Effects of Termination of Grantor Trust Status By Reason of The Grantor's Death, 97 J. Tax'n 149 (2002).
[3] E.g. 1014(b)(2),(3), and (9).

grantor trust at the moment of death."[4] The authors pose an interesting question from a policy standpoint. A well-advised taxpayer who can predict the timing of his death can achieve a stepped-up basis by purchasing the grantor trust's assets for cash (or an asset with no appreciation) immediately before death. The trust ends up with cash (or an asset with no gain), and the repurchased asset receives a basis step-up in the grantor's estate under Section 1014. Why should the result be different for a taxpayer who is advised poorly or unable to predict the timing of his death?

If the acquisition is characterized as a purchase by the trustee in exchange for the note, effective as of the grantor's death, then under Section 1012, the trustee's basis would be equal to cost. This results in an "asymmetrical effect" because, as the authors argue, there is no authority for treating the decedent or his estate as having made a sale. Notwithstanding this conceptual asymmetry, this is a plausible outcome that produces symmetry between the estate tax inclusion value of the note (and other consideration received by the grantor in the sale) and the basis adjustment of the trust's assets.

Finally, the acquisition could be treated as a gift with the basis consequences determined under Section 1015. There are three possible outcomes under Section 1015. First, if the acquisition is viewed as a pure gift (i.e. the note and other consideration are ignored), Section 1015(a) would apply, and the trustee would use the grantor's basis for determining gain or the lesser of the donor's basis or fair market value as of the "gift"[5] for determining loss.

---

[4] A complete discussion of this argument is beyond the scope of this short summary. The authors use statutory construction, legislative history, and policy considerations in their argument. It is well worth reading.

[5] The authors pose the question of when the gift occurs for purposes of determining fair market value—the date of the sale or the date the trust is no longer a grantor trust. If it is the date of the sale, isn't that contrary to the principle that transactions between a grantor and a grantor trust are disregarded for income tax consequences? Section 1015 is after all an income tax section.

Second, Section 1015(b) might apply. This subsection applies to transfers in trust other than by gift, bequest, or devise and where there is some consideration received by the donor. Here the trust's basis is equal to the grantor's basis increased by any gain or decreased by any loss the grantor recognizes in the transaction.

Third, the part gift/part sale rule of Reg. §1.1015-4 could apply. Here the trust's basis would be the greater of the grantor's basis or the amount paid by the trustee. The authors note that in a normal case this would produce a basis for trust assets equal to the sum of the grantor's basis and the amount of gain recognized by the grantor. But with a sale to a grantor trust, the grantor recognizes no gain. Does this mean that the trust receives a cost basis in the asset acquired from the grantor?

This basis issue is not as easy to sort through as the chief counsel advice would suggest. Ruling out Section 1014 does not answer the question of how the trustee of the former grantor trust determines the basis of assets acquired from the deceased grantor. Presumably, the chief counsel would argue that Section 1015 applies, not Section 1012. We see, however, with the assistance of Messrs. Blattmachr, Gans, and Jacobson, that the application of Section 1015 in the grantor trust context is not without questions.

ID: CCA-111831-08

Number: **200937028**
Release Date: 9/11/2009

Office:

UILC: 1014.04-00

From:
Sent: Tuesday, November 18, 2008 3:19 PM
To:
Cc:
Subject: RE: Request for Advice

We strongly disagree with taxpayer's contention. In this case, the taxpayer transferred assets into a trust and reserved the power to substitute assets.

Section 1014(b)(1)-(10) describes the circumstances under which property is treated as having been acquired from the decedent for purposes of the section 1014 step-up basis rule. Since the decedent transferred the property into trust, section 1014(b)(1) does not apply. Sections 1014(b)(2) and (b)(3) apply to transfers in trust, but do not apply here, because the decedent did not reserve the right to revoke or amend the trust. None of the other provisions appear to apply at all in this case.

Quoting from section 1.1014-1(a) of the Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally, . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]"

Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9).

Price v. Commissioner, T.C. Memo. 2010-2 (January 4, 2010)

Gifts of Limited Partnership Interests Fail to Qualify for Annual Exclusion

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

Synopsis

Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts that will qualify for the gift tax annual exclusion. There was no immediate enjoyment of the donated property itself, because the donees had no ability to withdraw their capital accounts and because partners could not sell their interests without the written consent of all other partners. Furthermore, there was no immediate enjoyment of income from the donated property (which can also, by itself, confer present interest status) because (1) there was no steady flow of income, and (2) distribution of profits was in the discretion of the general partner and the partnership agreement specifically stated that distributions are secondary to the partnership's primary purpose of generating a long-term reasonable rate of return. Perhaps most interesting is that the IRS pursued this annual exclusion argument in litigation even though there were limited donees (three, unlike the Hackl, case where there were 41 donees) and even though there were over $500,000 of actual distributions to the children from the partnership's creation in 1997 to 2002. Clearly, the annual exclusion issue is "in play" and the availability of the annual exclusion for limited partnership interest transfers cannot be assumed. Several drafting suggestions will assist in countering the court's objections.

Basic Facts

1. Before selling his closely held company, Father contributed his stock and commercial property leased to the company to a family limited partnership in 1997. The FLP sold the stock in early 1998, and the proceeds were invested in marketable securities.
2. The 1% general partner was a corporation owned by Father's and Mother's revocable trusts, with Father as president. The 99% limited partnership interests were initially held equally by Father's and Mother's revocable trusts.
3. The terms of the FLP agreement include the following:
    a. Prohibition Against Transfer. Partners cannot sell partnership interests without written consent of all partners, but a limited partner may sell its interest to another partner.

b. Purchase Option. If there is a voluntary or involuntary assignment of a partnership interest, the other partners have an option to purchase the interest for its fair market value, determined under a procedure requiring three appraisals. There is no time limit on exercising the purchase option in the event of voluntary transfers.

c. Distributions. Profits are distributed proportionally to all partners "in the discretion of the general partner except as otherwise directed by a majority in interest of all the partners, both general and limited." There is no obligation to make distributions to enable partners to pay their income taxes on the partnership's profits. Furthermore, the partnership agreement stated that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments."

4. Father and Mother each made gifts of limited partnership interest to each of their three adult children in each of the years 1997-2002. In each year, the gifts by the two donors to each child exceeded $20,000 ($22,000 in 2002), and they intended that the gifts would qualify for the federal gift tax annual exclusion.

5. The partnership actually made distributions to the children as follows:

Year	Total Partnership Distributions to Children
1997	---
1998	$ 7,212
1999	343,800
2000	100,500
2001	---
2002	76,824
Total	528,336

6. The gifts were large enough that the children collectively held a majority interest in the partnership in every year beginning in 1997. The children's cumulative interests in the partnership during the three years at issue (2000-2002) were 63%, 68.1%, and 99%, respectively.

7. The opinion described the gifts reported on gift tax returns by Father and Mother in 2000, 2001, and 2002. The IRS issued a "notice of gift value determination" for the 2000 gifts. The IRS issued notices of deficiency for 2001 and 2002. Each of these notices disallowed annual gift tax exclusions, and the opinion listed deficiencies for 2001 and 2002. (It is not clear if the IRS also questioned the annual exclusion availability for gifts made in 2000.)

Issue

Do the gifts of limited partnership interests in 2000 (perhaps), 2001 and 2002 constitute gifts of present interests that qualify for the federal gift tax annual exclusion under § 2503(b) of the Internal Revenue Code ($10,000 in 2000 and 2001 and $11,000 in 2002)? (The IRS conceded that the values were properly reported even though the appraised values allowed "substantial discounts for lack of control and lack of marketability.")

Holding

The gifts of limited partnership interests do not constitute present interest gifts that qualify for the federal gift tax annual exclusion.

Analysis

1. Regulations and Supreme Court Test. The regulations give this general description of a present interest:

> "An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property." Treas. Reg. § 25.2503-3(b).

An example in the regulations provides that where a trustee is authorized in its discretion to withhold payments of income, the beneficiaries' right to receive income payments is not a present interest. Treas. Reg. § 25.2503-3(c), Ex. (1).

The U.S. Supreme Court reasoned that the donee "must have the right presently to use, possess or enjoy the property," and this "connote[s] the right to substantial present economic benefit." Fondren v. Commissioner, 324 U.S. 18, 20-21 (1945).

2. Hackl Test. The Tax Court in Hackl v. Commissioner, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003) reasoned that the annual exclusion is available if the donee has the right to immediate use, possession or enjoyment of (1) property transferred, OR (2) income from the property. The Tax Court's test requires that under either alternative, the immediate use, possession or enjoyment must "be of a nature that substantial economic benefit is derived therefrom."

3. Taxpayer Position. The gifts constitute present interests because (1) donees can freely transfer of the interests to one another or to the general partner, (2) each donee has immediate rights to partnership income and may freely assign income rights to third persons, and (3) Hackl was decided incorrectly and in any event is distinguishable.

4. IRS Position. The interests are future interests because the partnership agreement effectively bars transfers to third parties and does not require income distributions to the limited partners.

5. No Right to Present Enjoyment of "Property."

   a. Mere Assignees. The donees were mere assignees, not substitute limited partners, because the children were not initial partners and §11.2 of the partnership agreement provided: "Any assignment made to anyone, not already a partners, shall be effective only to give the assignee the right to receive the share of profits to which his assignor would otherwise be entitled * * * and shall not give the assignee the right to become a substituted limited partner." (Emphasis supplied by court.) [Observe: It would be unusual for the partnership not to give the existing partners the ability to admit any transferee as a substitute

limited partner if they so desired. Even if the partnership agreement allowed that, apparently there was no documentation that the original partners (Father's and Mother's revocable trusts and the 1% corporate general partner) formally consented to their admission as substitute limited partners.] However, even if the children were substitute limited partners, the court said its decision would not have changed because of contingences on the "receipt of economic value for the transferred partnership interests."

b. No Withdrawal Rights. Like most partnership agreements, this agreement did not give the partners the unilateral right to withdraw their capital accounts.

c. Transfer and Sale Restrictions. The primary reason the court gave for refusing to find that the donees had an immediate substantial right to enjoyment of the property was because of transfer and sale restrictions in the partnership agreement.

> "Pursuant to section 11.1 of the partnership agreement, unless all partners consented the donees could transfer their partnership interests only to another partner or to a partner's trust. In addition, any such purchase would be subject to the option-to-purchase provisions of section 11.4 of the partnership agreement, which gives the partnership itself or any of the other partners a right to purchase the property according to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer."

Even though the donees could sell their interests to the general partner (or Father's or Mother's revocable trusts), that was not sufficient because the corporate general partners was owned by the donors and Father was the President. "If the possibility of a donor's agreeing to buy back a gift sufficed to establish a present interest in the donee, little would remain of the present interest requirement and its statutory purpose would be subverted if not entirely defeated."

d. Borrowing Ability Too Contingent. Donors argued that the donees' interests in the partnership enhanced their "financial borrowing ability." This is "at best highly contingent and speculative and does not, we believe, constitute a source of substantial economic benefit, particularly in the light of the restrictions on alienation (including on the ability of a partner to 'encumber' a partnership interest) contained in the partnership agreement."

6. No Right to Income From Transferred Property. The Tax Court has distilled a three-part test to show that the donees had the right to immediately use, possess or enjoy the income from the transferred property: "(1) The partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained." See Hackl v. Commissioner, 118 T.C. at 298 (7th Circuit opinion does not addresss that test); Calder v. Commissioner, 85 T.C. 713, 727-728 (1985).

The court agreed that the first test was satisfied — the partnership could be expected to generate income. However, it concluded that the last two tests were not met: income did not flow steadily and the portion of income flowing to the donees could be readily ascertained.

a. No Steady Flow of Income. In fact, no distributions were made in 2001.

b. Partnership Agreement Restriction That Distributions Are Secondary to Achieving Return. Profits are distributed at the discretion of the general partner (except as directed otherwise by a majority of the limited partners). Furthermore, "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments."

c. Tax Distributions Not Required. The donors allege that the partnership is expected to make distributions to cover the partners' income tax liabilities for flow-through income from the partnership, but the partnership agreement clearly says that is discretionary with the general partner.

d. No "Strict Fiduciary Duty" to Distribute Income. The court disagreed with the donors' argument that the general partner has a "strict fiduciary duty" to make income distributions and that meant the donees had a present interest. There was no citation of authority that such a strict fiduciary duty existed. Even if it did, it would not establish a present interest "where the limited partner lacks withdrawal rights." Finally, the donees were mere assignees, so there is a significant question as to whether the general partners owed them "any duty other than loyalty and due care."

Observations

1. IRS Pursuing Annual Exclusion Argument, Even Where There Are Only Limited Numbers of Donees. Hackl involved annual exclusion gifts to 41 donees; for both donor-spouses, that represent annual exclusion gifts of 41 x 2 x $10,000, or $820,000 per year. It is understandable that the IRS would challenge the annual exclusion availability in that scenario. This case, however, involves gifts to only three children, but the IRS is still pursuing the argument.

2. Substantial Discounts Allowed and Limited Tax Amount in Dispute. The IRS did not contest the valuation of the limited partner interests even though the appraisals applied "substantial discounts." This case continues the trend of cases where substantial discounts are allowed, either by court decision or by IRS concession, for transfers of limited partnership interests.

   The opinion only listed alleged tax deficiencies for 2001 and 2002 in the aggregate amount of $71,586 for both donors. It is rather surprising that both the IRS and the taxpayers chose to litigate this issue for that relatively small amount of deficiency. (The case does not address how the gift tax deficiency amounts were calculated. For example, if the issue in 2000 was the disallowance of $30,000 of annual exclusions for each donor, that would seem to result in a maximum gift tax deficiency of $30,000 x 60% [the maximum possible gift tax bracket], or $18,000 for each donor. Instead, the deficiency exceeded $20,000 for each donor [and was slightly different for each spouse].)

3. Planning Keys from This Case.

a. Use Rights of First Refusal, No Transfer Prohibitions. The court focused primarily on the restrictions against transferring an interest to anyone other than existing partners without written consent of all partners. Instead of including such a prohibition, provide that any transferee will be subject to a right of first refusal, with reasonable time limits on exercise. Furthermore, some planners even give donees the right to sell interests that could become "full-fledged" substitute limited partners, subject only to a right of first refusal, to build the best possible argument for the annual exclusion. (As a practical matter, the donee will probably have difficulty selling the interest in any event.) (However, the Hackl court intimated that permitting the donees to sell their interests, alone, does not assure annual exclusion treatment because the extreme lack of marketability of interests may raise questions about whether the right is by itself sufficient to produce a present interest. The Price court did not suggest any such hesitancy. In any event, that issue seems to merely go the valuation of the interest — it is marketable at a certain price, and if the interest is properly valued, the interest would be marketable at that price.)

The court rejected the ability to sell to other partners as constituting a present interest because the only possible purchasers were the donors' revocable trusts or the wholly owned corporation. Furthermore, the court said that any sale to a partner would be subject to a purchase option by other partners or the partnership to purchase the interest under a "complicated valuation process" involving three appraisers "without providing any time limit for exercising the purchase option with respect to a voluntary transfer."

b. Make Sure Donees Are Not Mere Assignees. Mere assignees have limited rights. Hackl and Price both concluded that gifts of assignee interests could not be present interest gifts because they "lack the ability 'presently to access any substantial economic or financial benefit that might be represented by the ownership units.'" Formally document that the existing partners consent to admit donees who receive limited partnership interests as substitute limited partners.

c. Do Not Explicitly Favor Reinvestments Over Distributions in the Partnership Agreement. In reasoning that there was no present enjoyment of income, the court focused on the fact that distributions of profits were discretionary with the general partner and that the partnership agreement specifically provided that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate or return, on a long-term basis, with respect to its investments."

d. Making Distributions Every Year and "Regularizing" Distributions Helps Bolster Annual Exclusion Qualification But May Make §2036(a)(1) Inclusion More Likely. To be in the best position to argue that the right to receive income creates a present interest, make distributions from the FLP or LLC every year. The court pointed out that the partnership did not make any distributions in 2001 for some reason (did the partnership not have any profits in 2001?), thus flunking the requirement that "some portion of the income … flow steadily to the donees." Making distributions every year does not assure present interest treatment based

on the right to income because another requirement is that the portion of income flowing to the donees can be readily ascertained. (The Tax Court emphasized this test in Hackl: "Furthermore, even if petitioners had shown that Treeco would generate income at or near the time of the gifts, the record fails to establish that any ascertainable portion of such income would flow out to the donees. Members would receive income from Treeco only in the event of a distribution. However, the Operating Agreement states that distributions were to be made in the manager's discretion. This makes the timing and amount of distributions a matter of pure speculation…") Indeed, making "regular" distributions in some manner would help satisfy the "readily ascertainable" requirement. In any event, the failure to make distributions every year sure made the court's argument easier, even though very large distributions had been made in other years.

Of course, all of this discussion must be considered in light of §2036. If regular distributions are made to the decedent (as well as to the donee-partners), the court may have little trouble in finding the existence of an implied agreement to make regular distributions, triggering the application of §2036(a)(1) at the individual's death.

e. Consider Mandating Distributions of "Net Cash Flow." Some attorneys favor requiring the distribution of net cash flow (defined to include the discretion to retain reserves needed to carry out the partnership's purposes), as a way of rebutting an allegation that §2036(a)(2) or §2038 would apply. That also has the advantage of bolstering an argument that the annual exclusions should be available. *However*, the IRS has argued in some cases that such a provision triggers §2036(a)(1), to create an express or implied agreement of retained enjoyment. For example, the IRS's brief in Estate of Black v. Commissioner, 133 T.C. No. 15 (2009) made that argument. Therefore, careful consideration must be given to including such a provision. The results of estate inclusion under §2036(a)(1) are much more draconian than the loss of gift tax annual exclusions.

f. Should "Tax Distributions" Be Required? The court noted that the partnership agreement gave the general partners discretion as to whether to make "tax distributions" so the partners could pay their income taxes on flow-through income from the partnership in response to the taxpayers' argument that the donee-partners expected to receive such distributions. Including a requirement to make "tax distributions" would provide a further argument for present interest status. However, be aware that the IRS has argued that the presence of mandatory tax distribution provisions triggers §2036(a)(1). In Estate of Black v. Commissioner, 133 T.C. No. 15 (2009), the IRS's brief argued: "Thus although there was no guarantee that Sam Black would receive the full amount of the dividends earned on the Erie stock he contributed, he nevertheless retained an express right to receive at least a significant portion of those dividends through the mandatory cash distribution provision contained in the partnership agreement." (That was not addressed in the reported case because the court in Black determined that the bona fide sale exception to §2036 applied.) Again, because the results of §2036(a)(1) inclusion can result in huge additional estate taxes, give careful consideration as to whether to include a mandatory tax distribution provision even if it could help as to the annual exclusion issue.

g. Fiduciary Duty. Be sure to provide that the general partner owes fiduciary duties to the partners. This can assist in rebutting an argument for estate inclusion under §§2036(a)(2) and 2038 and may help to bolster the availability of the annual exclusion, as discussed immediately below.

4. Fiduciary Standard Regarding Distributions. The court in Price rejected that there was a "strict fiduciary duty" to make income distributions, or that such a duty (even if it existed) would establish a present interest. However, some older IRS private rulings (predating both Hackl and Price) concluded that gifts of limited partnership interests may qualify as present interests if the general partner's discretion over distributions is subject to a fiduciary standard and if the donees have the right at any time to sell or assign the interests, subject to a right of first refusal. See Tech. Adv. Memo. 9131006 & Ltr. Rul. 9415007. Those rulings emphasized that the general partner has a fiduciary duty to limited partners and distinguished a general partner's powers from a trustee's discretionary power to distribute or withhold trust income or principal and also emphasized that the donees had the right at any time to sell or assign their interests, subject to a right of first refusal.

5. Substantial Actual Distributions Did Not Establish Immediate Right to Income. In one respect, this case is particularly hard-nosed in refusing to recognize a present interest right to income even though a majority of partners could demand distributions of profits and even though very substantial distributions were *actually made* from this partnership.

First, under the partnership agreement, a majority of partners could demand distributions of profits. The three children collectively constituted a majority of the partners and could have demanded distributions of profits under the agreement. However, the court apparently dismissed this as an issue because none of the donee-children individually held a majority interest and could demand a distribution. (In 2002, any two of the three children would have held a majority interest.) Prior cases certainly establish that if a donee can access immediate enjoyment only through the joint action of others, the present interest requirement is not satisfied. See Ryerson v. United States, 312 U.S. 405 (1941); Skouras v. Commissioner, 14 T.C. 523, 524-525 (1950), affd, 188 F.2d 831 (2d Cir. 1951) (gifts of undivided interests in life insurance policy to multiple donees did not qualify for annual exclusion).

Second, very large distributions were actually made from this partnership, and even in that situation the court agreed with the IRS that there was no immediate enjoyment of income from the donated asset under the three-part test announced in Hackl (because income did not "flow steadily" and the income flow could not be readily ascertained).

Based on the values reported on gift tax returns of gifts of specified percentage interests in the relevant years, the percentages of the partnership value actually distributed each year during 2000-2002 are as follows:

Year	2000	2001	2002
Value of gifts to children	44,715	62,310	355,215
Percentage of FLP transferred	3.0%	5.1%	30.9%
Value per 1% interest	14,905	12,218	11,496
Cumulative interests held by children	63%	68.1%	99%
Value of children's interests	993,105	832,046	1,130,067
Actual distributions to children	100,000	0	76,824
Percentage of total value distributed	10.7%	0%	6.8%

In addition, a very large distribution ($343,800) was made in 1999, the year preceding the first tax year mentioned in the case. While there is no reported value of the partnership in 1999, based on the value listed for 1999, this must have represented a distribution of over 25% of the FLP's value, estimated as follows:

In 2000, total value of partnership interests = $993,015/.63 = $1,576,214

Add distribution to children in 1999 + 343,800

Add distribution to other partners in 1999 (343,800 x 40/60) + 229,200

1999 total estimated value of partnership interests,

based on 2000 value $2,149,214

Distributions in 1999: 343,800 + 229,200 = 573,000

Percentage of value distributed in 1999: 573,000/2,149,214 = 26.7%

This background leads planners to wonder whether gifts of almost all closely held companies (both corporations, LLCs and partnerships) would have trouble satisfying the "right to income from the property" alternative for present interest treatment, unless the company actually makes regular cash distributions and the income flow is somehow ascertainable.

6. Annual Exclusion Arguably Should be Available for Value of Assignee Interest. The analysis in Hackl and Price indicates that generally the ability to sell donated property connotes a substantial economic interest in the property that qualifies for the annual exclusion. In Hackl, the court observed that the partners could sell their interests, but they could only sell what amounts to an assignee interest in the LLC. The Tax Court and the Seventh Circuit both observed that "the possibility that a shareholder might violate the operating agreement and sell his or her shares to a transferee who would then not have any membership or voting rights can hardly be called a substantial economic benefit."

In Price, §11.2 of the partnership agreement specifically says that an assignment to anyone, not already a partner, would only convey an assignee interest. However, the court said that did not override §11.1, which says that no partner shall sell any interest

in the partnership without the written consent of all partners (even though the first five words of §11.1 are "except as hereinafter set forth"). That seems incorrect — purported transfers are not simply voided; indeed the partnership agreement provided that in the event of any voluntary or involuntary assignment of a partnership interest, the assignment is not just voided but the remaining partners have an option to purchase the partnership interest for its fair market value.

In Price, the court reasoned that only an assignee interest was given to the children. If under state law and the partnership agreement (despite the court's interpretation of the agreement), a partner (or assignee) could sell the assignee interest, the entire donated interest in the partnership could be sold for value and should constitute a present interest.

However, observe that the Tax Court and Seventh Circuit clearly do not agree with that analysis.

7. Crummey-Like Withdrawal Power. Some planners have suggested giving the donees a Crummey withdrawal power with respect to gifts of limited partnership interests. Such a withdrawal right would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift. If the donees can only withdraw the "fair market value" of their interests, this type of provision should not have a significant impact on the amount of discount allowed in valuing the interests. "I have been doing this for years in FLPs I created where (1) the partnership agreement prohibited limited partners from transferring their interests and (2) the partnership was unlikely to generate immediate income and (3) the gifts were intended to qualify for the present interest exclusion…The buyback price is the fair market value of the units (determined as you would want the FMV to be determined for gift tax purposes). The FLP can borrow money to carry out the buyback, or distribute assets in-kind."

   Comments of Natalie Choate in Leimberg Estate Planning Newsletter (April 4, 2002).

8. Gifts of Cash Followed By Purchase of Partnership Interests. Another approach to avoid the annual exclusion issue is to make cash gifts to donees (perhaps grantor trusts), and have the donees exercise their own discretion to purchase limited partnership interests from the donor.

9. Put Right. Some planners have suggested giving donee-partners a limited period of time to sell the interest to the partnership for its fair market value, determined without regard to the existence of the put right. Others have suggested using a conditional assignment that is subject to the assignee being allowed to require the donor to substitute income producing property equal in value of the donated partnership interest. In either of those cases, the planner must make sure that the client is comfortable with the possibility of such a demand being made on the partnership or the donor.

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.