Ten Essential Tax Rulings for the Estate Planner's Tool Box

By Tye J. Klooster and Melissa C. Selinger

In the September/October 2009 issue of *Probate & Property*, the authors ran a flyer requesting that readers visit the ABA's website to vote for the 10 tax rulings that are essential to estate planners. The authors provided a list of 37 tax cases and rulings to select from, and readers also were given an opportunity to cast a vote for cases and rulings not on the list. Readers were asked to rank their top 10 in order from 1 to 10. Polls closed on October 31, 2009, after 83 individuals had officially cast their votes.

After receiving the votes, we allotted 10 points for each first place vote, 9 points for each second place vote, and so on. The final tally is shown in the box on this page.

Given the small number of votes cast, the results are far from scientific. Sound arguments can be made that other rulings should have made the top 10. Regardless, every estate planner should have a working knowledge of these 10 rulings.

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Crummey v. Commissioner

In the realm of estate planning, the *Crummey* case enjoys a good deal of name recognition. The case involves IRC § 2503(b), which provides that the allowable gift tax annual exclusion applies only to gifts in which the donee of the gift has a "present interest," as opposed to a "future interest." This distinction becomes particularly important when a gift is made in trust, rather than outright to the donee.

In *Crummey*, the issue was whether certain gifts to an irrevocable trust (which included minor beneficiaries) constituted a present interest that would allow the gifts to qualify for the annual gift tax exclusion. The court held that, rather than the existence of a present interest in the property turning on the beneficiaries' actual enjoyment of the property, the determination should rest instead on their right to enjoy the property. The terms of the trust in *Crummey* allowed the trust beneficiaries (including the minors) the right

Place	Tax Ruling	Total Score
1	*Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968)	572
2 (tied)	Rev. Rul. 85-13, 1985-1 C.B. 184	216
2 (tied)	*Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967)	216
4	*Bongard v. Commissioner*, 124 T.C. No. 8 (2005)	215
5	*Walton v. Commissioner*, 115 T.C. 589 (2000)	209
6	*Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947)	199
7	Rev. Rul. 59-60, 1959-1 C.B. 237	168
8	*Dickman v. Commissioner*, 465 U.S. 330 (1984)	145
9	*Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939)	138
10	*Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997)	126

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to withdraw a certain amount of the gifted assets from the trust immediately after the contribution to the trust, even though such right of withdrawal later lapsed. The court determined that the demand provision in the trust instrument was intended to give all trust beneficiaries (including the minors) the broadest demand power available to withdraw the assets of the trust. The court held that this right of withdrawal created a present interest in the gifted property and that the gift tax annual exclusion was available.

Although a large portion of the *Crummey* decision focused on rights of minor beneficiaries of the trust to demand trust property, the case represents much more than this narrow issue. In subsequent commentary and rulings over the years, the *Crummey* case has come to stand for the principle that a beneficiary's right to withdraw assets gifted to a trust for a limited period of time creates a present interest in such assets that qualifies the gift for the gift tax annual exclusion. For this reason, rights of withdrawal that exist for a limited time period are referred to in estate planning parlance as "*Crummey* powers." Numerous rulings have reiterated the principle that a beneficiary must be provided with notice of his or her right to withdraw and also must be provided with enough time to have a reasonable opportunity to make withdrawals. *Crummey* withdrawal rights were expanded by the *Cristofani* case, in which the court held that if contingent trust beneficiaries have a true right of withdrawal, annual gift tax exclusions of the contingent beneficiaries can be used as well. *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991).

In practice, a beneficiary of a *Crummey* trust is typically granted a present right of withdrawal over the lesser of the annual gift tax exclusion amount and the amount that was actually gifted to the trust (and not the entire trust). These rights typically last for up to 30 days after each gift is made, and the beneficiary must have actual notice of his or her right to withdraw. If the beneficiary fails to withdraw the gift within the specified time period, the right of withdrawal lapses (either for the entire gift or a portion thereof), and the portion of the gift that was not withdrawn remains an asset of the trust, control over which reverts to the trustee. Two caveats to this gifting technique are that (1) the beneficiary typically does not withdraw the gifted property (but has the power to do so) and (2) there may be income tax consequences that result from the lapse of this power, both of which are issues beyond the scope of this article. By drafting adequate rights of withdrawal in a trust instrument and adhering to the notice requirements, estate planners can introduce their clients to a practical, effective way of using their gift tax annual exclusion.

***Crummey* is not just an historical case with no modern day usefulness.**

Crummey is not just an historical case with no modern day usefulness. The *Crummey* saga continues today in the context of modern day family limited partnership cases. Whether a gift of a donor's partnership interest constitutes a present interest for purposes of the gift tax annual exclusion has been scrutinized in a few recent cases in which the courts have examined the extent of the restrictions on the transferred gift (for example, the extent to which the donee has a right to withdraw income or principal from the partnership). This continuing discussion is a good reason for practitioners to have an understanding of the *Crummey* holding.

Rev. Rul. 85-13

The importance of Rev. Rul. 85-13 cannot be overstated. Most estate planners rely on this ruling daily—even if they do not know it. The facts of Rev. Rul. 85-13 are in substance identical to the facts in *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984). The IRS in Rev. Rul. 85-13, like the court in *Rothstein*, concluded that the trust was a grantor trust. What is the effect of this? The Second Circuit in *Rothstein* held that the effect of the trust's being a grantor trust is that the grantor trust is a separate taxpayer—the trust calculates its own income and loss and those items are then reported on the grantor's tax return. Nothing more and nothing less (that is, because the trust is a separate taxpayer, transactions between the grantor and the trust are recognized for income tax purposes). In Rev. Rul. 85-13, the IRS held that because the trust is a grantor trust, the taxpayer is deemed to own the trust assets, and as a result transactions between the grantor and the grantor trust are not recognized as a sale for income tax purposes. The IRS noted the Second Circuit's contrary decision in *Rothstein*. The IRS, however, ruled that "[i]t is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor." The IRS concluded by stating it will not follow *Rothstein* on this issue.

Rev. Rul. 85-13 has been relied on in various subsequent rulings by the IRS, such as Rev. Rul. 87-61, 1987-2 C.B. 219, and PLR 9508007. Estate planners rely on the ruling when engaging in common estate planning strategies, including a sale of assets to a grantor trust (to disregard the sale), a loan to a grantor trust (to disregard interest payments), substituting trust assets with assets of equivalent value, and many other common estate planning strategies.

Commissioner v. Estate of Bosch

At issue in *Bosch*, which is most commonly experienced in the estate administration context, was whether a federal court or agency in a federal estate tax controversy was conclusively bound by a state trial court's determination of property rights, specifically, in a case in which the United States was not made a party to the proceeding. The *Bosch* Court ruled that federal authorities are not bound by such a determination.

The decision arose from two consolidated federal estate tax cases that illustrated a widespread conflict among the circuits. The Supreme Court held that, when federal estate tax liability turns on the character of a property interest held and is transferred by a decedent under state law, federal authorities are not bound by the determination of such property interest made by a state trial court. Instead, when the underlying substantive rule involved in the decision is based on state law, only the state's highest court is deemed to be the best authority on its own law. The *Bosch* Court ruled that, although the state's highest court is the best authority on its own law, if no decision by the highest court exists, then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of that state, unless such authorities are convinced by other persuasive data that the highest court of the state would decide otherwise.

From a practical standpoint, the *Bosch* decision allows the federal authorities to act as a sitting state court. Therefore, an estate planner would be well advised to find a ruling by the relevant state's highest court before making a decision on any issue affecting federal tax. One example would be when determining the deductibility of administration expenses, which, under IRC § 2053, are those allowable under the laws of the state where the estate is being administered. The approval of such expenses by the local probate court, although persuasive, should not be considered conclusive. Another example of how *Bosch* can apply is a postmortem reformation action in state court in the context of attempting to preserve the marital or charitable deduction, which would in turn affect federal estate taxes. Most importantly, as a general rule, although state law is determinative of property rights, the manner and extent to which such rights are taxed are determined by federal law.

Bongard v. Commissioner

The IRS has launched numerous attacks on FLPs since the late 1990s. One such argument made by the IRS is that IRC § 2036(a)(1) is applicable to the creation and funding of an FLP.

The examination used by the Tax Court and other courts in the application of IRC § 2036(a)(1) has evolved over time. The test used by the Tax Court in *Bongard* appears to be the test most often cited in recent court decisions. As a result, a working knowledge of the test provided by the Tax Court in *Bongard* is critical for estate planners.

The Tax Court held that the exception to IRC § 2036(a) is satisfied if (1) there is a legitimate and significant nontax reason for the creation of the entity and (2) the interests received in exchange are proportionate to the value of the property contributed to the entity. The Tax Court went on to provide that the significant nontax reason must be an actual motivation and not a theoretical justification. The courts will look to the nontax factors and determine if the cited factors are real or illusory. If the FLP was established solely to reduce estate taxes, the exception will not be satisfied. Valid nontax reasons that satisfy this exception have included, for example, joint management of assets, providing a single pool of assets for investment purposes, maintaining a taxpayer's investment philosophy, centralized management, and concern over the dissipation of assets.

If the exception to IRC § 2036(a) does not apply, courts look to the circumstances surrounding the transfers and the subsequent use of the transferred property to determine whether there was an implied agreement that the decedent retained the possession, enjoyment, or the right to the income of the property transferred to the FLP. In this analysis, courts are looking for the proverbial "bad facts" to determine whether there was an invalid implied agreement of a retained interest in the property transferred. Often the same facts that are examined for purposes of the exception to IRC § 2036 also are examined for purposes of this test. An exhaustive list of the bad facts cited in the various court decisions is beyond the scope of this article, but some of the more common factors are old age, bad health, not retaining sufficient assets outside of the FLP to support the taxpayer's lifestyle (and, in more recent

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decisions, to pay gift and estate taxes), disproportionate distributions, the FLP's paying personal expenses of the taxpayer, and partnership formalities not being respected.

Walton v. Commissioner

One of the most common techniques used by estate planners to reduce estate taxes is the grantor retained annuity trust (GRAT). Most GRATs created today are structured as "zeroed-out" GRATs, which are GRATs that can be created at very little (if any) gift tax cost. GRATs structured in this manner are often referred to as *Walton* GRATs, a reference to the infamous Tax Court case of *Walton v. Commissioner*, a case that ultimately made zeroed-out GRATs possible. Estate planners sometimes take for granted the genesis of the zeroed-out GRAT. A basic understanding of the history of the *Walton* GRAT is important for estate planners.

Before *Walton*, a large transfer to a GRAT would often result in a substantial taxable gift because, under Example 5 of Treas. Reg. § 25.2702-3(e), the most a settlor could retain as a qualified interest was an annuity for the shorter of the term of the GRAT and the settlor's death. The possibility that the settlor could die during the term of the GRAT resulted in a remainder always being created with some value. In the case of large transfers to a GRAT, the remainder value was often substantial. The result was that there was a real gift tax cost to creating the GRAT. For example, assume a 75-year-old transfers $5 million of marketable securities to a GRAT for a two-year term, reserving an annuity of $2.45 million in year one (49.000%) and $2.94 million in year two (58.800%). Assuming an IRC § 7520 rate of 5%, the value of the remainder interest (that is, the gift) after *Walton* would be $0.20. Before *Walton* the gift would have been $200,695.

Before *Walton*, estate planners either focused on how to reduce the value of the remainder interest to minimize the taxable gift or opted to take a position contrary to Example 5 of Treas. Reg. § 25.2702-3(e). In *Walton*, taking a position contrary to the example in the regulation, Audrey Walton transferred approximately $100 million worth of Wal-Mart stock to two GRATs, each of which had a two-year term with annuity payments continuing to her estate if she died during the term of the GRATs. The taxpayer's gift tax return reflected no taxable gift, and the IRS argued that the gift was over $3.8 million. The Tax Court, in a unanimous decision, agreed with the taxpayer (the taxpayer had conceded a gift of $6,195.10) and rejected Example 5 as an unreasonable and invalid interpretation and extension of IRC § 2702. The IRS did not appeal the *Walton* case and has issued Regulations that now make clear that continuing the annuity payments to the settlor's estate can reduce the gift tax value of the transfer. As a result, zeroed-out GRATs have flourished—so much so that Congress is considering imposing additional requirements to limit their effectiveness, such as requiring a minimum 10-year term.

Jennings v. Smith

A common technique used in estate planning is the creation of an irrevocable trust designed to shift the grantor's assets out of his or her taxable estate. Irrevocable trusts must be carefully drafted so as not to inadvertently cause the trust assets to be included in the grantor's taxable estate on death. Typically, under IRC §§ 2036(a)(2) and 2038(a)(1), a retained right or power of the grantor to change beneficiaries or shift benefits among beneficiaries results in the transfer being an "incomplete gift" for gift tax purposes and includable in his or her estate for estate tax purposes. To avoid this risk alto-

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gether, the authors do not recommend that a grantor act as a trustee (or other fiduciary) of the grantor's irrevocable trust.

Under *Jennings,* however, a grantor can be named as the trustee of a trust that he or she created and avoid violating IRC §§ 2036 and 2038, if the trustee retains no beneficial interest in the trust property and no power, other than fiduciary powers, the exercise or nonexercise of which is limited to a "fixed or ascertainable standard" (as defined in Treas. Reg. § 20.2041-1(c)(2)).

Decades later, *Jennings* is cited in a number of cases, including *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970), in which the court is faced with the decision to rule on whether a power to invade trust principal is of the character described in IRC § 2036 or § 2038. Whether or not a right or power under these sections exists is typically determined by examining the specific language that defines the scope of the grantor's powers. Because the conditional limitations of these powers are subject to much scrutiny in making this determination, the specificity (or inadvertence) with which these powers are drafted by the estate planner is of the utmost importance. For the most conservative application of an ascertainable standard for estate tax inclusion, it is advisable that a practitioner not deviate from the magic words "health, education, support, or maintenance." For guidance in this area, Treas. Reg. §§ 25.2511-1(g)(2) and 25.2511-2(b) and (c) on this topic are very helpful.

Although *Jennings* remains good law, the authors do not take lightly the chance of running afoul of IRC §§ 2036 and 2038 by naming a grantor as trustee or other fiduciary of his or her own irrevocable trust. Because irrevocable trusts are created with the goal of removing assets from a client's taxable estate, a significant concern is that, if the terms of the trust are not drafted with extreme caution (or the trust is not administered properly), the result can be an inadvertent inclusion of the assets in the grantor's estate. Because of this risk, the authors typically do not recommend this course of action to their own clients. If practitioners prefer to do so, however, they should tread carefully and be mindful of staying within the confines of *Jennings* and the Treasury Regulations. Even if you, like the authors, would not choose to designate a grantor as trustee, you may find this ruling to be useful in crafting a defensive argument for a client faced with an IRS challenge for includability when he or she was named as the trustee of his or her own irrevocable trust. Thus, having a working knowledge of the *Jennings* case in your toolbox can prove beneficial to your practice.

Rev. Rul. 59-60

Rev. Rul. 59-60, published in 1959, remains the IRS's definitive guidance on the approach, methods, and factors to be considered when valuing shares of closely held entities for estate and gift tax purposes. The value required to be reported on a gift or estate tax return is the "fair market value" of the asset. Both Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under a compulsion to buy and the latter is not under a compulsion to sell, both parties having reasonable knowledge of the relevant facts." In the case of many closely held corporations or other entities in which the number of shareholders is limited, reporting the value of such interests is much more challenging than reporting asset values that are readily determined, such as interests in publicly traded companies.

To offer guidance on how to provide a more accurate value and useful supporting documentation for transfers of these assets, the IRS issued Rev. Rul. 59-60. The ruling is especially helpful for appraisers of such assets, in that it sets forth and elaborates on eight factors required in the analysis. Those factors are (1) the nature of the business and the history of the enterprise from its inception, (2) the economic outlook in general and the condition and outlook of the specific industry in general, (3) the book value of the stock and the financial conditions of the business, (4) the earning capacity of the company, (5) the dividend-paying capacity, (6) whether or not the enterprise has goodwill or other intangible value, (7) sales of the stock and the size of the block of stock to be valued, and (8) the market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

The Ruling itself provides a more detailed discussion of each factor. The factors, while helpful, are not determinative, however, and are not created equal. Depending on the nature of the business that is being valued and the surrounding circumstances at the time of a transfer, one particular factor may hold more weight than another. In addition to these factors, the Ruling states that all available financial data as well as all relevant factors affecting the fair market value should be used in determining value. Another circumstance that often affects the valuation of an entity is whether any agreements exist that might restrict the transfer or sale of interests in the business, which would play a significant role in determining share value. When preparing gift or estate tax returns involving closely held interests, or instructing appraisers about the criteria needed for reporting purposes, estate planners should look to Rev. Rul. 59-60 for guidance in determining the value of such interests.

Dickman v. Commissioner

IRC § 2501 taxes the transfer of property by gift. At issue in *Dickman* and the line of cases that preceded *Dickman* was whether an interest free loan (or a below market loan) constituted a gift of the foregone interest. The IRS lost this argument in *Johnson v. Commissioner*, 254 F. Supp. 73 (N.D. Tex. 1966), and *Crown v. Comissioner*, 585 F.2d 234 (7th Cir. 1996), both courts holding that no gift of the foregone interest resulted.

The IRS did not give up. In *Dickman,* the taxpayers made significant interest-free demand loans to their son and a closely held business. The IRS again argued that a taxable gift was made equal to the foregone interest. The Tax Court again held for the taxpayer. The Eleventh Circuit, however, reversed.

The U.S. Supreme Court granted certiorari to resolve the conflict between the Eleventh Circuit in *Dickman* and the Seventh Circuit in *Crown.* The Court affirmed *Dickman.* The Court concluded that the gift tax law should be construed broadly to effectuate the intent of Congress and that the use of property was an interest in property for purposes of the gift tax. Whether at issue is the use of land and buildings or the use of money, "[i]n either case, there is a measurable economic value associated with the use of the property transferred."

As a result of *Dickman,* a transfer of property by gift is equal to the foregone interest on a loan. Unresolved by the Court in *Dickman* was the value of the gift. Congress has since enacted IRC § 7872, which now provides statutory confirmation of the holding in *Dickman* and also provides the means by which to value the taxable gift. An examination of IRC § 7872 is beyond the scope of this article. *Dickman* is important for its historical effect on this important issue and should remain applicable in the context of the foregone use of other assets that do not constitute money. Therefore, a basic understanding of *Dickman* (and IRC § 7872) is essential for estate planners.

Congress has since enacted IRC § 7872, which now provides statutory confirmation of the holding in *Dickman* and also provides the means by which to value the taxable gift.

Estate of Sanford v. Commissioner

If a donor transfers property to a trust and reserves the right to revoke the transfer or the right to alter the beneficial enjoyment of the donees, the transfer is not a completed gift. The law on this issue has been developed from several Supreme Court decisions, which have been incorporated into Treas. Reg. § 25.2511-2.

If the donor retains the power to revoke a transfer, the donor has retained a beneficial power over the trust and the trust is not a completed gift per the Supreme Court's holding in *Burnet v. Guggenheim*, 288 U.S. 280 (1933). If the donor retains the power to alter the beneficial enjoyment of the donees, the transfer is also not a completed gift per the Supreme Court's holding in *Estate of Sanford v. Commissioner. Sanford* is important not only for providing this rule, but for its discussion of the interrelationship between the estate and gift taxes.

In 1913 (before the enactment of the first gift tax statute in 1924), the donor created a trust and reserved the power to revoke or modify the transfer. In 1919, the donor surrendered the power to revoke the trust in the donor's favor but reserved the power to modify the trust (which could not be used to withdraw principal or income from the trust for the donor). In 1924, after the effective date of the first gift tax statute, the donor released the reserved power to modify the trust. The IRS ruled that the gift became complete only on the relinquishment of the power to modify the trust.

The Supreme Court first noted the rule that a transfer of property in trust with a reserved power in the donor to revoke or modify the terms of the transfer renders the transfer an incomplete gift. According to the Court, nothing suggests Congress sought to tax gifts before the donor had fully parted with its interest in the property or that the test of completeness was different from determining whether the donor retained an interest that causes the interest to be subject to estate tax. The Court held: "The gift tax was supplementary to the estate tax. The two are *in pari materia* and must be construed together." *Estate of Sanford*, 308 U.S. at 44. The Court went on to note that "[a]n important, if not the main purpose of the gift tax was to prevent or compensate for avoidance of death taxes by taxing the gifts of property *inter vivos* which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death." Id.

Commissioner v. Estate of Hubert

In general, when expenses are incurred in the administration of an estate, they are deductible from a decedent's gross estate. This eliminates the assessment of estate tax on dollars that are actually spent on costs of administration. Typically, an executor or trustee has the choice to deduct administration expenses on the estate tax return or on the fiduciary income tax return—but not both. Accordingly, executors generally elect to take the deduction when it will provide the greatest tax benefit. This decision often hinges on the characterization of various expenses, a comparison of marginal tax rates, the surviving spouse's own estate and mortality, and other factors.

In *Hubert,* the Commissioner argued that the executors should have reduced the estate tax marital and charitable deductions dollar-for-dollar by the amount of administration expenses deducted on the estate income tax return, citing Treas. Reg. § 20.2056(b)-4(a) (now superceded). Under this Regulation, the Commissioner bore the burden of proving materiality but had not argued that the specific amount of estate administration expenses in the case was material. The Supreme Court rejected this argument and stated that there was no basis for overturning the Tax Court's holding for the estate, granting the full marital and charitable deductions. In response to *Hubert,* the IRS issued Notice 97-63, whereby it asked for public comment on three alternatives for proposed Treasury Regulations, which would offer definitive guidance on when the use of postmortem income from a decedent's property used to pay administration expenses would constitute a material limitation on a spouse's right to income. As important as the *Hubert* ruling was, the IRS's subsequent decision to issue additional guidance on the administrative expense issue was an even more important result of this litigation.

The final Regulations, issued in 1999, focus on categorizing the different types of estate administration expenses as either "management expenses" or "transmission expenses" and clarify how each might reduce the marital share. In general, management expenses comprise expenses incurred in connection with the investment of estate assets or with their preservation or maintenance, and include items such as investment advisory fees, stock brokerage commissions, and interest, while "transmission expenses" are those that would not have been incurred but for the decedent's death and comprise items such as attorney's fees, executor commissions, court costs, and appraisal fees. Under the new Regulations, management expenses attributable to property of the marital share and paid from the marital share may be taken as income tax deductions *without* reducing the marital share. In the alternative, transmission expenses paid from the marital share will always reduce the marital share accordingly. Likewise, management expenses can be used as income tax deductions without requiring a dollar-for-dollar reduction in the credit shelter share, while transmission expenses used as income tax deductions *will* require a dollar-for-dollar reduction in the credit shelter share.

With these parameters in mind, the first step for an estate planner is to categorize the expenses as either management or transmission expenses and then determine where to deduct them. For the practitioner, this involves a careful analysis that weighs the potential benefits of reducing current income tax liability against preserving the marital or credit shelter share for future estate tax savings.

Conclusion

Whether drafting or administering an estate plan, or simply advising a client on a course of action, the authors hope that this article has helped clarify how these rulings form the foundation for so many of the standard clauses in our forms and the underpinnings of even our most basic advice to our clients. Every estate planner should have a basic understanding of these 10 rulings. ■