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

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

December 2008
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Synopsis:

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

Basic Facts:

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

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

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

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

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

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

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

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

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

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

Issues:

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

Holdings:

The court addressed these issues in reverse order.

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

Analysis:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Observations:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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