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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Article

TRANSFER FOR VALUE – SAFE HARBOR

By Jim Roberts
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The IRS issued Rev Rul 2007-13, 2007-11 IRB on February 16, 2007. This ruling is important in that it provides a safe harbor for transfers for value (cash, in this ruling) of life insurance policies from one trust to another trust, so long as the transferee is a grantor trust.

Section 101 of the Internal Revenue Code provides that amounts received under a life insurance contract are excluded from income. There is an exception in Section 101(a)(2) where the life insurance policy, prior to death, is transferred for some valuable consideration. In those cases, the sum of the amount paid for the policy plus whatever premiums are paid is still excluded from income. All amounts over that are included in income.

But Section 101(a)(2) provides for two exceptions: (i) first, if the basis of the policy in the hands of the transferee is the same as the basis of the transferor; and (ii) if the transfer is to the insured, a partner of the insured, to a partnership in which the insured is a partner and to a corporation in which the insured is a shareholder or officer.

The ruling addresses the second of those two exceptions, and does so in the context of a grantor

trust as the trustee.

“Grantor trust” is not a technical term, but is a moniker given to trusts wherein a person, typically the grantor (hence the name), is treated as owning some portion of the trust, which results under Section 671 in the taxation to that owner-grantor of some or all of the income tax consequences of the trust. The types of trusts or trust provisions that make a trust a “grantor trust” are found in Sections 673 through 677, with definitions in 672 and provisions related to someone other than the grantor being the owner found in Section 678. Foreign trusts are addressed in Section 679.

In Rev.Rul. 85-13 , the IRS, in response to the decision in the Rothstein case, clearly stated the rule that a grantor who deals with a trust with respect to which he is treated as the owner cannot create a taxable transaction in dealing with that trust. Other similar rulings followed.

Then, in 2002 and 2006, in two private letter rulings , the IRS ruled that the transfers of life insurance policies to grantor trusts were, in essence, a transfer to the insured. As a result, they were exceptions to the transfer for value rule, and, thus, the death benefits paid by the life insurance would be excluded from taxable income.

But those were private letter rulings which cannot be cited as authority (except by the taxpayer to whom they were addressed). The newly issued revenue ruling settles the matter for the rest of us.

The ruling addresses two fact situations. In the first fact situation, Trust 1 and Trust 2 are both "grantor trusts" for income tax purposes and the insured is the grantor, and, thus, under the grantor trust rules, is treated as the owner of all assets in both trusts. Trust 2 owns life insurance on the insured and sells the insurance to Trust 1 for cash. In the second fact situation, Trust 2 is not a grantor trust.

In the first fact scenario, the IRS reasoned that tax law does not recognize any tax consequences of a transaction with oneself, and, as a result, dealings between Trust 1 and Trust 2 are considered as dealing with oneself, and no tax consequence can flow from that. The IRS therefore concluded that no transfer at all occurs in this fact scenario.

In the second fact scenario, because Trust 2 is not a grantor trust, there is a transfer, and, moreover, it is a transfer for value. Here, the transferee is Trust 1, which is a grantor trust, and, therefore, the transfer is treated as a transfer to the insured-grantor. The transfer is thus within the exception and the death benefits are not taxable under the income tax system.

Note that the ruling does not address what the value of a life insurance policy is (a matter of some debate in this context notwithstanding Reg. §25.2512-6 on valuation of a life insurance contract - see Rev. Proc. 2005-25, 2005-17 IRB 962, 04/08/2005, IRC Sec(s). 402 and Reg §1.402(a)-1(a)(2)). And clearly, that regulation does not apply in the context of a state law examination of the actions of the trustees of Trust 2 when the question is asked whether the trustee obtained the appropriate amount of cash (or other value) for the policies.

Note also that this ruling does not mean that the life insurance remains outside of the insured’s-grantor’s estate. Clearly, Trust 1 must have all of the provisions that would keep the life insurance out of the estate.

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UPDATE ON PATENTING TAX ADVICE

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The idea of issuing patents (primarily business process patents) in the area of tax planning has stirred significant controversy. The expansion of patents in this area has worried many practitioners for a variety of reasons, most notably the possibility that a strategy conceived for a private client later exposed (typically through a dispute process with the IRS) may be the same as or substantially similar to an existing patent, triggering an infringement claim. And from that claim, discovery could reach into the practitioner’s other files, and, if part of a firm, into the files of other practitioners in the firm.

One key element in a successful patent application of any type is the novelty of a procedure for which a patent is sought. The examiner is looking for the best “prior art,” and searches a number of databases for evidence as to whether the tax strategy already exists. In tax law, the problem is that there may be no publications that detail how to comply with straightforward Internal Revenue Cod provisions because the language is obvious. And the concern is that a patent examiner at the US Patent Office will find no prior publications on a tax strategy in that area, thus allowing some to “’capture’ a property right in the Internal Revenue Code.”

On Friday, January 26, 2007, the State Bar of Texas Board of Directors approved a request by that bar's Tax Section to submit to the Internal Revenue Service a response to its request for comment on this area, and, in that response, offered specific legislation to prohibit enforcement of tax strategy patents. The model for the proposed legislation is the language added in 1997 to prevent patents on surgical procedures from being enforced against doctors and hospitals.

This is in clear contrast to the approach suggested in the preamble to the new proposed regulations under Section 6011 and in the modified version of that approach envisioned in the comments submitted by the Tax Section of the American Bar Association which both suggest making use of a patented strategy the same as participating in a listed transaction. This approach has already drawn sharp criticism from the AICPA. Tax Notes Today reported that there was only one witness at the March 20, 2007 hearing on the matter, Rochelle Hodes of PricewaterhouseCoopers, who argued against such a rule, and advocated that the burdens of seeking out the use of the strategy should be on the patent holder or licensee, who gets the benefit of seeking the patent.

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ATTORNEY-CLIENT PRIVILEGE ISSUES FOR ESTATE PLANNING ATTORNEYS IN TAX LITIGATION

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A recent case addressed the attorney-client privilege in a summons case involving an estate and gift tax audit about the formation of and transfers of interests in an FLP. U.S. v. Landon, 98 AFTR 2d 2006-7518 (N.D. Calif. Oct. 30, 2006).

Dale Landon and his wife transferred the bulk of his parents' assets from their revocable trust to a family limited partnership, and made gifts of units of the partnership in highly discounted chunks to Dale and his brother. The interests were transferred without being subject to gift or estate tax. Following the father's death, the IRS initiated a gift and estate tax audit. The IRS issued a summons to Dale and to the attorney, John Thornton, to answer questions regarding the FLP and subpoenaed associated documents. The stated motivation for the summons was to determine if the decedent's estate qualifies for the "bona fide sale" exception to §2036. Mr. Thornton and Mr. Landon were interviewed but asserted the attorney-client privilege with respect to many of the questions and requests for documents.

The court’s rulings as to what is privileged can be categorized into three major categories:

(1) Disclose Legal Advice or Nature of Services. Written or oral communications that disclose legal advice or disclose the specific nature of services provided are covered by the attorney-client privilege. Examples of this are requests to disclose a letter faxed from the attorney concerning the formation of the FLP, requests for correspondence from or to the attorney regarding the formation of the FLP, and requesting how many meetings were held with the attorney to form the LP. Those questions are intended to confirm the specific subject matter of the attorney's representation.

(2) Might Implicate Confidential Communication. Questions that might implicate the confidential communication between attorney and client are also privileged. Examples of these types of questions are "How did the idea of forming the LP come about?"
"Who has personal knowledge of your reasons and motivations for the formation and use of the LP?"
"Did you see any calculations or projections of the tax benefits to be achieved by forming the LP?"
Answers to each of these questions may be that the idea, knowledge, or calculations came from confidential consultation with the attorney. The attorney-client privilege would cover such a response because the information would identify the specific nature of services provided by the attorney. However, each of these questions could be refined to ask if the idea arose prior to or independent of consultation with an attorney, if the persons other than the attorney had personal knowledge, or if he received calculations or projections outside his confidential attorney-client relationship. (The effect would be to solicit the information desired by the IRS -- if the individual had not received that information from others, it would be readily apparent that the information came from the attorney.)

(3) Information in Billing Records Regarding Nature of Services. Billing records and invoices are not privileged, but Mr. Landon “may redact any privileged information which speaks to the specific nature or substance of the services provided or reveals client motives or litigation strategy.”

Requests that were not privileged include (many others were also listed; this is just a sampling):
Questions regarding the formation or operation of the partnership that were independent of attorney-client communications.
How the client met the attorney.
Who made the decision to form the LP.
Whether the parents were aware of the LP.
The extent to which other persons (other than the attorney) were involved in the decision to form and use the LP.
Who were present at meetings with the attorney.
Who was present at each meeting about the LP.
Whether the individual took any notes at meetings to form the LP.
Whether the decedent attended or asked any questions at the meetings about forming the LP.
Whether terms of the LP agreement were negotiated among the partners.
Whether the parents were financially dependent on the LP distributions.

The court concluded that none of those questions (or other similar questions) implicate correspondence or other communications with the attorney.

Observations

a. Important Roadmap. The Landon case is an important roadmap to the estate planning attorney about the scope of the attorney-client privilege. Not all dealings with a client are privileged.

b. Fact of Representation and Presence at Meetings Discoverable. The fact that there was legal representation can be discovered. The fact that the attorney was present at a particular meeting is fair game. (For example, one estate planning attorney reported that in a current case, he excluded his notes regarding client meetings in the production of documents to the IRS. A litigation lawyer in his firm reviewed the facts and said that the attorney must disclose the date of the meeting and who was present at meeting, but can redact everything else.)

c. Engagement Letter. The engagement letter is discoverable, but the specific nature of the legal services can be redacted.

d. Billing Records. Billing records are discoverable, but anything related to the subject matter of the advice or nature of the representation can be redacted. (This should comfort estate planning attorneys regarding the preparation of billing records.)

e. Nature or Substance of Legal Advice. Anything related to or that even possibly implicates the nature or substance of legal advice is protected.

f. IRS Can Rephrase. Often the IRS can rephrase the question to extract the desired information. The court told the IRS how to rephrase questions to avoid implicating the privilege.

g Waiver of Privilege. The IRS did not allege in Landon that the attorney-client privilege had been waived. The privilege can inadvertently be waived by sending copies to third parties, including the accountant. The attorney will want to cooperate with other planners involved, but do not waive the attorney-client privilege. The attorney must spend a lot of time with clients going over the ramifications of waiving the privilege and what waives it.

In Landon, the court permitted questions that inquired about facts that may have occurred that would have waived the privilege—not the nature of the communications, but WERE there communications? The court appears to bend over backwards to force a response as to whether the taxpayer has waived the privilege.

h. Strategic Decision. John Porter often points out in tax litigation planning seminars that the attorney should assume that everything in his or her file will be discovered during the planning process. Even if the privilege is claimed, as a practical matter, litigation in the Tax Court will result in the same judge who is deciding the substantive issue also being the judge who decides the privilege issues. (In the Schutt case, the attorneys agonized over whether to waive the privilege and produce attorney-client communications. They ultimately decided to do so, and those communications were very helpful to the court in determining that there were “legitimate and significant non-tax reasons” for forming the business trusts involved in that case.)

i. Burden of Proof and Penalties. In Kohler, T.C. Memo 2006-152, the IRS tried (unsuccessfully) to shift the burden of proof to the taxpayer because the taxpayer asserted the attorney-client privilege. Attorneys report anecdotally that the IRS has asserted penalties in audits where the attorney-client privilege was claimed.

j. Business Advice vs. Legal Advice. Some attorneys report that the IRS has argued in some cases that certain advice by counsel is business advice rather than legal advice, and saying that business advice communication is not privileged. Ex.—Discussing the protection from creditors that an FLP may or may not afford. Landon seems favorable to upholding the privilege against that kind of attack. If a communication relates to anything in the nature of legal representation, it is privileged.

k. Communications Prior to Attorney-Client Relationship. Any communications prior to attorney-client relationship are not privileged. So any proposals or writings that predated the engagement

of the attorney would appear to be discoverable.

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Effect of Rule 144 Restrictions and Redemption Agreement; Actual Purchases Four Months After Valuation Date Ignored To a Great Extent, Estate of Gimbel

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In Estate of Gimbel v. Comm'r, T.C. Memo. 2006-270, the court valued a large block of stock subject to Rule 144 dribble-out restrictions and the effect of a redemption agreement. The estate owned 13% of the stock of Reliance, a NY stock exchange company. Almost all of those shares were unregistered, and subject to the Rule 144 dribble out rules (in any 3 month period, the greater of 1% of the outstanding class of stock to be sold or the average weekly trading volume for the prior four weeks). The parties estimated that it would take 39 months to sell the restricted shares under the dribble-out rules. In addition, the Company had a formal Redemption Plan, and two weeks before the decedent's death, the CEO said at a steel conference that the Company had a "record year" and would consider repurchasing Reliance shares at around $19/share [but did not say how many shares would be repurchased, and the company was considering a large acquisition that would have required significant cash and credit, and the largest prior repurchase was about

$11 million]. In fact, the Company repurchased 63% of the estate's shares 4 months after the date of death at a price that reflected a 7.027% discount from the average trading price on the date of death. The estate claimed a 20.7% marketability discount on the Form 706, but an additional trial expert determined a 17% discount. The IRS claimed an 8% discount in the deficiency notice, and the IRS's trial expert concluded that a 9% discount was appropriate. The court held: (1) It was reasonably foreseeable on the date of death that the Company would repurchase only about 20% of the estate's stock, and the court used the IRS's expert conclusion of a 13.9% discount for that block; (2) As to the remaining 80%, the IRS expert said that an owner would use hedging contracts (i.e. costless collars) that would reflect a 5% discount, but the court concluded that hedging contracts were not available for this stock, and used the taxpayer's expert's conclusion of a 14.4 % discount considering the present value of the future payments and the risk that the stock might decline during the dribble out period. (The court refused to apply a private placement analysis, because there was no strategic purchaser.)The overall discount was 14.2%.

The court also addressed the effect of actual purchases after the valuation date. In fact, the Company repurchased 63% of the estate's shares 4 months after the date of death at a price that reflected a 7.027% discount from the average trading price on the date of death. The court concluded that it was reasonably foreseeable on date of death that the Company would repurchase about 20% of the estate's stock (rather than the 63% actually purchased 4 months later), and the court used the IRS's expert conclusion of a 13.9% discount for that block (as opposed to the 7.0% discount in the actual repurchase). The actual redemption of 63% of the shares at a lower discount did not control as to the valuation of that 63% block. The court gave the standard reasoning: "Post death events are generally disregarded…However, subsequent events which are reasonably foreseeable as of the valuation date may be considered."

The appraisal attached to the Form 706 did not consider the redemption agreement and the company's history of prior repurchases at all—in spite of the fact that the Company in fact purchased 63% of the estate's stock at a price that reflected only a 7.0% discount. Perhaps that was the primary red flag that triggered the audit and the lawsuit.

Attorneys have reported other cases involving contractual restrictions on selling stock (for example, special company restrictions on selling Rule 144 stock) in which government experts have utilized a costless collar analysis, applying a 20% discount. We may find an emerging trend by IRS appraisers to use a hedging analysis more frequently in an attempt to limit discounts.

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