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October 25, 2007

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Mr. Richard A. Hurst
CC:PA:LPD:PR (REG-141901-05)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: REG-128224-06 (Section 67 Limitations on Estates or Trusts)

Dear Mr. Hurst:

Enclosed are the comments to the proposed regulations REG – 128224-06 (Section 67 Limitations on Estates or Trusts) submitted by the Individual and Fiduciary Income Tax Committee of the Trust and Estate Law Division of the Real Property, Trust and Estate Law Section of the American Bar Association.

The comments have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Kathleen M. Martin
Chair, Section of Real Property, Trust and Estate Law

cc:
Donald L. Korb, Chief Counsel, Internal Revenue Service
Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
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ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

COMMENTS OF THE REAL PROPERTY, TRUST AND ESTATE LAW SECTION OF THE AMERICAN BAR ASSOCIATION

REG-128224-06 (Section 67 Limitations on Estates or Trusts)

October 25, 2007

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law ("Section"). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Individual and Fiduciary Income Tax Committee of the Trust and Estate Division of the Section. Principal responsibility was exercised by Bonnie E. Richards, chair of the Individual and Fiduciary Income Tax Committee ("Committee"), and the principal author of these comments was Jonathan G. Blattmachr. Also participating in the preparation of the comments were Robert S. Balter, Robert E. Barnhill, III, W. Birch Douglass, III, Von E. Sanborn, Martin M. Shenkman, Daniel Wintz and Diana S. C. Zeydel. These comments were reviewed by Carlyn S. McCaffrey on behalf of the Section's Committee on Governmental Submissions.

Although members of the Section who participated in preparing these comments and recommendations have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or to otherwise influence the development or the outcome of, the specific subject matter of these comments.

Background

Under Section 67(a)[1], an individual taxpayer may deduct miscellaneous itemized deductions for income tax purposes only to the extent they exceed two percent of the taxpayer's adjusted gross income (the "Two Percent Floor" or "Two Percent Floor Rule"). Section 67(e) provides that the adjusted gross income of an estate or trust is to be computed in the same manner as in the case of an individual, except that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate and the deductions allowable under Sections 642(b), 651, and 661 shall be treated as allowable in arriving at adjusted gross income." Expenses that are allowable as

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[1] The term "Section" throughout this letter refers to a section of the Internal Revenue Code of 1986 as amended, unless otherwise indicated.

deductions in arriving at adjusted gross income are not treated as itemized deductions and, therefore, are not subject to the Two Percent Floor Rule.

On June 25, 2007, as a result of a split among the circuits in interpreting Section 67(e) as it applies to the deductibility of investment advisory fees by estates and trusts,[2] the Supreme Court granted *certiorari* in *William L. Rudkin Testamentary Trust v. Commissioner.*, 467 F.3d 149 (2nd Cir. 2006), *sub nom*., *Michael J. Knight, Trustee v. Commissioner*. (United States Supreme Court Docket No. 06-1286).

On July 27, 2007, the United States Treasury Department ("Treasury") published proposed regulations ("Proposed Regulations") interpreting Section 67(e). The Proposed Regulations adopt and in some ways expand the strict standard for deductibility of investment advisory fees and other miscellaneous itemized deductions by estates and trusts that was established by the United States Court of Appeals for the Second Circuit in *William L. Rudkin Testamentary Trust v. Commissioner,* 467 F.3d 149 (2nd Cir. 2006) ("*Rudkin")*.

Comments and Recommendations

I. Withdraw Proposed Regulations or Extend Comment Period Until After the Supreme Court Has Ruled in *Rudkin*.

The Supreme Court has granted *certiorari* in *Rudkin,* and will examine this issue directly. Its decision in that case may address the different considerations and standards raised in decisions issued by four United States Courts of Appeals and may reconcile or eliminate the differences in opinions as to the scope of Section 67(e). *Certiorari* was granted in *Rudkin* even though the Treasury had opposed its grant. Treasury argued that the grant of *certiorari* was unnecessary because Treasury had prepared proposed regulations addressing the issue to resolve the different treatment of taxpayers in different circuits and would issue the proposed regulations shortly. Given the Court's implicit rejection of Treasury's position, it is appropriate to defer the regulatory process until the Supreme Court issues its opinion.

A member of the Section made an inquiry to Mr. Eric Solomon, Assistant Secretary for Tax Policy, as to whether Treasury would withdraw the Proposed Regulations or extend the comment period until at least 90 days after the Supreme Court issues its decision. Mr. Solomon would not give any assurance that Treasury would do either. Because we do not know whether the Proposed Regulations will be withdrawn, we address them in these comments. If the Proposed Regulations are not withdrawn, we respectfully request that the period to comment on the Proposed Regulations be extended until 90 days after the Supreme Court renders its decision in *Rudkin* to permit all interested parties to have the benefit of the reasoning in the Supreme Court's decision in

[2] Compare William A. Rudkin Testamentary Trust v. Commissioner, 467 F.3d 149, 154 (2d Circuit 2006)., *Scott v. United States*., 328 F.3d 132, 140 (4th Circuit 2003)., *Mellon Bank, N.A. v. United States.*, 265 F.3d 1275, 1279 (Fed. Cir. 2001) *O'Neill v. Commissioner*, 994 F.2d 302, 304 (6th Cir. 1993).

formulating their comments. In conjunction with extending the comment period, we also respectfully request that the public hearing scheduled for November 14, 2007, be delayed until 30 days after the close of the extended comment period to avoid the possible need for a second hearing.

II. Issue Final Regulations Consistent with the Taxpayer's Position in *Rudkin*.

The taxpayer in the *Rudkin* case took the position that administration costs, incurred in an estate or trust as a result of the fiduciary's special duties and responsibilities are fully deductible without regard to the Two Percent Floor Rule because those costs would not have been incurred if the property were not held in such trust or estate. We believe the taxpayer's position is correct and respectfully urge that the final regulations adopt that position.

In the absence of a ruling from the Supreme Court that the construction of the statute urged by the taxpayer in *Rudkin* is the correct one, we are doubtful that Treasury will adopt it. Accordingly, we offer comments on the Proposed Regulations on the assumption that the final regulations will not adopt the taxpayer's construction of Section 67(e) in *Rudkin*. We emphasize, however, that we believe the taxpayer's position is correct and that the final regulations should be consistent with that approach.

III. Change "Could" to "Would" to Be Consistent with the Statute.

Proposed Regulation § 1.67-4(b) provides that an expense must be "unique" to an estate or trust in order to avoid the Two Percent Floor Rule and that, ". . . a cost is unique to an estate or a non-grantor trust only if an individual *could* not have incurred that cost in connection with property not held in an estate or trust." (Emphasis added.)

We believe that this proposed rule is inconsistent with the Internal Revenue Code ("Code"). Section 67(e) does not require that a type of cost be unique to estates or trusts or that it could not have been incurred by an individual in order to avoid application of the Two Percent Floor. Instead, it requires only that a particular cost be "incurred in connection with the administration of the estate or trust and . . . *would* not have been incurred if the property were not held in *such* trust or estate."[3] (Emphasis added.) We believe that the Code's phrase "would not have been incurred" creates a standard that must be applied to the specific circumstances of each particular estate or trust. The possibility that an individual could have incurred such a cost is not relevant to the application of the Code's standard.

[3] Although we appreciate that some might debate the point and that it may become a focus in the Supreme Court's decision in *Rudkin,* we think it difficult to contend that the word "such" does not require that the determination of deductibility requires that the specific circumstances of the specific estate or trust be considered.

The use of the word “could” instead of the word “would,” in the Proposed Regulations impermissibly narrows the scope of the Section 67(e). The terms “could not” and “would not” have different meanings and are not interchangeable. We recognize that if the word “could” is changed to “would” further modifications to the Proposed Regulations will be required.

The applicability of the word “unique” in the context of the deductibility of investment advisory fees under Section 67(e) was originally used in *O’Neill v. Commissioner.*, 994 F2d 302, (6^{th} Cir. 1993), where it was said that fiduciaries “uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.” The word was not used to describe the nature of the cost incurred, but rather the quality of the relationship of the fiduciary to the beneficiaries and the trust assets. We believe the use of the word in the context of the Proposed Regulations to describe and limit the “type of product or service rendered to the estate or trust, rather than the characterization of the cost of that product or service,” is in error.

IV. <u>Adopt a Rule that Administrative Costs Incurred to Fulfill Fiduciary Duties Are Deductible Without Regard to the Two Percent Floor.</u>

In our view, the administrative costs of non-grantor trusts and estates that “would not have been incurred if the property were not held in such trust or estate,” include those incurred in order to fulfill the trustee’s fiduciary duties with respect to the administration of trust assets. These fiduciary duties are directly related to the specific circumstances of “*such* trust or estate” and the costs associated with them should not be subject to the Two Percent Floor Rule. Those administrative costs include fees for investment management, investment advice and legal that, under applicable state law, are incurred in order for the trust assets to be invested as required by state law (such as, in many states, a “prudent investor” would invest) taking into account factors including investment risk, investment return, the purposes of the trust, the specific provisions of the governing instrument, and the specific circumstances of the trust beneficiaries.

Trustees have fiduciary obligations not only to enhance the investment performance of the trust assets in general, but also to produce a return for current beneficiaries and protect and foster growth for future beneficiaries, including remainder beneficiaries, in accordance with the trust terms and state law. Individuals who are not subject to state law requirements with respect to prudent investment of their own assets and are not required to invest in such a manner. Protecting expenses incurred to enable the trustees to fulfill this fiduciary obligation from the Two Percent Floor Rule serves the purposes intended by Congress.

Other tax law provisions specifically provide that fiduciaries, as opposed to individuals, must seek out and rely on the advice of investment counsel in recognition of the special responsibility that fiduciaries assume when they agree to hold and manage assets for the benefit of persons other than themselves. For example, Section 4944 imposes an excise tax on a private foundation (and through the application of Section 4947(a) on certain other entities) for the making of a "jeopardy investment" and on a foundation manager who willfully makes such an investment. Treas. Reg. § 53.4944-1(a)(2) indicates that whether an investment jeopardizes the carrying out of the exempt purposes of the organization (and, therefore, constitutes a jeopardy investment) turns on whether the "foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes." Although the regulation was issued prior to the general adoption of the prudent investor standard, the regulation identifies a number of factors that a foundation manager may take into account in exercising the requisite standard of care and prudence, similar in nature to the kinds of factors that a trustee must consider under the prudent investor standard. The regulation also provides that, "the determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of the foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole." It is not difficult to draw the parallel that trustees of private trusts face similar obligations to preserve the purposes of the trusts in making investments and in administering the trust assets for the benefit of third parties, such a beneficiaries. The regulation suggests that this special duty (and liability) is not one that individuals face in making their own investments. Treas. Reg. § 53.4944-1(b)(2)(i)(v)(second sentence) provides that, in general, a foundation manager will not be treated as having "knowingly" made a "jeopardy investment" if the manager, after full disclosure of the factual situation to qualified *investment counsel*, relies on that counsel's advice. In effect, the regulations under Section 4944 compel a foundation manager to seek investment advice.

Similarly, an executor or trustee may seek the advice of an investment counselor to help the fiduciary determine if the fiduciary is acting prudently when required to invest under a state law standard. Presumably that advice, if obtained by a foundation, is a proper expense of the foundation pursuant to Treas. Reg. § 53.4944-1(b)(2)(i)(v). It follows that it also should be allowed as a proper expense of the estate or trust without application of the Two Percent Floor Rule because it is incurred to ensure that an investment meets a legally imposed duty of prudence. For example, when a fiduciary must or may distribute fiduciary accounting income, the fiduciary may seek legal and/or investment advice to ensure that the level of income generated is reasonable and consistent with the prudent investor duties.

In order for most trusts to qualify for the gift or estate tax marital deduction, the trustee must invest to produce a reasonable level of income for the spouse who is the trust beneficiary. See, e.g., Treas. Reg. § 20.2056(b)-5(f). Moreover, the trustee, under state law, may also be required to consider the effect of inflation and deflation in making investment decisions. See, e.g., New York Estates, Powers and Trusts Law 11-2.3. Just as the potential liability for making a jeopardy investment does not apply to an individual in making his or her own investments, so too the prudent investor obligations of an executor and trustee in seeking to fulfill the specific fiduciary duties arising in such capacities cannot apply to an individual. Just as a foundation manager may face penalties under Section 4944(b) for willfully making a jeopardy investment, an executor or trustee may face the equivalent of penalties under state civil law for not prudently investing the trust or estate assets consistently with his or her fiduciary duties.

Acknowledging the significance of the fiduciary obligations of trustees and executors as unique and different from any obligations that individuals may have will not result in all administrative expenses being deductible. A fiduciary may incur a variety of costs that are incidental to the maintenance of the assets being held by the fiduciary that are not related to fiduciary's duties to the beneficiaries under state law. For example, maintenance fees for rental real estate, bank fees, and cooperative apartment fees are not incurred as a direct result of the property being held in a trust or estate and should be subject to the Two Percent Floor. We believe that only those costs incurred that are directly related to a fiduciary's duties and responsibilities should be deductible without regard to the Two Percent Floor.

For these reasons, the final or new Proposed Regulations should provide that investment advisory fees incurred to carry out the specific duties of the executor or trustee, consistent with the duty of care imposed by the instrument or applicable local law in making investments, are deductible without regard to the Two Percent Floor. Failure to treat these costs as costs which "would not have been incurred if the property were not held in such trust or estate" ignores the specific responsibilities imposed upon fiduciaries.

We agree with the position taken in the Proposed Regulation that certain expenses (including those listed in Proposed Regulation § 1.67(e)-4(b) such as those rendered in connection with fiduciary accountings) in all cases should be allowed to an estate or non-grantor trust without regard to the Two Percent Floor.

V. Clarify That Expenses From a Pass-Through Entity Are Subject to the Two Percent Floor.

The potential abuse of using pass-through entities to avoid the application of the Two Percent Floor is recognized in Section 67(c). We think that all expenses attributed to an estate or trust from a pass-through entity, such as a partnership, should be subject in their entirety to the Two Percent Floor to the same extent as they would be if attributed to an individual partner. We do not view these expenses, even though incurred during the administration of an estate of trust, as directly related to the fiduciary duties of the executor or trustee.

VI. If the Recommendations Described Above are not Adopted, Consider Creating Safe Harbors.

The Preamble to the Proposed Regulations invites comments on whether safe harbors or other guidance concerning allocation methods would be helpful. We believe that safe harbors and further guidance are critical to the efficient administration of the rules contained in the Proposed Regulations.

The Proposed Regulations contemplate that a single fee may be composed of expenses which would be in part subject to the Two Percent Floor and in part fully deductible without regard to the Two Percent Floor Rule. Proposed Regulation § 1.67-4(c) provides that, when there is a single fee, a "bundled fee," "the estate or nongrantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission, or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor."

Under the Proposed Regulations, each fee incurred by a non-grantor trust would need to be analyzed to determine what portion of it is subject to the Two Percent Floor. This task will be unmanageable because of the extraordinary difficulty – indeed, perhaps the impossibility – of accurately characterizing portions of a single expense.

In the case of investment advisory fees, each fee would have to be analyzed to determine which portion of it was allocable to the kind of investment advise needed because the investments were being made by a fiduciary. Similar problems will exist with respect to other types of fees, such as, legal fees, incurred by trusts and estates. A case-by-case approach will likely result in frequent disputes between taxpayers and the IRS. Avoiding such disputes with respect to miscellaneous itemized deductions was one of the purposes of adopting Section 67.[4]

We believe the adoption of safe harbors with respect to particular types of expenses will reduce the risk of frequent disputes between the IRS and fiduciaries as to what part of investment advisory and other fees is deductible without regard to the Two Percent Floor and what part is not. Unless the taxpayer elects to make a specific allocation, safe harbor percentages should be available for certain types of expenses Although these safe harbors would not effectuate a principled application of the line the Proposed Regulations have drawn, the safe harbors would make the Two Percent Floor Rule more practical to administer.

The safe harbor percentages should be rooted in a fact-based analysis of the typical facts and circumstances applicable to estates and trusts. We propose below safe harbor percentages based on our collective experience. They divide the expenses following the lines drawn in the Proposed Regulations, taking into account the public policy favoring a fair and efficient administration of the tax laws. We also describe certain kinds of services generally obtained by fiduciaries from investment advisors and attorneys and certain kinds of services performed by fiduciaries the cost of which should not be subject to the Two Percent Floor Rule.

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[4] See, e.g., General Explanation of the Tax Reform Act of 1986, prepared by the Professional Staff of the Joint Committee on Taxation, p. 78.

A. *Safe Harbor for Investment Advisory Fees*

Assuming that the final regulations provide that the Two Percent Floor applies to the deduction of investment advisory fees relating to investing for total return, but also assuming, that the cost of investment advisory services incurred to allow the fiduciary to invest in accordance with the prudent investor rules of applicable state law to produce a reasonable amount of income and preserve the spending power of corpus will be deductible without regard to the Two Percent Floor, we think a safe harbor of 75% is appropriate in the case of trusts. In other words, unless the trustee chooses to demonstrate otherwise, 75% of investment advisory fees would be deductible by a trust without regard to the Two Percent Floor as related to the trustee's obligations to the beneficiaries to invest consistently with a prudent investor standard under the terms of the governing instrument or local law and to otherwise meet specific terms of the trust and 25% would be deductible only with respect to the Two Percent Floor. However, if the final regulations provide, as the Proposed Regulations do, that custody fees are subject to the Two Percent Floor, and if the investment advisory services include custody services which are not identified as a separate line item, we recommend that the safe harbor for investment advisory fees be reduced to 70%. (We are advised that many investment advisory firms make no additional charge for custody services but we understand that some do.)

In our experience, the purposes and scope of investment advisory services (and other services, such as legal and appraisal services) incurred during the administration of an estate are often different than the purposes and scope of such services during the administration of a trust. For example, on account of the obligation to pay the decedent's debts and to pay estate taxes soon after the decedent's death, investment advice often involves hedging investments or obtaining short-term fixed income obligation for short-term liquidity needs of an estate that do not typically arise with respect to a trust. Although we believe, therefore, that different safe harbors could be developed for estates as opposed to trusts, we think the added complications of doing so (e.g., for how long will the estate be treated as one for purposes of the estate safe harbors, when will a revocable trust that acts as a Will substitute be treated as a decedent's estate) is not worth the effort.

B. *Safe Harbor for Legal Fees*

The Proposed Regulations list legal fees as a type of expense that may or may not be deductible without regard to the Two Percent Floor. We believe that legal fees should be deductible without regard to the Two Percent Floor Rule unless they would have been incurred regardless of who owned the trust or estate property, that is, unless they are incidental to the maintenance of the assets being held by the fiduciary that are not related to the fiduciary's duties to the beneficiaries under state law. We recommend that any legal fees rendered that relate to the construction of the governing instrument, the enforceability of a provision in a governing instrument, the unique income tax treatment of estates and trusts (such as the determination of distributable net income within the meaning of Section 643(a) of the trust or estate), the determination of whether an expense is a proper charge to the trust or estate, whether a receipt or expense is allocable to income or corpus of the trust or estate, whether a trust or estate is subject to state or local income tax (as the rules governing the income taxation of estates and trusts generally are unique and different from the determination of whether an individual is subject to such state or local income tax)[5], accounting by the fiduciary, communications with the beneficiaries and their counsel and the scope or carrying out of fiduciary duties (such as the duty to account, to inform beneficiaries about certain matters and so on) should be listed as the type of legal fees that are deductible without regard to the Two Percent Floor.

Our list is not intended to be exhaustive but merely illustrative. In making our recommendation of a safe harbor for legal fees, we assume that that the final regulations will continue to provide, as the Proposed Regulations do, that legal services in defending a claim that arose during the decedent's lifetime and the preparation of a gift tax return, will continue to be listed as the type of legal expense that is subject to the Two Percent Floor. In our experience, the costs for legal fees related to the defense of a lifetime claim and the preparation of a gift tax return usually are *de minimis* compared to the universe of estate or trust legal fees, if they are incurred at all, and are typically dealt with differently on a post-death basis than they would have been during life when the taxpayer could have actively participated in the preparation of the such defense or gift tax return. For this reason, we believe that legal fees should not be subject to the Two Percent Floor, with the explicit exception that legal fees related to defending a claim that arose during the decedent's lifetime and preparation of gift tax returns are subject to the Two Percent Floor. If, however, the final regulations do not adopt this approach, we suggest a safe harbor for legal fees of 90%. Unless the fiduciary chooses to demonstrate otherwise, 90% of legal fees would be deductible by an estate or trust without regard to the Two Percent Floor and 10% would be deductible only with respect to that floor.

C. *Safe Harbor for Trustee's and Executor's Fees*

Executor's and trustee's commissions are not incurred unless property is held in a trust or estate. They should be deductible in full without regard to the Two Percent Floor. The Proposed Regulations, provide that if an estate or trust pays a single fee or commission for costs that are subject to the Two Percent Floor and those that are not, the fiduciary must identify the portion of the fee or commission that is subject to the floor and the portion that is not.

We respectfully suggest that fiduciary commissions should not be subject to such unbundling under the reasoning of the Proposed Regulations because no individual could incur an executor's or trustee's commission with respect his or her property. An executor's or trustee's commission is unique to an estate or trust as that term is used in the Proposed Regulations. We note, for example, that state laws providing for a percent commission for an executor or trustee do not vary the fee depending on the type of

[5] See, e.g., New York Tax Law § 605.

service the fiduciary renders. For example, under New York Surrogate's Court Procedure Act Section 2307, an executor's commission applies whether the fiduciary makes investment decisions with or without the advice of an outside investment counselor. We believe that statutory fees should not be required to be unbundled merely because the person serving as trustee has not paid for separate investment advice.

Section 67(e) requires a determination of whether costs incurred in connection with the administration of a trust or estate "would not have been incurred if the property were not held in such trust or estate." Giving the statutory language its plain meaning, the clearest case for applying it would be to trustee's and executor's commissions. These commissions should be fully deductible because they would not have been incurred if the property were not held in a trust or estate. Although none of the four court of appeals cases (*O'Neill, Mellon, Scott* and *Rudkin*) involved trustee or executor services, the opinions assume full deductibility of commission expenses. In *Rudkin*, the opinion, picking up on language used in the Scott opinion, stated that "fees paid to trustees...are fully deductible" *William A. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149, 154 (2d Circuit 2006). *See also, Scott v. U.S.*, 328 F.3d 132, 140 (4th Circuit 2003). A similar statement appears in *Mellon* ("It is undisputed that trustee fees are fully deductible," *Mellon Bank, N.A. v. United States.*, 265 F.3d 1275, 1279 (Fed. Cir. 2001)) and *O'Neill* ("Expenses such as trustee fees...are examples of expenses peculiar to a trust and, therefore, are subject to the § 67(e) exception," *O'Neill v. Commissioner*, 994 F.2d 302, 304 (6th Cir. 1993)) opinions. Obviously these commissions are not payable if the trust or estate has not been created. Therefore, we believe that they should be deductible without regard to the Two Percent Floor.

If the final regulations will provide that an executor's or trustee's commission must be "unbundled," we believe, based upon our experience, that the safe harbor for such fees should be at least 85%. We arrive at this percentage based on our experience that commercial trustees often reduce their trustee commission to 40% of their normal charges when asked what they would charge for pure trusteeship with delegated investment management. The remaining 60% that may appear to be related to investment advice, should be subject to the safe harbor of 75% suggested above, yielding a combined rate for this safe harbor of 85%. Unless the fiduciary chooses to demonstrate otherwise, at least 85% of commissions would be deductible by an estate or trust without regard to the Two Percent Floor and no more than 15% would be deductible only with respect to that floor.

D. *Safe Harbor for Other Expenses*

The Proposed Regulations, in dealing with the unbundling of fees, suggest that certain other expenses, such as appraiser and accounting fees, may be subject in part to the Two Percent Floor and in part not subject to it. We think that accounting and appraisal fees for the preparation of fiduciary income tax returns and accounting by the fiduciary (including periodic reports given to beneficiaries) should be expressly listed as not subject to the Two Percent Floor. We have difficulty envisioning circumstances where accounting fees would be incurred other than with respect to the duties of an executor or trustee to account for the actions the fiduciary has taken. Similarly, we have not experienced circumstances where a fiduciary would incur appraisal fees that do not relate to the duties of the fiduciary to account or to prepare tax returns required to be filed by the estate or trust. It would be helpful for the final regulations to specify what types of accounting or appraisal services would not relate to the fiduciary's duty to account or the preparation of the fiduciary income tax returns. If the final regulations do provide such a list of such services, we suggest that a safe harbor be developed for them.

We appreciate the opportunity to submit these written comments and would welcome the opportunity to offer any additional assistance that might be desired.

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TE Article

Tax-Free Gifting: Comparing GRATs and Sales to Grantor Trusts

by

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Tax-Free Gifting:

Comparing GRATs and Sales to Grantor Trusts

I. Estate planning.

Estate planning involves the transfer of wealth to beneficiaries in a tax-efficient manner.

A. At death.

For a married couple, tax-efficiency at the first spouse's death typically involves utilization of the estate tax credit[1] and marital deduction.[2] This combination results in no federal estate tax at the first death.[3] On the death of the surviving spouse, if the estate exceeds the applicable federal exclusion, federal estate tax will generally be due. For many clients, the prospect of making the government the majority beneficiary[4] of their estate is sufficient motivation to consider means of reducing the transfer tax burden.

B. Lifetime.

1. The primary strategy to reduce estate taxes involves lifetime gifts which are not subject to gift tax.[5]

2. Gifts not subject to gift tax include those made pursuant to the annual exclusion,[6] the tuition and medical expense exclusion[7] and the gift tax credit.[8]

3. For many clients, utilization of these gifting strategies still leaves a significant portion of their estate subject to estate tax upon the death of the surviving spouse. For such clients, additional opportunities for tax-free gifting may be attractive. Two techniques which are often considered are a grantor retained annuity trust (GRAT) and a sale to a grantor trust.

II. GRATs.

A. Summary.

In a GRAT, a Grantor contributes property to a trust and retains the right to be paid an annuity for a specified term, based on an applicable interest rate. Due to the retained annuity, there should not be a gift for gift tax purposes. If the investment performance of the trust exceeds the applicable interest rate, any remainder at the expiration of the term is in effect a tax-free gift to the trust beneficiaries. Unless the Grantor dies during the term, the trust property should not be includible for estate tax purposes. GRATs are generally not used for generation-skipping planning.

B. Annuity.

1. Section 2702, enacted in response to gift tax valuation abuses, provides that if an individual creates a trust for certain family members[9] and retains an interest in the trust, the value of the retained interest for gift tax purposes will be treated as being zero, unless the retained interest is a "qualified interest."[10]

2. The value of any retained interest which is a qualified interest is determined under section 7520.[11] Of the three types of qualified interests,[12] the one used in estate planning and that forms the basis of a GRAT is the "qualified annuity interest."

3. A qualified annuity interest is an irrevocable right to receive either a stated dollar amount or a fraction or percentage of the initial fair market value of the property transferred to the trust. The annuity does not have to be identical in each year, as long as it does not exceed 120 percent of the annuity amount in the preceding year.[13]

4. In a typical GRAT, the Grantor contributes property to a trust[14] and retains the right to be paid an annuity equal to a percentage of the initial fair market value of the property transferred to the trust.[15]

5. The governing instrument must contain provisions relating to adjustments for any incorrect determination of the fair market value of the trust property.[16]

6. The annuity must be payable to the holder at least annually.[17] The trust must prohibit distributions to any person other than the holder of the annuity during the term of the qualified interest.[18]

7. The annuity may be payable based on either the anniversary date of the trust's creation or the taxable year of the trust.[19] If the annuity is payable based on the anniversary date, it must be paid no later than 105 days after the anniversary date. If the annuity amount is payable based on the taxable year, it must be paid no later than the due date (without regard to extensions) of the trust's income tax return.[20]

8. The trust must prohibit commutation or prepayment of the annuity.[21] For trusts created after September 20, 1999, the trust must prohibit the trustee from issuing a note or other debt instrument in satisfaction of the annuity.[22]

9. Assuming the trust is a grantor trust[23], the distribution of any appreciated property in satisfaction of the annuity should not cause the trust to recognize gain for income tax purposes.[24]

C. Trust term.

1. The trust term must be fixed at the creation of the trust, and may be for the Grantor's life, for a specified term of years, or for the shorter of those periods.[25]

2. In order to achieve the best tax result, the term of a typical GRAT is for a specified term of years. Because of the risk of the Grantor's death during the term, a short term is often selected.[26] A short term also prevents good investment performance during one period from being diminished by poor performance in a subsequent period.[27]

3. Although a short term is generally preferable, in certain cases a longer term may be beneficial. This may occur where the 7520 rate is expected to increase during the longer term. In that case, the lower initial 7520 rate can be locked in for the entire longer term. By instead using successive short-term GRATs, the subsequent GRATs would be measured by the then higher 7520 rates.

D. Gift tax.

1. It is generally desirable to structure the GRAT so the Grantor's contribution of property is not treated as a gift for gift tax purposes (often referred to as a zeroed-out GRAT). This requires that the Grantor retain a sufficient annuity amount for the trust term which would consume the entire property plus interest at the 7520 rate. In order to take into account the possibility of a valuation adjustment by the IRS, the annuity amount is typically expressed as a percentage of the initial value of the trust property, which should then self-adjust for any valuation changes.[28]

2. In order for the GRAT to be zeroed-out, the Grantor must be treated as retaining the annuity for the full trust term. The IRS originally took the view, as reflected in its regulations, that the annuity would be treated as a qualified interest only for the shorter of the term of the trust or until the Grantor's prior death.[29] In response to the taxpayer victory in *Walton,*[30] the IRS has changed its view and the revised regulations now provide that the annuity will be treated as a qualified interest for the full term if it is payable to the Grantor, and to the Grantor's estate for the balance of the term if the Grantor dies.[31]

3. Despite the revised regulations, the IRS may assert that a zeroed-out GRAT violates public policy based on the often cited *Procter* case.[32]

E. Tax-free gift.

1. The GRAT will generate a tax-free gift for the remainder beneficiaries if its investment performance exceeds the 7520 rate.

2. Assume a $1,000,000 zeroed-out GRAT is created based on a 7520 rate of 5.8%, which pays an annuity of $544,000 to the Grantor (or to the Grantor's estate if the Grantor dies) for 2 years.

a) If the trust earns 5.8% or less each year, the Grantor will receive the entire trust property and there will be nothing left after 2 years for the remainder beneficiaries. Although the GRAT will not be successful, the Grantor will be in the same position as if the GRAT was never created.

b) If, however, the trust out-performs the 7520 rate by earning more than 5.8%, the Grantor will receive the annuity payments and there will also be property left for the remainder beneficiaries after the trust term ends.

3. The investments of a GRAT may be monitored in order to help achieve out-performance.[33] If the GRAT has out-performed but the term has not yet ended, it may be desirable to lock-in the gains and prevent any subsequent under-performance from diminishing the initial gains. This may be accomplished by having the Grantor purchase the trust property for its higher fair market value.[34] Conversely, if the GRAT has initially performed poorly, it may also be advantageous for the Grantor to purchase the trust property and then transfer it to a new GRAT at its lower fair market value.

F. Estate tax.

1. The GRAT should be structured to avoid inclusion of the trust property in the Grantor's estate.[35] If, however, the Grantor dies during the annuity term, the trust property will be includible in the gross estate.[36]

2. If the Grantor is survived by a spouse, it may be desirable to qualify the trust property for the marital deduction.

a) Prior to *Walton* and the revised regulations, it was common for GRATs to contain a contingent reversion to the Grantor's estate in the case of death during the term. In that case, marital qualification could easily be achieved by an appropriate provision in the Grantor's will.[37]

b) Pursuant to *Walton* and the revised regulations, if the Grantor dies during the term, the remaining annuity amounts must continue to be paid to the Grantor's estate. Marital qualification for the annuity payments could then be obtained by a provision in the Grantor's will, but it is then necessary to separately qualify any trust remainder for the marital deduction.[38]

G. Generation-skipping planning.

1. The GRAT will involve a generation-skipping transfer if the remainder is payable to grandchildren or other skip persons.[39] This would also occur if the remainder is payable to the Grantor's issue and a child dies during the GRAT term leaving surviving children.[40]

2. Once a generation-skipping transfer occurs, GST tax will be due unless there has been an allocation of GST exemption.[41] Since the remainder interest in a zeroed-out (or nearly zeroed-out) GRAT has a nominal value upon the creation of the trust, it would be advantageous if a nominal allocation could be made which would exempt the trust. Unfortunately, it may not be possible to accomplish this and GRATs are therefore not generally used for generation-skipping planning.

a) The most straightforward way to exempt the GRAT is for the Grantor to allocate GST exemption against the nominal remainder value. However, the so-called ETIP rules may preclude this result.[42]

b) Even if the ETIP rules prevent the Grantor from effectively allocating exemption, it might be possible for the remaindermen to gift or sell their interest and accomplish the same result. In an analogous situation, however, the IRS did not allow this result.[43]

III. Sales to Grantor Trusts.

A. Summary.

In a sale to a grantor trust, a Grantor sells property to a trust in exchange for the trust's promissory note. The Grantor does not incur any capital gain and is not taxed on the interest payments. The note is structured so that there is no gift for gift tax purposes. If the investment performance of the trust exceeds the interest on the note, there is in effect a tax-free gift to the trust beneficiaries. If the Grantor dies, the trust property is not includible in the estate. A grantor trust sale may also be used for generation-skipping planning.

B. Income tax.

1. Grantor trusts, also known as defective grantor trusts and intentionally defective grantor trusts (IDGTs), are trusts that are treated as owned by the Grantor for income tax purposes.[44] All of the income and deductions of a grantor trust[45] are attributed and taxed to the Grantor,[46] instead of to the trust.

2. By qualifying the trust as a grantor trust, a sale of property by the Grantor to the trust may be made without incurring any capital gain.[47] Similarly, the payment of interest by the trust is not taxed to the Grantor.

3. Since the favorable income tax treatment results from the grantor trust status of the trust, it is advisable to maintain such status until the note has been fully paid. The death of the Grantor, however, would terminate grantor trust status. If this occurs while the note is still outstanding, the income tax effect is uncertain.[48]

C. Estate tax.

1. It is important that the trust, while treated as owned by the Grantor for income tax purposes, not be treated as includible in the Grantor's estate for estate tax purposes. While many of the grantor trust provisions would also cause estate tax inclusion, certain provisions should not result in estate inclusion. One such provision is the power to reacquire the trust corpus by substituting other property of an equivalent value.[49] Other such provisions may include naming the Grantor's spouse as a permissible beneficiary[50] and including authority to borrow from the trust without adequate security.[51]

2. It is equally important that the trust be structured to avoid adverse estate tax consequences. Accordingly, the Grantor should not retain any interests or powers which would cause estate inclusion.[52] In this regard, section 2036 is of particular concern. The 2036 challenge attempts to re-characterize the note as a retained equity interest in the transferred property, instead of debt.[53] If successful, the Grantor would then be viewed as having made a transfer with a retained interest under section 2036. The retained equity argument will be strongest when the trust does not have sufficient independent funding to support the note. Accordingly, many practitioners have adopted a rule of thumb that the trust have independent assets (often referred to as seed money) equal to at least 10 percent of the value of the property sold.[54]

D. Gift tax.

1. In order to avoid any gift tax, the Grantor must receive from the trust adequate and full consideration in money or money's worth for the property sold.[55] The consideration given by the trust is typically in the form of a promissory note. In order for the note to constitute full consideration, it must have a face amount equal to the value of the property sold and bear interest at an appropriate rate.

2. The face amount of the note should equal the value of the property sold. Often, however, such property does not have an objective value, such as shares of a closely-held business or other property subject to a valuation discount. Particularly in such cases, the initial determination of value may be subject to future changes by the IRS. To eliminate any possible gift, it would be advantageous if the face amount could self-adjust for any subsequent valuation changes. However, such adjustment provisions have not generally been permitted.[56]

3. The appropriate interest rate to be used for the note is determined by reference to I.R.C. section 7872,[57] which refers to the applicable federal rate under section 1274 (d).[58]

4. As indicated, the IRS may attempt to re-characterize the sale transaction as a transfer with a retained interest. If this argument were to prevail, not only could there be adverse estate tax consequences, but there could be adverse gift tax consequences as well.[59]

E. Tax-free gift.

As indicated, the promissory note should bear interest based on the applicable federal rate under section 1274(d). Accordingly, the success of this technique will depend on whether the property sold to the trust generates a return that is greater than the applicable federal rate. Any such over-performance will in effect be a tax-free gift from the Grantor to the trust beneficiaries.

F. Generation-skipping planning.

1. In order to leverage the transfer tax savings, it may be desirable to structure the Grantor trust as a generation-skipping trust.

2. In order to avoid any generation-skipping transfer tax, GST exemption must be allocated to the trust.[60] In order to fully exempt the trust, an allocation should be made against the initial gift of seed money, so that the trust will have an inclusion ratio of zero.[61] The sale of property to the trust should not require any additional allocation to maintain the trust's exempt status.

IV. Comparison of GRATs and Grantor Trust Sales.

A. Tax-free gift.

1. In order for a GRAT to be successful and generate a tax-free gift, it must experience investment performance greater than the section 7520 rate. This rate is equal to 120 percent of the Federal midterm rate under section 1274(d).

2. The corresponding hurdle rate for a grantor trust sale is the applicable Federal rate under section 1274(d). Since this rate may be lower than the GRAT rate, it should be easier for the sale to succeed in generating a tax-free gift.

B. Gift tax.

1. If a GRAT is fully or even nearly zeroed-out for gift tax purposes, there is a risk the IRS may disallow it on public policy grounds. If the IRS succeeded, it is uncertain what the gift tax consequences would be. Since the regulations appear to allow zeroed-out GRATs, some practitioners may not be too concerned about this risk. If there is concern, it could be dealt with by creating a GRAT which includes a taxable gift.

2. The grantor trust sale has more gift tax risk than a GRAT. The IRS may claim the promissory note represents a retained interest in the property sold. Since the retained interest would not be a qualified interest under section 2702, the IRS could argue there has been a gift of the entire property. This risk may be dealt with by having sufficient seed money in the trust to support the payments on the note. The greater gift tax risk involves a revaluation of the property. It is not certain whether this risk may effectively be dealt with by some form of adjustment provision. This risk may be somewhat managed by leaving a portion of the gift tax credit to cover any taxable gift resulting from a valuation increase.

C. Estate tax.

1. The death of the Grantor during the GRAT term will generally cause the entire trust property to be included in the estate. This risk may be managed by selection of a short term, taking into account the Grantor's age and health. If the Grantor dies during the term and has a surviving spouse, a contingent marital deduction provision would at least defer any estate tax until the second death.

2. In a grantor trust sale, the death of the Grantor while the note is outstanding should not cause the trust property to be included in the estate (although the note itself will be included.) However, there is some risk the IRS will assert estate inclusion pursuant to section 2036, particularly where the trust does not have sufficient independent funding to support payments on the note.

D. Generation-skipping planning.

1. The ETIP rules may preclude generation-skipping planning with a GRAT.

2. The grantor trust sale affords a much better opportunity to accomplish generation-skipping planning. Assuming the trust is structured to avoid inclusion in the Grantor's estate, an allocation of GST exemption may be made to exempt the trust from any tax.

E. Conclusion.

Both GRATs and grantor trust sales are effective estate planning techniques which may allow for tax-free gifting. While the GRAT has less gift tax risk, the sale may yield a greater tax-free gift and should allow generation-skipping planning. Accordingly, the sale may have greater risk and greater reward than the GRAT. By understanding the risks and benefits, practitioners and clients will be able to decide which technique is best suited for a particular circumstance.

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[1]See I.R.C. section 2010. The "applicable exclusion amount" is $2 million for decedents dying in 2007 and 2008, and $3.5 million for decedents dying in 2009. The federal estate tax is scheduled to be repealed for decedents dying in 2010, and then reinstated in 2011 with a $1 million exclusion amount.

[2] See I.R.C. section 2056.

[3] Depending on the state of domicile, there may be state estate tax due at the first death. This will typically occur where the state exemption is less than the federal exclusion.

[4] The maximum federal estate tax rate is 45 percent for decedents dying in 2007 to 2009. See I.R.C. section 2001(c). Depending on the state of domicile, state estate tax may increase the tax burden to more than half of the taxable estate.

[5] It may also be advantageous to consider lifetime gifts which are subject to gift tax. Unless death occurs within 3 years of the gift [see I.R.C. section 2035(b)], the effective gift tax rate is lower than the effective estate tax rate. However, paying gift tax may have adverse tax consequences if at the time of

death there would otherwise be little or no estate tax due to subsequent changes in the law.

[6] See I.R.C. section 2503(b). The annual exclusion for 2007 is $12,000.

[7] See I.R.C. section 2503(e).

[8] See I.R.C. section 2505. The gift tax applicable exclusion amount is $1,000,000.

[9] See I.R.C. sections 2702(e) and 2704(c)(2).

[10] I.R.C. section 2702(a). Accordingly, if property is transferred in trust subject to the retention by the Grantor of non-qualified interests, the value of the gift for gift tax purposes would be the value of the entire property transferred.

[11] I.R.C. section 2702(a)(2)(B).

[12] See I.R.C. section 2702(b) and Regulations section 25.2702-2(a)(6).

[13] Regulations section 25.2702-3(b). It may be desirable to structure the annuity amount as an increasing series of payments in order to allow the trust assets to appreciate while held in the trust. In contrast, one commentator has suggested a GRAT with a very large first year annuity and a nominal second year annuity. The goal of such a front-loaded GRAT is to duplicate the results that would be achieved by a one year GRAT. See *Zero-Out GRATs and GRUTs – Can Still More Be Done?,* Harry F. Lee, Tax Analysts-Tax Notes, May 14, 2007.

[14] The trust must prohibit additional contributions. Regulations section 25.2702-3(b)(5).

[15] Although any income in excess of the annuity may be payable to the Grantor, the right to receive such income is not taken into account in valuing the annuity interest. Regulations section 25.2702-3(b)(1).

[16] Regulations section 25.2702-3(b)(2).

[17] Regulations section 25.2702-3(b)(1).

[18] Regulations section 25.2702-(3)(d)(3).

[19] Regulations section 25.2702-3(b)(3). If payment is made based on the anniversary date, proration is required only if the last period is less than 12 months. If payment is made based on the taxable year, proration is required for each short taxable year.

[20] Regulations section 25.2702-3(b)(4). The regulation appears to sanction the delay in payment of the annuity for 3½ months after the close of the annual period. If the annuity is payable at the end of the annual period, the trust would have use of the payment for an extra 3½ months. If the annuity is payable at the beginning of the period, query whether payment could be delayed for 15½ months. In either event, it is not certain whether authorization in the trust to delay payment is required, and if so whether this would affect the valuation of the annuity. See *GRATs vs. Installment Sales to IDGTs: Which is the Panacea or are They Both Pandemics*, Jonathan G. Blattmachr and Diana S.C. Zeydel, University of Miami School of Law, Heckerling Institute on Estate Planning, January 2007.

[21] Regulations section 25.2702-(3)(d)(5).

[22] Regulations section 25.2702-(3)(d)(6). The regulation does not, however, prohibit the trust from borrowing from a third-party lender and then distributing the proceeds in satisfaction of the annuity. This may be beneficial if the trust does not have sufficient liquid assets and it would be undesirable to distribute other assets to the Grantor.

[23] A grantor trust is treated as owned by the Grantor for income tax purposes. See I.R.C. sections 671-679.

[24] See Rev. Rul. 85-13, 1985-1 C.B. 184. See, e.g., Private Letter Ruling 9519029 (February 10, 1995).

[25] Regulations section 25.2702-3(d)(4).

[26] Although there are no rules as to how short the trust term may be, many practitioners have generally adopted 2 years as the minimum trust term, based on the regulations and private letter rulings.

[27] Similarly, if separate assets will be transferred to a GRAT, it is desirable to use separate GRATs for each asset class. This would prevent good performance of one asset class from being diminished by poor performance of another class.

[28] The regulations expressly sanction the use of an annuity expressed as a fraction or percentage of the initial value of the transferred property, as finally determined for gift tax purposes. Regulations section 25.2702-3(b)(1)(ii)(B).

[29] This view was originally set forth in the infamous Example 5 of Regulations section 25.2702-3(e).

[30] *Walton v. Commissioner*, 115 T.C. 589 (2000), IRS acquiescence in Notice 2003-72, 2003-2 C.B. 964.

[31] Regulations section 25.2702-3(e), Example 5.

[32] *Commissioner v. Procter*, 142 F. 2d 824 (4th Cir. 1944). In Private Letter Ruling 200245053 (July 31, 2002), the Service noted that the regulations should not be viewed as sanctioning a zeroed-out GRAT or even one with a nominal gift. In Rev. Proc. 2005-3, 2005-1 C.B. 118 (January 3, 2005), the Service listed areas in which rulings or determination letters will not ordinarily be issued, including GRATs where the annuity amount is more than 50 percent of the initial value of the trust property or where the value of the remainder interest is less than 10 percent of the initial value of the property. Some commentators have suggested that the GRAT regulations (permitting an annuity defined as a percentage of value as finally determined for gift tax purposes) constitute an override of *Procter*. See *Zero-Out GRATs and GRUTs – Can Still More Be Done?,* Harry F. Lee, Tax Analysts-Tax Notes, May 14, 2007.

[33] See *The Care and Feeding of GRATs – Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring*, Carlyn S. McCaffrey, University of Miami Law School, Heckerling Institute on Estate Planning.

[34] Assuming the trust is a grantor trust, this should not have adverse income tax consequences. See Rev. Rul. 85-13, 1985-1 C.B. 184. Conveniently, a common provision used to achieve grantor trust status is a power given to the Grantor to reacquire trust property by substituting assets of equivalent value. See I.R.C. section 675(4)(C).

[35] Accordingly, the Grantor should not retain any interests in or powers over the trust that would result in estate inclusion. In particular, it may be advisable to avoid naming the Grantor as a Trustee after the expiration of the GRAT term.

[36] There has been some uncertainty as to the application of sections 2036 and 2039 to GRATs. This has been clarified by the issuance of proposed regulations by the IRS on June 7, 2007. (A public hearing on the proposed regulations is scheduled for September 26, 2007.) Pursuant to the proposed regulations, only section 2036, and not section 2039, will apply if the Grantor dies during the annuity term. The amount includible in the gross estate is that portion of the trust necessary to yield the annuity amount, based on the appropriate section 7520 rate. For most GRATs with a short term and a large annuity amount, this will result in full inclusion.

[37] Such a provision could provide for either an outright marital disposition or for a qualified terminable interest property (QTIP) trust.

[38] While it may appear advisable to provide for a contingent reversion to the Grantor's estate which could easily be qualified for the marital deduction, this may not satisfy the requirement that the remaining annuity payments be made to the Grantor's estate. See *The Walton GRAT and Marital Deduction Planning,* Harry F. Lee and David L. Silvian, Taxes, July 2001.

[39] See I.R.C. section 2612.

[40] The death of a child during the term would not trigger the "move-up" rule under section 2651(e) for persons with a deceased parent. In order for such rule to apply, the child would have to be dead at the time of the GRAT's creation.

[41] See I.R.C. section 2632.

[42] If an individual makes a lifetime transfer which would be includible in the gross estate if such person died immediately thereafter, any GST allocation may not be made before the close of the estate tax inclusion period (ETIP). I.R.C. section 2642(f). Since the Grantor's death during the GRAT term would result in estate inclusion, the ETIP rule would prevent an allocation until the termination of the GRAT period, at which time the remainder interest may have a much greater value. The regulations, however, provide an exception to the ETIP rules if the possibility of estate inclusion is so remote as to be negligible. Regulations section 26.2632-1(c)((2)(ii). A possibility is considered negligible if it can be ascertained that there is less than a 5 percent probability of estate inclusion. Since most GRATs are designed specifically to minimize the risk of estate inclusion, the exception may be applicable in many cases. However, even if the exception applies, it is unclear as to how much exemption must be allocated in order to exempt the trust. See *GRATs and GST Planning – Potential Pitfalls and Possible Planning Opportunity*, Edward M. Manigault and Milford B. Hatcher Jr., 20 Prob. & Prop. No. 6 (Nov./Dec. 2006). A contrary view has been suggested that the ETIP exception should not apply even if the probability of the Grantor's death is less than 5 percent. The reason is that even if the Grantor survives the term, the trust property will have been returned to him as payment of the annuity, and will be therefore be includible in his eventual estate. See *Zero-Out GRATs and GRUTs – Can Still More Be Done?,* Harry F. Lee, Tax Analysts-Tax Notes, May 14, 2007.

[43] In Private Letter Ruling 200107015 (November 14, 2000), an attempt to leverage the GST exemption was made by having a child remainderman of a testamentary charitable lead annuity trust assign his remainder interest to his children. A ruling was requested that upon termination of the CLAT, the payment of assets to the child's children would not be subject to the GST tax because the child would be treated as

the transferor. The IRS ruled that it would not allow such an arrangement to circumvent the statutory rule and stated it might disregard the form of the transaction and treat the decedent as the transferor for GST purposes.

[44] See I.R.C. sections 671-679.

[45] A trust may be a grantor trust in whole or in part. For purposes of this discussion, a grantor trust refers to a wholly grantor trust.

[46] If the Grantor pays the income tax on a grantor trust, that does not constitute a gift by the Grantor to the trust's beneficiaries because the Grantor, and not the trust, is liable for the tax. See Revenue Ruling 2004-64.

[47] The I.R.S. has ruled that transactions between the Grantor and his grantor trust are not recognized for income tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184.

[48] See *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, Journal of Taxation, September 2002.

[49] I.R.C. section 675(4)(C). The statute requires that this power be held in a nonfiduciary capacity. In an often cited case, the Tax Court held that a decedent's power to substitute property of equal value would not cause estate inclusion where decedent was bound to act in accordance with fiduciary standards. *Jordahl v. Commissioner*, 65 T.C. 92 (1975). The case appears to stand for the proposition that fiduciary standards, which can be implied from a requirement of equal value, are sufficient to avoid estate inclusion, even if held in a nonfiduciary capacity. The Regulations provide that if a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary capacity depends on all the trust terms and the surrounding circumstances. Regulations section 1.675-1(b)(4).

[50] I.R.C. section 677(a).

[51] I.R.C. section 675(2).

[52] See I.R.C. sections 2036 – 2038.

[53] See e.g. Private Letter Rulings 9251004 (September 4, 1992) and 9515039 (January 17, 1995).

[54] Unless the trust is already in existence with independent assets, this will typically require the Grantor to make an initial taxable gift. Commentators have also suggested the use of guarantees to counter the retained equity argument. See *Using Beneficiary Guarantees in Defective Grantor Trusts,* Milford B. Hatcher, Jr. and Edward M. Manigault, Journal of Taxation, March 2000. An interesting variation has been suggested by having the Grantor make an additional transfer to the trust in a form which is incomplete for gift tax purposes. See *The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts*, Deborah V. Dunn, Domingo P. Such, III and Lucy K. Park, Estate Planning, February 2007.

[55] I.R.C. section 2512(b).

[56] There have been various attempts to limit the gift tax exposure of sales of uncertain value. These include provisions requiring a retransfer of property to the donor, price adjustment provisions and defined-value clauses. Based on public policy grounds and the often cited *Commissioner v. Procter*, 142 F.2d 824

(4th Cir. 1944), these attempts have generally been unsuccessful in the courts. However, there has been a recent taxpayer victory in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), reversing 120 T.C. 358 (2003). *McCord* involved a defined value clause that allocated any excess value to charitable donees. Although the clause was upheld by the Fifth Circuit, it did not refer to *Procter* because it was not raised on appeal. At the May 12, 2007 American Bar Association meeting, George Masnik of the I.R.S. addressed the Service's response to *McCord*. He indicated the Service does not agree with the Fifth Circuit's characterization of the gift using the defined valuation clause. Furthermore, the Service will continue to litigate this issue and would argue that such clauses are invalid as public policy violations.

[57] See *Frazee v. Commissioner*, 98 T.C. 554 (1992).

[58] For a term up to 3 years, the federal short-term rate applies. For a term over 3 but not over 9 years, the federal mid-term rate applies. For a term over 9 years, the federal long-term rate applies.

[59] Since the "retained" interest would not be a qualified interest under section 2702, the IRS could assert a gift of the entire property.

[60] Assuming that the trust has been structured to avoid inclusion in the Grantor's estate, the ETIP rules should not prevent an effective allocation of exemption. See I.R.C. section 2642(f).

[61] See I.R.C. section 2642(a).

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

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TE Article

PROPOSED REGS ON 2-PERCENT FLOOR FOR TRUSTS & ESTATES

by

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On July 27, 2007, Treasury issued proposed regulations that would address the issue of costs incurred by an estate or non-grantor trust, and whether and to what extent those would be subject to the 2% floor for miscellaneous itemized deductions under Code Section 67(a). Prop. Reg. §1.67-4. This is the issue in the now famous *Rudkin*[1] case. These regulations reflect, in many ways, the basic views of the *Rudkin* court. The new regulations, if adopted, add an additional level of complexity to the process. They require an "unbundling" by the taxpayer of the charges related to the trust or estate in order to identify the portion of the fees representing services that are unique to estates and trusts from those that are not. A cost incurred that is unique is not subject to the 2% floor; others are.

The regulations identify a non-exclusive list of "unique" services that are not subject to the floor as "fiduciary accounts, judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or contribution of income or corpus to or among beneficiaries." Non-unique services include "custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property." Prop. Reg. §1.67-4(b).

Similarly, fiduciary or trustee fees must be unbundled. If a single fee is paid by an estate of trust to cover both trustee fees and investment and other fees, the estate or trust has to break those down and identify the part that is "unique to estate and trusts and is thus not subject to the 2-percent floor." The regulations say that "any reasonable method to allocate the single fee, commission or expense" can be used. Prop. Reg. §1.67-4(c).

One trust officer reported that his/her bank is already trying to provide statements of fees and costs that are unbundled, as best it can, given the uneven reasoning behind the regulations. What concerns some tax preparers is that the Supreme Court decision on the matter probably will not be issued before the due date for fiduciary income tax returns for 2007. If that occurs, questions will arise and be unresolved on how investment adviser fees should be reported. This concern with this particular issue is hightened by the new return preparer penalties under Section 6694. The new “more likely than not” standard may not be met if the return tries to claim deductions in excess of what *Rudkin* and the proposed regulations allow. Presumably, some preparers will disclose whatever position they take on an attached Form 8725, as long as they think they have a reasonable basis for the provision. And those preparers in the 2nd Circuit who have to live with the *Rudkin* decision probably will not be able to argue for any position other than one that the proposed regulations and *Rudkin* seem to set forth.

Steve Akers pointed out, in a recent presentation to the Dallas Estate Planning Council, that the issuance of these proposed regulations came less than two weeks after the U.S. Supreme Court granted certiorari in the *Rudkin* appeal (now known as *Knight v. Commissioner* at the Supreme Court level). He also reported that he talked to Treasury officials in September about the timing. They said the regulations were ready to go before that, but that they pondered whether issuance would raise some suspicions regarding timing. As Mr. Akers pointed out, “apparently, they got over that.

”[1] *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F3d 149 (2nd Cir. 2006).

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TE Article

CIRCUIT COURT FLP CASE MAKES FOUR

by

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The Ninth Circuit Court of Appeals has issued its decision in *Bigelow v. Commissioner*[1]. The *Bigelow* decision joins a line of decisions from the Third, Fifth, and Eighth Circuits applying Section 2036 to family limited partnerships. This case, like the other Circuit level decisions, is not a surprising one given the background facts.

Basically, the decedent had a revocable living trust into which she transferred her home, which was then exchanged for other rental property which, subsequently, was encumbered with debt. In 1994, the trust exchanged those properties for interest in the FLP. The decedent's children each became limited partners, contributing only $100.00 each.

As in many of these cases, the transfer to the FLP left the decedent without adequate assets for her own support. Initially, she had a monthly shortfall in cash flow of $1200, which later grew to $2700 per month. As is typical in these "wounded animal" cases, the FLP paid some of the decedent's living expenses. In addition, the partnership made payments on at least one of the loans owed by the trust prior to the transfer of assets into the FLP. The Court also made note of the fact that there were 40 transfers from the FLP to the revocable living trust during a period of just over two years (but not to the other partners). While the FLP subsequently made a distribution to allow the decedent to pay back those advances, nonetheless the Court viewed those as evidence of the decedent's need for the assets. And, by the time the decedent died, some of the FLP units had been gifted to the children. The FLP was terminated a little over one year after the decedent's death, but not before the estate claimed a 31% marketability discount on the gifts of FLP interests and a 37% discount on the remaining interests in the estate.

In the findings by the Court, the Ninth Circuit went through the usual suspects, i.e., the decedent's being left without sufficient assets for her own support which, at the time of the transfer, would have been anticipated to grow worse after her long-term care coverage expired; the multiple transfers from the FLP to the revocable trust and the FLP's payments on the debt owed by the trust, none of which were not timely reflected as distributions; and the failure to follow partnership formalities.

One important element of the Ninth Circuit's decision was that it did not break down the "bona fide sale for full consideration" exception into discrete elements as done by other Circuits. Instead, the Ninth Circuit said that "bona fide sale" and "adequate and full consideration" are "interrelated criteria." It went on to say that the validity of the one "cannot be gauged independently of the non-tax-related business purposes involved in making the bona fide transfer inquiry." Furthermore, while saying that it agreed with the Third and Fifth Circuits, the Ninth Circuit left open the possibility that the differential between the value of assets transferred to the FLP compared to the FLP interest received in return could be attacked as not being in "full consideration," even though the transfers were proportional. Interestingly, the Ninth Circuit threw in a phrase which, once used, was never addressed or used again in the opinion. The Court, in addressing the proportionality of interests compared to contributions, said that the estate must show a "genuine" pooling of assets and, more than that, must show that there is a potential for "intangibles stemming from pooling for joint enterprise." However, once having said that, the Court focused on the lack of good faith, and, specifically, on the absence of non-tax benefits, as a reason to find that the bona fide sale exception does not apply. Nevertheless, practitioners should be wary of this language.

Finally, this is another case where the pre-death gifts were disregarded when the Court ultimately decided to include virtually all of the partnership assets in the estate of the decedent. In other words, even though the decedent owned only 45% of the partnership at her death, all of the assets were includable in her estate.

In conclusion, some of the lessons from the *Bigelow* case are the same lessons taken from the other cases. Do not impoverish the decedent; do not create a situation where the FLP is paying decedent's debts, expenses or other obligations; do not have the client or a revocable trust serve as the sole general partner; do not transfer assets that are subject to loans without considering whether the partnership should assume that liability (consider the income tax aspects of that decision); if possible, provide for some pooling of assets; when distributions are made, made them proportionately; and, in all cases, follow partnership formalities.

[1] 100AFTR2d 2007 – Bank (9th Cir. Sept14, 2007) affg. TC Memo 2005-65

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Bigelow v. Commissioner

Ninth Circuit Upholds Implied Agreement Under §2036 for Assets Transferred to FLP; Applies Non-Tax Benefit Analysis and Comparability Analysis to §2036 Exception; and Includes Troublesome Statement That Pooling of Assets is Required to Apply §2036 Bona Fide Transfer for Full Consideration Exception

By Steve R. Akers, Associate Fiduciary Counsel

September 24, 2007

Synopsis

The Ninth Circuit now joins the Third, Fifth, and Eighth Circuits in weighing in on the application of §2036 to family limited partnerships. Bigelow v. Commissioner, 100 AFTR2d 2007-xxxx (9th Cir. September 14, 2007), affg, T.C. Memo 2005-65. The Ninth Circuit upheld the Tax Court finding that §2036 caused the inclusion of all partnership assets in the decedent's gross estate without a discount. The Ninth Circuit decision is not surprising and generally does not plow new ground. The facts of an implied agreement for retained enjoyment of the assets contributed to the partnership are strong. The court focused on the lack of purported non-tax benefits to find that the bona fide sale for full consideration exception did not apply. The court seemed to be looking for *actual* particular claims or risks to support a liability protection purpose, an *actual* threat of a partition action to support avoiding partition as a purpose, and *particular assets or a business* requiring active management to support a management purpose. The court said that a heightened scrutiny analysis would apply, and the court said to consider whether the terms of the transaction differed from those of two unrelated parties negotiating at arm's length (in effect, suggesting a "comparability" test to determine if unrelated parties would have contributed assets to the partnership in the same situation as the decedent.)

The opinion contains a startling “requirement” for the full consideration exception to §2036. The opinion literally says that there must be more than just transfers to the partnership for a proportional number of units of the partnership, and that there “must” be a “genuine pooling” of assets — which would seem to require significant contributions by other partners. However, the reasoning in the next several pages of the opinion refers to other factors (primarily the absence of non-tax benefits) in addressing the bona fide transfer for full consideration exception to §2036. In fact, there were no significant contributions by other partners in that case, but the court made no mention of that as a reason to refuse application of the full consideration exception. Planners probably will not drastically change their planning for family limited partnerships to urge strongly that clients have other family members make substantial contributions to the partnership in light of this troublesome statement in the opinion —which the court itself did not seem to apply.

1. Key Facts.

Decedent created a revocable trust in 1991 and transferred her interest in her residence to the trust. The trust exchanged the residence for other rental property, and borrowed $350,000 and $100,000 under separate loans secured by the rental property. In December 1994, the revocable trust contributed the investment property to an FLP (but not the $450,000 of liabilities secured by the property, which remained as liabilities of the revocable trust). (The decedent’s children each contributed $100 for very small limited partnership interests.) After contributing the property to the partnership, the decedent had a monthly cash flow shortfall of $1,200 (and three years later the shortfall grew to $2,700 per month.) The partnership made payments on the $350,000 loan (which were owed by the revocable trust) and paid some of the decedent’s living expenses. The son (as agent) made 40 transfers between the partnership and the revocable trust during a period of a little over two years.

In December of 1994 and 1995, the son (as agent under the power of attorney) withdrew some of the trust’s units in the FLP and made gifts to himself and his sisters and to the decedent’s grandchildren. (No gift tax returns were filed until after the decedent’s death.)

Decedent died in August 1997 (when the revocable trust owned the 1% general partnership interest and a 45% limited partnership interest), and the FLP was terminated a little over one year later.

The estate claimed a 31% marketability discount on the gifts of the limited partnership interests and claimed a 37% marketability discount on the value of the limited partnership interests for estate tax purposes.

2. Section 2036(a)(1) Retained Enjoyment

The Ninth Circuit upheld the Tax Court’s finding “that decedent and the Bigelow children impliedly agreed that decedent would have access to income from the transferred property and that decedent continued to enjoy the economic benefit that the property secured her personal debt.” (Because § 2036(a)(1) applies, the Tax Court did not consider § 2036(a)(2) or §2038(a)(1).) The court’s holding supporting the finding of an implied agreement of retained enjoyment is not surprising. The combination of substantial disproportionate distributions to the decedent, the inability of decedent to meet her living expenses, and the use of the partnership property to secure the decedent's liabilities evidence the implied agreement to retain income from and enjoyment of the rental property that was transferred to the partnership.

The Ninth Circuit pointed to various factors suggesting an implied agreement that decedent could access partnership funds as needed, including the following:

- The contribution of the rental property to the FLP impoverished the decedent and left her vulnerable to monthly shortfalls.

- The children knew that decedent's long-term coverage was expiring soon after the contribution to the FLP (one policy in 9 months and another policy in 17 months).

- There were 40 transfers between the partnership and the revocable trust. The transfers were characterized as interest free loans (unaccompanied by a promissory note). Eventually a distribution was made from the partnership to the revocable trust to repay the earlier advances and later to pay decedent's expenses.

- The FLP made substantial payments on the $350,000 debt owed by decedent's revocable trust, but did not reflect those as distributions on the partnership accountings.

- The children considered having the partnership sell the rental property to have funds available to cover the decedent's living expenses.

- One child testified that she would not pay decedent's expenses out of her own pocket, but the children were committed to maintaining their mother in the manner to which she was accustomed.

- Partnership formalities were not observed. (1) Capital accounts were adjusted annually to reflect gifts made to the children, but not to reflect payments on the revocable trust's debt; (2) No other partner benefited from such informal access to partnership funds; (3) A post-mortem accounting (to reflect the payments on the $350,000 debt owed by the revocable trust) indicated an implied agreement that decedent could access income from the transferred asset.

The implied agreement facts were bad, and the court's decision is not surprising.

3. Section 2036(a) Bona Fide Sale for Full Consideration Exception

a. Not Two Distinct Requirements. Unlike other courts, the Ninth Circuit refused to break down the analysis into two discrete requirements, "bona fide sale" and "adequate and full consideration." Instead, the Ninth Circuit said "we consider the 'bona fide sale' and 'adequate and full consideration' elements as interrelated criteria." "The validity of the adequate and full consideration prong cannot be gauged independently of the non-tax-related business purposes involved in making the bona fide transfer inquiry."

b. No *Per Se* Disqualification for Exception. The IRS argued that a transfer of assets to a partnership in return for interests that are worth less than the value transferred, even though proportional to other contributions, means that the transfer cannot meet the exception. The Ninth Circuit responds that a transfer of real property to a partnership, which reduces the value of the decedent's interests, "does not *per se* disqualify the transfer from falling under §2036(a)'s exception." (The Ninth Circuit said that it was agreeing with the Third and Fifth Circuits in that regard.) In effect, the Ninth Circuit seems to reject the IRS argument that a contribution of assets in return for partnership interests that are proportional but that have a lesser value than the contributed assets necessarily means that the full consideration element is not satisfied.

c. More Than Proportionality Required; Pooling of Assets as a Factor. Proportionality of interests compared to contributions is not enough to satisfy the exception; the estate must also show (a) the "genuine" pooling of assets, AND (b) "a potential [for] intangibles stemming from pooling for joint enterprise." However, the court's subsequent analysis does not emphasize these two purported requirements, but instead focuses on supporting the Tax Court's finding of a lack of "good faith" (and specifically, the absence of non-tax benefits) as a reason to find that the exception does not apply.

Observation: This would be a very significant planning feature if we were to believe that the court is absolutely requiring a genuine pooling of assets. The court opinion literally says that an estate must do more than show a proportional exchange of assets contributed to the partnership in return for the units received, and the estate "MUST" also show a "genuine" pooling of assets, AND a potential for intangibles stemming from the pooling. Despite this very strong language, the court never mentions it again, but instead focuses primarily on the absence of non-tax benefits. This genuine pooling requirement would be particularly ironic in this case in which there was practically NO pooling of assets from various partners. The decedent's children just contributed $100 each for their miniscule partnership interests before the decedent made gifts of partnership interests to them in later years, and the court made absolutely no mention of the almost complete absence of "pooling" of assets under the facts of this case. Having significant contributions by others to create a genuine pooling of assets may be a helpful factor, but it does not yet appear to be a requirement to satisfy the exception. Still, the court's literal language is troubling. Having a legitimate non-tax purpose, avoiding causing the impoverishment of the client, and following partnership formalities appear to be more important factors in the court's discussion, as discussed immediately below.

d. Good Faith; (a) Impoverishment, (b) Formalities, and (c) Non-Tax Benefit. The Tax Court found that the transfer to the partnership was not in good faith because (a) the transfer resulted in the impoverishment of the decedent, (b) the partnership did not follow formalities, and (c) the transfer did not create a potential non-tax benefit. The Ninth Circuit found evidence to support each of these findings, focusing particularly on the absence of non-tax benefits.

(1) Non-Tax Benefit: Avoiding Potential Liability. The taxpayer argued that the partnership shielded family members from personal liability for injuries occurring on the property. The court responded that the

decedent was not shielded from liability because her revocable trust was both general partner and limited partner. Also, there was no evidence that the family member-partners "reasonably faced any genuine exposure to liability." The court later pointed to the absence of "some concrete incident or circumstance," the absence of any "particular incident," and "no general conditions of the business venture that posed inherent risks of litigation." The court noted that in *Strangi*, the court was not persuaded the possible claims by a housekeeper was a reason for liability protection planning when "no evidence was presented that the maid ever threatened to take such action."

(2) Non-Tax Benefit; Avoiding Partition. Similarly, the court rejected the proferred non-tax rationale that the formation of the partnership would protect the property from a partition sale where there was no evidence that other family member-partners contemplated a partition or had creditors that might resort to a forced sale.

(3) Non-Tax Benefit; Facilitating Management. Efficient management might count as a credible non-tax business purpose "only if the business of the FLP required some kind of active management." Here, the court said that the decedent's son managed the property as trustee of her revocable trust, and nothing changed after the property was contributed to the FLP. The court distinguished the situation in *Kimbell* where working interests in oil and gas properties were contributed to a partnership.

(4) Non-Tax Benefit; Facilitate Gift Giving. The court agreed with other courts that "gift giving is considered a testamentary purpose and cannot be justified as a legitimate, non-tax business justification."

e. Heightened Scrutiny; Comparability Analysis. The court evaluated these arrangements "through the heightened scrutiny of intra-family transactions." In particular, the court considered whether "the terms of the transaction differed from those of two unrelated parties negotiating at arm's length" (citing *Bongard*). In effect, the court applies a "comparability" test, to determine if unrelated parties would have contributed assets to the partnership in the same situation as the decedent.

4. Court Did Not Address Reason For Including Partnership Assets Attributable to Gifts of Partnership Interests to Family Members.

All of the rental property that was contributed to the partnership was included in the gross estate even though the decedent made gifts of about 54% of the limited partnership interests and only owned a 45% interest at her death. Perhaps this issue was not raised by the taxpayers, because neither the Tax Court nor the Ninth Circuit addressed the reasoning for this conclusion. One possible explanation is that § 2036 applied to the transfer of assets to the partnership, so those assets must be included in the estate regardless of any subsequent transfers or when they occur. That would seem troublesome as a general proposition — assuming that the decedent does not retain a § 2036(a)(1) right to income from or enjoyment of all of the partnership property or a § 2036(a)(2) right to designate who can enjoy all of the partnership property — and contrary to the purpose of having a three-year rule under §2035. Another possible explanation is that the court found an implied agreement that all of the FLP assets would be made available to the decedent. Apparently, distributions were only made to or for the benefit of the decedent, even though the decedent only owned a 45% interest in the FLP at her death. Another explanation is that §2035 applies because all of the gifts were made within three years of the decedent's death so the assets contributed to the partnership that are attributable to those transfers must also be included in the gross estate. (This was the reasoning of the full Tax Court in Bongard.) It would not seem appropriate to include the value of the underlying partnership assets attributable to transfers of partnership interests that are made more than three years before the decedent's death — if the decedent does not retain "(a)(1) or (a)(2)" rights with respect to the partnership property attributable to the transferred interests.

5. Observations Regarding Full Consideration Requirement.

Cases have previously analyzed two separate prongs to the "bona fide sale for full consideration" exception to §2036: "bona fide transfer" and "adequate and full consideration." (The Ninth Circuit in Bigelow refused to analyze these as two independent elements, but viewed them as "interrelated criteria.")

As to the "full consideration" requirement, the Bongard [124 T.C. 95 (2005)] and Kimbell [371 F.3d 257 (5th Cir. 2004)] cases said that the full consideration requirement is met by having proportionate transfers to a partnership that maintains capital accounts and allocates distributions among the partners pursuant to the capital accounts.

The Third Circuit in Thompson said that a dissipation in value from contributing assets to an FLP "will not automatically constitute inadequate consideration for purposes of §2036(a)" (but later suggested that a transfer resulting in a depletion in value does reflect a failure to establish a transfer for consideration when there is no legitimate business or when the sole benefit is a valuation discount).

Similarly, the Ninth Circuit in Bigelow stated that a transfer to an FLP that inherently reduces the value "does not *per se* disqualify the transfer from falling under § 2036 (a)'s exception" but stated that the estate must demonstrate more than just a proportional exchange, observing that the full consideration prong cannot be gauged independently of the non-tax-related business purposes involved in the bona fide transfer inquiry.

However, the IRS is still arguing that the "full consideration" test requires more proportional transfers. The IRS's brief in the Korby case to the Eighth Circuit, argued:

- The partnership must respect formalities (proportionate transfers reflected in capital accounts, which is the test in Tax Court and Fifth Circuit).

- ALSO, the transaction must not deplete the estate (before and after the transfer to the

FLP).

- The IRS recognizes that some immediate depletion in value occurs whenever there is a transfer to any entity, but "the diminution in value from the partnership restrictions must be offset by some other advantage to holding assets in partnership form."

Conclusion: We cannot assume the "full consideration" issue is resolved. The Third Circuit in Thompson said there is "heightened scrutiny" if there is a dissipation in value, and a concurring opinion, joined by 2 of the 3 judges, explained that the depletion rule would not apply in "routine commercial transactions" — intimating that it would apply in other transactions. The Ninth Circuit in Bigelow was not that restrictive as that, but agreed that the full consideration prong cannot be gauged independently of the non-tax-related business purposes involved in the bona fide transfer inquiry.

6. Planning Implications From This Case.

(1) Do not transfer so many assets to the partnership that it is apparent that the decedent must receive distributions from the partnership to maintain his or her lifestyle. Arguments could be made that individuals often make investments with the expectation of receiving an investment return without having the transaction recast as a § 2036 transfer. However, the cases that have found an implied agreement of retained rights to income or enjoyment of property transferred to an FLP often involve situations where the decedent is likely to need distributions from the partnership.

(2) Do not transfer assets that are subject to liens without also having the partnership assume the liability. (Of course doing so can have significant income tax implications, which might then suggest not distributing that particular encumbered asset to the partnership.)

(3) Do not have the client (or client's revocable trust) serve as the sole general partner (at least without letting the client know that doing significantly weakens the response to various attacks that the IRS might make.) Among other problems, having the decedent or a revocable trust serve as general partner removes the possible nontax reasons of liability protection and providing for management.

(4) Maintain proper capital accounts and make appropriate adjustments to the capital accounts to reflect the fair market values of all contributions and to reflect all distributions and gifts of partnership interests.

(5) If possible provide for some change in the management of the assets after they are transferred to the partnership.

(6) If possible, provide for some pooling of assets by having other partners make significant contributions (but the court did not emphasize that factor, despite its literal statement that genuine pooling of assets is a requirement to apply the §2036 ona fide transfer for full consideration exception).

(7) When distributions are made, make proportionate distributions to all partners.

(8) Do not have numerous continuous transactions between the client and the partnership. The court pointed several times to the fact that there were transfers between the trust and the partnership 40 different times over about a two-year period.