Recent Developments in Estate Planning

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I. Legislation Relating to Estate and Gift Tax

A. Well, Professor: Any predictions as to what Congress will do about the estate and gift tax? The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRUIRJCA"), signed President Obama by December 17, 2010, expires on December 31, 2012. Unless Congress does something in the meantime, on January 1, 2013 the law as it existed in 2001, including a $1,000,000 estate tax and gift tax exemption equivalent and estate tax rates than can reach 55 percent, will arise like Phoenix from the ashes—or from a molten puddle, like that relentless "policeman" in Terminator II.

1. **But surely Congress will do address the situation before the end of 2012!** Haven't we heard something like that before? That's what virtually everyone said throughout 2009 regarding expiration of the 2001 Bush Tax Act, and look what happened. (And don't call me Shirley.)

2. **There is more than a likelihood that Congress will do *nothing* until the lame duck session at the end of the year—and probably not even then.** Abraham Lincoln famously referred to "a house divided." That is assuredly the situation today. With the Republicans in control of the House of Representatives, the Democrats in control the of Senate, Mr. Obama as president, and an election in the first week of November, about all we can expect is that the "death tax" or "their fair share"—take your pick—could well be a campaign issue. There is a good likelihood that nothing will happen until sometime in early 2013, with "*wha happened*" depending on the election results.

3. **But won't Congress do something about the "fiscal cliff"?** That is quite likely. Everyone, on both sides of the political divide, is concerned about the "fiscal cliff" with respect to the income tax, under which the maximum tax rate will rise to 39.6 percent. The odds are high that Congress will do something about that before the end of the year, the issue being whether the current tax rates will be extended (perhaps for only one year) across the board or only for those with incomes of less than $250,000 or $200,000.

    a. But the income tax and transfer tax issues are separable, and the income tax problem is seen as the most urgent. There is a good possibility that Congress will address only the "major" concern and postpone any action on transfer taxes, probably well into 2013.

4. **Attorneys and other professionals should expect a lot of calls and inquiries as "the end is near"**, especially with the possible disappearance of the $5 million gift tax exemption equivalent—if you haven't been receiving those calls and inquiries already.

B. Obama administration's fiscal year 2013 budget proposal. On February 13, 2012, the Treasury Department published its Fiscal Year 2013 Budget Proposals ("the Greenbook"). The first six proposals relating to transfer taxes, summarized below, were carried over from the prior years. Item 7 is new and … startling.

1. **Provide reporting on a consistent basis between estate tax valuation and income tax basis in the heir's hands.** Under IRC § 1014, assets receive a new basis, for income tax purposes, equal to their date-of-death value. The value of property as reported on the decedent's estate tax return raises a rebuttable presumption of the property's basis in the hands of the heir—but more than a few heirs have successfully rebutted that presumption. Treasury's concern is that the executor may take a low valuation to reduce estate taxes, yet the heirs could argue that the reported value was low-balled to save transfer taxes. The

proposal would provide that the basis for income tax would be the same as values "as determined for gift or estate tax purposes (subject to subsequent adjustments)."

a. It is curious that Treasury is still concerned about this issue, when few estates must file estate returns because of the current law's $5 million exemption equivalent.

2. **Valuation discounts—amendments to IRC § 2704.** Treasury's Budget Proposal again recommends amending IRC § 2704 (the "disappearing rights and restrictions" special valuation rule). The statute as amended would add a new category of "disregarded restrictions." These restrictions would be ignored for transfer tax valuation purpose in valuing an interest in a family-controlled entity (*e.g.*, a family limited partnership) that is transferred to a member of the family if, after the transfer, the restriction could be removed by the transferor or the transferor's family.

3. **Require minimum—and maximum—term for GRATs**. The Budget Proposal once again includes a provision that would kill off short-term grantor retained annuity trusts [*cf. Walton v. Commissioner*, 115 T.C. 589 (2000)] by requiring a 10-year minimum GRAT term, requiring that the GRAT remainder interest must have a value greater than zero, and providing that the amount of the annuity payout could not be decreased during the GRAT term.

a. Additionally, the 2013 Budget Proposal would impose a *maximum* term on GRATs—to the grantor's life expectancy plus ten years.

4. **Limit GST-exempt trusts to 90 years**. Carried over from the 2012 Budget Proposal is a provision under which the GST exemption would expire after 90 years. The 90-year period is inspired by the Uniform Statutory Rule Against Perpetuities (USTRAP), which has been enacted in about a dozen states.

5. **Eliminate minimum distribution rules for small qualified plans and IRAs**. The 2012 Budget Proposal would eliminate the required minimum distributions for an individual whose aggregate qualified plans and IRAs are $50,000 or less. The 2013 Budget Proposal would increase the amount to $75,000.

6. **Portability of last deceased spouse's unused estate tax exemption equivalent would be made permanent**. This issue is discussed *infra*.

7. **Grantor trusts would be includible in grantor's gross estate**. The 2013 Budget Proposal would conform the estate inclusion rules to the grantor trust rules, by including the value of assets of a grantor trust in the grantor's gross estate. This proposal was made, said the Budget Proposal, because the lack of coordination between the income tax rules and transfer tax rules "creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth without transfer tax consequences." The proposal also would subject to gift tax any distribution from the trust to beneficiaries during the grantor's life, and subject to gift tax any remaining trust assets if the grantor ceased to be treated as an owner of the trust for income tax purposes. The proposal would apply to trusts created on or after the date of enactment, and to portions of a grandfathered trust attributable to contributions made after the date of enactment.

a. Treasury's concern about the disconnect between the income tax rules and the estate tax rules (*e.g.*, installment sales to a defective grantor trust) is understandable. However, the administration's sledgehammer proposal would create all sorts of problems. Without refinement, all life insurance trusts would be subject to the estate

tax. The proposal also, for example, would impact trusts structured as grantor trusts merely to be S corporation shareholders.

C. **The Sensible Estate Tax Act of 2011**, introduced by Rep. Jim McDermott (D.Wash.) and co-sponsored by Rep. Charles Rangel (D.N.Y.) on November 11, 2011, would, among other things, include a $1 million exemption (indexed for inflation). The bill also included most of the Treasury Budget Proposals discussed above, including portability.

1. **Want to be a millionaire?** Make a $5 bet that this will ever become law. (But this suggestion assumes that Las Vegas would even make book on something like this ever being enacted.)

II. Section 401—Qualified Plans and IRAs

A. **Five-year payout limit for beneficiaries other than spouses, minor children?** On July 6, 2012, President Obama signed H.R. 4348, the Transportation and Student Loan Interest Rate bill, which provided for over $100 billion to be expended on highway infrastructures. Well and good. The bill had an interesting Senate history, though. S. 2132, the Highway Investment, Job Creation and Economic Growth Act of 2012, was reported out of the Senate Finance Committee on February 27, 2012. The bill included a provision, added by Committee Chair Max Baucus (D. Mont.), that would modify the rules governing post-death distributions from qualified plans and IRAs, including Roth IRAs (in a Highway bill???). Under the proposal, except for spouses (who could continue to make spousal rollovers) and children under the age of majority, beneficiaries could no longer stretch out distributions over their life expectancy. Instead, payouts would be limited to five years after the decedent's death.

1. This caught Republican members of the Finance Committee by surprise, as it was added to the bill without discussion, and also because the proposal has no connection with highway programs (other than the humongous tax revenues that would be generated by such a rule). Baucus said he was open to alternative revenue raisers for the highway bill but suggested that this proposal could be part of broader tax reform.

2. The proposal was not met with enthusiasm (something of an understatement) by attorneys, CPAs and representatives of the finance industry. This provision was *not* included in the highway bill signed by President Obama.

B. **You've got 60 days to make that rollover.**

1. **Mistake by financial institution—relief granted**. In Ltr. Rul. 201113047, P was receiving monthly distributions from his IRA. Company distributed amounts in excess of the substantially equal monthly payments. After discovering the error, P attempted to return the excess distributions, but Company refused to accept them and did not inform P that he could roll the funds back into an IRA account. P kept the uncashed checks until he deposited them into an IRA account with a new company. The Service waived the 60-day rollover requirement.

   a. The same result—relief granted—was reached in Ltr. Rul. 201113048. P was advised by a financial institution's advisor that transferring her IRA to his institution would produce a more favorable yield. P, inexperienced in financial matters, allowed the transaction to be handled by the financial advisor, who promptly deposited the amount in a non-IRA account.

b. In Ltr. Rul. 201207013, 84-year-old P completed a form to withdraw required minimum distribution from her IRA. Before she received the first distribution, the financial institution erroneously sent her a duplicate form to withdraw her RMDs. P completed the second form, unaware that it requested a duplicate distribution. P received two distributions, and did not realize it until after the 60-day rollover period had lapsed. The Service granted an extension.

2. **But no relief where mistake was made by another financial institution**. In Ltr. Rul. 201118025, P withdrew funds from his IRA to assist his elderly Mother in the purchase of a home that would accommodate limitations on her mobility. To buy the new home, P's funds were pooled with money contributed by P's siblings and proceeds from the sale of Mother's house. Under the parties' plan, Mother would then take out a reverse mortgage with Bank and receive a lump-sum cash payment, which she would use to repay P and his siblings. Bank assured P that the reverse mortgage transaction would be completed in time for P to redeposit his funds back into his IRA. Needless to say, the transaction was not completed in time.

   a. The Service noted that although Bank may have been to blame for the delays, this factor was not relevant because Bank was not conducting any financial transactions relating to the IRA. In effect, the taxpayer made a short-term loan to Mother and assumed the risk that the loan might not be repaid in a timely manner. The circumstances regarding the delay did not include any of the factors warranting extension of the rollover period set forth in Rev. Proc. 2003-16, 2003-4 I.R.B. 359.

3. **And no relief where taxpayer did not rely on a professional advisor.** In Ltr. Rul. 201117046, the Service ruled, not for the first time, that a taxpayer's failure to understand the rollover rules (as distinguished from relying on the erroneous advice of a financial advisor) affords no ground for relief. P placed a check distributed from a qualified plan in her safe deposit box, and searched for a custodian for a rollover IRA. She deposited the checks after the 60-day period had lapsed, believing that the rollover period was 90 days. Too bad, said the Service. For relief to be granted, the taxpayer's misunderstanding must have been traceable to a financial institution or professional.

4. **Extension granted for medical reasons.** In Ltr. Rul. 201139011, on the advice of a financial advisor P planned to roll over his IRA to another institution. The evidence showed that P suffered from medical and mental conditions before, during and after the 60-day rollover period, which led to his death. The Service concluded that the facts satisfied the test for granting an extension.

5. **Extension granted in part on call to military service**. In Ltr. Rul. 201220055, P, having terminated his employment and receiving a distribution from a qualified plan, failed to make a rollover within the 60-day period. A waiver was granted, in part because P had been involved in providing care for his seriously ill child, and in part because he had been called into active military service by the Army National Guard.

C. **Transfer to beneficiary's special needs trust did not trigger income in respect of a decedent**. In Ltr. Rul. 201116005, decedent had named Son and Son's siblings as designated beneficiaries of two IRAs. Son, disabled and eligible to receive public benefits, proposed to transfer his share of the IRAs to a new IRA that would fund a special needs trust. Under the trust, the trustee would be directed to distribute so much of net income for Son's use as necessary for his best interest and welfare. If the income and other available resources were not sufficient to provide for Son, the

trustee could invade trust principal, but not if such principal invasion would affect Son's entitlement to governmental benefits. Any net income not distributed was to be added to principal.

1. The proposed transaction will not trigger IRD, said the Service. True, Rev. Rul. 92-47, 1992-1 C.B. 198, ruled that a distribution to the beneficiary of a decedent's IRA is IRD under IRC § 691(a)(1). In this case, however, the trust will be a grantor trust under Rev. Rul. 85-13, 1985-1 C.B. 184, and therefore Son will not recognize income on the transfer of the inherited IRAs to the trust.

D. Retirement benefit embezzled by guardian could be transferred to IRA. In Ltr. Rul. 201139011, P's minor daughter D was named beneficiary of P's qualified plan. Instead of directing a trustee-to-trustee transfer of the plan benefit to an inherited IRA, D's guardian G took the benefit in a lump sum, for which tax was paid on D's income tax return. When a conservatorship petition was later filed, it was discovered that G had misappropriated the fund. Pursuant to a court order, G restored the embezzled sum. Granting relief, the Service noted that but for G's decision to receive a lump-sum distribution and the later misuse of the funds, a tax-free transfer could have been made to an IRA.

E. What to do when participant's "estate" (or a trust) is named as beneficiary. As a general rule, a surviving spouse can make a rollover to his own IRA only if the decedent's qualified plan or IRA designated the spouse as beneficiary. When assets in a decedent's plan or IRA pass to a trust or the decedent's estate, which then distributes the assets to the surviving spouse, the spouse is treated as having received the IRA assets from a third party and not the decedent, precluding a spousal rollover.

1. **If will benefits spouse and gives broad distribution powers, there's an escape hatch.** A number of rulings have approved rollovers where the surviving spouse had the unrestricted power to distribute P's IRA or plan benefits to herself. See, for example, Ltr. Rul. 201212021, where W's interest in her IRA passed to her estate. Her will named her husband H as executor of the estate and its sole beneficiary, with the right to direct any and all amounts from the estate without restriction. Under these facts, H could make a spousal rollover, said the Service.

III. Section 2010—Unified Credit Against the Estate Tax

A. Temporary regulations on portability election. Under the 2010 Tax Act, any unused estate tax exemption equivalent of a deceased spouse can be carried over to the surviving spouse. To prevent spouse-stacking—what one CLE speaker referred to as the Larry King rule—portability of the unused estate tax exemption is limited to the unused exemption of the *last* deceased spouse. The "deceased spouse unused exclusion amount" [DSUE] is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate over adjusted taxable gifts. Portability applies only to any unused portion of the deceased spouse's estate tax exemption, and does not apply to any unused GST exemption.

1. **Election must be made on estate tax return.** In Notice 2011-82, IRB 2011-42, published in October 2011, the Service provided guidance on the portability election. The decedent's executor must timely file an estate tax return on which the amount of the decedent's unused exclusion is computed. The Notice stated that the return requirement was selected over a check-the-box procedure to make the election process uncomplicated and straightforward. According to the Notice, the Service did not want executors to have to affirmatively elect portability.

2. **Temporary regulations**. On June 15, 2012, the Service issued temporary regulations (T.D. 9593, IRB 2012-28) and proposed rules (REG-141832-11) on the portability election. The election must be made on a "timely filed" Form 706, which, regardless of the size of the estate, must be filed within nine months of death or, if an extension has been granted, the last day of the extension period. However, the temporary regulations provide a special rule for estates filing a return solely to make the portability election. These estates don't have to report the value of property that qualifies for the marital or charitable deduction, but instead must report only the description, ownership and other information necessary to establish the right to the deduction. To take advantage of this special rule, the executor must estimate the total value of the gross estate, using ranges of dollar values that will be provided in the Form 706 instructions and rounded to the nearest $250,000.

   a. **Opting out of the portability election**. The executor may make an affirmative statement on the estate tax return signifying the decision not to have portability apply. Not filing a timely return will be considered an affirmative statement signifying the decision not to make the election.

   b. **Election is made by executor**. If an executor is appointed, only the executor (not the surviving spouse) can file the return and make the portability election. If no executor is appointed, any person in actual or constructive possession of any of the decedent's property can file the return.

   c. **Returns of predeceased spouse can be examined**. The Service can examine returns of deceased spouses whose DSUE is included in a surviving spouse's applicable exclusion amount, regardless of whether the limitations period has expired for the earlier return. The DSUE amount reported on the earlier return can be adjusted, but additional tax on the earlier return can be assessed only within the applicable limitations period for that return.

3. **And how do we explain all of this to clients?** It's going to take considerable tact to explain to (and bill) the client as to why an estate tax return must be filed when the decedent's estate is well under the $5 million (or whatever) exemption equivalent.

   a. One approach might be to have the executor and spouse make written statements noting that the pros and cons of filing a return were fully explained to them, but they were satisfied that under the circumstance the expense involved in preparing an estate tax return was not warranted.

4. **Malpractice concerns**. In comments set out in the October 12, 2011, issue of Daily Tax Reports, attorney John Olivieri (White & Case, New York) and CPA Albert Isacks (Erie, Pennsylvania) expressed the concern that the return requirement creates a malpractice risk. In many situations there will appear to be no need for portability because the decedent's and surviving spouse's estates are relatively small. However, Olivieri said, executors can never be certain. "You would be filing that return to get [the surviving spouse] a bunch of exemption she is never going to use." But if the spouse wins the lottery or comes into a substantial inheritance, her executor will want to make the executor of the first decedent's estate accountable for not making the portability election.

B. What are the chances of the portability provision being made permanent? As it now stands, the portability provision disappears along with the rest of the 2010 Tax Act at the end of 2012. As a consequence, it is not enough for the first deceased spouse to die in 2011 or 2012; both spouses must die within that two-year period—unless Congress extends the rule into future years.

1. At first blush, chances would appear to be pretty good. Nearly every transfer tax bill introduced but not enacted in 2009 and 2010 contained a portability provision, including several bills introduced by Democrat senators and representatives. The portability idea has support on both sides of the aisle. As noted above, the Obama administration fiscal year 2013 Budget Proposal recommended making portability permanent.

b. On the other hand, if the estate tax exemption equivalent remains at $5 million, there may be some queasiness on the Democratic side of the aisle in going along with portability at that level.

IV. Section 2032—Alternate Valuation Date

A. Proposed regulations on post-death events that can be considered in an alternate valuation. Interests includible in a decedent's gross estate are valued as of the date of the decedent's death or, if the executor elects under IRC § 2032, as of the alternate valuation date, which is six months after the decedent's death (or, if the interest is sold, exchanged or otherwise disposed of with the six-month period, on the date of the sale, exchange or disposition). Proposed regulations published in November 2011 (which replaced proposed regulations published in April 2008) address post-death events that can be considered in making the alternate valuation election.

1. **The case that prompted the proposed regulations.** Kohler v. Commissioner, T.C. Memo. 2006-152, involved the estate of Frederic Kohler, an incapacitated member of the Kohler family that owned 96 percent of the stock in the plumbing parts company. With the assistance of a prominent Milwaukee law firm, work on a tax-free reorganization had commenced in 1996 and was completed and became effective on May 11, 1998. Frederic died on March 4, 1998. Pursuant to the reorganization, the estate exchanged its stock for stock that was subject to transfer restrictions and a purchase option. The estate tax return reported an alternate valuation date value of Frederic's stock at $47 million. The Service assessed a deficiency, taking the position that the value of Frederic's stock was $144.5 million. The government argued that the transfer restrictions should be disregarded in valuing the stock because Congress intended to provide relief under IRC § 2032 only for post-death decreases in value due to market forces, not voluntary actions. Rejecting the government's argument, the Tax Court concluded that the tax-free reorganization was not a "disposition" within the meaning of IRC § 2032.

2. **The April 2008 proposed regulations**. Concerned that hastily constructed post-death reorganizations might be employed to reduce value during the alternate valuation period, the Service announced a nonacquiescence to the Kohler v. Commissioner decision. In April 2008, the Treasury Department published proposed regulations that adopted the position the government unsuccessfully argued in Kohler v. Commissioner: An alternate valuation election is available only to estates that experience a reduction in the value of the gross estate due to market conditions and not to other post-death events. "Market conditions" were defined as events outside the control of the decedent, the decedent's estate, or other persons whose property is being valued that affect the fair market value of property in the estate. The proposed regulations included examples of events that are not considered changes as a result of market conditions, including (guess what?) the reorganization of an entity in which the estate has an interest, a distribution to the estate from such an entity, or distributions by the estate of a fractional interest in the entity.

3. **The new proposed regulations back down, but only slightly**. The November 2011 proposed regulations modified the "market conditions" test and clarified the factors that

impact the fair market value of the decedent's interest. The new proposed regulations make irrelevant, for purposes of determining the value of property as of the transaction date, the percentage of ownership or control in an entity includible in the gross estate and the extent of the estate's participation in the relevant post-death events. If an estate's interest is subject to such a transaction during the alternate valuation period, the estate must value that property on the transaction date. The value included in the gross estate is the fair market value of that property immediately prior to the transaction.

a. There are two exceptions to the general rule. If either exception applies, the estate may use the six-month valuation date. The first exception applies to transactions in which an interest in a corporation, partnership, or other entity is exchanged for one or more different interests (such as a different class of stock) in the same entity or in an acquiring entity resulting from a reorganization, recapitalization or merger. If during the alternate valuation period the interest in an entity is exchanged for a different interest in the same entity or for an interest in an acquiring entity, and if the fair market value of the newly acquired interest equals the fair market value of the property for which it was exchanged, the transaction will not be treated as an exchange, and the estate can use the six-month alternate valuation date.

b. Under the second exception, if the estate receives a distribution from an entity, the estate may use the six-month date if the fair market value of the interest in the entity includible in the gross estate immediately before the distribution equals the sum of the fair market value of the distributed property plus the value of the decedent's interest in the entity after the distribution.

4. **And what do the CPAs think about this?** Daily Tax Reports reported that on February 14, 2012, Patricia Thompson, Chair of the AICPA Tax Executive Committee, suggested that the regulations on alternate valuation should prohibit only valuations based on adjustments resulting from actions within the control of the decedent's executor. The CPA group urged that an exception should be made for actions taken by a publicly-traded entity and that, for interests in non-publicly-traded entities, the prohibition on valuation adjustments should be limited to adjustments resulting from actions within the control of the executor. "For over 70 years, this relatively simple statutory provision served its purpose with little difficulty on the part of tax practitioners and the IRS in applying its provisions."

V. Section 2032A—Special Use Valuation

A. **Transfer of farmland to LLCs was not a disposition that triggered additional tax.** In Ltr. Rul. 201129018, farmland passed from the decedent to his four children and to three trusts for the benefit of his grandchildren. Thus, the children and grandchildren were qualified heirs for purposes of IRC § 2032A. The children and the trusts transferred their undivided interests in the farm to LLCs. Each trust and the children received an ownership interest in the LLCs proportionate to the transferred interest in the farm. As a result, the children and trusts indirectly owned an interest in the farm through the LLCs. The Service ruled that the transfer was not a disposition that would trigger an additional tax.

B. **Regulation requiring special use valuation for at least 25 percent of adjusted gross estate held invalid**. In Finfrock v. United States, 2012-1 U.S.T.C. ¶60,641 (C.D. Ill. 2012), F owned (through her interest in a closely held corporation) four parcels of qualified real property that represented 68 percent of her adjusted gross estate. However, the estate made a special use valuation election for only one parcel whose value represented 15 percent of the adjusted gross estate, as the beneficiaries

planned to sell the other three parcels. Under IRC § 2032A(b), to meet the definition of "qualified real property" at least 25 percent of the adjusted gross estate must be real property that passes to a qualified heir. Reg. § 20.2032A-8(a)(2) requires that the property to be valued under IRC § 2032A must constitute at least 25 percent of the adjusted value of the gross estate. The court ruled that the regulation was invalid. Nothing in IRC § 2032A requires that the special use valuation election be made for all or a certain percentage of the qualified property. By adding the substantive requirement that an estate could not elect special use valuation for less than 25 percent of the adjusted gross estate, Reg. § 2032A-8(a)(2) conflicted with the statute.

VI. Sections 2036 and 2038—Retained Interests or Powers

A. **Feeling its oats, Service was too frisky in mounting challenges in two recent FLP cases**. The Service has been quite successful, in recent years, in challenging "basket case" FLPs, where the FLP transactions were poorly implemented. (See, *e.g.*, Estate of Turner v. Commissioner and Estate of Liljestrand v. Commissioner, discussed below.) Perhaps that is why the Service mounted a challenge in two recent cases where the FLPs were properly motivated and properly administered. As a result, the Commissioner had to eat crow. (I guess I'm also feeling my oats, metaphor-wise.)

1. **Desire to have undeveloped woodlands held and managed as family asset a legitimate nontax motive for establishing FLP.** So held in Estate of Stone v. Commissioner, T.C. Memo. 2012-48, involving a $2.56 million deficiency. S and her husband owned 30 parcels of real property in Cumberland County, Tennessee. Nine of the parcels were undeveloped woodlands (totaling 740 acres) near a lake. Deciding that they wanted the parcels to become a family asset to be held for future development, they consulted attorney Sabine. "At their first meeting with Mr. Sabine, decedent and Mr. Stone informed Mr. Sabine that they wanted to give gifts of real estate to various family members and were seeking the best way of doing so. Mr. Sabine discussed the use of a limited partnership and told decedent and Mr. Stone that it would simplify the gift-giving process by not requiring execution and recording of new deeds every year. Mr. Sabine also believed that using a limited partnership would help guard against partition suits, which could cause the land to be divided into smaller tracts." S and her husband established SFLP, and over a three-year period gave LP interests to 21 donees—children, in-laws and grandchildren, with the last gifts made five years before S's death. No discounts for lack of control or lack of marketability were taken with respect to the gifts. All of the gifts were valued on a pro-rata basis of the appraised value of the underlying real estate held by SFLP. SFLP held no other assets and earned no income; its only expenses were $700 in annual property taxes, which S and her husband paid from their personal funds. When S died at age 81, she and her husband each held a 1 percent general partnership interest.

    a. **Implementing gifts was not the only motive for establishing the FLP**. The government contended that the full value of S's one-half interest in the parcels was includible in S's gross estate under IRC § 2036(a), on the ground that gift-giving was S's sole motive in establishing SFLP. "While we agree with respondent that gift giving alone is not an acceptable nontax motive, we disagree that gift giving was decedent's only motive in transferring the woodland parcels to SFLP," said Judge Goeke. "Testimony at trial established that a significant purpose of decedent's transfer of the woodland parcels to SFLP was to create a family asset managed by decedent's family.... We find that decedent's desire to have the woodland parcels held and managed as a family asset constituted a legitimate nontax motive for her transfer of the woodland parcels to SFLP."

(1) Interestingly, the opinion makes no mention of the taxpayer's contention that avoiding partition actions was another motivation for establishing the FLP.

b. **The handling of partnership formalities was not perfect, but....** The government argued that the partners had failed to respect partnership formalities. The court agreed: In two divorce cases the interests of the soon-to-be ex-spouses were not handled properly, and S and her husband paid the $700 annual property taxes out of personal funds. However, (1) S did not depend on distributions from SFLP (in fact, no distributions were ever made), (2) S and her husband "actually did transfer the woodland parcels to SFLP," (3) there was no commingling of partners' personal and partnership funds, as SFLP had no partnership funds, (4) no discounting of SFLP interests for gift tax purposes occurred, and (5) S and her husband were in good health at the time the transfer was made to SFLP. Although S was over age 70 at the time of the transfer in 1997, "she lived until 2005 and was healthy enough to continue teaching Sunday school up to and including the last Sunday before she passed away." Thus, the bona fide sale exception under IRC § 2036(a) applied, and S received full and adequate consideration in making the transfer.

2. **There were legitimate nontax motives for transferring rock quarries and other real property interests to FLPs.** So held in Estate of Kelly v. Commissioner, T.C. Memo. 2012-73, involving a $2.2 million deficiency. K owned 27 parcels of Georgia real property, including two rock quarries (which the family operated), a subdivision with rental homes, a post office, and a rural property with a large waterfall and picnic facilities. K also owned 3,000 shares of Vulcan Materials, 32.6 million shares of Regions Financial Corp., 9,250 shares of Gordon Bank, and 9,250 shares of Liberty Bancorp. After being diagnosed with Alzheimer's disease in 1998, three of K's children were appointed as co-guardians of a fourth child, who had Down syndrome. As a result, routine maintenance and management decisions required court approval. Also, the children were concerned about K's potential liability exposure with respect to the properties. They consulted Stewart, an estate planning attorney. "Mr. Stewart discussed with the children the nature of decedent's assets, the difficulties of managing decedent's assets as guardians, and the desire that each of the children share equally in decedent's estate. The children further informed Mr. Stewart about dangerous incidents and special circumstances on decedent's property (*i.e.*, public access, dynamite blasting, rock throwing, and bullets discovered at a campsite). At the time she hired Mr. Stewart, decedent and the children had not considered tax consequences."

a. On Stewart's recommendation, K created FLPs: one for each child and one to hold the rock quarries, naming K as general partner of each partnership. K retained, in her own name, over $1,100,000 in liquid assets. A reasonable management fee was to be paid to K to "insure that the ward will be provided with adequate income to cover the ward's probable expenses for support, care and maintenance for the remainder of the ward's lifetime in the standard of living to which the ward has become accustomed." For their work in providing maintenance and financial services, each child was paid an annual salary of $21,600. Over a three-year period (including the year in which she died), K gave LP interests to the children and their descendants.

b. The Service mounted an IRC § 2036(a) challenge, contended that the value of the assets contributed to the FLP should be includible in K's gross estate. In an opinion by Judge Foley, the court disagreed. "Decedent's transfers of assets to limited partnerships meet this bona fide sale exception because decedent had legitimate and significant nontax reasons for creating the limited partnerships and received partnership interests proportionate to the value of the property transferred.... [D]ecedent's primary concern was to ensure the equal distribution of decedent's estate thereby avoiding litigation. In

addition, decedent was legitimately concerned about the effective management and potential liability relating to decedent's assets." Court approval was required for basic day-to-day management decisions. By contributing the quarries and other properties to partnerships, decedent limited her liability and reduced her management responsibilities. Through KWC [the general partnership], the children were able to manage the properties as individuals rather than as co-guardians. Decedent's ownership of two quarries, the waterfall property, the post office, and multiple rental homes required active management and would lead any prudent person to manage these assets in the form of an entity."

c. While it is true that the guardianship court petition "references estate tax savings upon implementation of the plan ... there is no evidence that tax savings motivated decedent. Prior to hiring Mr. Stewart, the children had not considered tax ramifications. Decedent's primary motives were to ensure effective property management and equal distributions among the children—not minimization of tax liability. Decedent had valid nontax reasons to contribute property to the limited partnerships. Furthermore, decedent received partnership interests equal in value to the assets she contributed to the limited partnerships."

d. The court also rejected the Service's contention that, pointing to the management fee that was to be paid to K, the parties had an implied agreement that K would continue to enjoy the income from the FLPs. "Decedent respected the partnerships and KWC as separate and distinct legal entities, observed partnership formalities, and retained sufficient assets for personal needs." The management fee the family limited partnerships paid KWC was reasonable. "Indeed, after evaluating both the income and expenses of the entities and fees charged by trust departments, the children selected fees that were lower than the industry standard.... In essence, respondent is requesting that the Court disregard KWC's existence, the general partner's fiduciary duty, and the partnership agreements. We will not do so.... Accordingly, the value of these family limited partnership interests will not be included in decedent's gross estate."

B. Some interesting conclusions reached by Tax Court's first opinion in Estate of Turner. Estate of Turner v. Commissioner, T.C. Memo. 2011-209, is a FLP (and life insurance trust) case that (1) not surprisingly on the facts, found a gross estate inclusion under IRC § 2036(a)(1)—implied retention of economic benefits, (2) somewhat disconcertingly, also held that IRC § 2036(a)(2) applied—power to control beneficial enjoyment, and (3) had a most interesting take on Crummey withdrawal powers and the annual exclusion, discussed under IRC § 2503, *infra*. In a supplemental opinion, the Tax Court addressed the very troubling "marital deduction mismatch" issue, discussed under IRC § 2056, *infra*. T and Wife transferred marketable securities and investment assets to an FLP, retaining a 1 percent general partnership interest and 99 percent LP interests. Shortly thereafter, they transferred 43.6 percent of the LP interests to family members and family trusts. On T's death two years later, the Tax Court held that T's one-half of the value of the partnership, and not just the value of T's retained interest, was includible in T's gross estate.

1. **Implied agreement for retained enjoyment of the transferred assets.** The Tax Court had no difficulty applying IRC § 2036(a)(1) to the partnership. The court ruled first that the transfers were not bona fide sales for adequate and full consideration. There were no legitimate and significant non-tax reasons for creating the FLP. The "usual" non-tax reasons trotted out—centralized management, resolution of family discord, asset protection—were based on standard boilerplate form used by the attorney, and were not persuasive. T sat on both sides of the transaction in setting up the LP. Also, there was ample evidence of an implied retention of economic benefits. The LP paid T and his wife a $2,000/month

management fee although they actually provided few services, T and his wife had the right to amend the agreement without consent of the limited partners, T used partnership assets for personal purposes (making gifts, paying life insurance premiums and paying for estate planning advice), and T had transferred most of his assets to the LP. [He did??? T and his wife retained $2 million in assets, which generated income of $90,000 per year.]

2. **A new and troubling issue: retention of power to control beneficial enjoyment.** Having decided that IRC § 2036(a)(1) resulted in a gross estate inclusion, the Tax Court could have stopped there. However, the court went on to conclude that IRC § 2036(a)(2) (the right to designate the persons who will enjoy the property or its income) also applied. (1) T was effectively the sole general partner—Wife was also a general partner but, said the court, IRC § 2036(a)(2) applies if the power is exercisable "alone or in conjunction with any person." (2) As general partner, T could amend the partnership agreement without the consent of the limited partners, and had sole and absolute discretion to make pro rata distributions of partnership income.

   a. Finding that IRC § 2036(a)(2) applied is troublesome, to say the least. It is invariably true that the LLC general power has discretion to make pro rata distributions. The only saving grace, perhaps, is that it is unusual for a partnership agreement to give the general partner a unilateral power to amend the partnership agreement.

C. Poorly implemented FLP leads to gross estate inclusion. Estate of Liljestrand v. Commissioner, T.C. Memo. 2011-259, involving a $2.57 million deficiency, is another "bad facts" case. D's revocable trust transferred 13 real estate properties (all of D's income-producing assets) to an FLP, leaving D with his house and some minor assets. D initially received 98.98 percent of the partnership interests, but he transferred 14.8 percent of the interests to trusts for his children. Thereafter—here we go again—nothing was done right. No bank account or capital accounts were created for two years, the FLP and revocable trust commingled funds, disproportionate distributions were made to D to pay living expenses, no partnership returns were filed for the first two years, there was one meeting of FLP members in seven years, the transactions were not at arm's length, etc. etc.

1. The Tax Court ruled that all of the partnership assets were includible in D's gross estate. D had retained the economic benefits of the property, and the transfers did not involve bona fide sales. The court did not accept the purported nontax reasons for establishing the FLP, and the transaction was not at arm's length.

VII. Section 2041—Powers of Appointment

A. Despite language of "welfare or other appropriate expenditures," principal distribution power was within ascertainable standard. In *Estate of Chancellor v. Commissioner*, T.C. Memo 2011-172, involving a $716,000 deficiency, the will of C's husband created a bypass trust of which C and Bank were co-trustees. The will authorized the trustees to apportion trust income among C and the husband's children and grandchildren "in accordance with their respective needs." The co-trustees could distribute trust principal for "necessary maintenance, education, health care, sustenance, ***welfare or other appropriate expenditures*** needed by [C] and the other beneficiaries … taking into consideration the standard of living to which they are accustomed." [Emphasis added.]

1. Finding no Mississippi cases addressing the scope of a power to invade principal for "welfare," Judge Thornton's opinion discussed several related Mississippi cases, and then

analyzed a large number of other cases addressing the ascertainable standard issue, some decided in favor of the government and others in favor of the taxpayer. The decision concludes: "[T]he phrase 'welfare or other appropriate expenditures needed by [the beneficiaries] taking into account the standard of living to which they are accustomed,' preceded as it is by a list of 'necessary' support-related items, merely rounds out the standard of living concept."

2. "This conclusion, we believe, is consistent with Mr. Chancellor's intent as revealed in his will. Although he left most of his estate to decedent outright, she was not the sole beneficiary of the trust; Mr. Chancellor's children and grandchildren were also beneficiaries. The co-trustees were authorized to invade trust corpus to make 'necessary' support related expenditures for any of these beneficiaries, 'as needed, taking into account their accustomed standards of living'.... [W]e believe that to implement Mr. Chancellor's intent a Mississippi court would construe the power narrowly to authorize invasion of trust corpus only for support-related needs like those described in the will, so as to conserve trust assets to provide, to the extent possible and necessary, for all of the beneficiaries' support and maintenance during decedent's lifetime."

3. This is a strong opinion that analyzes in detail just about every case that has addressed the ascertainable standard issue. The opinion is a "must read" for any attorney facing the issue; the attorney's research task has been ably and thoroughly completed by Judge Thornton.

B. Consequences of beneficiary's "hanging" withdrawal right and substitution power explained. In Ltr. Rul. 201216034, trust beneficiary B was given a "hanging" Crummey withdrawal power that lapsed only to the extent covered by the "$5,000 or five percent" exception to the general power of appointment rule. B also was given a nonfiduciary power to acquire trust corpus by substituting other property of equivalent value.

1. **Income tax consequences.** The Service stated that pursuant to IRC § 678(a)(1), B will be the owner of the portion of the trust over which his withdrawal power has not lapsed. To the extent that B does not exercise the power and the power lapses, what are the income tax consequences of B's holding the substation power? We can't answer that, said the Service. Whether B was the owner for purposes of IRC § 678(a)(2) turns on whether a power is exercisable in a fiduciary or nonfiduciary capacity, which is a question of fact. If B's power is found to be exercisable in a nonfiduciary capacity, he would be treated as the owner of the trust in its entirety.

2. **Estate tax consequences.** When B dies, the value of the trust corpus over which he may exercise his withdrawal right in that year, less any amount that may have been withdrawn in that year, will be includible in his gross estate.

VIII. Section 2042—Life Insurance

A. Substitution power to acquire policy from irrevocable trust—no gross estate inclusion. Under the facts of Rev. Rul. 2011-28, I.R.B. 2011-49, an irrevocable trust purchased a policy on grantor G's life. G made gifts each year that were used to pay premiums on the policy. G retained the power, exercisable in a nonfiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. The Service ruled that the substitution power, by itself, will not cause the value of the policy to be includible in G's gross estate under IRC § 2042. The ruling cautioned that such a substitution power cannot be exercised in a manner that could shift

benefits among the trust beneficiaries. Also, the trustee must have a fiduciary obligation, under local law or the trust instrument, to ensure the properties acquired and substituted by the grantor are in fact of equivalent value. The ruling discussed Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), which held that a decedent's retained substitution power over property held in an inter vivos trust was not a power to alter, amend, or revoke the trust within the meaning of IRC § 2038.

B. **Fractional interest discounts for gifts of life insurance policies?** In Oshins and Bauer, Life Insurance Could Be the Quintessential Value-Shifting Asset, 38 Estate Planning (June 2011), the authors make an intriguing planning suggestion: Fractional interest gifts of life insurance policies, which "because of the inherent nature of the product, are transfers that should receive valuation discounts far in excess of the typical entity discount." Oshins and Bauer use as an example gifts of one-third interests in a life insurance policy to trusts for each of the client's three children. What would a willing buyer pay for each donee's one-third interest, when contractual rules and restrictions imposed by all insurance companies require unanimity on all actions with respect to the policy? "Due to the contractual prohibitions, a partial owner has literally no control over a life insurance policy. He or she cannot borrow against the policy, surrender it, or even change the beneficiary without the unanimous consent of all co-owners. Furthermore, no market exists for such an interest."

1. Too good to be true, you ask? With the Service's grumbling acceptance of fractional interest discounts, and the Service's own regulations that set out the "willing buyer/willing seller" test, it is hard to find fault with this transaction from an analytical standpoint. And, as the authors point out, it took legislative action (*e.g.*, Chapter 14—the Special Use Valuation rules) to eliminate in other arrangements "which appear[ed] egregious and contrived to the IRS."

IX. Section 2053—Administration Expense Deduction

A. **Contingent and uncertain claims—guidance on filing protective claim for refund.** In October 2009, the Service issued final regulations under IRC § 2053, taking the position that except for claims that are "ascertainable with reasonable certainty," no deduction will be allowed for contingent or uncertain claims until actually paid by the estate. The regulations briefly addressed the filing of protective claims for refund, and advised that further guidance would be forthcoming. That guidance has been given by Rev. Proc. 2011-48, 2011-42 I.R.B. 527, published on October 14, 2011. The revenue procedure describes, in considerable detail, the timing of filing a protective claim, who can file the protective claim, and the specifics required in identifying the particular claim or expense. A separate Form 843, "Claim for Refund and Request for Abatement," is required for each claim.

1. **Make sure that you get an acknowledgment of receipt from the Service.** The Revenue Procedure states that the receipt of a protective claim should be acknowledged by the Service within 180 days, and advises contacting the IRS if the taxpayer does not receive acknowledgement within that time. This was reinforced by Cathy Hughes, Office of Tax Legislative Counsel, in speaking at a meeting of the ABA Section of Taxation in Denver in October 2011. As reported by Daily Tax Reports, Hughes urged practitioner to contact the IRS to ensure that their claims have been received. "The problem is if you don't let them know ... and they spot a problem with the way you've identified an asset, you're not going to get an opportunity [to amend] that description if you're beyond the statute of limitations for filing a protective claim."

2. **Dot all i's and cross all t's**. In Lewis v. Reynolds, 284 U.S. 281 (1932), the Supreme Court held that the IRS can examine all items on a return to offset any refund claim, even after the statute of limitations has run on a particular issue. In Notice 2009-48, the Service advised that "generally" it will limit the scope of review to the deduction that was the subject of the protective claim. In Rev. Proc. 2011-48, the Service advises that the limited review will not apply to "[a] taxpayer that chooses not to follow or fails to comply with the procedures set forth in this revenue procedure."

B. **Interest on 15-year balloon *Graegin* note was deductible where loan was from trust with same trustees and same beneficiaries.** In Estate of Duncan v. Commissioner, T.C. Memo. 2011-255, D had transferred a substantial part of his estate, including oil and gas interests, to a revocable trust. By his will, D exercised a special power of appointment over assets in a trust created by his father, and appointed the assets to an irrevocable trust with the same trustee as the revocable trust, and whose terms were virtually identical to the terms of the revocable trust. To pay federal and state estate taxes, debts and expenses, the revocable trust borrowed $6.5 million from the irrevocable trust. Inspired by Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, the loan was evidenced by a 15-year balloon note that prohibited repayment. The 6.7 percent interest rate on the note was quoted by the banking department of the corporate co-trustee, at a time when the AFR was 5.02 percent and the prime rate was 8.25 percent. (Those were the days!) It turned out that the revocable trust was able to generate $16 million in cash in the first three years, but the Tax Court was persuaded that the revocable trust was not expected to generate sufficient cash to repay the loan within three years. The estate claimed a $10.7 million deduction for the interest that would be paid at the end of the 15-year term of the loan. The Service denied the deduction (although at trial the government stated that it was willing to recognize a deduction for three years' interest).

1. **Tax Court allowed the deduction in full**. Although the lender and borrower trusts had the same trustees and the same beneficiaries, this was a bona fide debt between two separate entities. The loans were actually and reasonably necessary because the revocable trust could not meet its obligations without selling assets at discounted prices. On the facts presented, the 15-year term of the trust and the interest rate were reasonable, and the court refused to second-guess the trustees' decision in making the loan.

C. **Bankruptcy judge voids transfer to Alaska asset protection trust**. Battley v. Mortensen, 2011 WL 5025249 (BR. D. Alaska 2011), is the first reported addressing concerning the validity of a self-settled asset protection trust. The bankruptcy court set aside a transfer of real property to an Alaska asset protection trust. Bankruptcy Code § 548(e) provides that a bankruptcy trustee may avoid any transfer by the debtor made within 10 years before the date of filing the bankruptcy petition if (A) the transfer was made to a self-settled trust, (B) the transfer was by the debtor, (C) the debtor is a beneficiary of the trust, and (D) the debtor made the transfer with the intent to hinder, delay, or defraud any entity to which he was or became indebted, even if the debt arose after the transfer. The judge ruled that M's transfer passed the first three prongs of the test, but flunked the fourth prong.

1. M's mother transferred $100,000 to M with notes indicating that the funds were given in exchange for M's transfer of real property to the trust. The bankruptcy judge concluded that M was insolvent at the time he created the asset protection trust, despite the fact that he had signed an affidavit stating otherwise. The bankruptcy trustee cited the language from the trust agreement regarding its purpose which was to protect assets from the claims of creditors. Alaska law specifically provides that a settlor's expressed intention to protect trust assets from a beneficiary's potential future creditors is not evidence of an intent to defraud. At issue was whether the Alaska statute had an impact on the determination of "intent to defraud"

under the Bankruptcy Code. While as a general rule the extent of a debtor's interest in property is determined by state law, the court concluded that for federal law purposes, M's stated intention in the trust agreement could be evidence of an intent to defraud.

2. In finding that M's transfer to the trust was made with the intent to defraud his creditors, the court noted that M created the trust after several years of below-average income, high credit card debt, and the financial consequences of a divorce, and used the money received from his mother to speculate in the stock market rather than paying off his debts.

D. **Deduction allowed for life insurance proceeds paid to ex-wife pursuant to settlement agreement**. In Estate of Kahanic v. Commissioner, T.C. Memo. 2012-81, involving a $1.2 million deficiency, a divorce degree granted by an Illinois court incorporated the parties' agreement that K would maintain his wife as beneficiary of a $2.5 million life insurance policy. After an extended discussion and analysis of a number of life insurance issues, the Tax Court ruled that the policy proceeds were includible in D's gross estate, but that the estate could deduct the proceeds under IRC § 2053(a) because the settlement agreement created an indebtedness. The court noted that under IRC § 2516(1), written marital agreements relating to transfers of property rights within a stipulated period are deemed to be transfers made for a full and adequate consideration.

1. **Deduction also allowed for interest on estate's loan from ex-wife**. The estate was trying to sell K's medical practice when the estate tax was due, and did not have the liquid funds to pay the tax without a forced sale of the practice. The estate, with only $400,000 in cash and $1.125 million in liabilities, borrowed $700,000 from the K's ex-wife under a secured note bearing interest at 4.85 percent. The case did not involve a "Graegin" loan, because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction for the interest that would accrue over the life of the loan. At issue was whether the interest that had accrued up to the time of trial could be deducted under IRC § 2053. The court ruled that the interest could be deducted.

   a. The government argued that the ex-wife as lender never intended to create a genuine debt because she never demanded repayment, and also that she benefited from the estate being able to pay its estate taxes as she would have been liable for some of the estate taxes due to transferee liability. The court concluded, however, that the ex-wife did not demand payment of the loan after it became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the Service's estate tax determination. Moreover, the fact that the ex-wife benefited from the estate's payment of its taxes did not mean that she did not intend to collect the loan.

   b. The government also contended that the loan was unnecessary because the estate could have sold its illiquid assets to pay the estate tax. The court disagreed, finding that the estate would have had to sell the medical practice and its receivables at a deep discount. Therefore, said the court, the loan was reasonably necessary.

X. Section 2056—Marital Deduction

A. **The marital deduction mismatch issue is alive and well—and it is dangerous!** Here's the scenario. T establishes a family limited partnership, and over the years transfers FLP interests to various family members, discounting the gifted FLP interests by (say) 35 percent for lack of marketability, lack of control, and transfer restrictions. T dies leaving a will that makes a marital deduction formula gift to a QTIPable marital deduction trust. Because the FLP transaction was badly handled, the Tax Court rules that the full value of the FLP, and not just the LP interests

retained by T, is includible in T's gross estate under IRC § 2036(a)(1), on the ground that the transfers were not bona fide sales for adequate and full transaction, there were no legitimate and significant non-tax reasons for creating the FLP, and T retained economic benefits in the transferred property. See, *e.g.*, Estate of Turner v. Commissioner, T.C. Memo. 2011-209, and Estate of Liljestrand v. Commissioner, T.C. Memo. 2011-259, discussed under IRC § 2036, *supra*.

1. In the meantime, T's executor has partially funded the QTIP marital trust with LP interests that T had retained. And there's the potential mismatch! T's gross estate is sharply increased by reason of including the full fair market value of the FLP's underlying assets (including the interests gifted during lifetime) *without any discounts*, and unless the marital deduction formula clause saves the day the estate tax will be sharply increased. For gross estate inclusion purposes the FLP units are in effect valued at 100 percent. For marital deduction purposes, however, the Service can contend that interests passing to the surviving spouse or marital trust are to be valued at their fair market value—in this example, at their discounted value of 65 percent.

2. To date, no court has ruled in favor of the Service on the mismatch issue. The issue was asserted by the government in Estate of Black v. Commissioner, 133 T.C. 340 (2009), and Estate of Shurtz v. Commissioner, T.C. Memo. 2010-21, but in both cases the issue was not reached because the taxpayers won on the central issue: The Tax Court held that IRC § 2036(a)(1) did not apply to the FLPs.

3. **Estate of Turner II**. As discussed earlier, in Estate of Turner v. Commissioner, T.C. Memo. 2011-209, the Tax court held that the full value of an FLP was includible in T's gross estate under IRC § 2036(a)(1)—implied retention of economic benefits, and also held that IRC § 2036(a)(2) applied—power to control beneficial enjoyment. In a supplemental opinion, Estate of Turner v. Commissioner, 138 T.C. No. 14 (2012) ("Estate of Turner II"), responding to the estate's and government's motions for reconsideration, the Tax Court addressed the implications of its earlier decision on the allowable marital deduction. The estate contended that regardless of the IRC § 2036(a) inclusion, the formula clause in T's will required that the estate tax was to be reduced to zero. "In the estate's view, section 2036 applies a legal fiction for purposes of calculating the gross estate, and, for consistency, the marital deduction can also be increased to reflect that fiction. The estate argues that it would be inconsistent to conclude that Clyde Sr. retained a right to possess or enjoy assets he contributed to the partnership and at the same time ignore the values of those assets included in the gross estate under section 2036 in calculating the marital deduction."

   a. Calling this another "type of mismatch," Judge Marvel rejected the estate's contention. Although the gifted FLP interests were pulled back into the estate under IRC § 2036(a), they did not qualify for the marital deduction for two reasons. First, to qualify for a marital deduction an interest must pass to the spouse; here, the interests had passed to other family members. Second, the premise of the marital deduction is that interests qualifying for the deduction will be subject to tax in the surviving spouse's estate; here, there will be no such inclusion because the interests are owned parties other than the spouse. "There is no Code provision similar to sections 2044 and 2519 that would require adding such assets into her transfer tax base. The lack of such a provision would allow the assets to leave Clyde Sr. and Jewell's marital unit without being taxed, thereby frustrating the purpose and the policy underlying the marital deduction."

   b. **The mismatch problem left to another day**. In its motion for reconsideration, the government argued that for marital deduction purposes, the FLP interests passing to the

spouse should be valued at their discounted value. However, "this type of mismatch is not in this case: respondent allowed an increased marital deduction that he calculated on the basis of the value of assets transferred in exchange for the partnership interests that Clyde Sr. held at death, rather than on the basis of the discounted values of the general and limited partnership interests that Clyde Sr. owned at death, to the extent that they passed to Jewell ... and ***we leave this mismatch problem for another day***." [Emphasis added.]

4. **Are there malpractice concerns here?** As noted above, in Estate of Turner II, the Service did not raise the marital deduction mismatch issue until it was too late. Thanks to Judge Marvel's opinion, it is highly unlikely that the Service will make that mistake again. When an attorney prepares an estate plan that includes a marital deduction formula clause, he or she may include in a transmittal letter, memo or some other discoverable document words to the effect that "because of the marital deduction formula provision, no estate taxes will be paid by your estate." If the estate plan also includes a family limited partnership or an LLC and the entity is not implemented and administered properly, leading to the *two* mismatch problems discussed in Turner II, the client's estate should have no difficulty finding a plaintiff's attorney willing and eager to contend that the resulting estate tax was the fault of the attorney.

B. Defense of Marriage Act is unconstitutional; bequest to surviving spouse of same-sex marriage qualifies for marital deduction. In Windsor v. United States, 833 F.Supp. 2d 394 (S.D.N.Y. 2012), Ms. Windsor and Ms. Spyer were married in Canada in 2007, following a 40–year engagement. Spyer died in New York in 2009, and Windsor as her executor filed an estate tax return that claimed a marital deduction for interests passing to her. Although their Canada marriage was recognized by New York, the IRS denied the marital deduction by reason of Section 3 of the Defense of Marriage Act ("DOMA"), under which "the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife." Windsor filed a refund claim for $363,000, which the Service denied. Windsor filed this action on November 9, 2010, contending that the IRS's refusal to apply the estate tax marital deduction to her wife's estate—and by extension DOMA itself—discriminated against her on the basis of her sexual orientation in violation of the Equal Protection clause of the Constitution. The District Court agreed, and granted summary judgment to the estate. In reaching the decision, the court relied on the Court of Appeals decision in Massachusetts v. HHS, discussed below.

1. The Windsor v. United States litigation has a rather interesting history. The Department of Justice ("DOJ") appeared on behalf of the defendant United States, but in February 2011 the DOJ gave notice to Windsor and the court that it would "cease defending the constitutionality" of Section 3 of DOMA. The DOJ also notified Representative John A. Boehner, Speaker of House of Representatives, of its change in position and expressed its "interest in providing Congress a full and fair opportunity to participate in [this] litigation" while still "remain[ing] parties to the case and continu[ing] to represent the interests of the United States throughout the litigation." Daily Tax Reports (April 20, 2011) reported that Congress hired Paul D. Clement (King & Spalding, Washington, D.C.), solicitor general during the George W. Bush administration, to represent Congress and defend the constitutionality of DOMA.

2. **Two other courts have also held that DOMA is unconstitutional.** In Massachusetts v. HHS, ___ F.3d. ___ (1st Cir. 2012), an action was brought in federal district court by seven same-sex couples married in Massachusetts and three surviving spouses of such couples to enjoin various federal agencies and officials from enforcing DOMA to deprive them of

federal benefits available to opposite-sex married couples. In an unanimous decision, the Court of Appeals for the First Circuit ruled that DOMA was unconstitutional. "DOMA does not formally invalidate same-sex marriages in states that permit them, but its adverse consequences for such a choice are considerable. Notably, it prevents same-sex married couples from filing joint federal tax returns, which can lessen tax burdens, and prevents the surviving spouse of a same-sex marriage from collecting Social Security survivor benefits." However, citing the likely appeal of its ruling, the court stayed enforcement of its decision until the Supreme Court has the opportunity to issue its own ruling on the case.

a. The decision in Massachusetts v. HHS was handed down a week after a California district court ruled that DOMA was unconstitutional in excluding long-term care insurance coverage to participants in same-sex relationships. Dragovich v. United States, 2012 BL 128112 (N.D. Cal. 2012),

C. **Be careful if you super-copy language from one clause to another clause; judicial modification saves the marital deduction**. It is likely that Ltr. Rul. 201132017 arose in a community property state, as the estate plan involved is commonly employed in such states. H and W were co-trustees of a trust (probably a revocable trust). On the death of the first to die, the surviving spouse was to be the sole trustee, and the trust was to be divided into three trusts: a Marital Trust, a By-Pass Trust, and a Survivor's Trust (the latter containing the surviving spouse's separate property and one-half community property). Under the trust, debts, expenses and taxes in the decedent's estate were to be charged against the By-Pass Trust. (So far, so good; that's where such expenditures should come from on the death of the first spouse.) However, as drafted by Attorney #1 the trust further provided that on the surviving spouse's death, debts, expenses and taxes were to be charged against the By-Pass Trust, not the Survivor's Trust. (Oops! That would reduce the By-Pass trust corpus, and could be seen as giving the spouse a general power of appointment over the By-Pass Trust.) The problem was discovered by Attorney #2.

1. **Attorney eats crow**. Attorney #1 submitted an affidavit stating (according to the ruling) that "the language in Section 4.01 [the Survivor's Trust] was copied from Section 3.01 [the By-Pass Trust] but improperly edited and, therefore, the reference to the By-Pass Trust, rather than the Survivor's Trust, remained."

2. **Relief granted**. Concluding that the parties' intent was clear and that a drafting error had occurred, the Service gave its blessing to a judicial modification that moved the obligations to the Survivor's Trust. The modification did not constitute the exercise or release of a general power of appointment, said the IRS.

D. **Will drafted hastily for client in extremis was proofread too hastily.** In Ltr. Rul. 201214022, D's wife retained an attorney to prepare a will immediately prior to D's emergency surgery. The will provided for the distribution of the estate to a marital trust and a residuary bypass trust. However, in the rush to finalize the documents, the residuary trust mistakenly included a provision giving the wife a general testamentary power to appoint the trust corpus to any person, including her own estate. In a sworn affidavit, the attorney stated that the will should have given the wife a non-general power of appointment, and a state court authorized a modification to that effect. We'll buy that, said the Service. The reformation of the residuary trust was consistent with applicable state law.

XI. Section 2503—Annual Exclusion

A. **Gifts of FLP interests qualified for annual exclusions.** In recent years, the Service has mounted attacks on gifts of interests in family limited partnerships and limited liability companies, as to whether such gifts qualify for annual exclusions. The amounts involved can be quite substantial, if gifts have been made to a number of donees over a period of years. That was the situation in Wimmer v. Commissioner, T.C. Memo. 2012-157, involving gifts by H and W to five adult relatives and a Grandchildren's Trust over a five-year period (1996-2000). The six minor beneficiaries of the Grandchildren's Trust were given Crummey withdrawal powers. In three of the five years, each done made taxable gifts (totaling $152,000), meaning that gift tax returns were filed and the statute of limitations had commenced to run. An indication of the amount of the gifts is reflected by the fact that the gift tax deficiency was $236,711.

1. H and W created na FLP and were the initial general and limited partners. The FLP's only business was investing in marketable securities, and it was funded with publicly-traded and dividend-paying stock. "The partners intended the partnership to: increase family wealth, control the division of family assets, restrict nonfamily rights to acquire such family assets and, by using the annual gift tax exclusion, transfer property to younger generations without fractionalizing family assets." All partnership profits were to be allocated to the partners according to their proportional interests.

    a. The FLP generally restricted transfers of partnership interests and limited the ability of a transferee to become a substitute limited partner. However, the FLP permitted transfer of a partnership interest by gift or as the result of a partner's death without the consent of the general partners if the transfer benefited another partner or a related party. The partnership agreement gave the general partners full and exclusive power to manage, control, administer and operate the FLP's business and affairs, subject to fiduciary duties and the continuing duty to advance the partnership's purposes and best interests.

2. **These were present interests, said the Service**. The court stated that to qualify as a present interest under IRC 2503(b), the estate must prove that (1) the partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of the income can be readily ascertained.

    a. The first prong of the test was satisfied because quarter dividends had been received and distributed from the inception of the partnership, as was expected from the outset.

    b. The second prong was satisfied because the general partners, while given broad powers, were "subject, in all events, to fiduciary duties to Limited Partners and the continuing duty to advance the Partnership's purposes and best interests." The Grandchildren Trust's only asset was the FLP interest which, due to the transfer restrictions, could not be liquidated or exchanged for cash. As a limited partner, the trustee was allocated its proportionate share of the dividends paid each year. "Because the Grandchildren Trust had no other source of income, distributions of partnership income to the trustee were necessary to satisfy the Grandchildren Trust's annual Federal income tax liabilities. The Court holds that the necessity of a partnership distribution in these circumstances comes within the purview of the fiduciary duties imposed on the general partners. Therefore, the general partners were obligated to distribute a portion of partnership income each year to the trustee."

(1) Hackl v. Commissioner, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir.2003), and Price v. Commissioner, T.C. Memo.2010–2, were distinguished. Unlike the taxpayers in those cases, "decedent, in his fiduciary capacity as general partner of the partnership, made distributions each year at issue and was required to do so."

c. With respect to the third prong, the portion of income flowing to the limited partners could be readily ascertained. "The partnership held publicly traded, dividend-paying stock and was thus expected to earn dividend income each year at issue. Because the stock was publicly traded, the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership."

B. **Premiums paid directly to insurance company qualified for annual exclusions**. Estate of Turner v. Commissioner, T.C. Memo. 2011-209, an FLP case discussed under IRC §§ 2036 and 2056, also involved a life insurance policy held in an irrevocable life insurance trust. For the three tax years in question, T paid the premiums directly to the insurance company and not to the ILIT trustee. The court ruled that the premium payments qualified for annual exclusions—even though the beneficiaries did not know of the additions to the trust, and didn't even know that the trust gave them withdrawal rights! "The terms of Clyde Sr.'s Trust gave each of the beneficiaries the absolute right and power to demand withdrawals from the trust after each direct or indirect transfer to the trust. The fact that Clyde Sr. did not transfer money directly to [the] Trust is therefore irrelevant. Likewise, the fact that some or even all of the beneficiaries may not have known they had the right to demand withdrawals from the trust does not affect their legal right to do so."

1. In this respect, the facts and holding are right in line with Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), and Cristofani v. Commissioner, 97 T.C. 74 (1991)—but Crummey v. Commissioner was a 9th Circuit case and Cristofani v. Commissioner was appealable to the 9th Circuit. Estate of Turner v. Commissioner arose in Georgia, and is appealable to the 11th Circuit.

XII. Section 2511—Transfers in General

A. **This inter vivos trust was a tax disaster, according to the Chief Counsel's office**. In I.L.M. 201208026 (Internal Legal Memorandum—not a CCA for some reason), Donors created a trust naming Son as trustee, giving the trustee discretion to make distributions of income and principal among Donors' children, descendants, and their spouses for a beneficiary's health, education, maintenance, support, wedding costs, purchase of a primary residence or business, or for any other purpose ("beneficial term interests"). Distributions also can be made to a charitable organization. The trust stated that it was irrevocable, and that Donors renounced any power to control beneficial enjoyment. However, Donors retained testamentary limited powers of appointment. On Donors' death, if they do not exercise their testamentary powers, the trust terminates and distribution is to be made to Child A and Child B. Each beneficiary was given a Crummey withdrawal power with respect to additions to the trust. The construction, validity, and administration of the Trust are to be determined by State law, but provision is made for Other Forum Rules (presumably, arbitration provisions). The trust contains a no-contest clause: A beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the trust.

1. **As for beneficial term interests, transfer was "complete" for gift tax purposes**. Donors contended, not surprisingly, that because of their retained special powers of appointment, the

transfer was incomplete for gift tax purposes. Not so as to the beneficial term interests, said the National Office. "[W]hen each Donor transferred property to the Trust on Date, he or she retained a testamentary limited power to appoint so much of it as would still be in the Trust at his or her death. The Trust emphasizes that the Donors do not retain any powers or rights to affect the beneficial term interests of their children, other issue, and their spouses (and charities) during the Trust term. With respect to those interests, the Donors fully divested themselves of dominion and control of the property when they transferred the property to the Trust on Date.... The Donors' testamentary limited powers of appointment relate only to the Trust remainder."

2. **In valuing the gift, special valuation rule of IRC § 2702 applies; taxable gift is the value of the entire trust property**. Under IRC § 2702(a)(2), any retained interest that is not a qualified interest is valued at zero. "Section 25.2702-2(a)(4) provides that an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. Accordingly, under § 25.2702-2(a)(4), the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. Therefore, the value of the Donors' gift is the full value of the transferred property."

3. **Because of the no-contest provision, Crummey withdrawal rights are legally unenforceable and thus are not present interests.** Donors contended that, even if they made completed gifts, the gifts were of minority interests equal in value to their respective withdrawal rights, and thus annual exclusions effectively reduced any taxable gifts to zero. Not so, said the National Office. Under the trust, "a beneficiary cannot enforce his withdrawal right in a State court. He may only press his demand before an Other Forum and be subject to the Other Forum's Rules.... If the beneficiary proceeds to a State court, his [rights under the trust] will immediately terminate.... Thus, a beneficiary faces dire consequences if he seeks legal redress. As a practical matter, a beneficiary is foreclosed from enforcing his withdrawal right in a State court of law or equity. Withdrawal rights such as these are not the legally enforceable rights necessary to constitute a present interest. Because the threat of severe economic punishment looms over any beneficiary contemplating a civil enforcement suit, the withdrawal rights are illusory."

   (1) **Wow! Depending on its wording, no-contest provision in a trust may kibosh Crummey withdrawal provision—in particular (but not exclusively) if trust includes an arbitration provision**. To date, courts in California, the District of Columbia, Arizona (overturned by statute)—and Texas (Rachal v. Reitz, 347 S.W.3d 305 (Tex. App.—Dallas 2011, review granted)), have held that arbitration provisions in trusts are unenforceable. Until the dust settles, it would not be prudent to include an arbitration provision in a trust that has Crummey withdrawal powers designed to secure annual exclusions.

4. **We think we are right, but....** "Please note, however, that our belief in this regard carries certain hazards to the extent further study is required. Should you wish to pursue this argument, please coordinate with the National Office." It is not entirely clear from the Chief Counsel memorandum, but apparently this caveat applies only to the National Office position on whether the Crummey withdrawal provision constitutes a present interest.

5. **"I've got some good news for you, but also some bad news...."** The bad news is that the Donors had to pay front-end gift tax. The good news [sic]? When the value of the trust is includible in the Donors' gross estates by reason of their retention of the special testamentary

powers, any estate tax will be offset by their having prepaid some of the tax by reason of the gift tax.

6. **Did the donors file gift tax returns?** I.L.M. 201208026 makes no mention of gift tax returns. According to the Donors' position, no return was required because the transfers were fully covered by annual exclusions. If a return had not been filed, why would the Service know about the trust? More than a few attorneys and CPAs file Form 709s even though taxable gift is made, to start the statute of limitations running. But if you do that with respect to a sophisticated transaction, are you inviting an audit or examination of the transaction, as occurred here?

B. **"She's Got a Ticket to Ride."** That's one of the captions in the court's opinion in Dickerson v. Commissioner, T.C. Memo. 2012-60. Judge Wherry obviously enjoyed writing the opinion in this fascinating case, involving a lottery ticket. The story began at the Waffle House in Grand Bay, Alabama, where Tonda Dickerson was a waitress. Seward, a customer who showed up almost daily, was a good tipper, with his tips frequently being lottery tickets. As Alabama did not have a lottery, Seward would travel several miles to the neighboring Florida panhandle to purchase the tickets. On March 9, 1999, Seward gave Tonda an envelope containing a lottery ticket which, unbeknownst to Seward, was a winning ticket in the lottery draw the night before. The prize was $354,000 per year for 30 years ($10,000,000), with a cash payout amount of $5,075,000.

1. **"Family Values."** Tonda testified that there was a long-standing informal agreement that if anyone in the family ever bought a winning lottery ticket, the proceeds would be shared among the family members. "While the Court concludes there was a general vague lottery proceeds sharing agreement, this sharing agreement was never written down and there is no documentation to support its existence or its terms.... Before the winning ticket at issue here, there were never any discussions or consistent course of dealing about specific percentages each family member would get of any winning ticket. When questioned at trial, petitioner stated there were no specifics and that they 'just said that we would share, we would take care of each other.' True to these sharing beliefs, after petitioner realized she held the winning ticket, she wanted to share it. And conversations immediately started taking place among certain members of the Reece family about how they were going to 'split the money.' But just how could this be accomplished? She turned to her father for advice."

   a. **"Inc.-ing the Deal."** The next day, Father had an attorney prepare papers for an S Corporation, and shares were distributed 47 percent to Tonda and her husband, and 17 percent each to Mother, Sister and Brother. "[I]t is evident that it was [Father] who determined these percentages, not petitioner and not the Reece family as a group. [Father] himself stated that he was the one who worked out the percentages and that he did it at his kitchen table alone while petitioner and her then husband [since divorced] were looking at automobiles."

   b. **"House of Waffling."** When the parties showed up in Tallahassee to claim the winnings on behalf of the corporation, they learned that a competing claim had been made by Tonda's co-workers. They contended that Tonda was a party to a pooling agreement with the other employees at the Waffle House, who were entitled to 80 percent of the winnings. The case went to trial, and on April 30, 1999 (seven weeks after the lottery was won—swift justice in Alabama) the court ruled that the co-workers had a valid claim. In February 2000, the Alabama Supreme Court reversed, ruling that although an oral agreement may have existed, under Alabama law the agreement was

unenforceable because "founded on gambling consideration." Dickerson v. Deno, 770 So.2d 63 (Ala. 2000).

(1) In the meantime, Seward (the generous tipper) filed an action contending that Tonda breached her agreement to split the lottery proceeds. The lower court's dismissal of his claim was affirmed on appeal. Seward v. Dickerson, 844 So.2d 1207 (Ala. 2002).

2. **"Looking a Gift Horse in the Mouth."** Some years later, Tonda heard from the IRS: Are you going to file a gift tax return? A Form 709 was filed in October 2007, reporting that no taxable gift had been made. The Service disagreed, and assessed a $771,500 deficiency.

   a. **Not a valid contract under state law**. The Tax Court rejected Tonda's contention that a valid contract existed under Alabama law. "The 'terms' of the so-called Reece family agreement consist solely of offhand statements made throughout the years about sharing and taking care of one another in the event someone came into a substantial amount of money. This is not enough.... At most, the family had an 'agreement to agree'.... [T]he terms the alleged Reece family Agreement are too indefinite, uncertain, and incomplete for enforcement." Moreover, even if otherwise enforceable, the alleged agreement would be rendered void pursuant to Alabama's antigambling statute.

   b. **Not a valid partnership under federal law**. The Tax Court also rejected Tonda's contention that a valid partnership existed under federal law. The court distinguished Estate of Winkler v. Commissioner, T.C. Memo.1997–4, where on similar facts (but not similar enough, to the court) a valid partnership regarding the winning lottery ticket was found to have existed.

3. **But a 67 percent discount was recognized.** Having concluded that Tonda had made a gift of 51 percent of the lottery winnings, the final issue was valuation of the gift. The parties agreed that, for valuation purposes, the present value of the lottery ticket proceeds was $4.73 million. The court found the testimony of Tonda's valuation witness, a plaintiffs' attorney who regularly took cases on a contingent fee basis, to be "very credible." He testified that as of the date of the gift, the claim made by Tonda's Waffle House co-workers was a real concern, and that a discount in the range of 65 to 80 percent would be appropriate. The court agreed, concluding that "petitioner's loss in the trial court followed by an appeal and win at the Alabama Supreme Court ... confirms our own litigation tree analysis of just how uncertain the law was at the time the gift occurred." The court granted a 65 percent discount which, when adding in a 2 percent discount for the cost of potential litigation, resulted in a total discount of 67 percent. Thus, the amount of the taxable gift was "only" $1.53 million.

4. **And who were the real winners here,** when disputes over the lottery winnings generated two trials, two appeals to the Alabama Supreme Court, and a trip to the Tax Court?

5. **Do you have clients who regularly play the lottery** (and is this something you should inquire about in the client interview)? If so, what might you do on behalf of such clients?

XIII. Section 2512—Valuation of Gifts

A. **Tax Court upholds "defined value" formula clause in instrument of transfer**. In the recent past, four courts have upheld defined value clauses in making gifts of hard-to-value interests. McCord v.

Commissioner, 461 F.3d 614 (5th Cir. 2006); Estate of Christianson v. Commissioner, 586 F.3d 1061 (8th Cir. 2009); Hendrix v. Commissioner, T.C. Memo. 2011-33 (appealable to Fifth Circuit), and Petter v. Commissioner, 653 F.3d 1012 (9th Cir. 2011). In Petter v. Commissioner, John Porter (Baker Botts, Houston) argued the case before the Ninth Circuit on June 14, 2011. The decision, affirming the Tax Court, was handed down on August 4, 2011—seven weeks later! In all of the cases cited above, the clauses were allocation-type formula clauses, under which FLP or LLC units in excess of a stated value were to pass to a charity—more than mildly complicated and involving a third party. Wouldn't it be nice and a lot simpler if (as I suggested a year ago at this time) practitioners could employ a defined value clause in the instrument of transfer, with no charity involved? I suggested a provision along the following lines:

> I, [donor], give to [donee] that number of limited partnership interest in XFLP which is equal in value to [say] $1,013,000.

1. ***Mirabile dictu***! Such a provision was upheld in Wandry v. Commissioner, T.C. Memo. 2012-88, which Steve Akers (Bessemer Trust, Dallas) has described as "maybe the Blockbuster Case of the Year." Here is what happened. H, W and their children started a business, forming an LLC. On January 1, 2004 (a year in which the gift tax exemption equivalent was $1,000,000 and the annual exclusion was $11,000), H and W each executed assignments providing:

> "I hereby assign and transfer gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows: [then followed a "Gift Amount" of $261,000 for each of four children and $11,000 for each of five grandchildren].
>
> "Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

   a. On July 26, 2005 (oops; a little delay here!), an appraisal firm issued its report, concluding that a 1 percent membership interest had a value of $109,000. H and W filed gift tax returns, each reporting gifts of $1,099,000 and zero taxable gifts. "However, the schedules describe the gifts to petitioners' children and grandchildren as 2.39% and .101% Norseman membership interests, respectively (gift descriptions). Petitioners' C.P.A. derived the gift descriptions from the dollar values of the gifts listed in the gift documents and the gift tax returns and the $109,000 value of a 1% Norseman membership interest as determined by the K & W report."

b. The Service assessed a deficiency that was based on values tied to the 2.39 percent and .101 percent figures listed on the Form 709.

2. **Percentages listed on gift tax return were not binding admissions.** On this point, the government relied on Knight v. Commissioner, 115 T.C. 506 (2000), where the transfer document stated that the gifts of LP interest were to be a value of $300,000. However, the gift tax returns reported gifts of 22.3 percent to each child. The Service that such percentages exceeded $300,000; taxpayers contended that the gifts were less than $300,000. The court held that by arguing the gifts were less than $300,000, the taxpayers "opened the door to our consideration of the Commissioner's argument that the gifts were worth more than $300,000," The gift tax returns in Knight v. Commissioner showed their disregard for the transfer document and that they intended to give their children percentage interests in the partnership. But that was not the situation here, said the court. Here, the gift tax returns reported gifts with a dollar value of $261,000 and $11,000 to petitioners' children and grandchildren, respectively. Petitioners' CPA merely derived the gift descriptions from petitioners' net dollar value transfers and the K & W report. "Therefore, petitioners' consistent intent and actions prove that dollar amounts of gifts were intended."

a. The obvious lesson: Don't mentioned percentages or state a specific number of FLP or LLC units anywhere on the Form 709. Stick with the dollar amount of the gifts.

3. **Capital accounts did not control amount of gifts.** After the gift values were determined, the LLC capital accounts were adjusted accordingly. This reflected, the government argued, that the gifts were of percentage interests. "We do not find respondent's argument to be persuasive. The facts and circumstances determine Norseman's capital accounts, not the other way around. Book entries standing alone will not suffice to prove the existence of the facts recorded when other more persuasive evidence points to the contrary."

4. **This case isn't Procter v. Commissioner.** The government argued that Procter v. Commissioner, 142 F.2d 824 (4th Cir. 1944), should be followed. Not so, said the court. "On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to 'take property back.' Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K & W report understated Norseman's value. The clauses at issue are valid formula clauses.... Petitioners' formula had one unknown, the value of Norseman's assets on January 1, 2004. But though unknown, that value was a constant."

5. **It doesn't matter that no charity is involved.** "It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers.... In Petter v. Commissioner we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern."

6. **No public policy against formula clauses of this sort.** "Respondent argues that the public policy concerns expressed in Procter apply here. We disagree." In Petter v. Commissioner, "we held that there is no well-established public policy against formula clauses. The Commissioner's role is to enforce tax laws, not merely to maximize tax receipts.... Mechanisms outside of the IRS audit exist to ensure accurate valuation reporting.... For instance, in the cases at hand the donees and petitioners have competing interests because every member of Norseman is entitled to allocations and distributions based on their capital accounts. Because petitioners' capital accounts were understated, the donees were allocated

profits or losses that should have been allocated to petitioners. Each member of Norseman has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses. [A] judgment for petitioners would not undo the gift. Petitioners transferred a fixed set of interests to the donees and do not seek to change those interests. The gift documents do not have the power to undo anything. A judgment in these cases will reallocate Norseman membership units among petitioners and the donees. Such an adjustment may have significant Federal tax consequences. We are not passing judgment on a moot case or issuing merely a declaratory judgment."

7. **This is a major development!** True, this is "only" a Tax Court memorandum opinion, but it is a thorough and well-reasoned opinion. For clients not into the complexity of a formula allocation clause that includes a charity, there is much to be said for this simple and straightforward approach.

   a. **Yes, but we have a $5 million gift tax exemption equivalent**. That is true—at least for now. Granted, for the client who is inclined to make a gift of "only" $1 million or $2 million, this may not be all that important. On the other hand … any time the client is making a gift of hard-to-value interests, the defined value formula clause has much to commend it.

XIV. Section 2518—Disclaimers

A. **Estate of deceased spouse could disclaim retirement accounts, but not distributions already received.** In Ltr. Rul. 201125009, required minimum distributions from an IRA and three 403(b) plans were automatically deposited in the joint bank account of D and his wife S. D died, having named S as designated beneficiary on the four accounts. The beneficiary designations provided that if S survived and disclaimed her interest, the trustee of a testamentary trust was to be the contingent beneficiary. S survived D, and quarterly RMDs from the four accounts were automatically deposited in the bank account. S died intestate, and Daughter as administrator sought the Service's blessing of a disclaimer on behalf of S. (The dates are not given in the letter ruling, but S's death obviously must have taken place within nine months after D's death.)

   1. Citing Rev. Rul. 2005-36, 2005-1 C.B. 1368, the Service ruled that S was deemed to have accepted the RMDs deposited in the bank account and could not disclaim them. However, S "may make a qualified disclaimer of the balance of the Retirement Accounts if the requirements of § 2518 have been met."

XV. Section 2519—Disposition of QTIP Life Estates

A. **Gift taxes paid within three years of spouse's death includible in spouse's gross estate**. In Estate of Morgens v. Commissioner, 678 F.3d 769 (9th Cir. 2012), M was the beneficiary of two trusts for which QTIP elections had been made. In 2000, M relinquished her QTIP income interest in Trust A (worth $8.3 million) and, under net gift treatment, a gift tax of $2.3 million was paid by her sons. In 2001, M relinquished her QTIP income interest in Trust B (worth $28 million), and a gift tax of $7.7 million was paid by her sons. M died within three years after these transfers. The estate argued the trustees had paid the gift tax on the deemed transfers and that Congressional intent in enacting the QTIP regime was to shift both the primary and ultimate liability for the taxes from the QTIP donor to the donees.

a. Not so, said the Ninth Circuit, affirming the Tax Court. Citing Diedrich v. Commissioner, 457 U.S. 191 (1982), and Brown v. United States, 329 F.3d 664 (9th 2003), "the trustees acted as a conduit of funds for Mrs. Morgens, who actually paid the gift tax for the purposes of § 2035(b)." The court noted that if M had not made the deemed transfers, the entire value of the trusts would have been included in her estate under IRC § 2044. It was thus appropriate, said the court, that the gift taxes should be treated as having been paid by M.

XVI. Section 2601—Generation-Skipping Transfer Tax

A. **Trustee's failure to give beneficiary notice of taxable distribution may lead to liability**. A trustee who makes a taxable distribution from a GST non-exempt trust must give the beneficiary a Form 706-GS(D-1), alerting the beneficiary of the taxable distribution and of the obligation to pay GST tax. In Hobbs v. Legg Mason Investment Counsel and Trust Company, 2011 WL 39044, *clarified upon motion for reconsideration*, 2011 WL 304421 (N.D. Miss. 2011), involving Tennessee law, over a five-year period the trustee made taxable distributions to skip persons but did not give them the required Form GS(D-1). The beneficiaries ended up having to pay GST tax, penalties and interest. They sued the trustee for the amount of the GST taxes, interest and penalties, for interest on loans made to pay the GST taxes, for losses resulting from their having to liquidate stocks to pay the taxes, for emotional distress, for not severing the trust into GST exempt and non-exempt trusts, and for making distributions from the non-exempt trusts in a manner that would have reduced the GST taxes. On motions for summary judgment, the court dismissed most of the claims, but allowed the case to proceed to trial with respect to liability if the trustee failed to satisfy its duty, under Tennessee law, to keep the beneficiaries reasonably informed. Stay tuned on this one!

B. **Exercise of special power of appointment to extend duration of grandfathered trust**. One of the nicest things to have in the family is a pre-1985 trust that gives the current beneficiary a special testamentary power of appointment. If the trust was established prior to September 25, 1985, all interests created by the exercise of the special power, including the creation of new trusts and extending the duration of existing trusts (but not beyond the period of perpetuities established by the grandfathered trust) are grandfathered for GST purposes. This year's addition to a long list of rulings affirming this principle includes Ltr. Ruls. 201218001, 201218002, and 201136017.

C. **Sale of remainder interest to other beneficiaries did not affect trust's grandfather status**. In Ltr. Rul. 201136011, a GST-grandfathered trust included a spendthrift clause that (as is typical) prohibited beneficiaries from assigning their interests. Pursuant to a settlement agreement, one of two charitable remainder beneficiaries sold its interest in the trust to the decedent's great-grandchildren. Subsequently, with court approval some of the great-grandchildren purchased remainder interests from other great-grandchildren. We don't have any problem with that, said the Service. The sales price of the remainder interests was equal to their fair market value under the IRC § 7520 term interest tables, and the sales did not shift any beneficial interests to a lower generation.

XVII. Section 2702—Special Valuation Rules

A. **What if the grantor wants to stay in the house after the QPRT term expires?** When the term of a qualified terminable interest expires, it is not uncommon for the grantor (invariably a parent) to want to continue to reside in the house. However, continued possession without payment of rent

runs afoul of IRC § 2036(a) (transfer with a retained life estate). How can the grantor's objective be handled without adverse tax consequences?

1. **Have grantor pay market rental**. One of the benefits of the grantor's continuing to pay rent is that it depletes the grantor's estate as a gift-tax-free transfer to the remaindermen, who now own the fee simple. This approach is given approval to the preamble to the IRC § 2702 regulations, reprinted at 1998-1 Cum. Bull. 543, 1998-7 I.R.B. 66 (1997). This results in the creation of taxable rental income to the children with no offsetting deduction to the parent. However, with depreciation deductions, property taxes and the like, the children's cash flow is not likely to be adversely affected. It must be noted, though, that one problem with this approach is that persuading the parent to pay rent to continue to live in "her" house may be a tough sell.

    a. In Estate of Riese v. Commissioner, T.C. Memo 2011-60, the QPRT term ended on April 19, 2003, and the grantor continued to reside in the house, without paying rent, until her unexpected death on October 26, 2003. The court found, however, that the grantor understood at the outset that she would have to pay market rental if she wanted to occupy the house after the QPRT term expired, that after the term expired a daughter had contacted the estate planning attorney asking how to determine appropriate market rental, and that the grantor planned to pay rent before the end of the year once the rental price was determined. The court found that the grantor's continued occupancy established a tenancy at will under New York law, that rent was required (and was going to be paid), that there was no gross estate inclusion under IRC § 2036(a)—and that the estate was entitled to an IRC § 2053 deduction of $46,300 for the unpaid six months' rent.

    b. The Estate of Riese v. Commissioner litigation could have been avoided if the QPRT term explicitly required that market rental be paid for continued occupancy after the QPRT term expired.

2. **Have remaindermen create a reverse QPRT**. Another approach is to have the remaindermen establish a new QPRT after the QPRT terminates, giving the parent an additional term of occupancy in the house. This constitutes a taxable gift by the remaindermen, but the Service has issued a number of private letter rulings to the effect that the gift qualifies under the QPRT rules and thus is valued without regard to IRC § 2702. See, *e.g.*, Ltr. Ruls. 200935005, 200935004 and 200920033.

3. **Modify QPRT to give remaindermen a power of appointment**. Yet another approach, sanctified by a spate of letter rulings, is for the grantor to modify the trust, in a judicial proceeding, to give the remaindermen a general power of appointment. Exercise of the power by extending the grantor's term will result in a taxable gift, but will not be subject to the IRC § 2702 special valuation rules. A recent entry was Ltr. Rul. 201039001, where S deeded her residence to a QPRT for a term of X years. After expiration of the term, the trust was to continue for the benefit of S's issue until the death of S and her spouse, at which time the trust estate was to be distributed to S's issue per stirpes. "On Date 2, Settlor, in her capacity as Trustee of Trust, with the joinder and consent of Son 1 and Son 2 [her two adult sons], executed Modification to modify Trust." The modification provided that at the end of the QPRT term, Sons were to hold a power to appoint the trust property in equal shares to themselves or, alternatively, to direct the trustee to amend the trust so as to provide a term interest to S, her spouse, or both, as a gift by Sons. Sons exercised their power to grant S an additional term of years under the QPRT.

a. That's fine with us, said the Service. The trust modification resulted in Sons' making a gift of their term interest in the residence to S, and the QPRT exception to IRC § 2702(a)(1) and (2) applies to the transfer. However, "no opinion is expressed or implied concerning whether the transfer of Residence to Settlor, pursuant to the modification of Trust, would result in Residence being included in the gross estate of Settlor under IRC § 2036."

b. Reaching the same result on similar facts, see Ltr. Rul. 201144001.

4. **But does IRC Section 2036 apply?** In the rulings on the reverse QPRT and power of appointment approaches for extending the QPRT term, the rulings have invariably closed with the caveat that no ruling is being made as to whether the transfer will result in a gross estate inclusion under IRC § 2036(a)(1). It is difficult to understand why this caveat is expressed, unless the National Office's objective is to discourage timid counselors from recommending either procedure. Given that the result under either approach is a taxable gift, even if there is an understanding or contemplation at the outset that the QPRT term will be extended, the suggestion that IRC § 2036(a)(1) may be implicated is, at best, fanciful.

XVIII. Section 2704—Disappearing Rights and Restrictions

A. **In case involving owner of Atlanta Falcons, statute applied even though articles of incorporation antedated the statute**. Estate of Smith v. United States, 2012-1 U.S.T.C. ¶60,640 (Fed. Cl. 2012), involved the estate of Rankin M. Smith, Sr., who formed Company in 1965 for the purpose of acquiring and operating the Atlanta Falcons NFL franchise. Prior to the enactment of IRC § 2704, Company's articles of incorporation were amended to provide that upon Smith's death, his Class A shares of Company (which had 11.64 votes per share) were to be converted into Class B shares (which had one vote per share). Smith and his family controlled Company both before and after the lapse of voting rights. The court ruled that the lapse of voting rights, triggering IRC § 2704, occurred on the date of Smith's death, not at the time the articles of incorporation were amended.

XIX. Section 6166—Extension of time to Pay Estate Taxes

A. **Bifurcated election not permitted; you either elect to defer or not defer payment of the entire estate tax**. That's what the National Office ruled in CCA 201144027. An estate claimed that it should be allowed to make an IRC § 6166 election only with respect to the holding company stock that qualified the estate for the election. After noting that neither the Code nor any other authorities address the issue, the Service concluded that such an election was not available. An estate may elect either to apply IRC § 6166 to the entirety of the estate tax or to forgo the deferral option. A partial or bifurcated election is not possible, said the National Office.

XX. Section 6511—Limitations on Credits or Refunds

A. **Remittance to IRS was a tax payment, not a deposit; statute of limitations had run**. A six-month extension to file the Form 706 does not give you an extension to pay the estate tax. Well, then: What do you do when the calendar pages are rapidly turning toward that 9-month due date,

you are not ready to file the return, and you've made a guesstimate of the tax that will be due? The first thing you should do is read Rev. Proc. 84-58, 1984-2 C.B. 501, where you will discover that the terminology used on the remittance check and in the accompanying correspondence is terribly, terribly important. If it's a tax payment, the statute of limitations is in play. If it's a tax deposit, the statute of limitations does not begin to run if it turns out that the tax was overestimated.

1. In Boensel v. United States, 2011-2 U.S.T.C. ¶60,624 (Fed. Cl. 2011), part of the problem was that Father died in Louisiana and the executor (Son) lived in California. Son thought that gathering facts and values for the estate tax return (with the assistance of Father's accountant in Louisiana) would be pretty straightforward, given that little had changed in assets and values since Mother's death the year before. But when things started to slip, the accountants suggested payment of $435,000, their estimate of the estate tax liability. On July 1, 1999, Son submitted a check with the legend "Payment of Estimated Estate Taxes." (Oops! He just lost the case!)

    a. Six year later, the Service contacted Son: Where's the estate tax return? (Another oops! Son thought he had done all he needed to do when he sent in the $435,000.) Son filed an estate tax return that reflected an estate tax due of $325,000, and filed a refund claim for $112,000, which the Service denied on the ground that the statute of limitations had run.

2. **The government wins, said the Court of Claims**. The Court of Claims had previously ruled that there are six factors to consider whether a remittance is a tax payment or a tax deposit: (1) whether a tax had been assessed by the IRS, (2) whether the remittance was made without careful consideration of the potential tax liability, (3) whether the taxpayer contested the liability, (4) whether the taxpayer indicated that the remittance was a deposit, (5) whether the IRS viewed the remittance as a deposit or a tax payment, and (6) whether the remittance was made when payment was due and submitted with a request for an extension to file. Son contended that he should prevail because he satisfied factors (1) and (6). The court determined, however that, taking into account all six factors, the estate lost.

3. The court distinguished Huskins v. United States, 75 Fed. Cl. 659 (2007), in which, after an extended analysis of Rev. Proc. 84-58, the court ruled in favor of the taxpayer. The taxpayer had delivered a check for $165,000 to the Service along with a letter stating that "[t]his payment is to be applied to the estate tax on the above-named decedent." Four days later, the attorney sent another letter stating that "I have paid $165,000 ... to the United States Treasury as a deposit against the federal estate tax." The fact that the Service coded the remittance as a tax payment was not controlling, said the court.

XXI. Section 6651—Failure to File Tax Return or to Pay Tax

A. **Executor's reliance on dysfunctional attorney's assurances was understandable but misplaced; executor had duty to timely file the return**. In Freeman v. United States, 2012-1 U.S.T.C. ¶60,636 (E.D. Pa. 2012), Freeman as executor retained Byrne, "who held himself out as an experienced estate attorney, handled the administration of the estate, including the tax work. Byrne managed all correspondence with the IRS. He assumed responsibility for ensuring that the estate's tax returns were filed and its tax payments made.... Freeman spoke to Byrne about filing the estate tax return soon after hiring him and several times thereafter. Freeman relied on Byrne's assurances that he would handle the estate's tax obligations. Freeman and Byrne initially met monthly to discuss estate business, but over time Byrne became increasingly difficult to reach and

their discussions were limited to sporadic phone conversations initiated by Freeman. Freeman was unaware that Byrne was suffering from a litany of physical and mental ailments, and subsequently learned that Byrne had embezzled money from the estate." Three years later, Freeman received a bill from the IRS for the outstanding estate tax and related penalties and interest. He confronted Byrne, who advised him that, yes, the estate tax return was three years late.

1. Affirming the imposition of interest and penalties, the court concluded that "[t]here is no escaping the application of United States v. Boyle, 469 U.S. 241 (1985)," which established a "bright-line" rule: A taxpayer's duty to timely file a tax return is nondelegable, and reliance on an attorney does not excuse an untimely filing. That court said: "[O]ne does not have to be a tax expert to know that tax returns have fixed filing dates.... Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute."

XXII. Section 6901—Transferee Liability

A. **Estate of J. Howard Marshall still fomenting litigation, but this time not involving Anna Nicole Smith.** Topless dancer Anna Nicole Smith's dalliance with and marriage to wheelchair-bound octogenarian J. Howard Marshall, a Texas billionaire, engendered much litigation and—er, problems for Marshall's son Pierce and other family members in the 1990s. And the litigation continues as a result of some of J. Howard's transactions. In United States v. MacIntyre, 2012 WL 1067283 (S.D. Tex. 2012), Marshall's ex-wife Stevens had received 47,623 shares of Marshall Petroleum Inc. ("MPI") stock as part of a divorce settlement. In 1989, Stevens transferred 22,798 shares to a ten-year grantor retained income trust, with the remainder to pass to Pierce Marshall Sr. (Stevens' other MPI shares were transferred to charitable remainder annuity trusts, and were not involved the case.) In 1995, shortly before J. Howard's death (and before the GRIT had terminated), J. Howard sold MPI stock back to MPI at below-market value. Extended litigation between J. Howard's estate and the IRS resulted in three unreported Tax Court decisions that (among other issues) concluded that J. Howard's bargain sale to MPI resulted in an indirect gift to the other MPI shareholders. (It must *really* have been a bargain sale, because the gift with respect to the MPI stock in the GRIT was determined to be $36 million!)

1. **Transferee liability is to be imposed, but against whom?** When J. Howard's estate refused to pay the gift tax, the government brought an action against Stevens' estate and others seeking to impose transferee liability. The estate argued that with respect to the GRIT, the tax should be charged against the estate of Pierce Marshall Sr., because Pierce Sr. had received the trust corpus when the GRIT terminated in 1999. Noting that "courts have not addressed how to determine the identity of the donee" in such a trust, the court determined that responsibility for the gift tax "should lie with the income beneficiary, who benefitted from the increase in income distributed by the trust." The court analogized to cases involving gift tax annual exclusions, where the courts have concluded that the income beneficiary of a GRIT was the donee for gift tax purposes. Here, as with the donees in those cases, Stevens as income beneficiary held a present interest and right of enjoyment in the gift. Moreover, said the court, it would be inappropriate to charge the remainderman because "[a] remainder is a future interest, which is uncertain. The corpus of the trust could be depleted for many reasons prior to distribution of the corpus to the remainderman."

2. **Executor and trustee personally liable for distributions from the estate and for charitable set-aside after receiving notice of government claim**. In United States v. MacIntyre, 2012 WL 2403491 (S.D. Tex. 2012), the court held that Pierce Marshall Jr. as

executor of Stevens' estate and Finley Hilliard as trustee of the Stevens Living Trust were personally liable for distributions that had been made after the Service had given notice that it intended to impose transferee liability on the estate and the trust. The action was based on 31 U.S.C. § 3713, known as the Federal Priority Statute, for distributions by a fiduciary to lower priority creditors and for failure to preserve sufficient funds to pay taxes. Pierce Jr. was held liable for $42,900 for distributions of Stevens' personal effects and for the payment of funeral expenses in excess of $15,000 (the limit on Class 1 claims under the Texas Probate Code). Hilliard was held liable for $37,250 for accounting and legal services paid from the trust. Pierce Jr. and Hilliard were held jointly liable for $1.12 million for funds permanently set aside to charities under IRC § 642(c).

3. **Donees must pay interest on amount of transferee liability**. In United States v. MacIntyre, 2012 WL 2064977 (S.D. Tex. 2012), involving other donees of J. Howard's indirect gifts, the parties agreed that the donees were liable for interest attributable to the donor "at least up to the amount of each individual gift." They disagreed as to whether the government was entitled to interest on the unpaid donee liability. The court noted that the Fifth Circuit had not addressed the issue, and that other Courts of Appeal had taken opposing positions. Ruling for the government, the court chose to follow Baptiste v. Commissioner, 29 F.3d 1533 (11th Cir. 1994), and not Poinier v. Commissioner, 858 F.2d 917 (3rd Cir. 1988).