CURRENT DEVELOPMENTS

by Robin Klomparens

2010 TAX ACT

1. SUMMARY

2010 Estate Tax Election

Although EGTRRA provided for no federal estate tax for decedents dying in 2010, Congress' passage of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 modified the 2010 repeal. Rather than having no estate tax, estates of decedents dying in 2010 are now generally subject to estate tax. Estates must elect out of the estate tax by affirmatively filing the election with the IRS. The deadline for filing or an estate tax return for 2010 decedents has been extended to the later of: September 19, 2011, and nine (9) months from the decedent's date of death. The deadline for opting out currently remains April 15, 2011 with a six (6) month extension.

While the upside of electing into the estate tax is the heirs' stepped-up basis in the inherited assets, it is vital that estates evaluate this decision and affirmatively elect out of the 2010 estate tax before the deadline, or an estate tax is imposed by default, and estates not electing out could be subject to audit and assessment in the future.

EGTRRA Extension, Rates, Exclusions, Etc.

The 2010 Act extends EGTRRA (with some modifications) through December 31, 2013, however the 2010 Act provides a $5 million exclusion amount and a top rate of 35%. These rates will apply for estate taxes imposed on deaths between 2010 and 2013.

In general, the changes imposed by EGTRRA will continue, including the state death tax credit. This means that California's (and many other states') "sponge" tax will again take effect, and these states will again receive estate tax revenue (with no estate tax cost).

The gift and estate taxes are again unified, the $5 million applicable exclusion amount applying to gifts as well.

POWER OF APPOINTMENT, 2040 & 2041

2. POWER OF APPOINTMENT CAUSES-INCLUSION IN DECEDENT'S ESTATE

Technical Advice Memorandum 200907025
(TAM 200907025)

Decedent was the sole beneficiary of a trust over which he was granted a power of appointment. An issue arose as to whether the power of appointment was a general power of appointment for IRC section 2041 purposes. The language of decedent's trust stated that the decedent was entitled to discretionary distributions of the trust's net earnings throughout his life, a right of distribution of the trust estate at the trust's termination, and an equitable interest in the trust at his death. The decedent did not have a right to the distribution of the trust corpus during the decedent's lifetime.

The IRS ruled that because there is a presumption that appointment powers are presumed to be general in the absence of an expressed contrary intent, and since the language of the trust did not restrict decedent's ability to exercise the power, the power of appointment was a general one. The IRS noted that the trust document did not contain any language that limited the decedent's power of appointment exclusively to the discretionary distributions. The IRS also found that the fact that the decedent could not receive the corpus of the trust was irrelevant for purposes of determining the scope of the power of appointment. Because the decedent had a power of appointment over his entire interest in the trust, the value of the trust was includible in the decedent's gross estate.

3. INCLUSION OF JOINT PROPERTY UNDER SECTION 2040

***Estate of Oscar Goldberg v. Commissioner*, TC Memo 2010-26**

A decedent's predeceased spouse's joint interest in property was includible in the decedent's gross estate. The decedent had previously transferred his fractional interest in two (2) pieces of real property to both himself and his spouse. Upon, his spouse's death, the decedent transferred the spouse's interest in the property to a trust. Pursuant to applicable state law, the transfer of real property to a married couple is presumed to be a tenancy by the entirety, unless it is explicitly stated otherwise. Because, the transferor deed did not expressly state the manner in which the parties were to hold the property, the property interest was a tenancy by the entirety, which is not a divisible interest. Furthermore, according to the applicable state law, the court may not consider parol evidence to interpret the transfer because there was no ambiguous language on the face of the deed. Thus, the transfer of the spouse's property interest to the trust was ineffective and the entire property was includible in the decedent's gross estate.

GRANTOR TRUSTS

4. CRUMMEY POWER CAN CREATE A GRANTOR TRUST AS TO BENEFICIARY

IRS Letter Ruling 200949012

In Private Letter Ruling 200949012, the IRS opined that a Crummey demand right constitutes a contribution to the trust by the beneficiary to the extent the power is not exercised, even though allowing the right to lapse is excluded from gift tax pursuant to Internal Revenue Code ("IRC") Section 2514(e). The Ruling shows practitioners how to create a trust that is taxed solely to the beneficiary(ies).

IRC Section 677(a) provides that a grantor shall be treated as owning any portion of a trust whose income without approval or consent of an adverse party is or may be (in the discretion of the grantor or a non-adverse party) (1) distributed to the grantor or his spouse, (2) held or accumulated for future distribution to the grantor or his spouse, or (3) applied to the payment of premiums on life insurance policies of the grantor or his spouse. IRC Section 678(a) provides that a person other than a grantor will be treated as owning trust assets to the extent that (1) the person has a power exercisable solely by himself to vest trust corpus or income in himself, or (2) the beneficiary has previously released or otherwise modified a power and after the release or modification retains such control as would subject the beneficiary to grantor trust treatment (under the principles of IRC Sections 671 through 677) if the beneficiary were the grantor.

The trust in PLR 200949012 was a typical irrevocable trust in which the grantor did not retain any powers requiring grantor trust treatment. The trust allowed the beneficiary to withdraw up to the total of any direct or indirect transfer (for federal gift tax purposes) to the trust. This right lapses each year as to the greater of 5% of or $5,000 of trust corpus.

The grantor was not subject to grantor trust treatment because he did not retain any of the rights specified in IRC Sections 672-677. The IRS reasoned that by operation of IRC Sections 671 and 678, the entire trust was a grantor trust with respect to the beneficiary because of the beneficiary's right to unilaterally demand the contribution to the trust. Accordingly, the grantor enabled the trust property to be taxed to the beneficiary while still allowing the beneficiary to let the right lapse without incurring a gift tax.

Note that this result will differ if the grantor were treated as the owner of the trust assets because IRC Section 678 limits the extent to which a beneficiary is treated as a grantor if the trust assets are treated as owned by the grantor under the grantor trust rules.

This Ruling also illustrates another principle of the interplay between gift tax and grantor trust treatment. For instance, the lapse of a non-hanging 5 and 5 power will be treated as a contribution by the beneficiary to the trust. In this case, the beneficiary is an actual grantor (and not merely treated as one under IRC Section 678). Each year, the beneficiary has contributed the greater of the 5 and 5 amount to the trust and thus, to the extent that the beneficiary retains any grantor trust powers. This principle has been articulated in a number

of IRS authorities, most notably Rev. Rul. 81-6 and IRS Letter Ruling 9034004. While the calculation of this amount is in some dispute (Letter Ruling 9034004 requires the use of a convoluted and perhaps erroneous calculation), the reasoning behind Rev. Rul. 81-6 and Letter Rulings 9034004 and 200949012.

ADMINISTRATIVE

5. TAX RETURN PREPARER PENALTY RELIEF FOR TAX SHELTER TRANSACTIONS

IRS Notice 2009-5

Throughout 2007 and 2008, Congress and the IRS went through the task of reconciling the taxpayer and tax return preparer penalty standards of confidence. Out of this reshuffling of the penalties came an amnesty for taxpayers for penalties under IRC Section 6694(a) relating to tax shelter transactions. Congress was effective in coordinating the return preparer and taxpayer standards with respect to most types of understatement penalty. However, IRC Section 6662A (relating to understatement attributable to "tax shelters"—i.e., listed transactions and transactions wherein tax avoidance is a significant purpose) allows no exception for a taxpayer's level of confidence (aside from acting reasonably and in good faith as outlined in IRC Section 6664(c)).

Currently, IRC Section 6694(a)(2) requires a tax return preparer to reasonably believe that a tax shelter position is more likely than not to be sustained on the merits to avoid the return preparer penalty. In the midst of the IRS' and Congress' reconsideration of the proper standards to afford return preparation penalties, the IRS has issued Notice 2009-5. This Notice provides that the 6694(a) penalty will not apply to a tax shelter transaction if (1) there is substantial authority for the position, and (2) the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer if the transaction is deemed to have a significant tax avoidance purpose.

6. HEIRS MAY REQUEST A COPY OF THE ESTATE TAX RETURN

Chief Counsel Advice 201005052

The Office of Chief Trial Counsel has confirmed in an e-mail, that pursuant to Section 6103(e)(3)(B) the heirs of a decedent have a right to see the estate tax return filed by the executor. The heirs may also request a copy of the "return information", including the notice of deficiency. The heirs satisfied the requirement that they have an interest in the information by obtaining Limited Letters of Administration. However, the estate tax return and power of attorney submitted by the heirs were not valid because the return was not signed by the proper party and the Limited Letters of Administration did not support authority over the entire estate tax return.

7. PROPOSED REGULATIONS ADDRESS PERIOD FOR RECOVERY OF ADMINISTRATIVE COSTS

Proposed Regulations (REG-111833-99)

The proposed regulations address the period for recovery of administrative costs, which generally entitles the taxpayer to recover costs incurred after a notice of proposed deficiency (a "30-day letter") is mailed to the taxpayer. They clarify that such costs are recoverable only if at least one issue (other than recovery of costs) remains in dispute. The proposed regulations also address procedural requirements with respect to presenting an application to the IRS or, upon receiving an adverse decision from the IRS with respect to such application, filing a petition with the Tax Court to recover administrative costs. Pursuant to the proposed regulations, net worth calculation using the fair market value of assets to provide a more accurate assessment of a taxpayer's actual and current net worth as of the administrative proceeding date. The proposed regulations apply to costs incurred and services performed on or after the rules are published as final regulations apply to costs incurred and services performed on or after the rules are published as final regulations in the Federal Register.

8. LEAVE TO AMEND DENIED TO AMEND PETITION TO ADD AFFIRMATIVE DEFENSES

***Estate of Kwang Lee,* TC Memo 2009-303**

An estate was denied its requests for leave to amend its petition to assert an affirmative defense of equitable recoupment with respect to an earlier Tax Court decision denying the estate's marital deduction. In *K. Lee*, 94 TCM 604, Dec. 57,205(M), TC Memo. 2007-371, the decedent was not allowed to claim the marital deduction if there is not a surviving spouse. During the audit of the couple's returns, the executor of the wife's estate filed an informal claim for refund, attributable to the property that passed to the wife under a deemed survivorship provision in the decedent's will. At the time of this opinion, the IRS had yet to make a decision with respect to that claim. The government would be unfairly prejudiced if the estate was granted leave to amend its petition because of the time that had passed between when the deficiency was first asserted and the time the estate sought to add the affirmative defense. The estate was unable to establish good cause for the delay. In addition, the estate's first claim for refund was still open. Finally, the estate would not be able to prevail under the doctrine of equitable recoupment because, although a second claim for refund was denied by the IRS, the first claim had not yet been considered.

9. NO TAX COURT JURISDICTION WHEN NOTICE OF DEFICIENCY IS INVALID

***Estate of Paul Rule v. Commissioner*, TC Memo 2009-309**

The Tax Court did not have jurisdiction over a deficiency redetermination because the notice of deficiency was invalid under Section 6212. At the time the estate tax return was filed, the estate's executor listed an office address on S. Coast Highway in Oceanside, California (the Oceanside address). Several years later, a revenue agent, who was investigating the executor's income tax return, notified the estate tax examiner that the IRS's computer records indicated that the executor had a new residential address in San Diego (the San Diego

address). The examiner mailed a letter and summons to the executor to the San Diego address and discussed the letter and summons on the telephone with the executor after he received those documents. Less than two (2) weeks before the expiration of the statute of limitations, the IRS issued a deficiency notice to the estate, addressed to the executor at the Oceanside address, which was returned and marked "Attempted Not Known" by the U.S. Postal Service. In accordance with Code Sec. 7701(a)(6), the executor of the estate was the proper recipient of the deficiency notice. The examiner was aware of the estate's new address at the time the deficiency notice was issued because (1) information available through the use of the IRS's computer system was attributable to the IRS's agents and (2) the examiner was told that the executor had a new address by another revenue agent. In addition, the examiner failed to use reasonable care and diligence to ascertain and mail the deficiency notice to the estate's last known address because the executor's new address was not confirmed during the telephone conversations and the notice was not sent to both addresses.

10. REPLACEMENT CHECK DENIED

***Curtin v. U.S.*, No. 09-109T. (U.S. Court of Federal Claims, Feb. 26, 2010)**

The decedent, a U.S. citizen, passed away in France. After her death, individuals in both the United States and France were named as the executors of her estate. In August of 2007, the U.S. executors requested an extension of time to file the estate tax return and made a payment of $17.5 million in estate taxes. On February 19th, 2008, the executor in France, the decedent's son, filed an estate tax return and reported a $10.4 million overpayment to the France executor. The United States executors filed a complaint requesting a replacement check for the $10.4 million overpayment. On February 27, 2008, the U.S. executors filed a second estate tax return, reporting $5.1 million overpayment. The IRS sent a refund check for the $10.4 million to the France executor. After the check was cashed, the United States executors filed a complaint requesting a replacement check for the $10.4 million and an additional refund of $5.1 million. The U.S. executors claimed that the court had jurisdiction pursuant to 31 U.S.C. Section 3343 because the check was legally issued to the France executor who was not required to receive permission from the U.S. executors before cashing the refund. The argument that the IRS breached an implied-in-fact contract also failed because such claims are limited to non-taxpayers. Instead, it was noted that the U.S. executors' remedy could only arise out of a claim for refund. Consequently, the U.S. executors' claim for a replacement check was dismissed.

11. ESTATE ENTITLED TO REFUND

***Alan Baer Revocable Trust v. U.S.*, 105 AFTR 2d 2010-1544 (D. Neb.)**

A decedent's estate was entitled to a refund of an estate tax deficiency assessed against the value of certain contingent bequests. In accordance with the decedent's will, the majority of his estate passed to a trust for the benefit of his surviving spouse. The terms of the trust provided for certain specific bequests to individuals, which were contingent upon the sale of the decedent's stock in a private equity company for a profit during the lifetime of the surviving spouse. The decedent's estate tax return was audited and the value of the taxable estate was adjusted, in part, to reflect the determined value of the contingent bequests. Although the

estate originally valued the stock in the company at almost $11 million, over twice the value of the decedent's basis in the stock, that valuation was based on faulty data. A later appraisal, calculated using accurate information, showed that the stock was essentially worthless on the date of the decedent's death. Thus, the contingent bequests had no value, since there was essentially no possibility that they would be paid out during the surviving spouse's lifetime. Accordingly, the estate was entitled to a refund for the previously paid deficiency.

12. ESTATE ENTITLED TO EXTENSION OF TIME TO FILE ESTATE TAX RETURN WHERE IRS ABUSED DISCRETION

***Proske Est.,* 105 AFTR 2d ¶ 2010-2613 (DC NJ 2010)**

The U.S. District Court of New Jersey has held that an estate was not liable for penalties and interest resulting from the late filing of the estate tax return because the IRS abused its discretion when it denied the estate's request for an extension. The IRS has the discretion to grant requests for an extension of time with the showing of good cause even if the request is made after the due date. The decision is, however, subject to judicial review but the IRS did not provide rationale for denial of the request - and none could be presumed. The court found that the estate had demonstrated reasonable cause entitling it to an extension of time to file and the IRS abused its discretion in denying the estate's request for an extension of time.

13. IRS EXPANDS CIRCULAR 230 TO COVER UNENROLLED PREPARERS AND CLARIFIES RETURN PREPARATION STANDARDS

NPRM REG-138637-07

Circular 230 brings all paid return preparers under the IRS's rules regardless of credentials. It also clarifies return preparation standards and creates a new category of practitioner: the registered tax return preparer.

A practitioner will be subject to discipline under Circular 230 only after willful, reckless, or grossly incompetent conduct. Multiple practitioners from the same firm may be disciplined if their conduct is in connection with the same act(s) and does not comply with the standard of conduct required under the regulation.

A registered tax return preparer may only prepare or assist in the preparation of a tax return or claim for refund commensurate with the level of competence demonstrated by examination. The two initial competency exams will be offered to unenrolled preparers sometime in 2011. Tax return preparers will be required by the IRS to successfully complete 15 hours of continuing professional education during each registration year with a required allocation of subject matter.

14. IRS PROVIDES SAFE HARBOR FOR LIFE INSURANCE CONTRACTS IN FORCE AFTER AGE 100

Rev. Proc. 2010-18

The IRS announced a safe harbor for the application of Code Sections 7702 and 7702A to life insurance contracts that may continue in force after the insured individual attains age 100. The IRS acknowledged the disconnect between the change in maturity dates beyond age 100 developed by issuers and the agency's rules in Notice 2009-47. The safe harbor provision reflects the mortality tables currently used by issuers. Under the Age 100 Safe Harbor Testing Methodologies, all determinations under Code Sections 7702 and 7702A (other than the cash value corridor) assume that the contract will mature by the day on which the insured attains age 100, notwithstanding that the contract specifies a later maturity date (by such reason as using the 2001 CSO mortality tables).

15. CLAIM FOR ESTATE TAX REFUND FOUND UNTIMELY

***M. Dickow Est*., DC Mass., 2010-2 U.S. TAX CT. ¶60,599**

A district court in Massachusetts held that an executor was not entitled to an additional refund of estate taxes because the refund claimed was barred by the statute of limitations.

The executor made a second request for a refund within the statute of limitations under Code Sec. 6511(a). The amount of a refund is limited to "the portion of tax paid within the look back period, immediately preceding the filing of the claim, equal to three years plus the period of any extension of time for filing the return." The IRS is limited to granting one six-month extension of time to file an estate tax return, pursuant to Reg. §20.6081-1(b). The court added that a second request for a six-month extension of time to file did not conform with the language of Form 4768.

The court further held that the IRS can not be equitably estopped from denying an executor's claim for refund because the doctrine does not extend to the time to file a refund claim.

16. CLAIM FOR REFUND DISMISSED FOR LACK OF STANDING

***J. Green, Grdn.,* DC Okla., 2010-2 U.S. TAX CT. ¶60-600**

In order to have standing in a tax refund suit, the claimant must have paid the taxes and must have filed a valid claim for refund. The court stated that the fact that the payment of the estate tax may reduce an inheritance does not mean that the recipient paid the estate taxes. Consequently, where it is the estate that pays the taxes – rather than the individual receiving an inheritance – that individual does not have standing to file a claim for a refund of estate tax.

17. ADMINISTRATOR ONLY REQUIRED TO LOOK TO PLAN PROCEDURES AND INSTRUMENTS FOR DISPENSATION OF BENEFITS

***Kennedy v. Plan Adm' for DuPont Sav. & Inv. Plan*, 129 S. Ct. 865 (2009)**

The Court examined the duties of a retirement plan administrator in determining the rightful beneficiary under an ERISA plan following the participant's death. In this case, the participant failed to remove his ex-wife as a plan beneficiary. Though the wife had waived her right to benefits during their divorce proceeding, the Court held that the administrator was not required to engage in external fact-finding to determine the correct beneficiary. While a QDRO is not required to effectively waive rights, the waiver must conform to plan procedures and instruments.

***Staelens v. Staelens*, 677 F. Supp. 2d 499 (Mass. 2010)**

In a case whose facts are similar to *Kennedy* (*supra*) the Court determined that a wife's waiver of rights as designated beneficiary on ex-husband's pension was insufficient as an "assignment or alienation" as required by ERISA because she had not attempted to reallocate her interest in the benefit. The benefit could therefore not be distributed to the decedent's estate but was instead paid to the former wife as she was still named as the designated beneficiary. While successful assignment or alienation does not require a QDRO, a waiver should include a new beneficiary.

18. <u>INSUFFICIENT CLAIMS OF REASONABLE CAUSE FOR LATE FILING OF ESTATE TAX RETURN</u>

***R. Cederloff Est., DC Md., 2010-2* U.S. TAX CT. ¶60-604**

The U.S. District Court in Maryland held that an estate was liable for a late-filing penalty because the executor failed to prove that the late filing fell within the reasonable cause exception of Code Sec. 6651(a)(1).

Following decedent's death, the executor filed the estate tax return almost a year after the extension of time permitted by the IRS. Following an extension period pursuant to Form 4768, the Court determined that the executor's claim of an inability to properly value the estate failed to satisfy the requirements for a reasonable cause exception. The Court stated that the executor should have filled out the estate tax return using the best information available at the time the return was due. The Court also dismissed the executor's argument that the jurat statement at the end of the estate tax return prevented him from filing because, the Court stated, the jurat only requires that the return be true, correct, and complete based on the information the executor had at the time of filing.

CHARITABLE

19. <u>TAXPAYERS WHO FAILED TO SUBSTANTIATE CHARITABLE DEDUCTION TO OTHERS WERE SUBJECT TO</u>

ACCURACY RELATED PENALTIES

***Ramirez v. Commissioner*, TC Memo 2010-108**

Married taxpayers were denied various deductions on their return for failing to keep records and proving that they are entitled to deductions. Specifically, the taxpayers failed to substantiate their charitable deduction relating to contributions of household items and cash. They failed to substantiate their deduction of expenses related to the business use of their passenger automobile or cellular telephone. They also failed to prove the amounts claimed as capital losses on their return and on their Schedule A. Finally, the IRS satisfied its burden with respect to accuracy-related penalties applied against the taxpayers.

20. TAXPAYER MUST HAVE SUBSTANTIATION FOR CHARITABLE DEDUCTION

***Farber v. Commissioner*, TC Memo 2010-37**

Charitable contribution deductions claimed by an individual were allowed only to the extent she provided substantiation for the expenditures.

21. TRANSFERS TO FOREIGN TRUSTS/RECEIVED THE CHARITABLE DEDUCTION

IRS Letter Ruling 200901023

In Private Letter Ruling 200901023, the Internal Revenue Service held that a wife's lifetime and testamentary transfers to a foreign trust to manage and distribute her deceased husband's works of art would qualify for the estate and gift tax charitable deductions. The IRS found the transfers qualified even if the trust did not apply for tax-exempt status under IRC Section 501(c)(3).

Under its terms, the trust would operate for "purposes, objects or institutions exclusively charitable in law." The artwork would be made available for exhibition and loan at public galleries and museums. Because the entire collection is unlikely to be on show in public galleries at all times, items not on public exhibition would be available for private study by researchers, artists and others.

Under IRC Section 508(d)(2)(B), charitable deductions are not allowed for contributions to organizations not described under IRC Section 501(c)(3). However, trusts described in IRC Section 4947(a)(1) are not subject to said rule. The IRS found that the foreign trust fell within the exception of 4947(a)(1), since: (1) it was a trust under federal tax law; (2) the trust was not exempt from tax under IRC Section 501(a); (3) all of the trust's assets were devoted to charitable purposes; and (4) estate and gift tax charitable deductions under IRC Sections 2055 and 2522 would be allowed for the transfers to the trust.

Furthermore, because the trust met the requirements of IRC Section 508(e), the disallowance provisions of 508(d)(2)(A) did not apply. Section 508(e)(1) requires a private foundation's governing instruments to: (1) require compliance with the minimum distribution rules under Section 4942; and (2) prohibit the foundation from:

(a) engaging in any act of self-dealing (as defined in IRC Section 4941(d));

(b) retaining any excess business holdings (as defined in IRC Section 4943(c));

(c) making any investments in such manner as to subject the foundation to tax under IRC Section 4944; and

(d) making any taxable expenditures (as defined in IRC Section 4945(d)).

The IRS conditioned the ruling on the following: (1) the donor is either a citizen or resident alien of the United States at death; and (2) the trust's operations during the donor's lifetime and the terms of the lifetime and testamentary transfers met the requirements of IRC Section 2055 and 2522.

22. DETERMINATION OF CHARITABLE TAX DEDUCTIONS

***E. Williams Est.*, TC, 45,538; TC Memo 2009-5**

A decedent's will required that the decedent's entire estate, except stock held in Coca-Cola, would pass to a number of charities. The stock, which was held in trust for the benefit of decedent, was bequeathed to certain non-charitable beneficiaries. The trustee of the trust executed an agreement with Coca-Cola, which gave the company the right to purchase the stock from the non-charitable beneficiaries after the decedent's death. The charities entitled to decedent's estate sued the trustee after the decedent's death for constructive sale of the stock and breaches of fiduciary duties. After the suit commenced, the executor of decedent's estate placed the proceeds from the sale into a restricted fund where the non-charitable beneficiaries retained an interest. A settlement was later reached, and the estate claimed an additional estate tax charitable deduction equal to the lesser of the value of the shares and the value of the settlement proceeds.

The Court found that if the settlement was attributable to the constructive sale claim, the estate would be entitled to an additional charitable deduction, because the decedent would have been deemed to not own the stock when she died. Therefore, pursuant to the provisions of decedent's will, the value of the stock would have gone to the charities.

In order to assess whether an additional estate tax charitable deduction was valid, the Court first had to determine what portion of the settlement was attributable to the constructive sale claim, and what sale was attributable to the breach of fiduciary duty claims. After noting that the placement of funds into the restricted fund did not alter the characterization of the settlement, the court determined that based on the likelihood of success on the constructive sale claim as compared to the breach of fiduciary claim, 90% of the settlement was attributable to the constructive sale claim. Accordingly, the estate was allowed an additional charitable deduction equal to the lesser of 90% of the value of the settlement and the value of the shares.

23. NO CHARITABLE DEDUCTION ALLOWED

Technical Advice Memorandum 201004022

An estate was not entitled to an estate tax charitable deduction for the amount paid to a charitable trust pursuant to a settlement agreement. A decedent's will made a number of specific bequests, many of which gave the remainder interest to the charitable trust. However, the will was silent as to the distribution of the residue. As the decedent's sole heir, the decedent's son maintained that he was entitled to the residue through intestacy. The charitable trust claimed that the omission of a residuary clause from the will was a scrivener's error and that it was the decedent's intent that the charitable trust receive residue. The attorney, who prepared decedent's final will, confirmed this in an affidavit. After some negotiation, the son and the charitable trust settled. The application of the federal estate tax deduction are proper when the parties receive the property through an enforceable right under state law. Under the applicable state law there is a preference not to allow the passing of the estate through intestacy. However, when there is a valid will, there is also the presumption that heirs of an estate are not to be disinherited unless it is through the plain language in the testamentary documents. Furthermore, a court is permitted to consider external evidence when interpreting a will only when the language of the will is ambiguous. Because the will itself did not conflict with distribution of the residuary clause through intestacy, there was no reason under state law, and the estate was not entitled to the charitable deduction for the settlement amount.

24. CRT REFORMATION ALLOWANCE

IRS Letter Ruling 201016033

A judicial reformation of a charitable remainder unitrust (CRUT) to eliminate the reference to Section 170(b)(1)(A) in the definition of qualified organization did not cause a trust to fail to qualify as a charitable remainder trust (CRT) within the meaning as distributed to the husband's charitable foundation. The inclusion of Section 170(b)(1)(A) in the definition of a qualifying organization prevented the foundation from qualifying as a charitable remainderman. Rev. Rul. 76-8, 1976-1 CB 179, does not require that the remainder beneficiary of a CRUT qualify under Section 170(b)(1)(A). Furthermore, because the reformation was correcting a scrivener's error and it followed the original intent of the couple, the reformed CRUT did not violate the requirement that a remainder interest to a charity must be irrevocable. Accordingly, the reformation would not have any impact on the trust's qualification as a CRUT.

25. CHARITABLE CONTRIBUTION DEDUCTION DENIED

***Rosser v. Commissioner*, TC Memo 2010-6**

A charitable contribution deduction for a close corporation donation was denied. A corporation could not expense the cost of assets purchased as a going concern in the year purchased rather than in the tax year at

issue.

26. CHARITABLE CONTRIBUTION DEDUCTION ALLOWED—NO STEP TRANSACTION

***Klauer v. Commissioner*, TC Memo 2010-65**

A manufacturing company was entitled to charitable contribution deductions for the transfers of certain real property to a public land trust for the years at issue. Since none of the three (3) tests of the step transaction doctrine applied, the company was entitled to the deductions. The binding commitment test, which is the most restrictive test of the doctrine, did not apply because the trust's funding for land acquisition projects had in the past relied extensively on appropriations by Congress. There was no guarantee that the trust, which had to solicit funds on an annual basis for possible acquisitions, would receive any congressional funding for the purchase of any portion of the real property. The end result test did not apply because the company did not intend to reach a particular result by structuring a series of transactions in a certain way. The trust's exercise of each option that it had under an option agreement and its purchase of portions of the property pursuant to the exercise of those options were not component parts of a single transaction that the company intended and prearranged from the outset to be taken in order to sell the entire property to the trust. Finally, the interdependence test did not apply because the individual steps taken by the parties had independent significance. The trust's exercise of one (1) or more, but not all, of the various options that it had under the option agreement, and its purchase of each of the specified portions of the real property under any such exercise, was not fruitless without the trust's exercise of all of those various options.

27. FAILURE TO OBTAIN QUALIFIED APPRAISALS OR SUBSTANTIATE VALUE CAUSED DENIAL OF CHARITABLE CONTRIBUTION DEDUCTION

***Friedman v. Commissioner*, TC Memo 2010-45**

A couple was denied noncash charitable contribution deductions for two (2) tax years because they neither obtained timely and complete qualified appraisals, nor maintained adequate records related to the donated property. The donations consisted of diagnostic and laboratory equipment that the couple claimed had a value of several hundred thousand dollars. The two (2) written appraisals obtained by the couple did not appraise all the donated equipment and did not indicate the valuation method used. The couple did not otherwise comply with the requirements of Reg. Section 1.170A-13 by providing documents that adequately described, and stated the condition of, the equipment. Moreover, the required contemporaneous written acknowledgment from the donee did not meet the requirements of the regulation. The couple also failed to show substantial compliance with such requirements, including providing information about the manner of acquisition of the donated items and their cost or other basis of valuation.

28. PARTNERSHIP WAS ALLOWED CHARITABLE CONTRIBUTION DEDUCTION

***Consolidated Investors Group v. Commissioner*, TC Memo 2010-158**

A partnership was allowed a charitable contribution deduction for the gift portion of a part-

condemnation/part-contribution piece of real property it transferred to a government agency. The fair market value of the property transferred to the agency exceeded the amount the partnership received, the partnership had the requisite donative intent, and it substantially complied with the applicable substantiation requirements for charitable contributions of property. Moreover, the partnership's appraiser valued the property correctly when he divided the property between land that fronted a state road and that did not.

29. TAXPAYERS FAILED TO SUBSTANTIATE CHARITABLE DEDUCTION TO OTHERS WERE SUBJECT TO ACCURACY-RELATED PENALTIES

***Ramirez v. Commissioner*, TC Memo 2010-108**

Married taxpayers were denied various deductions on their return for failing to keep records and proving that they are entitled to deductions. Specifically, the taxpayers failed to substantiate their charitable deduction relating to contributions of household items and cash, their deduction of expenses related to the business use of their passenger automobile or cellular telephone, and they failed to prove the amounts claimed as capital losses on their return and Schedule A. The IRS satisfied its burden with respect to accuracy-related penalties applied against the taxpayers.

30. TAXPAYER MUST HAVE SUBSTANTIATION FOR CHARITABLE DEDUCTION

***Farber v. Commissioner*, TC Memo 2010-37**

Charitable contribution deductions claimed by an individual were allowed only to the extent she provided substantiation for the expenditures.

31. TRUST QUALIFIED FOR ESTATE TAX CHARITABLE DEDUCTION DESPITE AMBIGUITIES REQUIRING JUDICIAL RESOLUTION

IRS Letter Ruling 201022001; 6/14/2010

The IRS privately ruled that a trust established under a decedent's will for the benefit of various charitable organizations and a municipality qualified for an estate tax charitable deduction despite ambiguities that were resolved by the court.

The will gave payments to two non-charitable beneficiaries to receive payments for life with directions to build several buildings for a named municipality. The remainder of the estate was to be placed in trust with the non-charitable beneficiaries acting as co-trustees to maintain the buildings and benefit several other charities. When requested by the estate to resolve certain ambiguities in the trust document, the court concluded that the decedent intended to create a charitable trust that would qualify for a charitable deduction. Under Code Sec. 2055 it ordered that the non-charitable bequests be determined and distributed under the will and the remainder was to be held in trust for the charities.

The IRS concluded that as long as the requirements of Code Sec. 2055 were satisfied, the trust qualified for an

estate tax charitable deduction.

32. CHARITABLE DEDUCTION ALLOWED WHERE QUALIFIED DISCLAIMER WAS MADE

IRS Letter Ruling 201032002; 9/7/2010

The IRS privately ruled that where a daughter did not retain a discretionary power to direct the enjoyment of the disclaimed property, the disclaimer was a qualified disclaimer within the meaning of Code Sec. 2518.

The daughter was director of a 501(c)(3) private foundation and the beneficiary of a trust created by her parents which was to receive assets of the decedent's trust upon his death. Prior to his death, the decedent amended his trust to provide that the daughter would serve as the sole trustee when he ceased to serve as trustee and that, if she disclaimed any interest in the decedent's trust, the disclaimed assets would pass to the foundation. The daughter disclaimed her interest within nine months of her father's death.

Although she was the sole trustee of the decedent's trust, the IRS ruled that the daughter's actions in her capacity as a fiduciary did not constitute acceptance of the disclaimed property. Pursuant to the foundation's bylaws, the daughter did not retain the discretionary power to direct the enjoyment of the disclaimed property within the meaning of Reg. §25.2518-2(d)(2). The IRS therefore concluded that her disclaimer constituted a qualified disclaimer under Code Sec. 2518 and an estate tax charitable deduction was allowed under Reg. §20.2055-2(c)(1)(i) for the value of the property that passed to the charitable foundation.

33. IRS DENIES EASEMENT DONATIONS BASED ON PROCEDURAL OR REGULATORY NON-COMPLIANCE

***Evans v. Comm'r*, TC Memo 2010-207**

The Court upheld a denial of easement façade donations where Petitioner failed to provide sufficient credible evidence of their fair market value to meet his burden of proof for the claimed charitable contribution deduction.

34. VERY PARTICULAR REQUIREMENTS FOR A QUALIFIED APPRAISAL OF CONSERVATION EASEMENT

***Lord v. Comm'r*, TC Memo 2010-196; 9/8/2010**

A valuation of a conservation easement was deemed not qualified though it included an "effective date," a "report date," and an "estimated market value." The Court stated that a "qualified appraisal must include the date (or expected date) of [the] contribution, the date on which the property was appraised, and the appraised fair market value of the property on the date (or expected date) of the contribution. In addition, the appraisal must be made not earlier than 60 days before the contribution date of the appraised property nor

later than the due date of the tax return on which a deduction is first claimed."

35. SUMMARY OF FAÇADE EASEMENT RULES

***Chief Counsel's Advice 201014056;* 4/9/2010**

Chief Counsel's Office has provided a summary of façade easement rules. The memo covers substantiation of an easement, the requirements of a qualified appraisal, substantial compliance rules for taxpayers who have not strictly complied with the applicable regulations and valuation of a conservation easement.

36. DEDUCTION FOR FACE EASEMENT DENIED

***Kaufman v. Commissioner*, 2010 U.S. Tax Ct. LEXIS 10; 134 TC No. 9**

A married couple who contributed a façade easement and cash to a qualified donee organization was not entitled to a deduction for the façade easement contribution since the interest in the property conveyed by the façade easement was not protected in perpetuity and the contribution did not constitute a qualified conservation contribution. The property had a mortgage and the bank retained a prior claim to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident, and was entitled to those proceeds in preference to the donee organization until the mortgage was satisfied and discharged. Thus, the donee organization's right to its proportionate share of future proceeds was not guaranteed. Summary judgment was denied regarding the disallowance of the deduction for the cash contribution

MARITAL DEDUCTION

37. REASONABLE RELIANCE ON ATTORNEY FOR AVOIDANCE OF PENALTY ON LATE FILING RETURN AND LOSS OF MARITAL DEDUCTION

***K. Lee Est.*, TC Memo 2009-84**

An estate hired an attorney to draft the wills of a decedent and his wife. The wills drafted incorporated a survivorship clause that stated that the decedent would be treated as predeceasing his wife in order to

minimize the taxes owed on their deaths by utilizing the marital deduction. The decedent died 46 days after his wife.

The attorney was also hired to prepare the decedent's estate tax return. The executor had already obtained one (1) six (6) month extension on filing the return, however, the executor needed even more time to file. Based on the attorney's representation, the executor believed that the estate would receive either a second extension of time or a 10-day grace period in the event the extension was denied. Contrary to the attorney's representations, no second extension of time or 10-day grace period was given, and the estate tax return was filed late.

As to the validity of the marital deduction claimed, based on the survivorship provision in the will, the Tax Court held that the marital deduction was properly denied, because the will could not change the order of their deaths for purpose of determining who was the surviving spouse within the meaning of IRC Section 2056(a).

The Tax Court further held that the estate was not liable for an addition to tax under IRC Section 6651(a)(1) (due to the tardiness of the filing of the estate tax return) or an accuracy-related penalty for negligence under IRC Section 6662(a). The Court found that the executor reasonably relied on the advice of the estate's attorney.

38. QTIP ELECTION NULL AND VOID AND NO INCLUSION IN SURVIVING SPOUSE'S ESTATE

IRS Letter Ruling 200918014

Pursuant to the terms of decedent's will, tangible personal property was bequeathed to decedent's spouse. The will also required a creditor shelter trust to be funded with the largest amount that can pass free of estate tax. Upon decedent's death, the value of the estate did not exceed the exclusion amount, so the entire residue passed to the credit shelter. A QTIP election was made in the decedent's tax return as to a portion of the credit shelter trust.

The IRS found that the QTIP election was null and void. According to Rev. Proc. 2001-38, 2001-1 CB 1335, a QTIP election is void if it is unnecessary to reduce the estate tax liability to zero. As such, the IRS ruled that the trust property would not be included in the surviving spouse's gross estate. Moreover, in the event that the spouse disposed of the income interest in the trust, the spouse would not be making a gift under IRC Section 2519. Finally, the IRS found that the surviving spouse would not be treated as the transferor of the property in the trust for GST tax purposes under IRC Section 2652(a).

39. REDUCTION BY CONTINGENT BEQUESTS

Alan Baer Revocable Trust v. United States, 2009 WL 1451577 (D. Neb., May 18, 2009)

In *Baer*, the District Court denies the Government's motion for summary judgment regarding valuation of contingent bequests that would reduce marital deduction.

When Alan Baer died in 2002, he owned stock in the privately held ComoreTel Limited through two (2) partnerships. Baer's revocable trust provided for certain specific bequests of cash to individuals contingent on the eventual sale of the ComoreTel stock at a profit. Essentially, if Baer's interest in ComoreTel was sold and a profit realized, the trustee of his revocable trust was to distribute outright specified amounts to individuals who were set forth in order of priority. If the bequests were not funded prior to the death of Baer's spouse, they were to automatically lapse. The total amount of the contingent bequests was $1,346,000. The balance of Baer's estate of almost $62 million went to fund certain specific bequests to the surviving spouse and to a QTIP marital deduction trust which, according to the federal estate tax return, was to be funded with almost $57 million. The estate valued the contingent specific bequests at $997,763. The estate used a discounted value because it determined that the contingent specific bequests would not be paid, if at all, for six (6) years. The IRS asserted that a non-discounted value of $1,346,000 should be used. If this approach was adopted, the value of the marital deduction would be reduced. Along with other adjustments that the estate did not dispute, the IRS increased the value of the taxable estate from the $245,155 reported on the return to $824,139.

The estate paid the additional tax and filed a claim for refund. The IRS moved for summary judgment because the possibility that the bequests would be paid to someone other than the surviving spouse meant that the bequests should be subtracted from the amount qualifying for the marital deduction. The estate on the other hand argued that the bequests had no value because the estate did not believe that the ComoreTel stock could be sold and a profit realized.

The court rejected the IRS's summary judgment claim and noted that the estate did not argue that the contingent bequests qualified for the marital deduction. Instead, the estate presented evidence that the date of death value of the ComoreTel stock was speculative and overstated. The IRS examiner had acknowledged that the appraisal submitted in connection with the estate tax return was "incomprehensible." As a result, the Government was not entitled to judgment as a matter of law. Instead, the value of the ComoreTel stock would have to be determined.

40. APPORTIONMENT

***McCoy Est.*, TC Memo 2009-61**

In *McCoy*, the decedent's pour-over will and revocable trust did not effectively waive equitable apportionment, and therefore the marital deduction was not reduced.

The decedent had executed a revocable living trust and pour-over will in 1994. The pourover will left all tangible personal property to the decedent's spouse (if she survived) and directed that the residue be paid to the living trust for administration pursuant to that trust instrument. The living trust provided that upon the decedent's death certain specific bequests would be made to family members, with the residue held in trust

for his spouse if she survived. The living trust stated that if the decedent's spouse survived him, payment of estate taxes and all other debts were to be charged to the non-marital share of the trust.

In 1999, the decedent amended the living trust. Among other things, the restated trust agreement said that the trustee "shall pay from the residue of the trust estate prior to any distributions provided for herein, all of the Settlor's debts, expenses of last illness, expenses of disposal of remains, all expenses of trust administration and trust termination, including attorneys' fees, and shall pay all estate taxes, if any, attributable to Settlor's entire taxable estate." On the estate tax return, the decedent's estate claimed a marital deduction of nearly $4 million, the value of all assets in the gross estate except those specifically passing to beneficiaries other than the surviving spouse. In computing the estate tax, the return preparer, using the equitable apportionment scheme provided by applicable state (Utah) law, charged the estate taxes to the specific bequests and not the marital share. Like many other state apportionment statutes, the Utah law applied equitable apportionment, "unless otherwise provided in the will or other dispositive instrument…." UTAH CODE Section 75-3-916(2).

The IRS assessed a deficiency of just over $400,000 on the basis that the estate taxes had to be charged to the marital share, which thus reduced the amount of the marital deduction. After all, claimed the IRS, the quoted language from the restated trust instrument says that the residue is supposed to bear the burden of estate taxes. The estate responded that one could read the reference to the residue as a reference to the residue of the decedent's estate (as described in the pour-over will), which would include all property subject to probate except for the tangible personal property specifically bequeathed to the surviving spouse. In the face of two (2) legitimate interpretations of the wording, argued the estate, there is no evidence of a clear intent to deviate from the state apportionment statute.

The Tax Court sided with the estate, observing that "it is not clear whether decedent intended these provisions to govern the allocation of the taxes at all or whether he merely intended them to be the source of the estate tax payments. The restated trust agreement states that 'The Trustee shall pay from the residue of the trust estate prior to any distributions provided for herein, * * * all estate taxes, if any, attributable to Settlor's entire taxable estate.' (Emphasis added.) While decedent may have intended the word 'from' to indicate that the taxes were to be both charged to and paid out of the residue, this intention is not as clear as the statement in the original trust agreement that 'If the settlor is survived by his wife, payments under this section shall be charged to the Non-marital Share.' The restated trust agreement provides no similar clear guidance as to whether the residue of the restated trust agreement (whether the residue described in the will or in … the restated trust agreement) is also to bear the burden of the estate tax. While it is possible that, as respondent argues, decedent intended for the residue of the trust estate to both be the source of the estate tax payment and bear the burden of the estate tax, we find that this intent is not clear." The court considered several decisions from other courts, especially a decision of the Utah Supreme Court expressing a strong policy preference for the equitable allocation of the tax burden provided in the state statute absent a direction to the contrary in a will or other dispositive instrument that is expressed in terms that are specific, clear, and not susceptible of reasonable contrary interpretation. See *In re Estate of Huffaker*, 641 P.2d 120, 121 (Utah 1982). Since the restated trust was not clear and specific as to how the estate taxes should be apportioned and did not specify which residue those taxes should be paid from, Utah's default equitable apportionment scheme would control.

41. ESTATE NOT ENTITLED TO MARITAL DEDUCTION FOR COMMON LAW SPOUSE

***T.Beat Exrx., DC Kan.,* 2010-2 U.S. TAX CT.; 9/20/2010**

A court estopped the sole beneficiary and executrix of decedent's estate from claiming the marital deduction. The couple had been together for 26 years but had never claimed to be common-law spouses until the beneficiary (girlfriend) learned that she could avoid the estate tax through a marital deduction. Evidence showed that the couple had consistently insisted that they were not married and the duty of consistency denied the beneficiary's attempt to claim otherwise.

42. ESTATE'S CREDIT FOR TAX ON PRIOR TRANSFERS LIMITED; PROTECTIVE QTIP ELECTION UNTIMELY

***Estate of Lucien J. Le Caer and Estate of Marie L. Le Caer*, (2010) 135 TC No. 14**

The Tax Court has held that the Code Sec. 2013(b) and Code Sec. 2013(c) limitations applied to the Code Sec. 2013(a) credit for tax on prior transfers in a decision where a husband and wife died three months apart. Further, it said that the estate of the second spouse to die could not claim the credit for state estate tax paid by the estate of the first spouse to die. The Tax Court also held on the facts that the protective QTIP claim filed by the estate of the fist spouse to die was untimely.

Code Sec. 2013(a) provides for a credit against estate tax liability of a decedent's estate where the decedent received property in a transfer from a person who died within 10 years before, or two years after, the decedent's death. The transfer is subject to estate tax in the transferor's estate. If the transferor died within two years of the death of the decedent, the decedent's estate may claim as a credit the amount determined under Code Sec. 2013(b) and Code Sec. 2013(c), under which the allowable credit is subject to the smaller of two limits: the amount of the federal estate tax attributable to the transferred property in the transferor's estate, or the amount of the federal estate tax attributable to the transferred property in the decedent's estate.

Generally, an estate may deduct from the value of the gross estate the value of property passing from the decedent to his surviving spouse (the marital deduction), but there is no marital deduction for terminable interest property under Code Sec. 2056. An exception to the terminable interest rule for a QTIP (qualified terminable interest property) is granted in Code Sec. 2056(b)(7). Three requirements must be met for terminable interest property to qualify as a QTIP: 1) the property passes from the decedent, 2) the surviving spouse has a qualifying income interest for life in the property, and 3) the executor of the estate of the first spouse to die makes an affirmative election to designate the property as a QTIP. Upon the death of the surviving spouse, the value of his gross estate includes the value of the QTIP.

The executor of the estate must make the QTIP election with respect to property on the decedent's "return of tax imposed by Code Sec. 2001" – the last estate tax return filed by the executor on or before the due date of the return, including any extensions. If the estate does not file a timely return, the quoted phrase means the first estate tax return filed by the executor after the due date. The executor of the estate of the first spouse to

die may make a protective election to treat property as a QTIP if the executor reasonably believes that there is a bona fide issue when the federal estate tax return is filed and it concerns whether an asset is includable in the decedent's gross estate or the amount or nature of the property the surviving spouse is to receive. Such an election must identify the specific asset, group of assets, or trust to which the election applies and the specific basis for the protective election. (Reg. §20.2056(b)-7)

In this matter, the Tax Court agreed with the IRS regarding the claims of the second deceased spouse's (wife's) estate. Regarding credit sought for prior transfers, the Tax Court held that nothing that nothing in Code Sec. 2013 or the Regs. would condition the application of Code Sec. 2013(b) and 2013(c) as the estate suggested, and concluded that both limitations applied. It also rejected the estate's claim that state estate taxes paid by the first deceased spouse's (husband's) estate qualified for the credit for tax on prior transfers under Code Sec. 2013, as the code specifically applies to "federal estate tax."

The Tax Court further disallowed a claim by the wife's estate that her amended return had increased allowable deductions, and had overpaid with respect to her husband's estate which was not reduced by the tax liabilities. The Court said that the claim failed to prove that the value of the wife's estate was overstated and the estate failed to introduce any evidence to show that the federal and state estate taxes with respect to her husband's estate were in fact paid with assets of her estate, or that the Form 706 filed on behalf of the wife's estate incorrectly reported the estate's assets.

The Tax Court also agreed with the IRS that the QTIP protective claim filed by the husband's estate was invalid. The Tax Court said that the Regs. explain in detail the time and manner for making the QTIP election and the filing for protective election on the wrong form three years after the due date of the decedent's return was untimely.

43. EXECUTOR GRANTED EXTENSION OF TIME TO MAKE QTIP ELECTION

IRS Letter Ruling 201020002; 6/7/2010

The IRS privately ruled that a decedent's estate was granted an extension of time to make a qualified terminable interest property election (QTIP). Because the estate had acted reasonably and in good faith and had neglected to make the QTIP election only due to intervening events outside of the estate's control, the requirements of Reg. §301.9100-1 and -3 were satisfied. The estate was therefore granted a 60-day extension of time to make the election.

44. EXTENSION TO MAKE QTIP ELECTION FOR A TRUST GRANTED

IRS Letter Ruling 201025021; 8/2/2010

The IRS has ruled that a grantor who created an irrevocable trust for the benefit of her spouse was granted an extension of time to make a qualified terminable interest property (QTIP) election under Code Sec. 2523(f)(2) for the transfer of stock to the trust.

The law firm that prepared and filed the gift tax return for the grantor neglected to make the QTIP election on the return where the terms of the trust provided for the health, education, maintenance and support of the spouse of the deceased until his death at which time the trust was to be divided among the spouse's children or deceased children's issue.

The IRS determined that the requirements of Reg. §301.9100-3 for an extension of time were satisfied because the couple reasonably relied on the advice of a qualified tax professional and the interests of the government would not be prejudiced.

GENERATION SKIPPING

45. EXTENSIONS OF TIME FOR SEVERING MARITAL TRUST FOR GST PURPOSES

IRS Letter Ruling 200925008

A decedent's will created two (2) marital trusts (A & B). Upon the death of the decedent's surviving spouse, the corpus of Trust A was to be distributed to the decedent's grandchildren, while Trust B was to be distributed to the decedent's daughter. The executrix, the decedent's daughter, made a qualified terminable interest property ("QTIP") election as to both Trust A and Trust B. Thereafter, the executrix made a reverse QTIP election as to Trust A (the executrix hired a tax attorney to assist her in her decision making). The executrix allocated the decedent's generation-skipping tax ("GST") exemption to Trust A, but due to the amount of funding, a zero inclusion ration as to Trust A did not occur. The executrix then requested an extension of time to make an election to treat Trust A as two (2) separate trusts for GST tax purposes, pursuant to Treas. Reg. section 26.2652-2(c).

The IRS granted the executrix a 60-day extension to make an election to treat Trust A as two (2) separate trusts. Trust A was to be split into a GST exempt trust and a GST nonexempt trust. The exempt trust was to be funded in an amount determined by multiplying the current fair market value ("FMV") of the entire trust by a fraction; the numerator being the amount of GST exemption originally allocated to Trust A, and the denominator being the amount passing to Trust A under decedent's will. The non-exempt trust was to be funded with the balance of Trust A's corpus.

The IRS granted the extension, reasoning that executrix acted reasonably and in good faith and that granting relief would not prejudice the government's interest. As such, the IRS held that the executrix satisfied the requirements of Treasury Reg. Section 301.9100-1, 3. The IRS noted that under Treasury Reg. Section 301.9100-3(b)(1)(v), a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relies on a tax professional, who failed to make or who failed to advise the taxpayer to make an

election.

46. EXTENSION FOR GST ALLOCATION GIVEN

IRS Letter Ruling 201006008

A donor and her spouse were granted extensions of time to allocate their generation-skipping transfer (GST) tax exemptions to irrevocable trusts set up to benefit their children and children's issue. These trusts were funded with shares of stock in a company. Pursuant to Section 2513, the couple intended to treat the transfer as made one-half (1/2) by the donor and one-half (1/2) by the spouse. Although the company's CFO was responsible for directing and overseeing the preparation of all tax returns of the donor and her spouse and was notified by attorneys that the couple needed to file a gift tax return to report the gift and allocate their GST to the trusts, the CFO inadvertently failed to retain an accounting firm to prepare the couple's gift tax returns. No taxable events have occurred with respect to the trusts that would result in any beneficiary being subject to a GST tax liability. In addition, the couple was found to have met the requirements of Reg. Section 301.9100-3. Therefore, the donor and her spouse were granted 60-day extensions to file the gift tax return, elect gift-splitting, and allocate their GST exemptions to the transfers.

47. NO 2041 INCLUSION DUE TO REFORMATION AND NO LOSS OF GST EXEMPT STATUS

IRS Letter Ruling 201006005

The reformation of a trust to conform to the intent of the trustor at the time of execution of the trust, relating back to the date that the instrument was executed, did not cause the trust to be included in the gross estate of the trustor's son under Section 2041. A court order reformed the trust to correct a scrivener's error to clarify that the trustor's son, a beneficiary of the trust, never possessed a general power of appointment with respect to the trust. The reformation resolved a bona fide issue and was consistent with applicable state law. Accordingly, the son held a limited power of appointment under the terms of the reformed trust, and the reformation did not result in a taxable gift, nor did it cause the trust to lose its generation-skipping transfer (GST) tax exempt status.

48. SETTLEMENT AGREEMENT DOES NOT CAUSE GST TO DISTRIBUTIONS TO TAX UNDER 1985 TRUST

A settlement agreement concerning trust distributions to beneficiaries of a trust - the children and grandchildren of the trustor's son - was within the range of reasonable outcomes under Reg. Section 26.2601-1(b)(4)(i)(B)(2) and did not cause distributions from the trust to be subject to generation-skipping transfer (GST) taxes. The irrevocable trust was created and funded prior to September 25, 1985. The settlement agreement clarified which individuals were the beneficiaries of the trust. It also set fixed distributions for certain beneficiaries and the terms for certain discretionary distributions. The agreement did not shift a beneficial interest in the trust to any beneficiary who occupied a lower generation than the person who held the beneficial interest prior to the modification. Nor did it extend the time for the vesting of any beneficial interest in the trust beyond the period of 21 years after the death of the last to die of the beneficiaries in being at the time the trust became irrevocable.

49. EXTENSION OF TIME GIVEN FOR GST ALLOCATION

IRS Letter Ruling 201010005

A decedent's estate was granted an extension of time, pursuant to Section 2642(g), to allocate the decedent's available generation-skipping transfer (GST) tax exemption to transfers made to two (2) trusts. Prior to December 21, 2000, the decedent created two (2) irrevocable trusts (Trust A and Trust B). Trust A was created for the benefit of the decedent's son, his spouse, and his issue and was funded with a certain percentage of a limited partnership. Trust B was created for the benefit of the decedent's daughter and her issue and funded with a certain percentage of a second limited partnership. The decedent retained an appraiser to determine the value of the gifts and hired an accountant to complete the gift tax returns. The decedent's gift tax returns were audited, and the value of the gifts were adjusted. After the decedent's death, the executrix discovered that the accounting firms had failed to allocate a portion of the decedent's GST exemption to the trusts. It was determined that the decedent had reasonably relied on a tax professional who had failed to allocate or advise the decedent to allocate a portion of the decedent's available GST exemption to each trust. The inclusion ratio with respect to each trust was to be determined based on the adjusted value of the gifts.

50. MODIFICATION AND DIVISION DID NOT CAUSE GST INCLUSION

IRS Letter Ruling 201011002

The modification and division of three (3) irrevocable trusts into separate and equal trusts did not cause the trusts to lose their exempt status for generation-skipping transfers (GST) tax purposes under Section 2601. The original trusts were partitioned and merged into six (6) resulting trusts that were governed by the same provisions of the original trusts, except that the distribution provisions were modified. Under the resulting trusts, the principal was to be distributed to the issue of a deceased child of the grantor upon the child's death rather than upon the death of the survivor of the grantor's children. The division of the trusts did not result in a shift of any beneficial interest to any beneficiary who occupied a generation lower than the persons holding the beneficial interests prior to the division and did not extend the time for the vesting of any beneficial interest in the new trusts beyond the period provided for under the original trust. Accordingly, the transfers did not affect the GST tax-exempt status of the trusts. In addition, the modification and division did not result in a gratuitous transfer of an interest in the original trusts to any beneficiary. Thus, the transfers did not result in a taxable gift under Section 2501 for federal gift tax purposes. Furthermore, the division of the trusts did not cause the legal entitlement and interests prior to the division. Because the beneficiaries held essentially the same interest before and after the division, the transaction did not result in the realization of any gain or loss from a sale or other disposition of assets of any of the trusts under Section 1001.

51. GST TAX IMPOSED DUE TO GENERAL POWER

***Timken v. U.S.*, 2008 U.S. Dist. LEXIS 43543 (D. Neb., May 18, 2009)**

A decedent's general power of appointment over a generation-skipping transfer (GST) grandfathered trust coupled with the qualified disclaimers of her nieces and nephew resulted in direct skips, which were properly subject to GST tax. The decedent's predeceased husband created the trust, which became irrevocable on his death in 1968. No additions to the trust were made after September 25, 1985. Pursuant to the trust agreement, the decedent received a testamentary general power of appointment, which lapsed at her death. Several of the trust's beneficiaries, disclaimed their interest, causing their interest in the trust to pass to their children. Following E. Gerson Est., the GST grandfathering exemption did not apply to GST transfers that result from an exercise or lapse of a general power of appointment over grandfathered trusts. Furthermore, because the trust assets remained in trust after the estate taxes attributable to the inclusion of the trust property were includible in the decedent's gross estate due to the power of appointment, a constructive addition to the trust was deemed to have occurred. Thus, at the lapse of the general power of appointment, the trust assets were treated as though they were withdrawn and then re-contributed to the trust. Accordingly, those trust assets passing to the decedent's great-nieces and great-nephews were properly subject to the GST tax.

52. MODIFICATION OF TRUST DID NOT CAUSE LOSS OF GST STATUS

IRS Letter Ruling 200902009

An irrevocable trust was established for the benefit of Grandson, wherein the Grandson was to receive all of the net income. The trustee had the sole discretion to distribute the corpus to Grandson. Upon Grandson's death, his descendents would become the primary beneficiaries. The trust was to terminate if the trustee distributed all of the trust income and corpus to the Grandson.

In order to generate trust income, the trustee placed securities in a custodian account with a financial services corporation. However, regulations were enacted by the Office of the Comptroller of Currency which required the trustee to maintain custody of all Trust assets. In order to comply with the regulation, the trustee placed all of the securities into a limited partnership created by the trustee. The trust became a 99.9% limited partner, and also created an LLC for purposes of becoming the partnership's .1% general partner. The partnership and LLC agreements required distribution to the trust of the net income generated by the partnership.

The IRS found that amending the trust to distribute the securities to the partnership in exchange for a partnership interest did not cause the trust to loose its generation skipping transfer tax exempt status under IRC Section 2601. The IRS reasoned that because the transaction did not alter the trustee's requirement to distribute the trust's net income or change the date of the trust's termination, there was no shift in a beneficial interest to a lower generation beneficiary and did not extend the vesting of a beneficial interest. As such, the trust maintained its generation skipping transfer tax exempt status. The IRS also found that since the value of the partnership interest did not exceed the value of the securities placed into the partnership, there was no addition to the trust within the meaning of IRC Section 2601.

Finally, the IRS ruled that because the partnership was required to distribute the net income generated from

the partnership's operations, which was equivalent to the amount of income the Grandson was entitled to receive under the Trust, there was no change in the beneficial interest of any beneficiary. Accordingly, no trust beneficiary was held to have made a taxable gift under IRC Section 2501.

53. MODIFICATIONS DID NOT CAUSE ESTATE INCLUSION OR LOSS OF GST EXEMPT STATUS

IRS Letter Ruling 200919008

Grantor established a series of irrevocable trusts for the benefit of his children. Grantor also created another irrevocable trust with his spouse for the benefit of their children and other family members. The Grantor then modified a number of aspects of both trusts, including: the investment policy, provisions regarding the religious affiliation of the trustees, and the delegation of management and investment duties. The Grantor's power to amend the trusts was derived from a state statute which required the consent of all trust beneficiaries.

In determining whether the modifications to the trusts resulted in inclusion of the trust's assets in the gross estate of the grantor, the IRS relied on the nature of the modifications to determine whether the assets were includable. The IRS found that the modifications were administrative in nature as they did not change any beneficial interests in the trusts. Because no beneficial interests were changed, the modifications did not cause any beneficiary to be treated as making, or as having made, a transfer of trust property or an interest in any of the trusts.

The IRS also found that the modifications did not cause the trusts to loose their GST exempt status. Because the modifications were made in accordance with state law and did not result in a transfer of a beneficial interest to any lower generation beneficiary, and since the modifications did not extend the time for vesting of any beneficial interest beyond the period provided for in the trusts, the trusts would maintain a zero inclusion ratio.

54. NONQUALIFIED DISCLAIMERS REDUCE GST TAX

IRS Letter Ruling 200901013

In Private Letter Ruling 200901013, the IRS held that the use of nonqualified disclaimers by beneficiaries of a generation-skipping trust could render the beneficiaries the new transferors for GST tax purposes, thereby reducing GST taxes on further taxable distributions and terminations.

A married couple established an irrevocable trust for the benefit of their children. Upon the death of the couple, the trust is to be divided into separate shares for the then living children, if a child predeceased the couple, the child's spouse and children would each receive a portion of the child's share. The children proposed to execute nonqualified disclaimers of their entire interests in the trust.

Because the disclaimers were not made within nine (9) months of the transfer creating the children's/ disclaimants' interest, the disclaimer was not qualified. The IRS ruled that the disclaimers would be transfers subject to federal gift tax under IRC Section 2501, and that the disclaimed property would be treated for federal gift, estate, and GST tax purposes as passing from the disclaimants (children) to the person entitled to receive the property as a result of the disclaimer (grandchildren). Because the disclaimants were not a generation that is two (2) or more generations above a grandchild of the couple/settlors, a grandchild of the settlors would not be a skip person, as defined in IRC Section 2613, with respect to such portions of the trust. The trust will be subject to GST tax only as to interests held by the settlors' grandchildren at the time of the disclaimers. Finally, the IRS rules that the portions of the trust that were disclaimed would not be subject to GST tax upon further distributions to the grandchildren.

55. TRUST AMENDMENT TO DEFINITION OF ISSUE RESULTS IN GIFT TO BENEFICIARIES BUT NOT LOSS OF GST EXEMPT STATUS

IRS Letter Ruling 200917004

Settlor created a trust for the benefit of his sister and her descendants. According to the definition of "issue" and "descendants", as used in the trust, the definition did not include legally adopted issue. Later, an amendment was requested to the trust wherein the definitions of issue and descendants would be changed to include legally adopted issue. At the time of the amendment, the sister had one (1) adopted grandchild and two (2) adopted great-grandchildren.

The IRS found that the amendment resulted in a gift to the adopted grandchild and great-grandchildren. The addition of the adopted relatives as beneficiaries reduced the beneficial interests of the sister's non-adopted grandchildren and great-grandchildren. Therefore, under IRC Section 2501, each of the non-adopted beneficiaries made a taxable gift of the portion of their beneficial interest relinquished due to the amendment.

As to the status of the trusts GST tax-exempt status, the IRS ruled that because the amendment only caused a shift in beneficial interests to beneficiaries in the same generation, and since the amendment did not extend the time for vesting of any beneficial interest beyond the period provided for in the original trust, the trust did not lose its GST tax-exempt status.

56. LATE GST ALLOCATION ALLOWED

IRS Letter Ruling 201001003

A donor's predeceased spouse's estate was granted an extension of time to allocate the estate's generation-skipping transfer (GST) tax exemption to transfers made to two (2) trusts. The couple intended to allocate GST exemption to the transfers. However, the firm hired by the couple to prepare their federal gift tax returns failed to make the allocations. The firm's failure to allocate the couple's GST exemption was not discovered until the spouse's federal estate tax return was being prepared. In accordance with Notice 2001-50, 2001-2 CB 189, and Code Sec. 2642(g)(1)(B), the request for an extension of time was governed by Reg. Section

301.9100-3. The spouse met the requirements of Reg. Section 301.9100-3 because the spouse acted reasonably and in good faith and granting extension of time to allocate GST exemption to the transfers to the trusts. Although the allocations would be treated as being made on the date of the transfers, the IRS specifically did not rule on whether any transfer made by the spouse would be subject to an estate tax inclusion period under Section 2642(f) and, consequently, the effective date of the allocations. Furthermore, the IRS specifically did not rule on the transfer tax value of the transfers to be used in determining each trust's inclusion ratio.

57. EXTENSION TO ALLOCATE GST GRANTED

IRS Letter Ruling 201014032

A grantor and spouse were given an extension of time to allocate their generation-skipping transfer (GST) exemptions to their respective transfers to a charitable lead annuity trust (CLAT) pursuant to Section 2642. After the couple created the CLAT, the grantor transferred a number of shares of publicly traded stock to the trust. Under the terms of the CLAT, charitable organizations were to receive an annuity for a period of years, and the remainder was to be distributed to certain skip persons. The couple's CPA told them that he would file the federal gift tax return on their behalf; however, he neglected to do so. After the couple discovered that no gift tax return had been filed, they retained an accounting firm to complete the return.

58. TRANSFER BY NONRESIDENT ALIEN NOT SUBJECT TO GST TAX

IRS Letter Ruling 20103202; 9/10/2010

The IRS has held that a nonresident alien donor's transfer of the naked title of her shares in a holding company to her U.S. resident alien daughter and U.S. grandchildren did not subject the donor to gift or generation-skipping (GST) tax. The donor was not a U.S. citizen and the assets transferred were shares of an entity that was not a U.S. corporation. Therefore, the IRS found that the transfers to the daughter and grandchildren were not subject to gift tax under Code Sec. 2501(a)(2). Additionally, although the grandchildren were skip persons, the transfers were subject to the GST tax only to the extent that the transfers were also subject to the gift tax, pursuant to Reg. §26.2663-2.

In this matter, neither the gift tax nor the GST tax applied to the transfers by the donor. The donees were required to complete and file Part IV of Form 3520, the Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, with the IRS on or before the due date of the donees' federal income tax returns for the taxable year during which the gift was received.

QPRTS

59. QPRT RULES CLARIFIED

IRS Letter Ruling 200904022

A father owned a residence, and deeded it to a trust with the condition that he would possess, occupy, and maintain an interest in the residence for a term of years. The father was both the settlor and trustee of the trust. At the expiration of the term, the father's interest was to expire and continue for the benefit of his children. The trust was intended to qualify as a qualified personal residence trust ("QPRT") under IRC Section 25.2702-5(c). The father later modified the provisions of the trust to provide that upon the expiration of the father's term of years, the trustee could liquidate the trust or provide a gift of a term interest in the property to anyone chosen by the children (the remainder beneficiaries).

After the term expired, the father's interest and the remainder passed to his children. Thereafter, the children transferred their interest in the residence to a second trust which was also intended to be a QPRT. According to the provisions of the second trust, the father would be granted a term interest in the residence.

The IRS ruled that IRC Section 2702 did not apply to the transfer of the residence from the children to the second QPRT. The IRS reasoned that 2702 would not apply to the transfer as long as: (1) the second trust instrument is substantially similar to the sample in section 4 of Rev. Proc. 2003-42; (2) the trust operates in a manner consistent with the terms of the trust instrument; (3) the second trust is a valid trust under applicable local law; and (4) the residence qualified as a personal residence under 25.2702-5(C)(2).

60. SALE OF REMAINDER INTEREST ALLOWED

IRS Ruling 200919002

IRS has issued favorable rulings to a taxpayer who transferred a residence to a trust, retaining a life interest and selling the remainder to a second trust. The IRS ruled that the property transferred was a personal residence for purposes of the exception to the full valuation rule of IRC Section 2702 for personal residence trusts and that no gift arose on the sale of the remainder.

In the ruling, Husband and Wife had transferred a residence to a QPRT. Under the terms of the QPRT, the trustee was to hold property for the exclusive rent-free use by Husband and Wife. Upon the death of the survivor of Husband and Wife, the trustee was to distribute the remaining assets of the QPRT to the trustee of the "Purchasing Trust".

After the transfer to the QPRT, the Purchasing Trust will transfer to Husband and Wife marketable securities with an FMV equal to that of the remainder interest each is transferring to the Purchasing Trust as determined using the IRC Section 7520 valuation tables. Husband and Wife intend to use the property for residential purposes, and the Purchasing Trust was funded in an unrelated transaction before the current transaction was proposed.

The IRS reasoned that this transaction was indeed a sale of the remainder interest to the Purchasing Trust with the retention of a life estate by Husband and Wife. Accordingly, assuming the QPRT satisfied the QPRT

rules, Husband's and Wife's retained interests in the QPRT would be valued under the IRC Section 7520 valuation tables.

As a result, the IRS concluded that there was no gift as a result of the sale to the Purchasing Trust since the consideration paid was equal to the FMV under the IRC Section 7520 tables.

Note: If these regulations are finalized, valuation rules will be imposed on QPRTs.

61. SECTIONS 2702(A)(1) AND (2) DOES NOT APPLY TO QPRT MODIFICATION BUT SECTION 2036 MAY

IRS Letter Rulings 200935004, 201006012, 201014044, 201019006

Many private letter rulings were issued in 2010 regarding the validity of reverse QPRTs, where the owner of a residence places the residence in a trust, transfers a term interest to another, and retains the reversionary interest for himself. Therefore, the donor is charged with making a gift of the value of only the term interest in the property. Reverse QPRTs have become increasingly popular in today's economy because of low interest rates and the relatively low present value of right to use real property.

In PLR 200935004 (August 28, 2009), the IRS allowed the initiation of a reverse QPRT at the end of an original QPRT. In this case, a mother transferred her residence into a trust and retained a right to possess the residence for a number of years, with her children taking the reversion (a straight QPRT). At the end of the mother's term interest, the children sought to transfer their reversion interest in the residence to another trust and give the mother a right to possess the residence, with the children again retaining a reversion (a reverse QPRT). IRS approved the creation of the reverse QPRT as long as: (1) the trust instrument was substantially similar to the sample in section 4 of Revenue Procedure 2003-42; (2) the trust operated in a manner consistent with the terms of the trust instrument; (3) the trust was valid under applicable local law; and (4) the residence qualified as a personal residence as defined in Treas. Reg. § 25.2702-5(c)(2).

PLRs 201006012 (February 12, 2010) and 201014044 (April 9, 2010) involved a similar situation in which settlors and their children wanted to amend trust instruments to allow the settlors to have a secondary term interest in the residence once their initial term interests expired and the children received the reversionary interest. IRS approved these amendments so long as they met the four part test established above. Furthermore, in PLR 201019006 (May 14, 2010), IRS allowed the modification of two QPRT trusts, one created by the mother and one created by the father, into reverse QPRTs allowing each of the mother and father to retain a 50% term interest in the residence. IRS further held that the children, who held the reversion interests, were gifting term interests in the residence to the mother and father under IRC section 2501.

GIFT TAX

62. GIFT OF LIMITED PARTNERSHIP INTEREST INSUFFICIENT TO CREATE A PRESENT INTEREST IN THE GIFT

Price v. Commissioner, TC Memo 2010-2

In *Price*, the Tax Court held that the gift of a partnership interest did not qualify for the annual gift tax exclusion because it was a gift of a future interest as defined in Code section 2503(b). *Price* provides an example of the types of restrictions on a partner's right to partnership income that will affect the characterization as a present or future interest for purposes of the gift tax exclusion.

Code section 2503 allows a donor to exclude a specified amount of each gift to each donee ($13,000 in 2010), provided that the gift is not of a "future interest". A gift of a partnership interest is a particularly troublesome context in which to analyze the future interest rule because a partner's ability to receive income is subject to the terms and conditions of the partnership agreement. In *Hackl, v. Comm'r.,* 118 TC 279, 293-94 (2002), aff'g 335 F.3d 664 (7th Cir. 2003), the Tax Court articulated a standard by which to evaluate whether a gift of a partnership interest is one (1) of a present interest:

> "[The authorities] require a taxpayer claiming an annual exclusion to establish that the transfer in dispute conferred on the donee an unrestricted and non-contingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. In other words, petitioners must prove from all the facts and circumstances that in receiving [a partnership interest], the donees thereby obtained use, possession, or enjoyment of the [interest] or income from the units within the above-described meaning of section 2503(b)."
> To satisfy the present interest requirement under Hackl, it must be shown that (1) the partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained.

The partnership owned rental real estate, and therefore, the court found that the first prong was met. But the court characterized the gift as a future interest because the record failed to show that any ascertainable portion of the income would flow steadily to the donees.

The partnership agreement placed significant restrictions on the partnership's distribution of profits. For instance, partnership profits were distributed at the discretion of the general partner unless directed otherwise by a majority of the interests of all partners. Further, the partnership agreement stated that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments." Though there were potential options for the donees to satisfy the second and third prongs, the court found these contingencies to be extremely unlikely and inconsistent with the nature of the partnership. Accordingly, the court held that the gift was not of a present interest.

Price illustrates the importance of the nature and extent of restrictions on partnership assets that will nullify the annual gift tax exclusion. While a *Price* result can be avoided through careful planning and ensuring that

donees will be entitled to withdraw an ascertainable amount from the partnership, the average partnership agreement will probably not pass muster under *Hackl*. Use of lapsing Crummey rights (such as is done in the case of a trust) is one way of potentially addressing this concern.

63. NO ANNUAL EXCLUSION ON LLC GRANTS

Fisher v. U.S., **105 A.F.T.R.2d 2010-1347 (S.D. Ind. 2010)**

A husband and wife's transfer of membership interests in a limited liability company (LLC) to each of their seven (7) children failed to qualify for the annual gift tax exclusion because the transfers were of a future interest in the underlying property. The couple gave each of their children a 4.76% membership interest in the LLC, whose primary asset was an undeveloped plot of lake-front property. Under the terms of the operating agreement, both the children's' right to receive distributions, as well as their right to transfer their membership interests were significantly restricted, preventing them from retaining a "substantial present economic benefit" in the property. Thus, the gifts were not of a present interest in the LLC, and they did not qualify for the annual gift tax exclusion under Section 2503.

64. OPERATION OF COMMUNITY PROPERTY LAWS DID NOT RESULT IN GIFTS

IRS Letter Ruling 201021048; 6/7/2010

The IRS has privately ruled that the treatment of a taxpayer and his domestic partner's earnings as community property did not result in a transfer of property between the couple for purposes of the federal gift tax.

The California state government enacted Senate Bill 1827, effective January 1, 2007, which began treating earned income of registered domestic partners as community property for state income tax and property law purposes. The IRS ruled that when earnings are treated as community property under state law, half of the earnings vest with each spouse for federal tax law purposes. The cases it cited were determined with respect to the income tax, but the IRS found that the Supreme Court's rationale also applied to gift taxes. *H.G. Seaborn*, SCt, 2 U.S. TAX CT. ¶611, 282 US 101; *R.K. Malcolm*, SCt, 2 U.S. TAX CT. ¶650, 282 US 792.

The IRS also ruled that the taxpayer and his partner must each report one-half of their combined community income and each was entitled to one-half of the credit for income tax wage withholding imposed on the earned income component. This position is consistent with California's treatment but contrary to its previous position.

65. STEP TRANSACTION DOCTRINE APPLIED TO TREAT LLC TRANSACTIONS AS GIFTS

***Pierre*, TC Memo 2010-106**

The Tax Court has applied the step transaction doctrine to collapse four gift and sale transfers of interests in an individual's limited liability company (LLC) into transfers of two 50% interests in the LLC. The court then provided discounts for lack of control and lack of marketability.

In the first case, the court held that transfers of interests in a single-member LLC, that was treated as a disregarded entity under the check-the-box Regs., were to be valued for gift tax purposes as transfers of interests in the LLC. It rejected the IRS's position that the transfers should be valued as transfers of proportionate shares of the underlying assets owned by the LLC. As a result the transfers were subject to valuation discounts for lack of marketability and control.

In the second case the Tax Court addressed whether the step transaction doctrine should be applied to collapse the gift and sale transfers into transfers of two 50% interests in the LLC. It agreed with the IRS noting that the step transaction doctrine embodies substance over form principles. It treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Whether several transactions should be considered integrated steps of a single transaction is a question of fact. Here, they all occurred on the same day with minimal time between them. Additionally, there was evidence that the individual intended to transfer her entire interest in the LLC to the trusts without paying any gift taxes. The Tax Court found that the multiple steps taken were all for one transaction, divided to avoid gift taxes.

Next, the Tax Court had to determine whether the lack of control and marketability discounts the individual reported should be reduced. Weighing the evidence, the court found that there should be a slight reduction in the lack of control discount and no reduction in the discount for lack of marketability.

2053

66. ESTATE FAILS TO MEET BURDEN OF PROOF TO RECEIVE ATTORNEY'S FEES

***Rayford L. Keller, et al., v. US*; 2010 U.S. Dist. LEXIS 96465**

The estate did not meet its burden of proof to establish that the attorney's fees, for which it claimed a deduction, were necessarily incurred in the administration of the estate. The estate did not provide any evidence related to the amount of fees or the work which the attorney did for the estate. In addition, the estate also failed to demonstrate that the decedent had not previously made unreported taxable gifts. In both instances, the estate did not satisfy the burden-shifting requirements of Section 7491(a). Therefore, the estate was not entitled to the deduction for attorney's fees and the value of the taxable gifts was includible in the decedent's gross estate.

67. COURT USES POST-2053 SETTLEMENT TO VALUE CLAIM AGAINST ESTATE AND DEDUCTION NOT ALLOWED FOR UNCERTAIN INCOME TAX LIABILITY

***Marshall Naify Revocable Trust v. U.S.*, 106 AFTR 2d 2010-6236 (N.D. CA.)**

A U.S. District Court in California held that a decedent's estate was limited to a deduction under Code Sec. 2053 for the amount of state income tax paid following a settlement agreement between the estate and the state taxing authority and not the potential income tax liability that could have been incurred. The decedent was a resident of California who had formed a wholly-owned Delaware investment corporation with its principal office in Nevada. The estate was precluded from seeking an estate tax advantage by taking the position that the corporation was not a legitimate Nevada entity while gaining an income tax advantage by arguing the opposite position.

The Northern District of California ruled where an estate came to a settlement agreement on income tax owed, it can only claim income tax liability at the amount settled upon. The Court used four tests:

1. The Ascertainable Value Test: Under 26 C.F.C §20.2053-1(b)(3), a gross deduction against the gross estate for a claim against the estate for an amount that "is ascertainable with reasonable certainty, and will be paid" is allowed.

2. The Will Be Paid Test: Under the same statute, the court determined that the liability failed the "will be paid" test.

3. Whether Post-Death Events Should Be Considered: Based on Propstra v. United States, Ninth Circuit precedent states that post-death events are relevant for disputed claims. 680 F.2d 1248.

4. Judicial Estoppel: The Estate stated that the company was a legitimate Nevada corporation, which would have avoided the [California] income tax assessment, and could not thereafter take the opposite position to gain advantage.

2035

68. GIFT TAX PAID IS NOT INCLUDABLE IN ESTATE OF NONRESIDENT ALIENS

Chief Counsel; Advice Memo (6/1/2010)

An IRS legal memo has concluded that the Code Sec. 2035(b) gift tax gross-up rule does not apply to the payment of a gift tax by a nonresident alien within three years of death. As a result, the amount of the gift tax is not includable in the U.S. estate of such an individual.

An individual who transferred an interest in, or relinquished a power over, any property within three years of death, must include the value of the property in his gross estate to the extent it would have been included in his gross estate under Code Sec. 2036 (transfers with retained life estate), Code Sec. 2037 (transfers taking

effect at death), Code Sec. 2038 (revocable transfers), or Code Sec. 2042 (life insurance proceeds), if the interest or relinquished power has been retained (Code Sec. 2035(a)). This rule doesn't apply to any bona fide sale for full and adequate consideration (Code Sec. 2035(d)).

Under the "gross-up rule", a decedent's gross estate must be increased by the amount of any gift tax paid by the decedent or his estate on any gift made by the decedent or his spouse during the three-year period ending on the date of the decedent's death (Code Sec. 2035(b)).

Estates of decedents who, at the time of death, were neither citizens nor residents of the U.S. (nonresident aliens), are subject to estate tax on property situated within the U.S. determined as provided in Code Sec. 2031 (Code Sec. 2101, 2103). Any property transferred by a nonresident alien, whether the transfer is by trust or otherwise, within the meaning of Code Sec. 2035 through 2038, is deemed to be situated in the U.S., if it was so situated either at the time of the transfer or at the time of the decedent's death (Code Sec. 2104). The memo stated that the language in Code Sec. 2104(b) requires that the decedent gratuitously transfer such property before it will be deemed situated in the U.S. The payment of a gift tax is not a gratuitous transfer within the meaning of Code Sec. 2035 to 2038 for the purposes of Code Sec. 2104(b), according to the memo.

Taking into account the legislative purpose of the gift tax and the language of Code Sec. 2035(a) and (b), the transfers considered under Code Sec. 2104(b) logically apply to transfers under Code Sec. 2035(a). Consequently, the payment of gift tax considered made under Code Sec. 2035(b) is not a transfer within the meaning of Code Sec. 2035 to 2038. It is therefore not property that is deemed situated in the U.S. at the time of payment of the tax under Code Sec. 2104(b). Accordingly, the nonresident alien's gross estate is not increased by the amount the gift tax paid by such individual on a gift made during the three-year period ending on the date of his death.

***Morgens v. Commissioner,* 133 T.C. No. 17 (December 21, 2009)**

During the lifetime of the surviving spouse, the surviving spouse and the remainder beneficiaries of a QTIP Trust terminated the QTIP Trust. This triggered a gift by the surviving spouse under IRC section 2519 equal in value to the remainder value of the trust. Under IRC section 2207A, the surviving spouse has a right of reimbursement for transfer taxes triggered by the assets of the trust.

The surviving spouse died within 3 years of QTIP termination. The question presented was whether the gift tax triggered by termination of the QTIP Trust was includible in the surviving spouse's estate under IRC section 2035(b).

After going through many technical arguments including statutory interpretation, Congressional intent, and legislative history, the Tax Court held that the gift tax paid was includible in the surviving spouse's estate under 2035(b). This was true even though the taxes were to be paid from the predeceased spouse's property. Ultimately, this is likely the correct result given the hole in the estate tax that would be opened if the Court had held that it was not includible.

2036

69. FLP ASSETS NOT SUBJECT TO ESTATE TAX INCLUSION UNDER IRC SECTION 2036 BECAUSE THE BONA FIDE SALE RULE WILL APPLY WHERE THE DECEDENT USES THE PARTNERSHIP FOR LEGITIMATE AND SIGNIFICANT NON-TAX REASONS.

***Black Est.,* 133 TC No. 15 (2009)**

In *Black*, the IRS took the position that, by reason of IRC Section 2036, the decedent's gross estate included the value of the assets owned by an FLP in which the decedent owned an interest (rather than the value of the FLP interest itself). The court rejected this argument and held for the taxpayer, noting that the bona fide sale exception to Section 2036 applied where the FLP was used for significant non-tax purposes.

Prior to his death, Decedent was a key employee-officer-board member-shareholder of an insurance company. The stock in the corporation had increased substantially over time, and Decedent had a strong "buy and hold" investment policy with respect to his company stock. Over the years, Decedent gifted some of the stock to relatives, but when he became concerned about his relatives' respect for his policies and for other family issues, he created an FLP through which all the family members owning stock contributed the stock subject to Decedent's management. When Decedent died, he left his property to his devisees and used a marital deduction formula to determine the amount to pass to his spouse.

The IRS argued that Decedent retained significant control over the FLP such as to require inclusion under IRC Section 2036, which provides,

"The value of the gross estate shall include the value of all property to the extent of any interest therein which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) … under which he has retained for his life … (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right … to designate the persons who shall possess or enjoy the property or the income therefrom."

In *Thompson Estate v. Commissioner*, 382 F.3d 367 (3d Cir. 2004), the Third Circuit determined that the bona fide sale requirement requires "some potential for benefit other than the potential tax of estate tax advantages." In dictum, the *Thompson* court noted caution to be applied in situations where (1) the partnership does not operate a legitimate business, and (2) obtaining a valuation discount is the sole benefit of the partnership.

The court reasoned that Decedent had multiple valid non-tax reasons for the transfer:

> "primary reasons for wanting to form [the FLP] were to provide centralized long-term management and protection of the Black family's holdings in [the] stock, to preserve Mr. Black's buy-and-hold investment policy … , and to pool the family stock so that it can be voted as a block (thereby giving the family the swing vote

> in the not unlikely event of a split between the two [other principal] shareholders), and to protect the … stock from creditors and divorce."

Once the non-tax purpose was established, the second prong of the "bona fide" analysis required that the parties "needed to transfer their … stock" to the FLP to ensure implementation of that philosophy. The constraints imposed by the partnership agreement regarding distributions to partners and the limitations thereon were sufficient to achieve these purposes. Citing to *Shutt Est. v. Commissioner*, T.C. Memo 2005-126, the court held that the FLP helped achieve these non-tax purposes.

In addition to being a bona fide sale, the consideration received by the transferee must also be "adequate". Again relying on *Shutt*, the court held that it was adequate, applying four (4) factors: (1) the participants in the entity received interests proportionate to the value of the property contributed by each; (2) the respective contributed assets were properly credited to transferors' capital accounts; (3) distributions required negative adjustments to distribute capital accounts; and (4) there was a legitimate and significant nontax reason for forming the entity. Each shareholder joining the FLP received an interest commensurate with the value of the stock contributed. This fact eviscerated factors (1) through (3) above as the FLP properly credited and adjusted the partners' capital accounts. The final prong was addressed by the court under the *Thompson* analysis.

70. <u>2036 APPLIES</u>

***Estate of Malkin*, TC, 2009-212**

Malkin owned a significant portion of shares in Delta & Pine, Co. He wanted to transfer a number of the shares to his two (2) children. To this end, a number of limited partnerships and trusts were created to hold the shares for the benefit of the children. After the creation of the trusts, an unidentified source deposited $25,000 in the bank account of the children's trusts. Each trust issued to each child/beneficiary a $25,000 demand promissory note. A few days later, Malkin - now "decedent", made gifts of $500,000 to each of the two (2) trusts.

The decedent transferred 365,371 Delta & Pine, Co., shares to one of the limited partnerships ("LP 1) for all the general partner interests and 99.5% of the limited partner interests. The trustees of two (2) of the children's trusts transferred $25,000 to LP 1, for two (2) 0.25% limited partner interests. The trustees of each trust then entered into a contract with the decedent for the purchase of 44,297 limited partner units for $442,424 in cash, and a nine (9) year $3,981,816 self-cancelling installment note with interest at 7.14%. The trustees executed security agreements granting the decedent a security interest in LP 1.

One of the other limited Partnerships ("LP 2"), was also funded with shares of Delta & Pine, Co., as well as four (4) limited liability companies ("Malkin LLCs") which the decedent had previously formed.

A month after the transfer of shares into LP1 & 2, the decedent pledged LP 1 assets to secure his personal debt to Bank of America. In return, decedent agreed to personally guaranty to pay LP 1 a fee of 0.75% of the $4,345,000 required as security for his Bank of America debt. In a subsequent transaction, the decedent

authorized the re-pledging of LP 1 assets to secure his personal debt to Morgan Guaranty Trust, Co. of New York. The decedent also executed a personal guaranty to secure the debt.

The Tax Court has ruled on a number of issues related to the transaction. As to inclusion in the Gross Estate under Section 2036, the court found that under Section 20.2036-1(b)(2) decedent controlled the Delta & Pine, Co., shares before and after the transfer to LP's 1 & 2. The decedent's use of the stock to obtain personal loans suggested that there was an implied agreement that the transferred shares would be available for decedent's use.

Ultimately, the Court found that IRC Section 2036(a)(1) applied to assets in the LP's that were pledged by the decedent as the general partner of LP 1, and that were contributed to LP 2 that was encumbered by a pledge to provide security for decedent's personal debt. After determining the issue of inclusion, the Court turned to whether an IRC Section 2501(a)(1) tax on the transfer of property by gift would apply to the transfers.

The Court found that the assets contributed to LP's were indirect gifts to the partners. However, trusts for the decedent's children were treated as owning interests in the LP's prior to the contribution.

The purported sales of the LP were treated as gifts, because the sale transactions were not at arm's length and there was no expectation of repayment.

Decedent's payment of debts of entities owned by the LP's constituted indirect gifts to the children.

The cash loans to the children were also treated as gifts because there was no intent to repay the loans

71. BAD FACTS MAKE GOOD LAW—NO APPLICATION OF 2036

***Shurtz Est.*, TC Memo 2010-21**

In 1997, the Estate of Bonnie Barge received a split-the-difference decision from the Tax Court on the valuation of gifts of undivided interests in Mississippi timberland (T.C. Memo. 1997-188) and had to pay taxes on almost $5 million of valuation increase. On February 3, 2010, the estate of Ms. Barge's daughter, Charlene Shurtz, prevailed in a section 2036(a) case and owed no additional taxes. The Court examined whether transfers made to a family limited partnership six (6) years before death, and gifts made between two (2) and six (6) years before death, should be included in the estate under section 2036(a) and / or 2035(a). In spite of certain bad facts, the Court ruled that the transfers to the partnership met the "bona fide sale" and "adequate and full consideration" tests.

In 1993, the Barge family, including Charlene Shurtz, formed C.A. Barge Timberlands, L.P. (Timberlands L.P.) and contributed the family's undivided interests in its extensive holdings of Mississippi timberland. Mrs. Shurtz and her husband owned a much smaller amount of timberland directly. In 1996, they formed Doulos L.P. and contributed their direct timberland holdings and their interests in Timberlands L.P., to the family partnership. In 1996 through 2000, Mrs. Shurtz made gifts of limited partner interests in Doulos L.P. to her children and trusts for her grandchildren.

The IRS contended that the values of the assets contributed to Doulos L.P. should be included in the gross estate of Mrs. Shurtz due to "her retention of the control, use, and benefit of the transferred assets within the meaning of sections 2036 and/or 2035(a)." The Court disagreed, in spite of certain facts that were not favorable to the estate's position.

The Court found that the transfers met the "bona fide sale for an adequate and full consideration in money or money's worth" exception under section 2036(a). The Court felt that the transfers were bona fide sales because there were legitimate nontax reasons for forming Doulos L.P. There was credible testimony that the Shurtzes were concerned about their perception that Mississippi is a litigious environment and that the limited partnership would provide asset protection for the timberland that they owned directly. In addition, they believed that the limited partnership form would make it easier to manage the directly owned timberlands, which required active management.

The Court was satisfied that the assets were contributed to Doulos L.P. for adequate and full consideration because (1) the contributors received interests in proportion to the values of their contributions, (2) the asset values were properly contributed to the capital accounts of the contributors, (3) partners' capital account balances were reduced by the amount of the distributions they received, and (4) as mentioned above, there were significant nontax business reasons for the formation of Doulos L.P. The Court made this finding in spite of certain bad facts:

1. "Doulos L.P. did not maintain books of account, as required by section 4.5 of the partnership agreement. Instead, Mr. Romberger [their CPA] created his own 'work papers like a trial balance' in creating the partnership's tax returns."

2. "Doulos L.P. was laggard in opening a bank account; it did not establish one until April 11, 1997, nearly 4 months after the partnership was established."

3. "Inasmuch as only a limited number of checks each month could be written from the money market account [of Doulos L.P.], Mrs. and Reverend Shurtz paid some of Doulos L.P.'s disbursements from their personal bank accounts. Doulos L.P. reimbursed the Shurtzes for some of these payments. Payments made by Mrs. and Reverend Shurtz that were not reimbursed were credited to their capital accounts."

4. "Distributions from Doulos L.P. to its partners were not always proportional. In 1997 Mrs. Shurtz was the only partner to receive a distribution; in 1999 only Mrs. Shurtz and Reverend Shurtz received distributions; and in 2000 Mrs. Shurtz received a distribution greater than her proportionate share of the partnership's income. However, the partnership made up the missed distributions in subsequent years."

These facts suggest a certain lack of the usual care expected in handling the finances of a non-family partnership, and have caused trouble for other taxpayers in other section 2036(a) cases, but the Shurtz Court was not sufficiently troubled to rule against the taxpayer in this case.

Having satisfied itself that the Shurtz transfers qualified for the "bona fide sale" and "adequate and full consideration" tests, the Court ruled that the assets transferred to Doulos L.P. should not be included in the gross estate of Mrs. Shurtz under section 2036(a) and / or 2035(a).

72. SECTION 2036 CAUSES INCLUSION IN GRANTOR'S ESTATE OF REMAINDER BUT SECTION 2055 DEDUCTION ALLOWED

The charitable remainderman of a reformed CRUT was includible in a grantor husband's gross estate under Section 2036 because he had the retained power, together with his wife, to substitute the charitable remainderman designated in the trust instrument with one (1) or more alternate qualified organizations. Because the husband's power to designate charitable beneficiaries extended only to the charitable remainder, just the remainder interest was includible in the gross estate. Therefore, the husband's estate qualified for an estate tax charitable deduction under Section 2055 equal to the amount of the trust corpus included in his gross estate.

73. NO RECOVERY OF TAX ON P.O.D. ACCOUNTS FROM BENEFICIARY

***Sheppard v. Schleis*, 2009 AP1021, Supreme Court of Wisconsin, 2010 WI5; 322 Wis.2d 129; 799 N.W.2d 181**

An estate had no right to recover the federal estate taxes attributable to two (2) payable on death (P.O.D.) accounts from the accounts' beneficiary. The decedent died intestate. However, prior to his death, the decedent established two (2) P.O.D. accounts for the benefit of his minor goddaughter. After the decedent's death, the beneficiary's parents signed an agreement to retain 50% of the accounts' value for the purpose of paying the "required estate taxes." The guardian ad litem representing the beneficiary advised the parents that because the P.O.D. accounts were not part of the probate estate, the beneficiary was not responsible for the estate taxes. Pursuant to Reg. Section 20.2002-1, the executor is responsible for the payment of the estate tax, even if the gross estate includes non probate property. Section 2207B provides an exception to Section 2002 for retained interests' under Section 2036. According to applicable state (Wisconsin) law, the creator of a P.O.D. account has complete control over the account until his or her death. Thus, no interest is transferred to the beneficiary of the P.O.D. account during the creator's lifetime. Section 2036 is only applicable when a decedent has made a transfer during his or her life. The court also rejected the estate's request to apply the common law rule of equitable apportionment finding that the state legislature has not enacted a statute thereon and Wisconsin precedent declines to recognize such a rule.

74. TAX COURT ERRED IN FINDING DECEDENT RETAINED ENJOYMENT OF ENTIRE TRANSFERRED INTEREST

***Estate of Margot Stewart v. Comm.*, (2010, CA2) 106 AFTR 2d ¶ 2010-5183**

The Second Circuit has vacated and remanded a Tax Court's holding that a decedent retained a lifetime interest in the 49% share of real estate that she transferred to her son. It found that the Tax Court clearly erred in finding that the terms of an implied agreement provided that the decedent retained enjoyment of the

entire 49% share, with the result that the entire property remained in her estate under Code Sec. 2036(a).

Prior to her death, the decedent transferred a 49% interest in one property to her son with whom she lived in the lower portion of that building. The upstairs floors were rented to an unrelated commercial tenant. Following her death, decedent's estate filed a Form 706, United States Estate (and Generation Skipping Transfer) Tax Return, which reported her estate including a 51% interest in that property. Upon audit, the IRS issued a notice of deficiency stating that the decedent had retained possession or enjoyment of the transferred 49% interest and the entire property was, therefore, part of her estate for federal tax purposes, under Code Sec. 2036.

The Tax Court found that the full value of the property was includible in her estate under Code Sec. 2036. The court concluded that decedent and her son had an implied agreement that decedent would retain the economic benefit of the property: the $9,000 per month rent from the commercial tenant. The court did not give credence to the son's testimony that he and decedent intended to use the income of another property to off-set the income and then reconcile their accounts at the end of the year.

The Second Circuit vacated and remanded the Tax Court's decision as clearly erroneous, finding that the terms of the implied agreement provided that the decedent would enjoy 100% of the substantial economic benefit of her son's 49% undivided interest in the property. It directed the Tax Court to make factual determinations on remand to determine the amount of the net income from the son's 49% interest enjoyed by the decedent. Thereby, the Tax Court could calculate the value of the property included in the decedent's gross estate under Code Sec. 2036.

The Second Circuit held that where, as in this case, the Tax Court failed to make specific findings relating to the enjoyment of the residential portion of the property, and IRS pointed to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning the residential portion could not stand. It stated that the finding of an implied agreement was not clearly erroneous, but it was clearly erroneous for the Tax Court to find that the terms of the agreement were such that the decedent would enjoy the substantial economic benefit of 100% of her son's 49% interest in the property where the son manifestly enjoyed the benefits of the residential portion of his 49%. It concluded that the remaining question was what part of the son's 49% interest should be included in the estate, for which reason the case was remanded for the Tax Court to consider all of the facts and circumstances surrounding the transfer and later use of the property.

A dissenting opinion sharply criticized the majority, concluding that it had failed to show how the Tax Court clearly erred as a factual matter in concluding that the decedent retained all of the benefits, given that her relationship to the property did not change before or after the transfer. The dissent further stated that the majority had turned the long-standing and proper construction of Code Sec. 2036 on its head by focusing on what the son supposedly received rather than on what the decedent retained. In doing so, it contravened the plain language of the Code Section which provides that a decedent's gross estate includes transfers under which he retained the possession or enjoyment of, or the right to the income from, the transferred property.

VALUATION

75. VALUATION OF ANNUITIES IN TRUSTS

Proposed Reg. Section 20.2036-1

On April 29, 2009, IRS issued proposed regulations that would "fine-tune" the existing regulations for figuring estate tax on retained interest. The proposed regulations provide guidance as to the portion of trust property includible in a grantor's gross estate under IRC Section 2036 where the grantor has retained a "graduated retained interest" and in other highly specialized circumstances. The rule would apply to estates of decedents dying on or after the date the regulation is finalized.

The proposed regulations would provide the method to be used to determine the portion of the trust corpus includible in the grantor's gross estate if the grantor reserves a graduated retained interest in a trust. This method would apply to graduated retained interest in property whether or not the property is held in trust.

The final regulations calculate the grantor trust portion of a GRT to be the portion of the trust necessary to generate a return sufficient to pay the decedent's retained annuity, unitrust, or other payment. The proposed regulation introduces a more complex formula for the calculation:

> Step 1: Determine the fair market value of the trust corpus on the date of death.
>
> Step 2: Determine, in accordance with paragraph (c)(2)(i) of this section, the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment (determined on the date of the decedent's death) payable to the decedent for the trust year in which the decedent's death occurred.
>
> Step 3: Determine, in accordance with paragraph (c)(2)(i) of this section, the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment that the decedent would have been entitled to receive for each trust year if the decedent had survived the current recipient.
>
> Step 4: Determine the present value of the current recipient's annuity, unitrust, or other payment.
>
> Step 5: Reduce the amount determined in Step 3 by the amount determined in Step 4, but not to below the amount determined in Step 2.
>
> Step 6: The amount includible in the decedent's gross estate under section 2036 is the lesser of the amounts determined in Step 5 and Step 1.

76. SINGLE MEMBER LLC NOT IGNORED FOR VALUATION PURPOSES

***Pierre v. Commissioner*, 133 TC No. 2 (2009)**

On August 24, 2009, the Tax Court issued *Pierre v. Commissioner*, 133 TC No. 2 (2009), holding that a single-member LLC ("SMLLC") was not disregarded for purposes of a donor making a gift of interests in the LLC. The IRS argued that the Petitioner could not gift interests in the LLC since the LLC was disregarded for Federal tax purposes, positing that the transfer was instead a deemed transfer of the LLC's assets. At the heart of the dispute were valuation discounts; if characterized as a transfer of the LLC's assets, valuation discounts would not have been available to the taxpayer.

IRC Section 2501 imposes a tax on transfers of property by gift. Generally, the value of the property at the time of gifting is the value used for purposes of calculating the gift tax. "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." (Treasury Regs. 25.2512-1.) Valuation discounts are often applied to gifts of minority interests in LLCs since the minority interests are less marketable and do not give the donor control over the entity, and, therefore, would result is a lower price from a willing buyer.

The Taxpayer in Pierre owned a SMLLC and gifted a 9.5% interest in the LLC to two (2) trusts he had created for his children's benefit. Per an independent appraisal, the taxpayer applied a 30% discount to the value of the non-managing interests in the LLC due to a lack of marketability and control. The IRS decided that the Petitioner's transfers should be characterized as a transfer of the underlying assets of the LLC and not a transfer of LLC interests since the LLC was a disregarded entity. The IRS issued a deficiency notice against the Petitioner.

The Tax Court rejected the IRS's contention that the check-the-box regulations also controlled for gift tax purposes. The Tax Court stated that the IRS's position would result in federal law rather than state law defining property rights and would be incompatible with the Supreme Court's interpretation of federal estate and gift tax statutes. The Court also noted that Congress has enacted laws to specifically address perceived abuses in the valuation rules and has chosen to eliminate valuation discounts for LLCs (neither generally nor to SMLLCs in particular).

77. DEFINED VALUE FORMULA IS APPROVED

***Estate of Christiansen v. Commissioner*, 104 AFTR 2d ¶ 2009-7352 (8th Cir. 2009), aff'g 130 TC 1 (2008)**

This was an appeal of one issue that arose in *Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), in which the Tax Court denied the validity of a disclaimer of property to a charitable lead annuity trust, but, by a 10-2 vote, permitted a disclaimer using a defined value formula to a private foundation. The latter holding was regarded as one of the most significant estate tax judicial developments in recent years, giving "national" credentials to the affirmation of "defined value" or "value definition" clauses provided by the Court

of Appeals for the Fifth Circuit in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), rev'g 120 T.C. 358 (2003).

In *Christiansen*, Mother and Daughter lived in South Dakota where both operated their own farming and ranching operations. Both Mother and Daughter were deeply involved in their community and both served on the boards of many charitable organizations. They wanted some way to permanently fund projects in education and economic development. To do so, on the advice of a local law firm, they established a charitable foundation as part of Mother's estate plan. The Foundation was intended to fund charitable causes at a rate of about $15,000 annually. The initial funding was $50,000 and it was expected that a testamentary charitable lead annuity trust to be established in Mother's will would provide $12,500 a year for twenty (20) years. At the end of the twenty (20) year period, any property remaining in the charitable lead annuity trust would pass to Daughter.

The issues in the case at the Tax Court level arose from some "complex wrinkles" in Mother's estate planning. The first wrinkle was the restructuring of Mother's farming and ranching operations, which were previously run as sole proprietorships, but then converted to family limited partnerships. Mother kept 99% of the limited partnership interests. Daughter and her husband were the two (2) members of the limited liability company that was the 1% general partner of each of the two (2) family limited partnerships.

The second wrinkle was that Mother left all her property to Daughter rather than dividing it between Daughter, the foundation, and the charitable lead annuity trust. Mother's will provided that if Daughter disclaimed any part of Mother's estate, 75% of the disclaimed portion of the estate would go to the charitable lead annuity trust, and 25% would go to the foundation.

After Mother's death in April 2001, the value of the estate was determined to be $6,500,000 after taking account of the discounts for the family limited partnership interests. Daughter then executed a partial disclaimer, the intention of which was to disclaim that amount of the estate exceeding $6,350,000. This figure was the amount that Daughter believed would allow the continuation of the family businesses and would provide for Daughter and her family in the future. In drafting the disclaimer a defined value fractional formula was used so that if the value of the estate was increased for federal estate tax purposes, the excess would go to the charitable lead annuity trust and the foundation. Much of any excess would escape federal estate tax because of the estate tax charitable deduction.

Upon audit, the value of the estate was increased from $6,500,000 to almost $9,580,000. If the formula disclaimer worked as intended, $2,422,000 would pass to the charitable lead annuity trust and $807,000 would pass to the foundation. The IRS asserted that the disclaimer was not qualified and therefore the property disclaimed failed to qualify for the estate tax charitable deduction. The Tax Court held that Daughter's disclaimer of 75% of the property to the charitable lead annuity trust was invalid because Daughter was the remainder beneficiary of the charitable lead annuity trust. For a disclaimer to be effective under section 2518, the disclaimed property must pass to someone other that than the disclaimant (subject to the exception for surviving spouses).

With respect to the disclaimer to the foundation, the IRS argued that the use of the defined value formula

made the disclaimer ineffective. The IRS stated that any increase in the amount disclaimed was contingent on a condition subsequent and that the use of the phrase "as finally determined for federal estate tax purposes" for determining the amount of disclaimed property was void as contrary to public policy. According to the IRS, the use of such a formula would discourage the IRS from examining estate tax returns because any deficiency would be offset by an equivalent charitable deduction.

To qualify for the estate tax charitable deduction, the amount passing to charity must be ascertainable as of the date of the decedent's death. The IRS felt that this requirement was not met. The Tax Court disagreed, noting that the value of property passing to charity is routinely increased or decreased on audit without affecting the charitable deduction. The Tax Court also disagreed with the analogy made by the IRS in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the Court held that a clause requiring a gift to revert to the donor if it was subject to gift tax was an illegal condition subsequent, void as against public policy (an issue the Fourth Circuit had raised on its own). The Tax Court distinguished this situation from that in Procter by saying that the fractional disclaimer to the foundation would not undo a transfer, but merely reallocate the property among Daughter, the charitable lead annuity trust, and the foundation. Thus, the Tax Court found that a defined value clause would work to prevent the imposition of additional estate tax.

The only issue before the Eighth Circuit was the validity of the disclaimer of 25% of the property over $6,350,000 as adjusted for federal estate tax purposes to the private foundation. The IRS made the same two (2) legal arguments that it had made at the Tax Court level. First, the IRS argued that because the overall value of Mother's estate was not finally determined until after the conclusion of the IRS's successful challenge of the valuation of the family limited partnerships, a transfer based upon the value "as finally determined for federal estate tax purposes" was dependent upon a "precedent event" contrary to the provisions of Reg. section 20.2055-2(b)(1). Second, the IRS contended that permitting partial disclaimers of property over a fixed amount would act as a disincentive for the IRS to audit estates in which the formula disclaimers were made since no additional tax revenue would be realized if such estates were audited. Because of this disincentivising effect, the IRS said that such disclaimers were contrary to public policy.

In a pithy eight (8) page opinion, the Eighth Circuit rejected the first argument by noting that there is a difference between those post-death events that actually change the value of an asset or estate after the death of a decedent and those post-death events that are "merely part of the legal or accounting process of determining value at the time of death." The court looked at cases in which, for example, the gift to charity was dependent upon the testator's daughter dying without descendants, *Commissioner v. Sternberger's Estate*, 348 U.S. 187 (1955), or where the gift to the charity was one of the remainder of the trust and the trust's primary beneficiary could invade the principal, *Henslee v. Union Planters*, 335 U.S. 595 (1949). The Eighth Circuit also cited Reg. section 20.2055-2(e)(2)(vi)(a) in which the IRS recognized that references to values as finally determined for federal estate tax purposes are sufficient for the value of a guaranteed annuity interest to be determinable as of the date of death or creation.

The Court also rejected the IRS's second argument that the Court should interpret the statutes and regulations to maximize the incentive of the IRS to challenge and audit returns. First, the role of the IRS is to enforce the tax laws, not to increase the amount of revenue. Second, there was no evidence of a clear Congressional policy to maximize the incentives for the IRS to audit returns. Instead, the purpose of the charitable deduction

is to encourage taxpayers to make charitable gifts. Third, the IRS was wrong in its belief that a policy of not encouraging audits would encourage executors and administrators to understate the value of assets. Instead, they are bound by state law to perform their responsibilities or otherwise face criminal or civil penalties. Moreover, charitable beneficiaries in a situation such as this would want to see the values maintained since that would give them more. The Court believed that there are sufficient mechanisms in place to ensure the accurate valuation of assets.

78. COURT APPROVES FORMULA CLAUSE

***Petter Est.*, TC Memo 2009-280**

Anne Petter had inherited stock of United Parcel Service of America, Inc. (UPS) from her uncle, who was one of the first investors in UPS. Her holdings in the traditionally closely-held UPS were substantial enough that she was restricted from transferring stock during a "lock-up period" associated with an IPO. She created the Petter Family LLC ("PFLLC"), which was initially a single-member LLC "disregarded" for income tax purposes, and contributed UPS stock to it. She and her advisors then undertook to finalize the PFLLC operating agreement (including class voting, restrictions on transfer, and other refinements), and involved two (2) of her three (3) adult children in the process. (The other child was disabled, and she provided for him in other ways.) As the court summarizes, "[t]his was undoubtedly the most complex transaction any of the Petters had been a part of. Donna [Anne's daughter] struggled to understand it and even hired an attorney to help her."

Then Anne created grantor trusts for those two (2) children and their descendants. To each trust she gave PFLLC interests defined by a formula referring to the "dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code section 2001(c)." Three (3) days later, in sale documents, she assigned to each trust PFLLC interests defined as "the number of Units … that equals a value of $4,085,190 as finally determined for federal gift tax purposes." (That dollar amount was half of her remaining applicable exclusion amount for gift tax purposes.) In exchange, she received twenty (20) year interest-bearing notes. On each occasion – gift and sale – the documents identified a specific total number of shares Anne was transferring and directed that the excess over the amount the formula assigned to the trusts would pass to two (2) charitable community foundations. One of the community foundations was assisted by a lawyer, who participated in negotiating the terms of the transfer. Among other things, she negotiated terms to assure both community foundations that they would bear no legal costs and would become members of the PFLLC rather than mere assignees. She also assured her client that safeguards would be put in place to prevent it from being exposed to unrelated business taxable income.

Although the transactions were structured on the basis of estimates of the value of the PFLLC interests, they were completed, shares were allocated, and Anne's gift tax return was prepared, all on the basis of a professional appraisal that compared the PFLLC to closed-end mutual funds and applied an aggregate

valuation discount of about 53%. On Anne's gift tax return, the court said, "[s]he hid nothing."

As the court put it, "[t]he Commissioner had several quarrels." The IRS originally contended that the value of the LLC interests was about half again the value Anne had reported on her gift tax return, though the two parties ultimately agreed on a compromise value. While the formula clauses would have self-adjusted to prevent an increase in the gifts to the trusts in either case, the IRS characteristically denied the validity and effectiveness of those clauses as "contrary to public policy."

Judge Holmes, who also wrote the majority Tax Court opinion in *Christiansen*, wrote an opinion seasoned with savvy descriptions of grantor trusts, donor advised funds, valuation discounts, and estate planning in general. The opinion begins with *Commissioner v. Procter*, F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944), rev'g & rem'g 2 TCM [CCH] 429 (1943), which the opinion says "became the cornerstone of a body of law regarding 'savings clauses,'" built on the propositions that such savings clauses are invalid "conditions subsequent" and are "contrary to public policy" because they discourage collection of tax, obstruct the administration of justice, and would require courts to render unauthorized declaratory judgments. The opinion traces the case history in the Tax Court and other courts. It cites *McCord v. Commissioner*, 120 T.C. 358 (2003), rev'd, 461 F.3d 614 (5th Cir. 2006), where, because the formula in question operated only on the parties' current estimates of value (i.e., not values finally determined for gift or estate tax purposes), the Tax Court "did not find it necessary to consider *Procter*."

Judge Holmes recalls that in *Christiansen* the Tax Court had "found that the public policy arguments were undermined by *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966), where the Supreme Court warned against invoking public-policy exceptions to the Code too freely." He emphasizes that "[a]lthough *Christiansen* was a split decision on other issues [relating to the validity of the disclaimer], we were unanimous in concluding that 'This case is not Procter.'" Estate of *Christiansen v. Commissioner*, 130 T.C. 1, 17 (2008), aff'd, 586 F.3d 1061, 2009). Thus armed with the encouragement of the Supreme Court and the authority of a unanimous Tax Court, but faced with the IRS's determined pitched stand on the public policy issue, Judge Holmes elaborates, in a section captioned "Drawing the Line". There, he drew a distinguishing line between *Christiansen* and *Procter*, concluding that the facts of this case were sufficiently different from the Procter formula, in which the court held that the formula did raise the same policy concerns.

Comment: There are several "good facts" in this case, including:

- a family "legacy" investment (UPS stock) which centralized holding could be preserved (although the court did not stress this point);
- active participation in finalizing the PFLLC operating agreement, including the engagement of an attorney by Anne's daughter;
- active involvement of counsel for one (1) of the charities, resulting in changes in the charity's favor that the court found material in clarifying the fiduciary duties owed to the charities;
- the involvement of trustees and LLC managers to assume those fiduciary duties;

- Anne's unequivocal aggregate transfer of a specified amount of an LLC, with no attempt on her part to "get anything back";
- the reliance on a professional appraisal; and
- Anne's full disclosure on her gift tax return.

But there are questions about the scope of the ruling, including the following:

- Will the IRS appeal, and, if so, how will the Ninth Circuit rule and will still more cases in the future be appealed to other circuits?
- What does it mean when the court says "[w]e do not fear that we are passing on a moot case" when there is no possibility of finding a deficiency on these facts? Is it because the decision results in an increased charitable income tax deduction – which is not a deficiency but it is something?
- What if a charity were not the recipient of the gift over? Would the absence of an income tax deduction affect the "moot case" analysis? Would it reduce the importance of fiduciary duties? Would it decrease the likelihood of the vigilance residing in a third party that the court seemed to find material?
- How comfortable will estate planners be relying on the principles reflected in Christiansen and Petter to continue to recommend transfers where not just the allocation of the aggregate transfer, but the aggregate transfer itself, is defined by a value formula?

The Tax Court has not repudiated Procter. But it has drawn a line around it. This is being appealed by the Government.

79. VALUATION OF FRACTIONAL INTERESTS IN VACATION HOME—17% DISCOUNT

***Ludwick v. Commissioner*, TC Memo 2010-4**

The fair market value of the transferor's interests in a vacation home was determined by taking into account the rate of return, cost of partition, annual operating costs, length of time to partition the property, and cost of selling the property. The transferors owned a vacation home as tenants in common. They each transferred their separate one-half (1/2) interests to a qualified personal residence trust and applied a 30% discount to the fair market value of the property. The IRS limited the discount to 15% and issued a gift tax deficiency for the difference. Because neither party's experts were found to be persuasive, the court used its own method to calculate the appropriate value of the fractional interests. According to the court, a buyer would be willing to pay half of the fair market value of the property less the cost of maintaining and eventually disposing of the

property, which could include the cost of partition. In addition, a buyer would discount the price of the property based on the marketability risk. The marketability discount was determined to be 10%. The long-term sustainable growth of the property was also taken into account. After taking into consideration all of the above mentioned factors, a discount of approximately 17% was applied to the fractional interests.

80. STEP TRANSACTION DOCTRINE APPLIED TO INVALIDATE GIFTS OF LLC INTEREST

***Linton v. US*, 2011 US App. LEXIS 1174 (9th Cir.)**

The Ninth Circuit reversed a district court's grant of summary judgment to the government that transfers of real estate, cash, and securities (the bulk of which were municipal bonds) to a limited liability company (LLC) in which trusts for the donors' children were given interests were indirect gifts, to the trusts, of pro rata shares of the assets transferred to the LLC. The Ninth Circuit reversed the district court's finding that the contributions to the LLC occurred after the transfer of LLC interests to the children's trusts, and sent the case back to the district court to reexamine this issue.

The Ninth Circuit also reversed the district court's grant of summary judgment to the government based on the step transaction doctrine.

Under the district court's holding, no discount was allowable for the restrictions imposed by the operating agreement. As a result of the reversal and remand, if it is determined that the contributions to the LLC occurred before the transfers of the LLC interests to the children's trusts, the value of the LLC interests might be discountable for gift tax purposes.

Facts

On their gift tax return, William and Stacy Linton reported gifts of LLC interests and claimed a 47% marketability discount because the operating agreement imposed limitations on transfers to non-family members and gave the donors the sole authority to act for the LLC.

All of the documents contributing property to the LLC, creating a trust for each child, and giving each trust an LLC interest indicated bore an identical date—January 22, 2003, however the attorney who prepared the documents testified that while preparing the LLC's minute book several months after the transactions, he noticed that the trust agreements and the gift documents were not dated and that he filled in the January 22, 2003 date. The attorney further testified that he later realized that he had made a mistake in so dating the documents because the intended date for the creation of the trusts and the transfers of interests in the LLC thereto was January 31, 2003.

District Court

The IRS argued that the discount was allowable because the Lintons did not make gifts of LLC interests but made indirect gifts of the property contributed to the LLC.

The district court agreed with IRS, finding that the attorney's testimony about the dating of the trust agreements did not prove the sequence of events the donors asserted. The court emphasized that each trust agreement provided that it was effective upon contribution of property to the trust and that the LLC interests were transferred to the trustee concurrent with the execution of the trust agreements. Thus, the express language of the documents established that the trusts were created and the gifts were made on January 22, 2003. Because the trusts were created and gifts were made on January 22, 2003—either before or simultaneously with the contribution of property to the LLC—the court held that the Lintons' transfers enhanced the LLC interests, thereby constituting indirect gifts to the trusts.

Alternatively, the district court found that even if the Lintons could establish the proper sequence of events, they nevertheless made indirect gifts to the children's trusts under the step transaction doctrine.

Ninth Circuit

The appeals court reasoned that it first had to determine whether the Lintons donated the LLC interests to the trusts before or after they funded the LLC. The court concluded that the assets were transferred to the LLC at some date or dates between January 22 and January 31, 2003.

The court observed that a gift is complete for federal tax purposes when the donor has so parted with dominion and control as to leave him with no power to change its disposition. (Regs. § 25.2511-2(b).) State law determines whether and when a donor has parted with dominion and control.

Under applicable Washington law, a completed gift requires: (1) an intention of the donor to give; (2) a subject matter capable of delivery; (3) a delivery; and (4) acceptance by the donee. The Ninth Circuit discussed each of these elements separately, considering the donors' intent last because it was the decisive element in this case and the most difficult to determine. The Ninth Circuit remanded the case to district court to determine the factual issue as to when the intent to donate occurred. As the Ninth Circuit suggested, that date could have been January 22, 2003, when James Linton left the meeting with copies of the undated gift documents or as late as April 2003, when the attorney finalized the gift documents.

81. DETERMINATION OF DISCOUNTS (MINORITY, MARKETABILITY AND BUILT IN GAINS

***Jensen v. Commissioner*, TC Memo 2010-182**

Taxpayer received a dollar-for-dollar discount, although the Tax Court refused to blindly apply a dollar-for-dollar adjustment.

Decedent died owning 82% of the stock in a C corporation. The principal asset of the corporation was a 94-acre waterfront parcel of real estate in New Hampshire. The Court and the experts for each party applied an

asset based valuation approach. When applying an asset-based valuation approach, it is appropriate to make an adjustment for the capital gain that would be triggered upon the sale of the corporation's assets (the so-called built-in capital gain). See *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998) (the circuit to which *Jensen* was appealable).

The taxpayer's expert claimed a dollar-for-dollar discount for the built-in capital gain. IRS' expert analyzed closed-end mutual funds holding securities and closed-end funds that hold primarily real estate. IRS' expert's conclusion was that there was no correlation between the discount to the net asset value these funds trade and the amount of built-in gain. Respondent's expert did find, however, that discounts to net asset value for funds holding real estate are greater than those holding marketable securities. Based on this difference, the expert concluded the subject C corporation should receive a 10% discount (about 45% of the built-in capital gains tax). IRS' expert also pointed to IRC section 1031 exchanges and converting to an S corporation as ways of avoiding the built-in capital gains tax.

The Tax Court did "not accord [IRS' expert's] valuation much weight" because the effects of built-in capital gains and discounts to net asset value are inconclusive. The Tax Court also rejected the notion that the built-in capital gains tax could be avoided in this case. The Court also criticized IRS' expert for not taking into account appreciation or time value of money concepts.

The Court then proceeded to apply a present value approach stating, "We may assume arguendo, on the evidence of the record, that a present-value approach is applicable to determine the estate's discount for the built-in LTCG tax." The Court cited *Borgatello* and *Litchfield* for this proposition.

In *Litchfield* the taxpayer's expert applied a present value approach, thus the taxpayer did not ask for a dollar-for-dollar discount. Further, the *Litchfield* Court stated that since the dollar-for-dollar discount was not requested, they were not determining whether it was appropriate.

The *Jensen* Court then proceeded to take the role of appraiser and determined the useful life of the property was 17 years based on depreciation figures used by taxpayer's expert (and assuming the property would be sold at that point). Based on that assumption, the Court made the following computations:

1. Calculated future values for the corporation's assets based on 5% and 7.725% appreciation rates;

2. Determined the capital gains tax that would be paid if the assets were sold based on the appreciated values; and

3. Determined the present value of the capital gains tax that would be paid in 17 years.

Based on this approach, the Court determined the present value of the built-in capital gains tax liability would be between $1,232,740.66 and $1,263,551.88. Since the taxpayer was asking for a discount of $1,133,283, the Court "accept[ed] the estate's value for the built-in LTCG tax discount of $1,133,283 because although not

precise, it is within the range of values that may be derived from the evidence (and the estate did not argue for a greater amount)."

Takeaways from this case and built-in capital gains tax cases generally:

1. The built-in capital gains discount applies to asset based valuation approaches, not necessarily market or income approaches (unless there are additions to value for net operating assets, see *Simplot v. Commissioner*, 249 F.3d 1191 (9th Cir. 2001).

2. Dunn and Jelke both rejected the present value approach, thus if you are in the Fifth or Eleventh Circuits, the proper approach is a dollar-for-dollar discount for the built-in capital gains taxes (but see the comment below regarding Dunn being a controlling interest).

3. If you are in other Circuits, the appraiser should analyze multiple approaches, including dollar-for-dollar, present value and increasing the marketability discount. Thereafter, the appraiser should apply the approach he or she determines is most applicable under the circumstances. The appraiser should be able to defend the approach taken!

4. There is disagreement in the appraisal community as to proper approach. Some appraisers say the dollar-for-dollar approach is proper in all cases. Others say it depends on the assets in the corporation and the ownership percentage at issue (note Dunn focused on the fact that the subject interest was a controlling interest, but Jelke dealt with a minority interest). If the interest is controlling, then the hypothetical buyer can liquidate the company.

Litchfield Est. v. Comm'r., **TC Memo 2009-21**

At decedent's death, decedent held a 43% and 23% interest in two (2) closely held corporations (Company A & B). Company A's assets was farmland, while Company B's assets was securities. Company A converted from a C corporation to an S corporation and executed a shareholder agreement that restricted the transfer of shares. The estate claimed discounts of 68% for the decedent's interest in Company A, and 65% for the interest in Company B on the decedent's estate tax return. The IRS audited the return and found that the discounts should have only been 30% and 23%, respectively.

As a threshold matter, the court held that in accordance with IRC Section 7491(A), the burden of proof as to the discounts shifted to the IRS because the decedent's estate cooperated with the IRS's request for documentation, produced credible evidence, maintained adequate records, and complied with the substantiation requirements.

The court found that the estate's discounts for capital gains and lack of control were appropriate, but the court found that the 36% and 29.7% discounts taken by the estate for lack of marketability were too high. The

court found that the estate used outdated information relating to restricted stock studies arriving at the discounts. Moreover, the court also found that the estate procured a valuation of the decedent's interest in Company B for gift tax purposes, which contained a 21.4% discount for lack of marketability. As such, the court calculated the lack of marketability discounts to be 25% for Company A, and 20% for company B.

82. STEP TRANSACTION APPLIED TO GIFTS AND SALES OF LLC INTERESTS BUT DISCOUNTS ALLOWED AND TAXPAYER'S EXPERT'S TESTIMONY STANDS

***Pierre v. Commissioner*, TC Memo 2010-106.**

A donor's concurrent gifts and sales of limited liability company (LLC) interests to trusts for her son and granddaughter were treated as a single event under the step transaction doctrine. The evidence showed that the gifts and sales were part of an integrated plan to transfer the donor's entire interest in the LLC to the trusts. Specifically, the record revealed that: (1) the transfers all occurred on the same day with little separation in time; (2) the donor intended to transfer her whole interest in the LLC without incurring any gift tax liability; and (3) the transfers were originally recorded as two (2) gifts of 50% interest in the LLC. The structure used by the donor for the transfers was primarily motivated by tax reasons, as there was no tax-independent event of significance that occurred between the gift and sale transactions. Because the transactions were part of an integrated plan, the donor was treated as making a gift of a 50% LLC interest to each trust, to the extent that the interest exceeded the value of the promissory note executed by the trust.

The donor's gifts of 50% interest in a limited liability company (LLC) were entitled to an 8% minority interest discount and a 30% marketability discount. The 10% minority interest (lack of control) discount advanced by the donor's appraiser was based on the valuation of a 9.5% interest in the LLC, not the 50% interest that was actually found to have been transferred. The 10% discount figure was reduced to 8%, consistent with the admission of the donor's expert trial witness, to reflect that the owner of a 50% interest would have the ability, for example, to block the appointment of a new manager. The 30% marketability discount relied on by the donor was accepted because the IRS failed to argue that such figure was inappropriate, and offered no evidence or testimony regarding value of an LLC interest.

83. NO ACCURACY RELATED PENALTY FOR UNDER VALUATION

***Thompson v. Commissioner*, 2010 U.S. App. LEXIS 5517; 105 A.F.T.R.2d (RIA) 1413**

The IRS imposed an accuracy-related penalty against the estate because the estate's stated value of the asset at issue was less than 25% of the correct valuation. At trial, the Tax Court found that the estate was not liable for the accuracy-related penalty because calculating the value of the asset at issue was particularly difficult. However, the court neglected to determine whether the estate's reliance on its appraisers was reasonable and in good faith as required under Section 6664. The appellate court affirmed the Tax Court's decision, explaining that although the appraisers were inexperienced in valuing large corporations, as here, the estate's reliance upon them was reasonable. Moreover, the court noted that the Tax Court did not find that there was a conflict of interest between one of the appraisers in his dual role as executor and appraiser. Accordingly, the Tax Court's opinion was affirmed, and the estate was not subject to the accuracy-related penalty.

84. BUY/SELL RESTRICTIONS DISREGARDED UNDER SECTION 2703

***Holman v. Commissioner*, 601 F.3d 763 (9th Cir. 2010), aff'g 130 TC 170 (2008)**

A. Tax Court

Petitioners set up custodial accounts for their children, then made annual gifts of stock thereto. Petitioners, as general partners, then formed an FLP in November of 1999, setting out nine stated purposes for the entity. The children's custodianships and certain trusts for the children's benefits were the FLP's limited partners. Petitioners had discussed the use and advantages of a limited partnership with their attorney, including the availability of valuation discounts in connection with the entity and gifting FLP interests to the children's custodial accounts. The Tax Court respected the FLP as a valid entity.

Ultimately, Petitioners defeated IRS' two "indirect gifts" arguments. First, IRS argued that gifts of the stock, rather than FLP interests, were made. However, the Tax Court had no problem distinguishing the facts of this case from Shepherd v. Commissioner, 115 T.C. 376 (2000), and *Senda v. Commissioner*, T.C. Memo. 2004-160, because Petitioners gifts of FLP units occurred six days after the FLP's formation and funding. Second, the Tax Court rejected the IRS' step-transaction argument, noting that the value of the assets contributed to the FLP were subject to real market risk in connection with the time that passed from date of formation to date of funding.

On the other hand, the Tax Court had trouble with Petitioners alleged "business purposes" and certain restrictions in the partnership agreement, which Petitioners claimed should reduce the value of the FLP interests. More specifically, the IRS successfully argued that transfer restrictions in the FLP agreement should be disregarded because they did not satisfy two of the three elements of the "safe harbor" test of IRC § 2703(b) (i.e., it was not "bona fide business arrangement" and the restrictions involved a "device" to transfer the FLP interests to family members for less than full and adequate consideration in money or money's worth). Thus, the restrictions were disregarded for valuation purposes under IRC § 2703(a) and Petitioners' valuation discounts claimed for lack of control and lack of marketability were reduced to 12.5%.

B. Eighth Circuit

In this appeal, the taxpayers challenged the Tax Court's holdings that: (i) certain restrictions in the FLP's limited partnership agreement were not a bona fide business arrangement within the meaning of IRC Section 2703(b); and (ii) the applicable lack of marketability discount of 12.5%.

Maintenance of family ownership and control of a business may be a bona fide business purpose, but not necessarily in the absence of a business. The Holman's FLP was not a bona fide business arrangement. They made no showing of special investment knowledge or of any particular investment philosophy. Rather, the

facts suggest the Holmans intended to diversify their investments. The restrictions in the FLP's limited partnership agreement were, therefore, not a bona fide business arrangement within the meaning of IRC Section 2703(b). They were "predominately for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education of the children."

On the marketability discount, the Tax Court relied upon IRS' expert. The taxpayers objected to that expert's use of "what insiders likely would do in the face of potentially large discounts in partnership share price relative to Dell stock prices." They argued that the IRS' expert's analysis violated the hypothetical willing buyer/willing seller test because it asks what the partnership or particular family members in this case would. The question is supposed to be what hypothetical buyers and sellers would do. The Eighth Circuit rejected this argument, finding that it casted the "potential buyer merely as a rational economic actor." The "Tax Court did not impermissibly ascribe personal non-economic strategies or motivations to hypothetical buyers."

ELECTIONS

85. SECTION 2032A EXTENSION GRANTED UNDER 9100 RELIEF

IRS Letter Ruling 201001014

An executor was granted an extension of time to make an alternate valuation election under Section 2032. The executor timely filed the federal estate tax return. However, the accountant retained to complete the return neglected to make an alternate valuation election. The executor then filed a supplemental return, making the election. The extension was granted because the standards of Reg. Section 301.9100-3 were satisfied and the supplemental estate tax return was filed within one (1) year after the due date of the return (including extensions).

86. ESTATE QUALIFIES FOR SECTION 6166 AND SECTION 303

IRS Letter Ruling 201013024

Distributions of stock in a corporation to a trust beneficiary qualified for sale or exchange treatment under Section 303. A decedent's estate qualified to pay its estate tax in installments pursuant to Section 6166. Under the terms of the decedent's will, the decedent's interest in a corporation was to pass to a trust. However, the executor retained a number of the shares in order to continue to pay federal and estate tax liabilities. As a result of a settlement agreement, the now sole beneficiary of the trust requested that the executor distribute a portion of the shares. In accordance with the request, the beneficiary would be liable for a proportionate obligation to pay estate taxes relative to the value of the distributed shares. The redemption of shares received Section 303 treatment because it was represent that: (1) the decedent's interest in the corporation exceeded 35% of the value of the gross estate; (2) shareholders were not obligated to purchase redeemed shares; (3) the beneficiary received the fair market value for the redeemed shares; (4) the value of the stock distributed to the beneficiary did not exceed the lesser of the taxes referred to in Section 303(a)(1)

and (2) and remained unpaid or the value of the taxes paid during the prior year; (5) the redemption occurred within the period permitted under Section 303(b)(1); (6) both the beneficiary and corporation were responsible for any individual expenses incurred during the transaction; (7) only the corporate shares were transferred in the redemption; and (8) there were no declared, but unpaid, dividends separate from the shares to be redeemed. Accordingly, the redemption amount received did not exceed either Section 303(a) or (b)(4) and the requirements of Section 303(b) were satisfied. Thus, the gain recognized from the transactions was measured by the difference between the redemption price of the shares and the beneficiary's basis.

87. SECTIONS 2032A, 2057, 61666--LATE ELECTIONS ALLOWED

IRS Letter Ruling 201015003

An estate filed its federal estate tax return late due to the negligence of a hired tax professional. Nonetheless, it was still entitled to elect special use valuation for its farm property under Section 2032A and to elect to have the farm property treated as a qualified family-owned business interest (QFOBI) under Section 2057. Pursuant to page seven (7) of the instructions of the federal estate tax return and Temporary Reg. Section 22.0(b), elections under Section 2032A are valid if made late, so long as the election is made on the first estate tax return filed. Furthermore, Section 2057(i)(3)(H) states that the rules similar to those listed in Sections 2032A(d)(1) and (3) shall apply to QFOBI elections. Thus, the special valuation and QFOBI elections made on the late filed estate tax return were valid.

A decedent's estate failed to elect a deferral and installment payment of estate tax under Section 6166 because the election was not timely filed. The tax professional retained to prepare the decedent's federal estate tax return requested an extension of time to file the return. However, the tax professional failed to make a Section 6166 election. The election to pay estate tax in installments is a statutory, rather than a regulatory election provision of Reg. Section 301.9100-3. Therefore, the Section 6166 election made on the late-filed return was ineffective.

88. SECTION 2032A EXTENSION ALLOWANCE

IRS Letter Ruling 201016006

A decedent's estate which had filed a supplemental estate tax return (Form 706) within one (1) year of the due date of the return, was granted an extension of time to make the alternate valuation date election under Section 2032. The estate's personal representative filed the federal estate tax return. However, the attorney retained to prepare the return, neglected to make an alternate valuation election. After discovering the oversight, the personal representative filed a supplemental information return making that election. The extension was granted because the standards of Reg. Sections 301.9100-3 were satisfied. The estate had acted reasonably and in good faith in relying on a qualified tax professional and granting relief would not prejudice the interests of the government. In addition, the supplemental information return was filed within a year of the due date for the estate tax return.

TAX LIABILITY

89. TRANSFEREE AND TRUSTEE LIABILITY FOR ESTATE TAX

***L. Bevan*, DC Cal., 2009-1 U.S. TAX CT. 60,570**

After the decedent's death, a federal estate tax return was filed showing that the estate owed estate tax in the amount of $756,000. The IRS audited the return, and found that the estate owed the IRS approximately $3.33 million. Although notice and demand for payment was made, the daughter of the decedent, as trustee, never paid the estate tax debt. The daughter had previously transferred $978,000 to herself, and $1.5 million to her brother. At the time of decedent's death, the trust contained a total of $3.1 million in assets.

The Tax Court noted that IRC Section 6324(a)(2) imposes personal liability for unpaid taxes on a trustee and the transferees of non-probate assets. As such, the daughter was personally liable for the unpaid debt as both trustee and transferee. The daughter's personal liability as trustee was equal to the trust's date-of-death value: $3.1 million. Also, as a transferee, the daughter was personally liable for the $978,000 transferred to herself. Correspondingly, the brother was personally liable for $1.5 million, the-date-of death value of non-probate assets he received from the estate.

90. LEVY ATTACHED TO DECEDENT'S INTEREST IN REAL PROPERTY AND THE SPOUSE'S SHARE DUE TO ACTING AS FIDUCIARY

Chief Counsel Advice 200949001

The IRS's sale of property that a decedent and his spouse held as tenants by the entirety transferred only the decedent's share to the purchaser. After the decedent's death, the surviving spouse, who was also the executor of the estate, transferred most of the decedent's assets out of the country and then left the United States. No transferee or fiduciary liability was assessed against her. The IRS issued a levy against the decedent's interest in property located in the United States, which the decedent and his spouse owned as tenants by the entirety. The property was advertised and sold at a public auction. However, it was not made clear at the auction that the spouse also held an interest in the property. After the sale, the purchaser was unable to record the conveyance because the spouse's name was not on the deed. The purchaser had only purchased the interest over which the IRS had a right to issue a levy under Section 6324 (i.e. the portion of the property includible in the decedent's gross estate. Pursuant to Section 2040(b), the decedent's interest in the property was a qualified interest, causing only half of the property to be includible in his gross estate. A fiduciary liability may still be assessed against the spouse, which would allow the IRS to seize and sell her interest in the property as well. Alternatively, an action could be filed in federal court to have the spouse's share sold judicially.

91. IRS DID NOT SHOW AN OWNERSHIP INTEREST TO SUPPORT INCLUSION OF COMPANIES IN ESTATE

***Estate of Robert C. Fortunato*; TC Memo 2010-105**

The Tax Court has held that IRS failed to conclusively establish that an individual had an ownership interest in a group of warehouse companies where there was an asserted estate tax deficiency of over $11.6 million and an asserted fraud penalty of over $8.6 million. Thus, the value of the companies could not be included in the individual's estate.

The Tax Court held that the decedent never desired or intended to be a shareholder of the companies for two reasons. First, he was fearful that if his creditors were aware of any assets owned by him, they would attempt – forcibly or otherwise – to collect the debt. Second, he was worried that his own past criminal convictions would stigmatize any company in which he had an ownership interest. The court said he had no financial reason to be a shareholder. Thus, the decedent was given carte blanche use of the companies' coffers, which enabled him to enjoy a generous quality of life. Moreover, he had no need to accumulate wealth to pass on to others upon his death as he had no spouse and was estranged from his children. His only bounty was his brother who already owned the companies in question.

The court also observed that the decedent did not have any of the financial burdens associated with equity ownership. He was never asked to, nor did he, make any contributions or loans to the companies, and did not guarantee any of their debts. He had no risk of loss, no capital risk, and no potential personal liability. Thus, on the totality of the record, the Tax Court found that the decedent did not own a property interest in the companies in question at the time of his death.

The court added that it was not faulting the IRS for attempting to protect the federal government in suspecting the decedent's owned an interest in the companies.

NON-RESIDENTS

92. GROSS ESTATE OF NONRESIDENT ALIEN INCLUDES U.S. STOCK THAT WAS DECEDENT'S SEPARATE PROPERTY; NO LATE FILING PENALTY

***Estate of Charania, et al. v. Shulman*, 2010 WL 2404423, 105 A.F.T.R. 2d ¶2010-988**

The First Circuit partially affirmed a Tax Court decision holding that the gross estate of a Ugandan exile, who was a British citizen permanently residing in Belgium, included all of his shares of U.S. corporate stock that were registered only in the decedent's name. The First Circuit disagreed with the Tax Court's refusal to abate a fragment of the late filing penalty.

The estate argued that the stock qualified as community property under Belgian Law which should be applied because the spouses were living in Belgium when the decedent bought the stock. As such, the estate argued that only 50% could be included in the gross estate. The First Circuit rejected this argument based on controlling precedent. Belgium's conflict of law rules required the court to look to England for the law controlling marital property. Under English law, the only precedent on point dictated that because the spouses were domiciled in Uganda at the time of their marriage and Uganda's marital property regime corresponded to England's marital/ separate property regime at that time, the separate property regime controlled. The court said that this required the stock to be fully included in the decedent's estate as his separate property.

The estate objected that the mutability doctrine, which would have applied the community property law of Belgium, should control. The court stated that this was based in part on a misapplication of a certain treatise or on a misguided fairness theory and otherwise off base.

The husband's estate filed his estate tax return almost a year late but the IRS applied the reasonable cause exception and rescinded the late filing penalty. The IRS later determined that the estate included all of the U.S. stock held by the husband rather than half of it. It levied an additional late filing penalty based on the increased estate tax due to the inclusion of additional stock in the decedent's estate. The Tax Court agreed with the IRS and rejected the estate's request for abatement of the increased portion of the late filing penalty. On appeal, however, the First Circuit abated the balance of the penalty, refusing to allow the portions of the late filing penalty to be treated differently. It stated that although the penalty was imposed in two stages, it was really a single penalty applying to a single default / single return filing failure. Therefore, the First Circuit stated that once the abatement was given as to the initial portion of the penalty, it should have also been given to the increased portion as these were really part of the same, single penalty. It added that there may be some instances where splitting the penalty and abatement would be justifiable, but the IRS hadn't shown any justification for doing so here.

DISCLAIMER

93. DISCLAIMER TIMELY IF MADE WITHIN NINE MONTHS OF BENEFICIARY REACHING MAJORITY

IRS Letter Ruling 200953010

A disclaimer of a contingent remainder beneficiary's right to receive a distribution from a pre-1977 trust upon its termination that was made within nine (9) months of reaching the age of majority was timely; thus, it did not result in a transfer subject to the federal gift tax. Although the beneficiary's interest was established at the creation of the trust, rather when her interest vested, the time period for making a disclaimer did not begin until she reached the age of majority. In addition, the beneficiary's retained right to receive discretionary distributions of trust corpus and income during the term of the trust prior to its termination did not invalidate her disclaimer of her remainder interest. Under applicable state law, an individual may make a

valid disclaimer of any separate interest in property while retaining other separate interests in the same property. Moreover, the disclaimer was determined to be unequivocal and the disclaimed interest would not pass pursuant to any direction on the part of the beneficiary. Further, the beneficiary's receipt of discretionary distributions during her minority did not constitute acceptance of the interest subsequently disclaimed.

MISCELLANEOUS

94. INCLUSION RULES REGARDING CANADIAN RETIREMENT PLAN

Chief Counsel Advice 201003013

Based on the facts and representations made by a Canadian decedent's estate, the decedent possessed a sufficient interest in or control over a registered retirement savings plan (RRSP), which is similar to an individual retirement account in the United States, such that it could be includible in his gross estate. According to the information provided, the decedent was able to make withdrawals from the RRSP at will and designate the beneficiary of the RRSP proceeds upon his death. Consequently, the RRSP would be includible pursuant to: (1) Code Section 2031 if the interest was deemed to be in the nature of outright ownership, similar to a brokerage account; (2) Section 2036 or Section 2038 if the RRSP was considered a trust or other entity; and (3) Section 2039 if the interest was more in the nature of a retirement annuity. The characterization of the RRSP did not affect the determination of the situs of the property held by the RRSP. As a result, the RRSP would be includible in the decedent's gross estate if the assets held by the RRSP had a U.S. situs at the time of the decedent's death.

A Canadian decedent's Canadian RRSP was not includible in his gross estate for federal estate tax purposes under Section 2104. The decedent, a Canadian resident, citizen and domiciliary, had contributed to the RRSP. The RRSP held shares of Canadian mutual funds owned shares of U.S. Corporations. The situs of the assets held by the RRSP was dependent upon whether the Canadian mutual funds owned by the RRSP were treated for US tax purposes as corporations or trusts, which was dependent on the entity classification rules of Reg. Sections 301.7701-1 through 301.7701-4. If the mutual funds held by the RRSP were classified as corporations for U.S. tax purposes, the shares of mutual funds would not constitute U.S. situs property within the meaning of Section 2104(a) and would not be includible in the decedent's gross estate. Although the mutual funds were organized as trusts under Canadian law, according to the information provided, the mutual funds should be classified as corporations for U.S. tax purposes.

95. PROPOSED REGULATIONS ADDRESS PERIOD FOR RECOVERY OF ADMINISTRATIVE COSTS

Proposed Regulations (REG-111833-99)

The proposed regulations address the period for recovery of administrative costs, which generally entitles the taxpayer to recover costs incurred after a notice of proposed deficiency (a "30-day letter") is mailed to the

taxpayer. They clarify that such costs are recoverable only if at least one issue (other than the recovery of costs) remains in dispute. The proposed regulations also address procedural requirements with respect to presenting an application with the IRS or, upon receiving an adverse decision from the IRS with respect to such application, filing a petition with the Tax Court to recover administrative costs. Pursuant to the proposed regulations, net worth calculation uses the fair market value of assets to provide a more accurate assessment of a taxpayer's actual and current net worth as of the administrative proceeding date. The proposed regulations apply to costs incurred and services performed on or after the rules are published as final regulations in the Federal Register.

96. FINAL REGULATIONS ON SSN AND CLAIMS ON RETURN

TD 9501

The IRS has finalized regulations, effective September 30, 2010, providing guidance to tax return preparers with regards to furnishing an identifying number on tax returns and claims for refunds of tax that they prepare. Under prior regulations, the identifying number of a tax return preparer who is an individual is the preparer's Social Security number (SSN) or alternative number as prescribed by the IRS. The regulations provide that for tax returns or refund claims filed after December 31, 2010, tax return preparers will not be able to use an SSN as a preparer identifying number unless specifically prescribed by the IRS. Instead, a tax return preparer will be required to use a preparer tax identification number (PTIN) as the identifying number unless the IRS prescribes in the future a replacement to the PTIN. Tax return preparers who do not use a valid PTIN on a tax return or claim for refund filed after the effective date may be subject to penalty under Section 6695(c). An individual tax return preparer must be an attorney, certified public accountant, enrolled agent, or registered tax return preparer preparing, or assisting in the preparation of all or substantially all of a tax return or claim for refund of tax. It does not include an individual who is not otherwise a tax return preparer as that term is defined in Reg. Sections 301.7701-15(b)(2), or who is an individual described in Reg. Section 301.7701-15(f).

Most practitioners have already received their PTIN through the IRS' on-line registration.
(www.irs.gov/taxpros/)

97. TAXPAYERS FAILED TO ESTABLISH NONTAXABILITY OF GIFTS FROM MOM

***Felt v. Commissioner*, TC Memo 2009-245**

A businessman and his wife had unreported income from the husband's mother that they could not establish were nontaxable gifts. The IRS's deficiency notice with respect to these amounts was not arbitrary or erroneous because the IRS secured bank records showing checks written to the couple or used for their expenses. Some amounts that were traced to the husband's business entities were subtracted from the amounts shown in the deficiency notice so that the income would not be double counted and taxed twice.

98. THE SMALL BUSINESS JOBS ACT OF 2010 SIGNED INTO LAW INCLUDING NOTABLE CHANGES TO THE INTERNAL REVENUE CODE

Public Law No: 111-240; 9/27/2010 (previously H.R. 5297)

The act will create the Small Business Lending Fund Program to direct the Secretary of the Treasury to make capital investments in eligible institutions in order to increase the availability of credit for small businesses to amend the Internal Revenue Code of 1986 to provide tax incentives for small business job creation amongst other purposes. Notable changes include:

- Reduction in holding period to avoid S corporation built-in gains tax;
- 100% exclusion of small business capital gains;
- General business credit carried back five years;
- General business credit not subject to alternative minimum tax (AMT);
- Increase of Code §179 expensing and expansion to certain real property;
- Extension of 50% bonus depreciation;
- Increased deduction for start-up expenditures;
- Deductibility of health insurance from self-employment tax;
- Removal of cell phones from "listed property"

99. IRS BEGINS NEW PTIN REGISTRATION

FED ¶46.458; TRC IRS 3.200 (Updated)

The IRS launched its new online preparer tax identification number (PTIN) registration system. All paid preparers were supposed to be registered on the new system and have a PTIN before filing any return after December 31, 2010, including preparers who already have a PTIN. This means that PTINs will no longer be processed on Form W-7P. Due to enrollment problems on-line, they are allowing late registrations.

Paid preparers who prepare all or substantially all of a tax return or claim for refund will be required to obtain a PTIN from the IRS and provide the number when the tax return preparer signs a tax return or claim refund.

100. THIRTEEN STATES PASS BENEFICIARY PROTECTION LAWS

Georgia Senate Bill 461; Florida Laws of 2010, Chs. 122 and 132

Georgia and Florida bring the total to thirteen states that have now passed legislation protecting beneficiaries from the unintended consequences of the federal estate tax repeal.

The Georgia law interprets certain formula clauses in the testamentary documents for decedents dying in 2010 as though they refer to the federal estate tax laws of 2009. Personal representatives and/or affected

beneficiaries then have the right to a determination of whether the decedent intended for the formula clause to be construed under the laws in effect after December 31, 2009.

The Florida law does not automatically interpret certain formula clauses as referring to the federal estate tax laws of 2009. Instead, it permits the trustees or beneficiaries of irrevocable trusts, or the personal representative or beneficiary of wills to go to court to request that certain formula clauses be interpreted according to the trustor's or decedent's likely intent.

Both are effective from January 1, 2010 through December 31, 2010, or until Congress passes legislation extending the federal estate tax.

(For other states' code sections, reference: Indiana Code §29-1-6-1(n), Md. Code Ann. Est. & Trusts §11-110, L. 2010, LB1047 (Nebraska), Tenn. Code Ann. §32-3-113, Utah Code Ann. §75-3-917, Va. Code Ann. §64.1-62.4, L. 2010, S6831 (Washington), and L. 2010, S670 (Wisconsin))

101. IRA'S FAILURE TO HAVE A DESIGNATED BENEFICIARY COULD NOT BE CORRECTED AFTER DEATH

IRS Private Ruling; PLR 201021038

The IRS ruled privately that a deceased taxpayer's IRA did not have a designated beneficiary under Code Sec. 401(a)(9) and a post-death judicial modification to name a designated beneficiary of the IRA could not be recognized for tax purposes.

According to Reg. §1.401(a)(9)-4, a designated beneficiary does not need to be specified in the plan in order to be a designated beneficiary so long as the individual is identifiable under the plan. Even a member of a class of beneficiaries that is capable of contracting or expanding will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. Following the Reg. section, Q&A-1 provides that the passing of an employee's interest to an individual under a will or otherwise under applicable state law will not make that individual a designated beneficiary under Code Sec. 401(a)(9)(E) unless that individual is designated as a beneficiary under the plan. A person who is not an individual may not be a designated beneficiary, including the estate. If the designated beneficiary is not an individual, the IRA owner will be treated as having no designated beneficiary for the purposes of the code section.

There is, however, an exception for trust beneficiaries under which the trust beneficiaries may be treated as designated beneficiaries if:

a) the trust is valid under state law, or would be except for the fact that there is no corpus;
b) the trust is irrevocable or will become irrevocable, by its terms, on the employee's death;
c) the beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument; and
d) relevant documentation has been timely provided to the plan administrator.

Reg. §1.401(a)(9)-4, Q&A-4 provides that in order to be a designated beneficiary, an individual must be a

beneficiary as of the date of the employee's death.

The facts of the case included a husband and wife who created a revocable trust. As restated, the trust provided for the creation of various trusts on the death of the first spouse to die. One of these was a Bypass Trust for which the surviving spouse was to act as trustee and distribute the income in installments for requirements of the beneficiary of the trust, but only if other resources are clearly inadequate or not reasonably available to meet the needs of the beneficiary. The beneficiary of the Bypass Trust had the power to allocate principal from the trust to Secondary Beneficiaries and their descendants as long as the grantor beneficiary was competent and exercised the power in writing. If the beneficiary did not do so effectively, the balance of the trust was to be disposed of pursuant to the terms of Article X therein.

Upon the death of the wife, the husband named his daughters as co-trustees of the bypass trust and named the trustee of the trust as the beneficiary of his IRA. Upon the death of their father, the co-trustees filed for a declaratory judgment to modify the trust to comply with regulatory requirements. The court modified the trust to provide, among other things, that: 1) all amounts received from the custodian of the IRA were to be distributed to the beneficiaries of the other trusts; 2) the trustee was authorized to arrange direct distributions from the IRA to the beneficiary; and 3) the oldest of the co-trustees was named as the designated beneficiary to satisfy Reg. §1.401(a)(9)-4, Q&A-4, and the trust was administered so that all beneficiaries following the co-beneficiaries were successor beneficiaries.

The private letter ruling stated that the decedent was treated as not having a designated beneficiary for his IRA for purposes of Code Sec. 401(a)(9). The IRS reasoned that the efforts to modify the terms of the trust were not to be given retroactive effect for federal tax purposes. As a result, the designated beneficiary of the IRA had to be determined under the terms of the Restated Trust as it existed at the time of decedent's death.

The IRS will generally only treat a state court order as controlling with respect to a reformation if the reformation is specifically authorized by the Code. Here, there was no applicable federal statute which authorized the co-beneficiaries' retroactive reformation of the trust. The modifications were therefore not recognized for federal tax purposes.

If the trust meets the requirements in Reg. §1.401(a)(9)-4, Q&A-5 it is permissible to look through the trust in order to determine who, if anyone, is the designated beneficiary. In this matter, however, there was no identifiable designated beneficiary for the IRA at the time of the decedent's death. The post-mortem judicial modification had the effect of creating a designated beneficiary after decedent's death, but this was not recognized for the purposes of Code Sec. 401(a)(9). Accordingly, the IRS concluded that the IRA was to be distributed as if the decedent had no designated beneficiary. Here, entities that were ineligible to be treated as designated beneficiaries (charities) were eligible to receive amounts from the IRA, and therefore became contingent beneficiaries under Code Sec. 401(a)(9).

102. COURT COMPELS PRODUCTION OF MOST DOCUMENTS THAT WERE CLAIMED TO BE PRIVILEGED

***Tom Gonzales, Personal Representative v. U.S.*, 105 AFTR 2d 2010-2194 (N.D. CA)**

A district court has ordered an estate to produce documents possessed by an accountant and an attorney relating to transactions engaged in by the decedent prior to his death. The estate claimed that the documents were protected by the attorney-client privilege, the work product doctrine, and the joint defense privilege. Conversely, the court found that most of the documents at issue were not protected.

The estate argued that communications between counsel and an accountant are privileged because: 1) the estate is like a corporation and therefore, communications are privileged under the subject matter test for corporate communications under *Upjohn Co. v. U.S.*, (1981, S Ct) 47 A.F.T.R. 2d 81-523; and 2) the accountant is an agent of the estate, so his communications are protected by *U.S. v. Kovel, Louis*, (1961, CA2) 9 A.F.T.R. 2d 366.

The court stated that the estate cited no authority to support the argument that an estate is like a corporation for purposes of the attorney-client privilege. It also stated that even if an estate is like a corporation for the purposes of the attorney-client privilege, there was no showing that the accountant was an employee of the corporation who was empowered to speak for the corporation under the *Upjohn* test. Instead, the court said that the accountant merely provided services to the decedent and consulting services to the estate. The court further stated that the accountant was not an agent for the purposes of *Kovel* and his communications were also not protected under this theory.

The court stated that the work product argument failed because the doctrine affords protection when it can fairly be said that the document was created because of anticipated litigation, and would not have been created in substantially similar form but for the prospect of that litigation. However, the court said that the accountant was not only the tax preparer but also an important fact witness, so the estate waived any work product protection for any of his documents. At the underlying hearing, the IRS agreed that it was not seeking non-factual documents that only revealed litigation and settlement strategy.

The decedent's attorney provided the decedent with an opinion letter describing the facts of the financial transactions at issue, analyzing the law related to the proper tax treatment of the investment, and concluding that if the IRS challenged them, the decedent would prevail. He continued to communicate with the estate after the decedent's death. The estate argued attorney-client privilege, the work product doctrine, and the joint defense privilege. To support its position on the attorney-client privilege, it stated that: 1) the decedent's death did not extinguish the privilege; 2) they are protected as corporate communications under Upjohn; and 3) the attorney acted as an agent for the estate under *Kovel*. The court held that because the estate produced the attorney's opinion letter upon which the decedent had relied, any privilege that may have attached to the documents and their subject matter was waived. The court rejected the other arguments for the same reasons it rejected them with respect to the accountant and stated that any work product claims were not viable. The court rejected the joint defense privilege as well, stating that there was no evidence of a Joint Defense agreement to protect the attorney's communications, nor did the estate establish that there are parallels between the IRS investigations of the accountant and the decedent that conclusively establish their common legal interest.