

## NAVIGATING AUDIT, APPEALS, AND LITIGATION: THE INTERNAL REVENUE SERVICE'S PERSPECTIVE ON ESTATE AND GIFT TAX CONTROVERSIES

by Robin L. Klomprens

### POWER OF APPOINTMENT

#### 1. 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 arise 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 decedents 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.

### CHARITABLE

#### 2. 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 Internal Revenue Code ("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.

### 3. DETERMINATION OF CHARITABLE TAX DEDUCTIONS

#### ***E. Williams Est., TC, 45,538*** **(T.C. 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.

#### **MARITAL DEDUCTION**

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

##### ***K. Lee Est., 94 TCM 604***

An estate hired an attorney to draft the wills of 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 six 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 reasonable relied on the advice of the estates attorney.

5. 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).

**GENERATION SKIPPING**

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

**IRS Letter Ruling 200925008**

A decedent's will created two 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 GST exemption to Trust A, but due to the amount of funding, a zero inclusion election as to Trust A did not occur. The executrix then requested an extension of time to make a Treas. Reg. section 26.2652-2(c) election to treat Trust A as two separate trusts for GST tax purposes.

The IRS granted the executrix a 60-day extension to make an election to treat Trust A as two 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 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 reasonable 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 taxpayers reasonably relied on a tax professional, who failed to make or who failed to advise the taxpayer to make an election.

7. 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 descendants 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 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 lose 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.

8. 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 modifications were administrative in nature as the modifications 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 lose 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.

## 9. 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 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 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.

10. 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 definition of issue and descendants would be changed to include legally adopted issue. At the time of the amendment, the sister had one adopted grandchild and two 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.

**QPRTs**

11. 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 the residence for a terms 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 fathers 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).

## 12. MODIFICATION OF QPRT DID NOT CAUSE TAXABLE GIFT

### **IRS Ruling 200848003**

The grantor of a qualified personal residence trust (“QPRT”) modified the original trust, such that at the end of the grantor’s retained term, the trustee could liquidate the trust property or provide a gift of a term interest in the property to the remainder beneficiary, the grantor’s daughter. At the end of the grantor’s term, the daughter transferred her interest in the residence to an irrevocable trust, with the intention that the trust qualify as a QPRT. The daughter intended to use the property as her personal residence.

Because the daughter intended to use the property as her personal residence, the zero-value rule applicable to retained interests under IRC Section 2702 did not apply to the transfer. The IRS ruled that the zero-value rule would not apply to the transfer so long as: (1) the trust was substantially similar to the sample in section 4 of Rev. Proc. 2003-42; (2) the trust operated in a manner consistent with the trust instrument; and (3) the trust was valid under applicable state law.

As to the grantor’s modification of the terms of the QPRT, to permit the gift/conveyance of his retained interest in the residence to the remainder beneficiary/daughter, the IRS ruled that the modification did not result in a taxable gift under IRC Section 2702.

## 13. PLR 200919002

IRS has issued favorable rulings to a taxpayer who transferred a residence to 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 transferred a residence to a QPRT. Under the terms of the QPRT, the trustee is 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 is 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 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.

## VALUATION

### 14. VALUATION OF ANNUITIES IN TRUSTS

#### **Proposed Reg. Section 20.2036-1, issued in April**

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.

## 15. 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 in 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 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 assessed 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 continued 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).

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

***Linton v. Unites States of America (USCS Tax Ct. 2:08-cv-00227) (2009, Wash. D.C.)***

In Linton, the court had to decide if it would dismiss Linton's suit seeking a tax refund. The suit would be dismissed if the Court found that Linton made indirect gifts to his children when he contributed property to an LLC, or if Linton's actions fell under the step transaction doctrine.

In 2002, Linton created an LLC. On January 22, 2003 Linton placed real estate and securities into the LLC. On January 22, 2003, Linton made gifts to his children of minority member interest and claimed a 47% discount for lack of control and marketability. On the same day the gifts were made to Linton's children, a trust for the benefit of Linton's children was established. In 2003, Linton filed gift tax returns wherein Linton reported taxable gifts in the amount of \$1.5 million. Although the express language of the trust documents indicated that the trust was created on the same day as the gifts, Linton testified that the trust was intended to be created prior to the gifts. The IRS audited the gift tax returns and found that the taxable gifts actually totaled \$3 million, based on the IRS's findings that the discounts for lack of control and marketability did not apply because the gifts consisted of assets to LLC members rather than transfers of LLC interests.

The Court found that the trusts were created and the gifts were made on the same day. As such, when the trust agreements were signed, the membership interest in the LLC had already been or was contemporaneously gifted to the trust, thereby making the transfer effective. The contribution of the underlying assets was applied to all capital accounts of the entity, not only to those of the contributing partner or member, so the transfer was an indirect gift of the underlying assets to each of the partners or members, the same as if the assets were transferred directly to the other partner/member and then contributed to the partnership/LLC. Accordingly, entity-level valuation discounts do not apply.

The Court also noted that even if Linton could establish that the LLC was funded prior to gifting his interest, indirect gifts were made to the children under the step transaction doctrine. The court reasoned that even if the sequence is correct: the assets are contributed, then the contributing member capital account is credited, then fractional interests in the entity are transferred, the steps are all part of one integrated whole. Therefore, the individual steps should be collapsed under the step transaction doctrine as effectively a transfer of the underlying assets to the other members.

17. IRC Section 2703 DID NOT APPLY TO THE VALUATION OF A TAXPAYER'S INTEREST

**IRS Letter Ruling 200852029**

A number of parties in a real estate joint venture executed a buy-sell agreement. Pursuant to the agreement, at each party's death, their interest would be purchased by the remaining parties for the deceased party's current equity in the book value of the JV. One of the parties to the agreement sold his interest in the JV to a trust established for his children. Although the party sold his interest to the trust, his life, not the life of any trust beneficiary, was still the measuring life for purposes of the agreement.

The IRS ruled that IRC Section 2703 did not apply to the valuation of the taxpayers interest on the date of the transfer. IRC Section 2703(a) provides that the value of any property for estate, gift and GST tax purposes is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than fair market value, or any restriction on the right to sell or use such property.

The IRS found that when the party sold his interest to the trust, there was a substantial modification to the agreement, because the trust beneficiaries were subject to the restrictions of the agreement and were assigned to a lower generation under IRC Section 2651. Since more than fifty percent of the joint venture was owned by members who were not members of the Taxpayer's family, and because their interests would be subject to the transfer restrictions to the same extent as the Taxpayer's interest, the exception under IRC Section 25.2703-(b)(3) applies to the transfer of the Taxpayer's interest in the joint venture to the trust, and therefore IRC Section 2703 does not apply to the valuation of the Taxpayer's interest on the date of the transfer.

#### 18. DETERMINATION OF DISCOUNTS (MINORITY, MARKETABILITY AND BUILT IN GAINS)

##### ***M. Litchfield Est., TC, 45,539(M)***

At decedent's death, decedent held a 43% and 23% interest in two 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, however, 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-percent 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.

19. TRANSFER OF SHARES/INCLUSION/GIFT TAX

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

Malkin owned a significant portion of shares in Delta & Pine Co. Malkin wanted to transfer a number of the shares to his two 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 trusts.

The decedent transferred 365,371 Delta & Pine shares to one of the limited partnerships ("LP 1) for all the general partner interests and 99.5 percent of the limited partner interests. The trustees of two of the children's trusts transferred \$25,000 to LP 1 for two .25 percent 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 9-year, \$3,981,816 self-cancelling installment note with interest at 7.14 percent. 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 as well as four 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 .75 percent of the \$4,345,000 required as security for his Bank of America debt. In a subsequent transaction, the decedent authorized the repledging 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 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 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.

### **6166**

#### **20. EXTENSION OF TIME TO MAKE ELECTION TO PAY ESTATE TAX IN INSTALLMENTS MUST BE MADE ON A TIMELY FILED RETURN**

##### **Chief Counsel Advice 200848004**

An estate retained a CPA to prepare the decedents federal estate tax return. The CPA was unable to complete the tax return on time. The CPA thereafter filed a request for an extension of time to file the return and attached a statement that it was anticipated that the estate would be eligible for a Code Sec 6166 election.

The IRS ruled that attaching a statement anticipating the estates eligibility to make an IRC Sec. 6166 election to a request for an extension of time to file a return was insufficient. Pursuant to Treasury Reg. Sec. 20.6166-1(b), the 6166 election must be made by attaching a notice to a "timely" filed return. Moreover, since the estate tax installment election is statutory rather than regulatory, the IRS found that the time to make a IRC Section 6166 election could not be extended under the regulatory provision of Reg. Sec. 301.9100-3.

### **TAX LIABILITY**

#### **21. TRANSFeree AND TRUSTEE LIABILITY FOR ESTATE TAX**

##### ***L. Bevan, DC Calif, 2009-1 USTC 60,570***

After the decedent's death, a federal estate tax return was filed showing that the estate owed estate tax 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 equaled 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.