

RECENT ESTATE PLANNING DEVELOPMENTS

Stanley M. Johanson

Distinguished Teaching Professor and
Fannie Coplin Regents Chair in Law
The University of Texas School of Law
Austin, Texas
512/252-1270
Fax 512-471-6988

Of Counsel, Vinson & Elkins L.L.P., Houston

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RECENT ESTATE PLANNING DEVELOPMENTS

I. Legislation and Regulations—Recent Developments

- A. Will 2010 really be an estate-tax-free year? The consensus is No.** Under the 2001 Tax Act (the Bush tax bill), the federal estate tax is scheduled to be repealed as of January 1, 2010 (and replaced with a “new, improved” carryover basis regime). However, because of gyrations in the Senate (having something to do with the Budget Reconciliation Act and the “Byrd Rule” in the Senate), the repeal expires December 31, 2010, and on January 1, 2011, the law as it existed in 2001—including a \$1,000,000 exemption equivalent—will arise from the ashes. Is this going to happen? The near-universal consensus—er, speculation—is that, now that the election is history but with some rather pressing problems facing Congress and the president (an understatement!), at some time in 2009 Congress will extend the 2009 rules for another year, meaning that instead of an estate-tax-free year in 2010, we will see an exemption equivalent of \$3,500,000 and an estate (and GST) tax rate of 45 percent. The will give Congress time to decide what to do on a permanent basis. (The term “permanent” is used with some hesitation, given the almost annual roiling of our transfer tax laws that began with the Tax Reform Act of 1976.)
- 1. What did the candidate Obama say about the estate tax during the campaign?** In the numerous Democrat presidential primary debates, and in the Republican primary debates, while the “Bush tax cuts” were either excoriated or supported in the context of the income tax, nary a word was said about repeal or reform of the estate tax. It was pretty clear that no candidate, Democrat or Republican, saw the estate tax as an issue worth milking. However, Jason Furman, Sen. Obama’s economic policy director, was quoted as saying that under an Obama presidency the 2009 rules would remain permanent: A \$3.5 million exemption equivalent and a 45 percent top tax rate. But what with the recent turmoil in the financial, housing, etc. etc. markets, all bets are off.
- B. SB 722, introduced on March 26, 2009.** Of the three estate tax bills that have been introduced in the first three months of 2009, this one is the most significant because it was introduced by Sen. Max Baucus (D. Mont.), chairman of the Senate Finance Committee.
- 1. \$3.5 million exemption equivalent (with inflation adjustment) and 45 percent tax rate.**
 - 2. Gift tax recoupled with estate tax.** The \$3.5 exemption equivalent under the estate tax also would apply under the gift tax.
 - 3. Portability of spouse’s exemption equivalent.** There has been wide interest and support for the portability concept, under which any unused exemption equivalent of the deceased spouse is carried over to the surviving spouse. Under this change, an “all my property to my spouse” would no longer lead to estate stacking for estate tax purposes. SB 722 adopts the portability concept in the context of the estate tax exemption equivalent, and not a deceased spouse’s unused GST exemption.
 - a. To prevent spouse-stacking, cap placed on amount of carryover.** “The term ‘aggregate deceased spouse unused exclusion amount’ means the lesser of (A) the basic exclusion amount and (B) the sum of the deceased spousal unused exclusion amounts computed with respect to each deceased spouse of the surviving spouse.”

- b. **Estate of deceased spouse would have to file and make election on estate tax return.** To secure the carryover of the deceased spouse's unused exemption equivalent, the spouse's executor would have to file a timely (including extensions) estate tax return.
 - c. **Statute of limitations would remain open.** "Notwithstanding any period of limitation under section 6501 ... the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount"—after the surviving spouse dies, no doubt.
- C. **HR 498, introduced on January 19, 2009.** This bill was introduced by Representative Mitchell (D. Ariz.) and referred to the Ways and Means Committee.
- 1. **\$5 million exemption equivalent (with inflation adjustment) and 45 percent tax rate for estates under \$10 million.** The bill would increase the exemption equivalent to \$5,000,000, phased in gradually: \$3,750,000 in 2010, \$4,000,000 in 2011, with annual increases of \$250,000 until the \$5,000,000 level is reached in 2015. Beginning in 2016, the \$5,000,000 amount would be adjusted annually for inflation.
 - a. The 45 percent estate tax rate would be retained. However, the tentative tax would be increased for taxable estates over \$25 million.
 - 2. **Gift tax recoupled with estate tax.** As under SB 722, the exemption equivalent under the estate tax also would apply under the gift tax.
 - 3. **Repeal of §2058 estate tax deduction for state death taxes for estates of decedents dying after 2009.**
 - 4. **Portability of spouse's exemption equivalent.** This portion of the bill is similar to the language of SB 722. In fact, the two bills' language dealing with keeping the statute of limitations open is identical.
- D. **HR 436, introduced on January 9, 2009.** This bill was introduced by Rep. Earl Pomeroy (D. N.Dak.), a member of the House Ways and Means Committee. The bill states in the preamble that its purpose is "[t]o amend the Internal Revenue Code of 1986 to repeal the new carryover basis rules in order to prevent tax increases and the imposition of compliance burdens on many more estates than would benefit from repeal, to retain the estate tax with a \$3,500,000 exemption, *and for other purposes.*" It is those "other purposes" that are attention-grabbers, as they would have an enormously negative impact on valuation and minority discounts.
- 1. **\$3.5 million exemption equivalent and 45 percent tax rate.** The bill would retain the \$3,500,000 exemption equivalent and the 45 percent estate tax rate. However, the tentative tax would be increased by an amount equal to 5 percent on amounts over \$10 million, with the amount of the increase not to exceed the sum of the applicable credit amount under section 2010(c) and \$119,200. Carryover basis would be repealed. This portion of the bill would have an effective date of December 31, 2009.
 - 2. **Goodbye to valuation discounts.** A new §2031(d) would provide that "the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets)." A nonbusiness asset is defined as "any asset which is not used in the conduct of one or more trades or businesses." The

definition of nonbusiness assets includes “passive assets,” and the bill lists five categories of assets that are deemed to be passive assets.

3. **Goodbye to minority discounts and hello to family attribution.** A new §2031(e) would provide that “in the case of the transfer of an interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family (as defined in section 2032A(e)(2)) of the transferee have control of such entity.”
4. **This bill has a “history.”** Because there was speculation afloat that Pomeroy had introduced a similar bill in the past, I had my research assistant look into the matter, and he uncovered the following facts. First, HR 436 has no co-sponsors (which is mildly unusual.) Mr. Pomeroy is the 10th most senior Democrat on the House Ways and Means Committee and either 109th or 106th (according to different sources) in overall House seniority. Since 1993, Mr. Pomeroy has introduced 115 bills, two of which have been enacted. “I am not very steeped in the ways of Congress,” says my research assistant, “but that does not seem like a particularly high rate of success.”
 - a. My research assistant found that Mr. Pomeroy introduced the same bill in 2002 as an amendment to H.R. 2143 (failing 197-231) and then as H.R. 5008. In 2003, these provisions were again introduced as an amendment to H.R. 8 (failing 188-239). In 2005, these provisions were introduced, first as H.R. 1577 (which was referred to Ways and Means), then as an amendment to H.R. 8 (failing 194-238). Finally, in 2007 these provisions were introduced as H.R. 4242 (again referred to Ways and Means, where it died).
 - b. “As near as I can tell,” says my assistant, “the valuation provisions in each of these attempts was exactly the same as (or at least very similar to) those in H.R. 436.”

E. What may happen to valuation discounts? Given the record deficits and the costs of all of the bailouts, whatever Congress does with the estate tax is likely to be accompanied by revenue offsets—and valuation discounts, obtained through entities such as LLCs and FLPs, are likely to be at the top of the list. History suggests what such proposals might be.

1. **Limit discounts to active businesses.** This was proposed by the Clinton administration in 1999 (and again in 2000 and 2001). The 1999 proposal “would eliminate discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds readily marketable assets (including cash, cash equivalents, foreign currency, publicly traded securities real property, annuities, royalty-producing assets, non-income producing property such as art or collectables, commodities, options and swaps), at the time of the gift or death.” The 2000 and 2001 proposals changed “readily marketable assets” to “non-business assets.”
2. **Aggregation rules may be on the table.** A January 27, 2005 report by the Staff of the Joint Committee on Taxation addressed both lack of control discounts and marketability discounts.
 - a. **Control discounts.** The JCT Staff suggested both a transferor aggregation rule (the interest transferred would be valued at a proportional share of the total interest owned by the transferor before the transfer) and a transferee aggregation

rule (the interest received by the transferee would take into account assets already owned by the transferee. Example: If Father owned 80 percent of an entity and gifted 40 percent to Son, under the transferor aggregation rule the interest would be valued at one-half of the 80 percent interest owned by Father. If Father dies and bequeaths the remaining 40 percent to Son, under the transferee aggregation rule the bequeathed interest would be valued at one-half of the 80 percent interest now owned by Son, including the 40 percent previously gifted to Son. Interests of spouses would be aggregated with transferors and transferees.

- b. **Look-through rule as to marketable assets.** The JCT Staff report also suggested that the portion of an interest in an entity represented by “marketable assets” would be valued at its pro rata share of the marketable assets if such assets represented at least one-third of the value of the entity’s assets.

F. Other recent legislation

1. **Charitable IRA rollovers extended.** The Emergency Economic Stabilization Act of 2008 (a.k.a. the Bailout Act) extended the use of charitable IRA rollovers (allowed under the Pension Protection Act of 2006 for 2006 and 2007) for all of 2008 and 2009. The same rules apply: The IRA owner or beneficiary, who must be age 70½ or older, can make qualified charitable contributions of up to \$100,000 in a calendar year. Married couples can each make a qualified contribution if both have IRAs and both are over age 70½.
2. **Residence gain exclusion for surviving spouse.** The 2007 Mortgage Debt and Relief Act amended §121 to provide that a surviving spouse now has up to two years (rather than just one year) to sell the residence and take advantage of the deceased spouse’s exclusion from recognition of gain, as long as the spouse has not remarried at the time of the sale. The Emergency Economic Stabilization Act of 2008 addresses the circumstances under which both spouses’ exemption can be used.
3. **Worker, Retiree and Employee Relief Act of 2008 (“WRERA”): Minimum required distributions suspended for 2009 (only).** The problem: Paul has an IRA whose balance, on December 31, 2007, was \$400,000. As Paul was 74 years old, his required minimum distribution in 2008 was [$\$400,000/14.1 =$] \$28,369. However, by the end of November 2008 the balance in his IRA had dropped to \$240,000—and there were a lot of “Pauls” in this very troublesome circumstance. There was an effort to suspend required minimum distributions for 2008, that didn’t come to pass. However, a new §401(a)(9)(H) provides that required minimum distributions are suspended—for 2009 only.
 - a. The suspension applies only to IRAs and defined contribution plans under §§ 401(a), 403(a), 403(b), and 457. The suspension does not apply to distributions from a defined benefit plan.
 - b. **Effect on distributions under five-year rule.** If a participant dies before the required beginning date and has no designated beneficiary, the plan benefits must be distributed within five years. Under WRERA, the five-year period is determined “without regard to calendar year 2009.” §401(a)(9)(H)(ii)(II). Effectively, the five-year rule becomes a six-year rule for participants who died between 2004 and 2009.

4. **WRERA: Non-spousal rollovers.** Many qualified plans do not offer a life expectancy distribution option to non-spouse beneficiaries. In this situation, many plans provided for distributions either in a lump sum or over five years. The Pension Protection Act of 2006 ("PPA") contained some good news for non-spouse designated beneficiaries. The Act allowed non-spouse beneficiaries to roll over distributions from a qualified plan, just as surviving spouses have always been able to do, provided that the rollover is made by December 31 of the year following the year of the participant's death. This would enable the beneficiary to take distributions over his or her life expectancy, using the Single Life Table. It seemed clear (at the time) that the Congressional intent was to give non-spouse beneficiaries the ability to stretch distributions over their life expectancies via a "stretch IRA."
 - a. The bad news was that the statute was unclear as to what would happen if a plan did not offer the rollover option. Notice 2007-7, 2007-5 I.R.B. 395, giving guidance on the PPA's provisions, stated that "[a] plan is not required to offer a rollover of a distribution to a nonspouse beneficiary." This raised a disturbingly clear implication that a rollover could not be made if the plan did not offer this option.
 - a. WRERA clarifies this by requiring that qualified plans offer this option—*but only for 2010 and thereafter*.

G. What has happened to issues raised in the Priority Guidance Plan 2007-2008 projects? A lot!

1. **Charitable lead trust ordering provisions.** The Service has issued proposed regulations under which ordering provisions in CLTs, under which the "bad" income (ordinary income) is first distributed to the charity, will not be respected. Prop. Reg. §1.642(c)-3 and §1.643(a)-6. Under the proposed regulations, unless the CLT's ordering provisions have an economic effect, they will be disregarded in determining the character of income paid permanently or set aside for the charity. The regulations give as a "no-go" example a CLAT provision under which distributions in satisfaction of the annuity are first to be paid from ordinary income, second from short-term capital gain, third from 50 percent of UBTI, fourth from long-term capital gain, fifth from the balance of UBTI, and last from tax-exempt income. Instead, the distribution to charity that qualifies for a deduction under §642(c) is deemed to consist of a proportionate share of all classes of income.
2. **Charitable lead unitrust sample forms.** The Service has published sample CLUT inter vivos forms (Rev. Proc. 2008-45, 2008-30 I.R.B. 224) and sample CLUT testamentary forms.
 - a. **Third-party nonfiduciary substitution power given tacit approval.** In recent years, there has been considerable discussion in the literature and at CLE programs as to whether, as a means of making an inter vivos trust a grantor trust, it is "safe" to use a §675(4) power under which a third party is given a nonfiduciary power to substitute assets of equal value. Among the concerns is that nobody really knows what it means to exercise a power in a nonfiduciary capacity; and that all of the PLRs on the issue close with the admonition that whether a substitution power has been or can be exercised in a nonfiduciary capacity is a fact question that we can decide on later.

Interestingly, the sample grantor trust forms contain such a substitution power, as did the sample CLAT forms that were published in 2007.

3. **Division of charitable remainder trusts.** Over the years, a number of PLRs have been issued as to the effect of an early division of a CRT with multiple lead beneficiaries into separate trusts, one for each beneficiary. Section 5 of the 2008 Rulings Revenue Procedure stated that this issue was on the “no rulings” list until further guidance was issued. That guidance came in Rev. Rul. 2008-41, 2008-30 I.R.B. 1, addressing the division of CRTs into new separate CRTs on a pro rata basis. A pro rata division (i) does not result in a failure to qualify as CRTs, (ii) is not a sale, exchange or other disposition producing gain, (iii) the basis of each separate trust’s share of each asset is the same share of the basis before the division, (iv) is not an act of self-dealing, and (v) is not a taxable expenditure under §4945.
 - a. **Non-pro rata divisions not addressed.** The Revenue Ruling does not address non-pro rata division because that would have required the input of the IRS’s income tax group.

4. **Section 2032 alternate valuation: Commissioner didn’t like the Tax Court decision, so he changed the rule.** That’s what Treasury did in response to *Kohler v. Commissioner*, T.C. Memo. 2006-152—although, in fairness, work on the proposed regulations had been ongoing. The case involved the estate of Frederic Kohler, an incapacitated member of the Kohler family that owned 96 percent of the stock in the plumbing parts company. With the assistance of a prominent Milwaukee law firm, work on a tax-free reorganization had commenced in 1996 and was completed and became effective on May 11, 1998. Frederic died on March 4, 1998. Pursuant to the reorganization, the estate exchanged its stock for stock that was subject to transfer restrictions and a purchase option. The estate tax return reported an alternate valuation date value of Frederic’s stock at \$47 million. The Service assessed a deficiency, taking the position that the value of Frederic’s stock was \$144.5 million. The government argued that the transfer restrictions should be disregarded in valuing the stock because Congress intended to provide relief under §2032 only for post-death decreases in value due to market forces, not voluntary changes. Rejecting the government’s argument, the Tax Court concluded that the tax-free reorganization was not a “disposition” within the meaning of §2032.
 - a. The Tax Court also ruled that burden of proof on the valuation issue shifted to the government, that the government’s valuation witness was not credible, and that the taxpayer’s two valuation witnesses gave impressive testimony.
 - b. The Service announced a nonacquiescence to the decision on March 3, 2008. AOD 2008-01, 2008-9 I.R.B. 483. Then, on April 25, 2008, the Treasury Department published proposed regulations to Reg. §20.2032-1 which adopt the position that the government unsuccessfully argued in *Kohler*: An alternate valuation election is available only to estates that experience a reduction in the value of the gross estate due to market conditions and not to other post-death events. “Market conditions” are defined as “events outside the control of the decedent, the decedent’s estate, or other persons whose property is being valued that affect the fair market value of property in the estate.” The proposed regulations include examples of events that are not considered changes as a result of market conditions, including (guess what?) the reorganization of an entity in which the estate has an interest, a distribution to the estate from such an entity, or distributions by the estate of a fractional interest in the entity.

- (1) Interestingly, proposed regulation's test may not have applied to the *Kohler* case, for the reorganization was "outside the control of the decedent."
 - c. The IRS has received a number of critical comments on the proposed regulations, and so the final regulations may not be quite as stringent. Final regulations are expected "soon." The regulations, when finalized, will apply to estates of decedents dying on or after April 25, 2008.
5. **Family-owned trust companies.** Notice 2008-63, 2008-31 I.R.B., addresses some of the tax effects of trusts that have a private trust company as a trustee, where family members that created the company are grantors or beneficiaries of the trust. The Notice outlines a proposed revenue ruling that is in the works.

H. What is happening to issued raised in the Priority Guidance Plan 2008-2009 projects? Several of the comments under this section are based on notes taken by Steve Akers (Bessemer Trust, Dallas) at the Fall 2008 ACTEC meeting and the 2009 University of Miami (Heckerling) Institute on Estate Planning.

1. **Bombshell under §2704 regulations?** Section 2704(b)(4) gives the Secretary authority to issue regulations regarding a restriction that has "the effect of reducing the value of the transferred interest for purposes of this subtitle, but does not ultimately reduce the value of such interest to the transferee." For the past six years, (beginning in 2003-2004), the Priority Guidance Plan has included "guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership." At the Fall 2008 ACTEC meeting, Cathy Hughes, of Treasury's Office of Tax Policy, said that work on such regulations is "at the top of the list," and that they should be issued by the end of the year. There have been rumblings that the regulations will address some of the grounds for valuation discounts in FLPs and LLCs.
2. **Updated mortality tables.** The current mortality tables under §7520 are based on 1990 census tables. As the tables must be revised every ten years, look for new tables based on data from the 2000 census.

I. Joint Committee on Taxation. On April 4, 2008, the Staff of the Joint Committee on Taxation published a report titled "Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas of Possible Reform." In addition to discussing several of the reform proposals mentioned above (*e.g.*, portability of spouse's exemption equivalent, valuation discounts), the report mentioned limiting dynastic trusts by making the GST exemption shelter only one generation of skips, and eliminating or drastically limiting the use of Crummey withdrawal powers as a means of securing gift tax annual exclusions.

1. **No mention of zero-out GRATs.** There have been rumors that Treasury, or someone, was going to make recommendations aimed at curtailing the use of short term zero-out GRATs, perhaps by amending the rules to require that the remainder interest be of a value of at least 10 percent of the value of the transferred interest. To date, however, that appears to be just a rumor. This is not mentioned in the JTC report, and none of the "estate tax" bills that were introduced in 2007 (and got nowhere) addressed this issue.

J. Freeze on new and pending regulations. On January 26, 2009, President Obama's Chief of Staff Rahm Emanuel sent a memo to the heads of executive departments and federal agencies stating that unless related to an emergency situation or other urgent circumstances,

no proposed or final regulation should be sent to the Office of the Federal Register (OFR) for publication until it has been reviewed and approved by a department or agency head appointed or designated by the President. Proposed or final regulations that have not been published in the Federal Register should be withdrawn from the OFR so they can be reviewed and approved, and the recipient should consider extending for 60 days the effective date of regulations that have been published in the Federal Register but not yet taken effect “for the purpose of reviewing questions of law and policy raised by those regulations.” Federal Register, 1/26/09, Volume 74, Number 15, page 4435.

II. Section 401—Qualified Plans and IRAs

A. Loan from IRA used by church for purchase of life insurance policy on participant’s life. Under §408(a)(3), no part of an IRA may be invested in life insurance contracts. Is there any way around this proscription? Well, the taxpayer in Ltr. Rul. 200741016 found a way. The ruling was issued in response to “a letter dated May 22, 2004, as supplemented by correspondence dated February 17, 2005, June 2, 2005, August 30, 2005, January 9, 2006, June 21, 2007, June 26, 2007, June 28, 2007, and July 3, 2007,” meaning that a lot of negotiation and give-and-take was involved.

1. Under the facts set out in the ruling, A has an IRA maintained by Company. The custodial agreement provides that A may direct Company to invest the IRA assets in any lawful investment acceptable to Company, that A is responsible for determining the suitability, nature and risk of the investment, and that A may not invest IRA assets in an investment that would constitute a prohibited transaction within the meaning of §4975. A proposes to direct an investment in the form of a loan to Church. A is neither a board member nor an employee of Church, and has no control, ownership or financial interest in Church. A further represented that he has no intention of taking a charitable deduction in conjunction with the proposed loan transaction.
2. In exchange for the loan, the IRA will receive a twenty-year promissory note at 5 percent interest, with interest payments to be made by Church on an annual basis. A balloon payment is to be made upon the earlier of the end of the 20-year term of the note or within 120 days after A’s death. The note further states that Church grants Company a continuing security interest in the insurance policy, and that Church shall not be entitled to convey, borrow upon or otherwise transfer any rights associated with the policy without Company’s written consent.
 - a. “You represent that the purpose of this security agreement within the promissory note is to provide additional certainty for Taxpayer A that the ownership of the insurance policy, will, from the date of purchase until the date of death, continue to qualify as an insurable interest under state law. Taxpayer A, pursuant to the terms of the security agreement within the promissory note will directly require Church B to seek written approval of Taxpayer A for transactions related to transfer of ownership, borrowing and other major changes that may impact the policy.”
 - b. “You also state that commercial reasonability requires proper collateralization of the promissory note and that this collateralization, in this case, is evidenced by two agreements: (1) the collateral assignment form agreement between the company that will issue the life insurance policy, Taxpayer A, Church B and Company P, and (2) the security agreement within the body of the promissory note executed between Church B and Company P.”

- c. “You represent that the intent to have two collateral agreements is to provide ample protection, outside of the contractual terms set forth within the insurance company's collateral assignment, that there will be a continuing ‘insurable interest’. You state that Taxpayer A is the most appropriate party to protect this interest. It is further represented that while written approval is required to convey, borrow upon or otherwise transfer any rights associated with said policy, Taxpayer A is never directly entitled to the death benefits under the policy and that Company P is the obligor [sic] under the promissory note and it will receive any payments of funds. You note that Taxpayer A, however, is the insured and should have the ultimate decision with respect to their individual insurable interests.”
 - d. “The promissory note will be secured by collateral assignment of a permanent life insurance policy which will insure Taxpayer A's life. The life insurance policy will be purchased and owned by Church B and provide a death benefit in the amount of Amount D. Church B will be the beneficiary of the life insurance policy. Church B will have all rights of ownership and benefit from any increasing death benefit that may be generated by the life insurance policy. Neither Taxpayer A nor IRA X will have the right to surrender, convert, pledge, cancel or sell the life insurance policy. Neither Taxpayer A nor IRA X will have the right to change or amend the beneficiary designation of the life insurance policy. Church B will not be entitled to convey, borrow upon or otherwise transfer any rights associated with the life insurance policy during the period of collateral assignment without the express written consent of Taxpayer A.”
 - e. “It is represented that IRA X is not the contract owner of the life insurance policy nor is IRA X the beneficiary thereof. IRA X, through Company P, does not have the ability to surrender, convert or sell the life insurance policy. Further, IRA X does not possess equity features in the form of either (1) the ability to surrender, convert, pledge, sell, cancel, or transfer the policy, (2) the ability to amend the beneficiary designation nor (3) any continuing beneficial interest in the increasing death benefit that may occur during the ownership of the life insurance policy.”
 - f. “It is further represented that the IRA X investment is a collateralized loan bearing interest with adequate collateral to guarantee repayment of the principal amount of the loan outstanding at Taxpayer A's death to IRA X. It is represented that IRA X is a secured creditor of Church B and not an investor in or contractual owner of the life insurance policy so that the IRA X proceeds are not invested in life insurance contracts as that term is used in section 408(a)(3) of the Code.”
 - g. A further represented that the annual interest paid by Church will be utilized, in part, to satisfy his required minimum distributions, and the balance of required minimum distributions will be satisfied by distributions from other IRAs held by A.
3. **This will work, said the Service.** Taxpayer made two ruling requests, and received favorable answers to both of them.
- a. This is not a prohibited transaction within the meaning of §4975, and thus the IRA will not cease to be an IRA under §408(e)(2). Church is not related to the IRA in manner that would come within the definition of a disqualified person

under §4975(e)(2). A is not a board member or an employee of Church, nor does A control or have a financial interest in Church.

- b. Church will purchase and own the life insurance policy, will have all rights of ownership under the policy, and will pay the policy premiums. The IRA is not the owner of the life insurance policy and is not the beneficiary of the policy. On A's death, only the promissory note will be repaid to the IRA. The IRA will not receive any death benefit generated from the policy. "Accordingly, we conclude that the above described transaction is not a prohibited investment in insurance within the meaning of section 408(a)(3) of the Code such that the IRA would cease to be an IRA under section 408(a)(3)."

4. **This would appear to be a great boon to the life insurance industry.** Under this ruling, a client can tap his or her IRA to find the money to pay premiums for a life insurance policy that will be payable to the client's favorite charity. But remember this: "This letter ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent."

- B. Life expectancy rule and not five-year rule applied even though no distributions were made for three years.** In Ltr. Rul. 200811028, P died at age 66, having named Child as beneficiary of his IRA. Required minimum distributions for the three years following P's death were made in the aggregate during the third year, and Child paid the 50 percent excise tax for failure to receive required minimum distributions for the first two years.

1. The ruling notes that the Explanation of Provisions of the 2002 final regulations under §§401(a)(9) and 408(a)(6) provides that "if an employee dies before the employee's required beginning date and the employee has a designated beneficiary, then the life expectancy rule in section 401(a)(9)(B)(iii) is the default distribution rule. Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule applies in all cases in which the employee has a designated beneficiary. Accordingly, the failure to timely take the required minimum distributions on behalf of Taxpayer A for 2003 and 2004 does not affect the calculation of minimum required distributions in subsequent years based on the single life expectancy of Taxpayer A initially determined in 2003 and reduced as provided in the final regulations."

- C. Bookkeeper failed to send SEP-IRA distribution to the broker.** In *Atkin v. Commissioner*, T.C. Memo. 2008-93, A, the sole shareholder of an incorporated law firm, received a \$25,000 distribution from his SEP-IRA and deposited the distribution in the firm's operating account. Within 60 days, A instructed his law firm's (former) bookkeeper to write a \$25,000 check and mail it to Broker, who had been instructed by A to roll the funds over into a new IRA. Broker stated that he never received the check. The firm's new bookkeeper stated in her affidavit that a \$25,000 check had been written but was never cashed. A testified that he was not aware that the new IRA had not been funded until he received a deficiency notice.

1. The court determined that A's reliance on *Wood v. Commissioner*, 93 T.C. 114 (1989), was misplaced. In that case, the IRA trustee recorded the rollover of stock in the wrong account. "[W]ithin 60 days of the distribution, the taxpayers had opened the IRA, delivered the stock to the trustee, instructed the trustee to roll over the stock into the IRA, and been assured by the trustee that the rollover would be consummated as instructed. In *Wood* the failed rollover occurred as a result of a clerical error on the part of the broker. The facts in this case are distinguishable.... Mr. Atkin waited over 2 years before inquiring into the status of the distribution. Mr. Atkin claims that the

check was lost in the mail and thus the failed rollover was not his fault. Whether the check was lost in the mail is not dispositive. Mr. Atkin should have been alert to the fact that he never received a statement regarding the IRA account he thought he had opened, never discussed investment strategies with [Broker], and never noticed that the \$25,000 had not been withdrawn from his law firm's operating account.”

2. The court also affirmed the Service’s imposition of a 10 percent early distribution excise tax and an accuracy-related penalty.

III. Section 671—Grantor Trust Rules

A. **Modification giving trustee discretion to reimburse grantor for income taxes has no adverse consequences.** In Ltr. Rul. 200822008, G established and named Wife trustee of a GST-Exempt Trust (tied to G’s unused GST exemption) and a GST Non-Exempt Trust. Both were grantor trusts because of discretionary powers given to Wife as trustee. The trust provided that the trustee was prohibited from reimbursing G for any income tax, and G expressly waived any right of reimbursement.

1. In the ruling request, the trustee proposes to petition a state court for a modification under which the trustee would be authorized, but not directed, to pay to G all income taxes resulting from the trusts’ status as grantor trusts. Such distributions would be subject to the approval of a “Reimbursement Committee,” the initial member of which be G’s attorney A. “It is represented that A is neither an employee of Grantor, nor an employee of a corporation whose stock is owned by the Grantor (or Trust, Exempt Trust or Non-Exempt Trust) or whose executives include Grantor, nor a relative of the Grantor listed in section 672(c). Spouse, if she is then living, otherwise Grantor's living children by majority vote, or if there are no then living children of Grantor, then Grantor's living issue (by majority vote) may remove any persons then serving on the Reimbursement Committee, and or appoint additional persons at any time with or without cause. However, no one related or subordinate to the Grantor within the meaning of §672(c), can be appointed to the Reimbursement Committee.”
2. **Income tax rulings.** “[A]ssuming there is no understanding, express or implied, between the Grantor, the members of the Reimbursement Committee and the trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy Grantor's obligation would not alone cause the inclusion of the trust in Grantor's gross estate for federal estate tax purposes. However, as noted in Rev. Rul. 2004-64, 2004-2 C.B. 7, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between Grantor and the trustee, or member(s) of the Reimbursement Committee regarding the trustee's exercise of this discretion; or applicable local law subjecting the trust assets to the claims of Grantor's creditors) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes.”
3. **Generation-skipping transfer tax ruling.** “No guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, a modification that does not affect the exempt status of a trust that is not subject to the GST tax because it was irrevocable on to September 25, 1985 should similarly not affect the inclusion ratio of a trust created after September 25, 1985. In the instant case, the proposed modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in 2651) than the person or persons who held the beneficial interest prior to the modification,

and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, we conclude that the modification, as proposed will not affect the inclusion ratio of the Exempt Trust for GST tax purposes.”

B. Revenue Ruling: Grantor’s substitution power exercisable in nonfiduciary capacity does not cause gross estate inclusion. In Rev. Rul. 2008-22, 2008-16 I.R.B. 796, the Service ruled that a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate. This result is subject to the proviso that the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value. Also, the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. This latter is not a concern, says the ruling, if either (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries, or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries.

1. In the situation posited in the ruling, the grantor was not the trustee and was prohibited from serving as trustee. The ruling notes that in *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), acq. in result, 1977-2 C.B. 1, which ruled that there was no gross estate inclusion, the grantor was the trustee. “Thus, [the grantor] D is not subject to the rigorous standards attendant to a power held in a fiduciary capacity. However, under the terms of the trust, the assets D transfers into the trust must be equivalent in value to the assets D receives in exchange. In addition, [the trustee] T has a fiduciary obligation to ensure that the assets exchanged are of equivalent value. Thus, D cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase D's net worth. Further, in view of T's ability to reinvest the assets and T's duty of impartiality regarding the trust beneficiaries, T must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by D. Under these circumstances, D's retained power will not cause the value of the trust corpus to be included in D's gross estate under § 2036 or 2038.”

C. Revenue Ruling: Grantor’s exercise of substitution power exercisable in fiduciary capacity not a taxable gift and not a problem under estate tax. In Ltr. Rul. 200842007, a trust created by G for the benefit of his wife and descendants gave G the power to substitute assets of equivalent value, exercisable in a fiduciary capacity, meaning that the power had to be exercised in good faith and in the best interest of the beneficiaries. The Service ruled that G’s exercise of the substitution power will not constitute a gift to the trust, and will not cause the trust property to be includible in G’s gross estate on his death.

D. Trust was grantor trust even though beneficiary held withdrawal power over trust assets. Ltr. Rul. 200840025 involved four trusts for the benefit of G’s children. Each trust gave a non-adverse trustee the power to make loans to G without adequate security. (The power was subject to an on-and-off switch: The non-adverse trustee could release this power by giving written notice to G and the current trust beneficiary.) After a child attained age X, the child could withdraw all or any portion of the trust assets.

1. The ruling points out that the beneficiary’s withdrawal power ordinarily would make the beneficiary the “owner” of the trust for income tax purposes under §678(a).

However, the power to loan funds to G without adequate security made the trusts grantor trusts. “Because the separate trusts are grantor trusts under §675(2) with respect to G, they are grantor trusts in their entirety with respect to G notwithstanding the powers of withdrawal held by the Beneficiaries that would otherwise make the Beneficiaries the owners under § 678 when they attain age X.”

IV. Section 2032—Alternate Valuation Date

- A. **Alternate valuation election was not timely.** In *Estate of Loree v. United States*, 2008-1 U.S.T.C. ¶60,555 (D.N.J. 2008), the estate tax return, due on September 26, 2003, was filed on August 19, 2003. The estate did not elect alternate valuation. An amended estate tax return using the alternate valuation date was filed seven months later, in March 2004. Too late, said the court. The alternate valuation election must be made on an amended return filed within the time prescribed for filing the return. Because the amended return was filed more than six months after its due date, the election was not timely made.

V. Section 2036—Transfers With a Retained Life Estate

- A. **Inept lawyering graphically described.** “It is a truth universally acknowledged, that a recently widowed woman in possession of a good fortune must be in want of an estate planner.” So begins the opinion in *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278, involving the widow of a former president of Hunt Oil Company. That first sentence reflects Judge Holmes’ breezy and easily readable writing style, and I recommend reading the opinion despite its length for its entertainment value. (Entertaining, that is, if you find satisfaction in seeing a supposed estate planning attorney absolutely skewered for his ineptitude.)
1. **How not to select an estate planning attorney.** The story began with H retaining Santo (Sandy) Bisignano, a highly regarded Dallas attorney, to plan the Hurfords’ estates. Although Bisignano recommended some “slightly more aggressive techniques” including ILITs, GRATs and FLPs, H “took a conservative approach to estate planning,” and the result was mirror wills for H and W, each with a bypass trust and a QTIP trust. When H died in April 1999 survived by his wife Thelma and three children, his one-half of the \$14.2 million community property estate passed into the bypass trust (\$650,000 exemption equivalent) and the QTIP trust. The will named W as executor and trustee of the two trusts. Bisignano commenced to develop an estate plan for W, which began with gifts of \$675,000 (the exemption equivalent in 2000) to the couple’s three children. Developing the rest of a proposed plan took some time *and was complicated by W’s being diagnosed with cancer in January 2000 (nine months after her husband’s death)*, and Bisignano was weighing the benefits of a full QTIP election versus a partial election that would produce a PTP credit under §2013.
 - a. The family got impatient with Bisignano. W was “concerned that he was not completing Gary’s estate tax return or her own estate plan quickly enough and worried that he was too expensive.... Advice from Bisignano and KPMG was no longer free, because Hunt Oil stopped paying their bills after Gary died.” One of the children started to look for a replacement attorney, “but living in Louisville made this mission difficult and he turned to his brother-in-law, an orthopedic surgeon living near Houston, for advice. This brother-in-law recommended Joe Garza.”

- b. Two of the children “asked Garza to critique Bisignano's proposed estate plan and make suggestions on what he would do differently. Their infatuation with Garza was understandable. We observed Bisignano to be reserved and fastidious, and proud of the high quality of his work, but with a manner that on first appearance is perhaps not the most inviting. Garza, in contrast, is a model of the amiable and pleasing man; and his debut in the notes of Thelma's meetings with him show that she thought him one of the most agreeable men (or, at least, lawyers) that she had ever met.” He also promised results. “We know from [daughter] Michelle's notes that Garza bragged that he had ‘experience obtaining 50 percent discounts in settlements on estates with IRS, and also [he] had coached a lawyer in Mississippi in a valuation battle with IRS, and he got a 50 percent discount.’”
 - c. “According to Garza, a ‘brilliant estate-planning strategy’ is one ‘that saves estate tax.’ His plan was to separate Thelma's, the Marital Trust's, and the Family Trust's assets into three groups: (1) cash, stocks, and bonds; (2) the Hunt Oil phantom stock; and (3) the farm and ranch properties. Then he created three FLPs, one to receive each group of assets, giving an interest in each to Thelma, Gary's estate, Michael, David, and Michelle. Finally, Garza directed Thelma to sell her and Gary's estate's interests in each FLP to Michael, David, and Michelle through a private annuity agreement.” (Yeah; a private annuity when the client has been diagnosed with cancer is a really good idea!)
2. To say that the resulting plan was badly conceived and even more badly implemented would be an understatement—and Judge Holmes pulls no punches. A small sampling:
 - a. The partnership agreements “show an unsteady drafting ability to even an untrained eye—a table of contents pointing to incorrect page numbers, a grant of a limited-partnership interest to the “Gary T. Hurford Trust” when no such trust existed at the time, and signature pages showing HM-1 as the general partner of all three partnerships.”
 - b. “Garza prepared another of his form letters to notify Hunt Oil that Thelma wanted the phantom stock moved to HI-2.” Richard Massman, Hunt's transfer agent and general counsel, received the letter on March 24, 2000, and quickly sent W a list of documents needed to okay the transfer: Letters testamentary, an excerpt from the will identifying W as beneficiary, documentation showing that the phantom stock was transferred from the estate to W, and an assignment from W to HI-2. One of the children got back to Massman *in October*—W had been diagnosed with cancer, remember—and Massman asked for an indemnity letter. “This prompted Garza to send Massman an indemnity letter on November 18, 2000, but this letter was as sloppy as the other paperwork he'd prepared, including a space on a signature line for ‘Daniel’ instead of David. Massman is a meticulous man, and he wanted the letter corrected. But it took Garza almost two months to fix his mistakes. The second letter satisfied Massman, though, and on January 15, 2001, Massman responded with his own letter stating that Hunt Oil recognized HI-2 as the owner of the phantom stock.”
 - c. One of the LPs was to be funded with real estate. “To complete this chore, Garza prepared twenty deeds for Thelma to sign. Why twenty? We're not sure. We could not figure out by examining the deeds how eleven parcels (or fifteen, if a couple contiguous properties were divided) had multiplied into twenty. There was also another patent problem with the deeds. Garza had drafted each deed so that it conveyed the property to ‘Hurford No. 3, Ltd.’ not ‘Hurford

Investments No. 3, LTD.’ Garza filed the deeds with the counties on March 23, 2000. But even twenty deeds were not enough: Garza failed to prepare a deed for a parcel that was in both Ellis and Dallas Counties. Garza waited until April 10, 2002, and then mistakenly deeded this parcel to ‘Hurford No. 3, Ltd., too.’”

- d. In valuing HI-1's for purposes of computing the private annuity to be paid in exchange, Garza reported values for the stocks, bonds and mortgage notes. “We don't know where Garza got these numbers—while they are close to those on Gary's estate tax return, they differ by about \$200,000. They are also significantly lower than the minimum of more than \$5.5 million that the Hurfords agree was transferred into HI-1. And they in no way take into account the changes in the composition of Gary's and Thelma's assets in the year after he died.”
- e. “In his April 4 letters, Garza valued the phantom stock at \$5,552,377. That is the same value that he reported on Gary's estate tax return. It comes from a letter that Massman had sent Bisignano in May 1999 that included an estimated value for the phantom stock as of December 31, 1998. Garza testified that he used this value because it was the ‘most current information that we had’ and ‘it didn't appear to me that the value was increasing very much.’ But we know that the December 1998 value was already out-of-date because Hunt Oil recalculated phantom-stock values at the end of each calendar year. And we specifically find that the value of the phantom stock was increasing. In February 2000, Massman met with a Chase employee to discuss the phantom-stock plan and during that meeting he estimated that the phantom stock was already worth \$6.4 million.”
- f. ”In his April 4 letters, Garza listed the value of HI-3 as \$2,020,800. This was again based on the same valuation used to report real estate values on Gary's estate tax return. But using the number from the return was wrong. Those real-estate values came from an appraisal that Bisignano had prepared and reflect the properties' values on April 12, 1999, the day Gary died, and Garza made no effort to consider any change in their values in the year that had passed. The \$2,020,800 reported on Gary's estate tax return also included the Arlington and Tyler houses, and the Ellis/Dallas county property, none of which was actually transferred to HI-3.”
- g. “The method that Garza used to pick the discount factors to apply to the FLP interests was similarly haphazard. [H]e contacted several valuation appraisers [but] the appraisals were never done. Garza chose instead to use his own discount percentages, but even the precise percentages that he chose are unclear from the record. They fell, more likely than not, within the range bounded by the two versions of his April 4 letter.”
- h. On H’s estate tax return, a marital deduction of \$6.54 million was taken. “The problem is that we have no idea which property is included in that number. On the schedule M it is only described as ‘QTIP.’. At trial, when asked about the number, Garza replied that he didn't remember how he computed it.”
- i. KPMG was replaced by another accounting firm, Turner & Stone. A K-1 for 2000 showed substantial capital contributions by the children. “These numbers appear to be complete fictions. We specifically find no evidence of money coming into or services provided for any of the FLPs or LLCs from the three Hurford children, much less the millions of dollars that Turner & Stone reported.”

- j. On the estate tax return signed by Garza as preparer, three of the No answers given to four questions were problematic. However, “Garza's answer of ‘no’ to the final question is just egregiously false. He himself had prepared Gary's estate tax return and should have known that section 2056(b)(7) refers to a QTIP trust like the one for which he claimed a deduction on that return.”
- 3. **The private annuity.** In April 2000, two of the three children signed a private annuity agreement in exchange for W’s transfer of LP interests. Why not Michael, the third child? He “has struggled with difficult personal problems, some of them severe, for much of his life.” W wanted to benefit all three, so she received assurances from the two other children that they would take care of Michael—laying the predicate for the government’s successful contention that W retained a §2036(a)(2) power to retain beneficial enjoyment. In satisfying the \$80,000 monthly annuity payments, the two children distributed back to W—guess what? The children did not have the resources to make the annuity payments, so the distributed assets that W had transferred to the FLP that contained marketable securities.
 - 4. W died in February 2001. The estate tax return reported no taxable gifts, nor did it report a \$240,000 refund claim that was shown on W’s final income tax return (prepared by Turner & Stone). The Service assessed a deficiency. “Thelma's estate has conceded an increase in the estate's value of \$3,381,999 because Garza failed to report the money Thelma received when she liquidated her IRA, her individual tax refund, and the proceeds from the sale of ... stock. The estate also concedes that the true value of Thelma's THAA account was \$426,206. The main issue that we are left to decide is what else should have been included—specifically, whether Thelma's transfers to the FLPs and the subsequent private-annuity transaction were valid under sections 2035, 2036 and 2038.”
 - a. Guess what? The court found for the government on every issue—with two exceptions. The government had challenged the \$45,000 deduction for attorney’s fees paid to Garza. Although there was no documentation to support this number, the court found that Garza had done some work for the estate and that \$45,000 (out of the total of \$300,000 he had received in fees) sounded about right. Also, the court declined to assert negligence penalties, concluding that these lay persons couldn’t be expected to comprehend the ineptitude of the attorney and accountants who represented them.

VI. Section 2039—Annuities

- A. **Annuity interest in structured personal injury settlement had to be valued under term interest tables.** So held in *Anthony v. United States*, 520 F.3d 374 (5th Cir. 2008), affirming the district court. The estate argued that the three annuities should have been assigned their fair market value without regard to the §7520 annuity tables because nontransferability clauses rendered the annuity tables subject to a restriction. Not so, said the court. The “restricted beneficial interest” exception of Reg. §20.7520-3(b)(1)(ii) does not create an exception to the tables based on a marketability restriction.
 - 1. The court cited *Cook v. Commissioner*, 349 F.3d 850 (5th Cir. 2003), in which the court said that Congress displayed a preference for convenience and certainty over accuracy. The tables provide some measure of certainty and administrative convenience that would be disrupted if every attempt to value an annuity deteriorated into a battle of experts regarding market value.

VII. Section 2041—General Powers of Appointment

- A. **Pre-1942 power of appointment cases still arise.** For trusts created prior to October 21, 1942, a general power of appointment did not result in a gross estate inclusion unless the power was exercised. Enactment of the current rule, under which the power-holder is subject to tax whether or not the general power is exercised, affected a sizeable number of wills that already have been drafted. To grant relief in this situation, the Power of Appointment Act of 1951 permitted holders of general power of appointment to shave them down to special powers by way of a release. In Ltr. Rul. 200812022, prior to November 1, 1951, 19-year-old grandchild G executed a partial release of her testamentary power of appointment over a trust, relinquishing the power to appoint to herself, her creditors, her estate, or the creditors of her estate, but retaining the power to appoint by will to her descendants. Although G was not of majority age when she partially released the power, the trust authorized a beneficiary to exercise a power of appointment upon attaining age 18. As a result, G's partial release of her power of appointment was valid.
1. In the ruling request, G proposed to exercise the testamentary power in favor of her descendants. That will not be a problem, said the Service. G will be exercising a special power of appointment, and the exercise will not affect the GST-grandfathered status of the trust.
 2. **And another one!** Ltr. Ruls. 200733008-012 and 200734010 also involved pre-1942 trusts. Each trust gave a child a general inter vivos power of appointment and a special testamentary power of appointment. In the ruling, the Service concluded that a beneficiary's power to appoint and remove a bank or trust company as successor trustee will not be considered the creation of a general power of appointment, and the exercise of this power will not cause the assets of a beneficiary's trust to be includible in his or her estate. The Service also concluded that the exercise of a beneficiary's testamentary special power of appointment will not be considered an exercise of such beneficiary's lifetime general power of appointment, and none of the foregoing actions will constitute an addition to the grandfathered GST trust.
 3. **And another one!** In Ltr. Rul. 200825037, D died without having exercised a general power of appointment. This resulted in a lapse of the power—but because the trust was created before October 22, 1942, there were no adverse tax consequences. The ruling also involved disclaimers by a daughter, the daughter's current spouse and her former spouse, and four grandchildren.

VIII. Section 2055—Charitable Deduction

- A. **Final regulations clarify effect of unrelated business taxable income.** On June 19, 2008, the Treasury Department issued final regulations amending Reg. §1.664-1(a), relating to the treatment of UBTI in charitable remainder trusts. No substantial changes were made to the proposed regulations that had been issued in March. Acting in response to amendments to §664 made by the Tax Relief and Health Care Act of 2006 (Pub. L. No. 109-432), under the regulations the CRT's income is allocated among the trust income categories under Reg. §1.664-1(d) without regard to whether any part of the income constitutes UBTI. The trust is subject to a 100 percent excise tax on UBTI, which is payable from trust corpus.

1. While a 100 percent excise tax is rather heavy, the new rules, applicable to taxable years beginning after December 31, 2006, are a beneficial change from the former law, under which a CRT that had UBTI in any year lost its exempt status for that year.

B. Proposed regulations regarding ordering provisions relating to payments to charitable beneficiaries. On June 18, 2008, the Treasury Department published proposed amendments to the regulations under §662(c) with regard to the tax consequences of an ordering provision in a trust, a will, or under local law that attempts to determine the tax character of the amounts paid to a charitable beneficiary. As stated in the preamble to the proposed regulations, such provisions “must have economic effect independent of income tax consequences in order for [such provisions] to be respected for Federal tax purposes.... To make this concept clearer and easier to understand, the proposed regulations amend the regulations under section 642(c) to add the principle of economic effect directly into the language of the regulation itself, rather than being incorporated by reference to other regulation provisions.”

1. The preamble gives as an example of an unacceptable provision one that directs that annuity or unitrust payments to a charitable beneficiary (*e.g.*, in a charitable lead trust) be made first out of ordinary income and capital gains in order to maximize the trust’s taxable income, in an attempt to retain in the trust tax-exempt income and unrelated business taxable income (for which no deduction can be claimed or whose deductibility is limited).
2. As amended, the regulations will apply to taxable years beginning after the date the final regulations are published.

C. Guidance given on dividing charitable remainder trusts. In Rev. Rul. 2008-41, I.R.B. 2008-30, the Treasury Department gave guidelines on how to divide a charitable remainder trust into two or more trusts. If properly handled, the pro rata division will not be considered a sale, exchange or other disposition, the basis of each separate trust’s share of each asset will not change, and the trusts’ status as charitable remainder trusts will not be affected. The revenue ruling addresses two scenarios. In the first situation, two individuals are to take equal shares of a CRAT annuity or CRUT unitrust amount, and on the death of one beneficiary is entitled to the entire annuity or unitrust amount. In the second scenario, payments are made to a married couple who are in the process of obtaining a divorce.

D. You don’t get a charitable deduction unless something passes to charity. Sometimes the taxpayer’s arguments, as set out in the court’s opinion, are so bad that you have to wonder whether the court misunderstood or misinterpreted those arguments. Unfortunately, that was not the situation in *Offner v. United States*, 2008-1 U.S.T.C. ¶60,556 (W.D. Pa. 2008). D’s will bequeathed \$1,000,000 to be divided among her children. “Should any of my children predecease me, then his/her issue shall receive and share equally in his/her respective share of such property.” The will bequeathed D’s residuary estate to a trust for the support and education of her grandchildren. Two children each disclaimed \$125,000. The estate contended that the disclaimed interests passed to the residuary trust (!), and therefore the \$250,000 qualified for a charitable deduction. (!!) Not so, said the court. Under the Pennsylvania disclaimer statute, a disclaimed interest is to be distributed as though the disclaimant predeceased the testator. Therefore, the disclaimed interests passed to the children’s issue and not to the residuary trust.

1. But what of the fact that the grandchildren may have been basket cases? “The Court need not reach the IRS’ alternative rationale that a trust for the education of decedent’s grandchildren serves a private rather than a public purpose.”

2. “Plaintiff argues, in the alternative, that the disclaimed interests qualify for the generation-skipping transfer tax and/or were transfers for educational purposes. These arguments are unavailing [that’s one way to put it—would could the arguments have been?] because they are based on the faulty premise that the disclaimed interests funded the Trust.”

E. Settlements that passed muster for charitable deduction purposes.

1. **Settlement between charitable beneficiaries, resulting in outright distributions in lieu of trusts, approved.** Ltr. Rul. 200825014 involved a testamentary trust established for the benefit of Charity 1 and Charity 2. A conflict arose between the charities as to the scope of their respective interests. To resolve their differences, the parties entered into a settlement agreement that provides for the immediate distribution of the trust assets to the charities. The state attorney general was joined as a party to the proceedings and did not object to the agreement, which was approved by a local court. That’s fine with us, said the Service. The value of the trust assets will qualify for the estate tax charitable deduction.
2. **Settlement on charities’ constructive sale claim supported additional charitable deduction.** In *Estate of Williams v. Commissioner*, T.C. Memo. 2009-5, D’s will bequeathed her stock in a closely held Company to the issue of her father’s business partner, and the rest of her estate to four charities. As the result of a merger between Company and a Public Company, D’s stock in Company could have been sold before her death. However, one of the noncharitable beneficiaries, acting under a power of attorney, gave Public Company an option to purchase Company’s stock for a fixed price after D’s death. The charities sued the noncharitable beneficiaries on theories of constructive sale of the stock and breach of fiduciary duty. The parties settled, and the estate claimed an additional charitable deduction for the lesser of the Company stock’s value and the settlement amount.
 - a. The Tax Court upheld the additional charitable deduction, taking into account the charities’ probable success in asserting the constructive sale claim, and also the specific noncharitable beneficiaries who bore the economic burden of the settlement.

F. Cases involving non-qualifying split interest trusts continue to arise. It has now been 40 years since Congress, in the Tax Reform Act of 1969, decreed that there can be no charitable deduction under the income tax, gift tax or estate tax for a charitable remainder unless the noncharitable interest takes the form of an annuity or unitrust payout. And yet, sadly, each year brings a number of cases and rulings involving nonqualifying dispositions. Because of a continuing stream of cases involving nonqualifying dispositions, Congress granted temporary—later, permanent—provisions authorizing reformation actions provided such actions were taken within a prescribed period.

1. **Having a “professional” executor didn’t help.** In *ESB Financial v. United States*, 2008-2 U.S.T.C. ¶60,567 (D. Kan. 2008), a trust provided for income to Daughter for life, remainder to Charity. On April 26, 2003 (the due date after an extension), ESB Financial filed the Form 706, taking a \$325,000 charitable deduction. In early June, the Service advised that it was opening an examination of the estate tax return regarding the claimed charitable deduction. On April 2004 (!), the executor filed a motion to retroactively modify the trust, and the state court granted the modification. Too late, said the court in granting summary judgment for the government. The

reformation proceeding was commenced more than 90 days after the due date for the return.

2. **Service takes hard line on nonjudicial division of nonqualifying trust.** The trust codes of a number of states authorize the division of a trust into two or more separate trusts without a judicial proceeding. E.g., Tex. Ppty. Code §112.057. The National Office has made it clear that this is not the procedure to follow in dealing with a non-qualifying split interest trust. In Ltr. Rul. (T.A.M.) 200840008, a testamentary trust provided for 25 percent of the income to, 25 percent to B, and the balance to be distributed to charities as selected by the trustee. The executors filed with a local court and the state attorney general a notice advising that, pursuant to the state's statute, they were going to divide the trust into two trusts, one for the noncharitable beneficiaries and the other for charitable beneficiaries.
 - a. No charitable deduction, said the Service. A charitable deduction will be allowed for a nonqualifying trust only if a reformation action that meets the requirements of §2055(e)(3) is filed within the prescribed time. "Allowing the deduction under these circumstances would be contrary to the intent of Congress in enacting §2055(e)(3) and would render §2055(e)(3) superfluous."

IX. Section 2056—Marital Deduction

- A. **QTIP trustee did not have duty to transfer marketable securities to a family limited partnership.** So ruled in *Matter of Galloway*, C5-05-200042 (Minn. 2d Dist., April 23, 2007). Noting that the reduction in value of the assets transferred to the FLP would have been greater than the reduction in estate tax liability, the court concluded that it would be difficult to create an FLP that would produce the desired valuation discounts while still satisfying the trustee's fiduciary duties.
- B. **If the spouse improperly withdrew corpus from the QTIP trust, you still have to pay the tax.** So held in *Estate of Hester v. United States*, 2007-1 U.S.T.C. ¶60,586 (4th Cir. 2008), in a per curiam decision, "affirm[ed] for the reasons stated by the district court in a per curiam decision. D, trustee and beneficiary of a QTIP trust, withdrew all of the trust assets (\$3.2 million in cash and a \$1.25 million promissory note). He transferred the cash to his individual Schwab brokerage account, which already held over \$4 million in assets, and proceeded to lose over \$2 million in day trading. D withdrew \$450,000 from the commingled account and collected \$280,000 of principal and interest from the promissory note. In the estate's own words: "At some indeterminable point after the trust terminations and before Hester's death, the commingling became so complex that it was impossible for anyone to determine which interests in the combined whole belonged to Hester and which interests in the combined whole belonged to his children." The executor filed an estate tax return that included the value of all assets on hand and showed tax liability of \$2.5 million. The estate paid the tax, and \$289,000 in additional taxes and interest that were assessed after audit. Three years later, the estate filed refund claims, seeking to exclude the value of assets appropriated from the trust, or in the alternative to deduct those amounts as claims against the estate. On these facts, the court entered a motion for summary judgment in favor of the government.
 1. Under its "exclusion theory," the estate contended that the misappropriated assets should be excluded from the gross estate calculation because D possessed no interest in the assets after his breach of fiduciary duty. Alternatively, if the assets are included

in the gross estate, they should be valued at \$0 because the beneficiaries of the trust were the proper owners.

- a. The district court summarily rejected this contention. D “exercised dominion and control over the assets as though they were his own without an express or implied recognition of an obligation to repay and without restriction as to their disposition, commingling the misappropriated assets with his own to the extent that it could not be determined which interest in the combined whole belonged to [D] and which interest belonged to the beneficiaries”. As D controlled the misappropriated assets and did not reimburse them before his death, they were properly included in his gross estate.
2. As for the estate’s claim theory, the district court had concluded that the estate was not entitled to a deduction under §2053 because the beneficiaries never asserted a claim against D or his estate. Moreover, even if a claim were made, it would have been barred by the Virginia statute of limitations. “Allowing a deduction here, where a taxpayer is attempting to secure a refund for a theoretical liability that will never be paid and that is now barred by the statute of limitations, would essentially ‘exalt form over substance.’”

X. Section 2511—Gift Tax Transfers in General

- A. **No indirect gift where gift of LP interests made six days after FLP was funded.** In a long-awaited opinion (the decision was handed down two and a half years after the case was argued), the Tax Court ruled that no indirect gift occurred where substantial gifts of LP interests were made six days after a family limited partnership was established and funded. *Holman v. Commissioner*, 130 T.C. No. 12 (2008). In another important aspect of the decision, the court held that §2703 (“Certain Rights and Restrictions Disregarded”) applied to transferability restrictions in the partnership agreement, precluding a discount for such restrictions.
 1. **The facts.** H worked for Dell Computer Corp. from 1988 to November 2001, and had acquired substantial holdings of Dell stock and stock options. In 1997, the family moved from Texas to Minnesota, where over several years H and W obtained estate planning advice from a Minneapolis attorney. On November 2, 1999, H and W created an irrevocable trust for their issue (they had four minor children), naming H’s mother M as trustee. On that same day, H, W and the trust joined in the creation of a family limited partnership, with H and W contributing 70,000 shares of Dell stock and M as trustee contributing 100 shares. In exchange, H and W each received 0.89 percent general partner interests and 49.04 percent limited partnership interests. The trust received a 0.14 percent LP interest. Six days later, on November 8, H and W made gifts of 70.06 percent of the LP interests to the trust and a smaller gift to a UTMA custodianship for their youngest daughter (to make up for earlier UTMA gifts to the three older daughters). H and W made annual exclusion gifts of LP units on January 4, 2000, contributed additional shares of Dell stock in exchange for LP units in January 2002, and made annual exclusion gifts of LP units in February 2001. On all three gift tax returns, H and W took discounts of 49.25 percent. After these transactions, H and W each held 0.56 percent general partner interests and 5.04 percent limited partner interests, the trust held 44.29 percent of the LP units, and each of four UTMA custodianships held 11.13 percent of the LP units.

- a. The court found that H and W had plans to make the gifts of LP units at the time the partnership was created. During the relevant period (1999-2001), the FLP owned nothing but Dell stock. When the FLP was established, H had no immediate plan other than that it would hold the Dell shares. The partnership had no business plan, no employees, no telephone listing in any directory, and prepared no annual statements. The partnership had no income to report, and it filed no federal income tax return for any of the three years.
 - b. **The government's contentions.** The Service assessed gift tax deficiencies of \$230,000, challenging the taxpayers' valuation of the gifted interests and the discounts taken thereon. The government made two "indirect gift" arguments: that the transactions should be treated as gifts of the Dell stock itself and not LP interests or, alternatively, that the step transaction doctrine should be applied. The government also contended (successfully, it turned out) that §2703 applied to preclude discounts for restrictions on transferability contained in the partnership agreement. The government abandoned two arguments it initially made: that gifts to the partnership should be treated as gifts to a trust, and that under §2704(b) restrictions on liquidation should be disregarded.
2. **Gift to partnership not indirect gift to partners.** The government contended that the transfer of assets to the FLP was in substance an indirect gift to the partners, just as a gift by a shareholder to a corporation is a gift to the other shareholders. The government relied on *Shepherd v. Commissioner*, 115 T.C. 376, 283 F.3d 1258 (11th Cir. 2002), and *Senda v. Commissioner*, T.C. Memo. 2004-160, affd. 433 F.3d 1044 (8th Cir. 2006), "in both of which we concluded that transfers by a partner to a partnership were indirect transfers to the other partners."
- a. In *Shepherd*, S transferred property and shares of stock to a newly formed family partnership in which he was a 50-percent owner and his two sons were each 25-percent owners. Rather than allocating contributions to the capital account of the contributing partner, under the partnership agreement the contributions were allocated pro rata to the capital accounts of each partner. Because the values of the noncontributing partners' interests were enhanced by S's contributions, "we held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests." In *Senda*, S's transfers to the partnership and the transfers of LP interests occurred on the same day.
 - b. The facts in this case are distinguishable, said the court. When the transfers were made to the FLP, the contributing partners received partnership interests proportional to what they had contributed, and the gifts occurred six days later. "Petitioners did not first transfer LP units to [M as trustee and UTMA custodian] and then transfer Dell shares to the partnership, nor did they simultaneously transfer Dell shares to the partnership and LP units to [M]. The facts of the *Shepherd* and *Senda* cases are materially different from those of the instant case, and we cannot rely on those cases to find that petitioners made an indirect gift."
3. **No indirect gift under the step transaction doctrine.** The government alternatively argued that H and W made an indirect gift under the step transaction doctrine. "The nub of respondent's argument is that petitioners' formation and funding of the partnership should be treated as occurring simultaneously with their 1999 gift of LP units since the events were interdependent and the separation in time between the first two steps (formation and funding) and the third (the gift) served no purpose other

than to avoid making an indirect gift.... While we have no doubt that H and W's purposes in forming the partnership included making gifts of LP units indirectly to the children, we cannot say that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift. Indeed, respondent does not ask that we consider either the 2000 gift (made approximately 2 months after formation of the partnership) or the 2001 gift (made approximately 15 months after formation of the partnership) to be indirect gifts of Dell shares.”

- a. *Senda v. Commissioner*, on which the government relied, was distinguishable because in that case the gifts were made on the same day the partnership was formed. Here, the gifts occurred almost a week later. Moreover, H and W “bore the risk that the value of an LP unit could change between the time they formed and funded the partnership and the times they chose to transfer LP units.... Respondent apparently concedes that a 2-month separation is sufficient to give independent significance to the funding of the partnership and a subsequent gift of LP units. We assume that concession to be on account of respondent's recognition of the economic risk of a change in value of the partnership that petitioners bore by delaying the 2000 gift for 2 months. We draw no bright lines.”
- b. “[W]e shall treat the 1999 gift the same way respondent concedes the 2000 and 2001 gifts are to be treated; *i.e.*, we shall not disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine.”
- c. In a footnote, the court observed that “[t]he real economic risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a 6-day hiatus differently in the case of another type of investment; *e.g.*, a preferred stock or a long-term Government bond.”

4. **Section 2703 applied to transfer restrictions.** Although buy-sell agreements are not mentioned in §2703, the legislative history makes it clear that the primary thrust of the statute is to tighten the rules as to when a buy-sell agreement or similar arrangement is binding for transfer tax valuation purposes. Unless a three-prong statutory test is satisfied, the value of property is to be determined without regard to any option, agreement, or other right to acquire the property at less than fair market value, and without regard to any restriction on the right to sell or use the property. An agreement will be recognized for valuation purposes only if (1) it is a bona fide business arrangement; (2) it is not a device to transfer property to family members for less than full and adequate consideration, and (3) its terms are comparable to similar arrangements arrived at in arms length transactions. In *Holman*, the court ruled that §2703 applied to the FLP's transferability restrictions, and concluded that the restrictions failed tests (1) and (2).

- a. **Restrictions on transferability were similar to those found in many FLPs.** The partnership agreement prohibited transfers of LP interests with the written consent of all the partners, permitted transfers to other family members, and provided (in paragraph 9.3) that if a transfer to a non-family member nonetheless occurred the partnership had the option to purchase the assignee's interest. As the taxpayers' expert witness testified, these provisions “are comparable to provisions one most often finds in limited partnership agreements.”

- b. **No business purpose.** The court noted that in *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, it had held that the subject of a restrictive agreement need not directly involve an actively managed business. In that case, the asset in question was D's minority interest in a closely held bank. Before her death D's conservator entered into an agreement that fixed the value of D's shares. The court held that the term "bona fide business arrangement" encompassed the value-fixing arrangements made by the conservator, who was seeking to exercise prudent management of his ward's minority stock investment consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate.
- (1) "Here, however, we do not have a closely held business." The Holman partnership carried on little activity other than holding the shares of stock in Dell, which is not a closely held business. Unlike the situation in *Estate of Amlie*, "[t]here was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report [on §2703] as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and "disincentivizing" them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares."
- b. **The "device" test.** The court determined that paragraph 9.3 of the partnership agreement flunked the test that the restriction not be a device to transfer property to family members for less than full and adequate consideration. If a partner made an impermissible transfer, the assignee interest would be redeemed at its fair market value, and not for a price equal to his share of the partnership's net asset value. This redemption at a discount would benefit the partners, all of whom were members of the Holman family. "[W]e have no doubt that [H] understood the redistributive nature of paragraph 9.3. and his and [W's] authority as general partners to redistribute wealth from a child pursuing an impermissible transfer to his other children. We assume, and find, that he intended paragraph 9.3 to operate in that manner, and this intention leads us to conclude, and find, that paragraph 9.3 is a device to transfer LP units to the natural objects of petitioners' bounty for less than adequate consideration."
- c. **No opinion given on the "comparable terms" test.** The opinion summarizes at some length the parties' experts' conflicting views on the comparability test.
- (1) The government's witness, a law professor, summarized his testimony by saying "based on my experience and based on conversations with more than a dozen practitioners who do this stuff, I couldn't find anybody would do this deal, who would let their client into a deal like this as a limited partner without writing a very large CYA memo, saying: 'We advise against this.'"
- (2) Petitioner's expert, an attorney who had drafted or reviewed over 300 limited partnership agreements, testified that the restrictions in the Holman FLP "are comparable to provisions one most often finds in limited partnership agreements among unrelated partners," and that paragraph 9.3 "is not out of the mainstream of what one typically finds in arm's length limited partnership agreements."

- (3) To all of which the court concluded: “Even were we to find that paragraph 9.3 is comparable to similar arrangements entered into by persons in arm's-length transactions (thus satisfying section 2703(b)(3)), we would still disregard it because it fails to constitute a bona fide business arrangement, as required by section 2703(b)(1), and is a prohibited device within the meaning of section 2703(b)(2). Therefore, we need not (and do not) decide today whether respondent is correct in applying the arm's-length standard found in section 2703(b)(3) to the transaction as a whole.”

5. **Control and marketability restrictions applied by the court.** After extended discussion of the valuation reports of two expert witnesses, the court applied combined control and marketability discounts of 22 percent, 25 percent and 16.25 percent in valuing the gifts in 1999, 2000 and 2001. (Interestingly, these were lower discounts than the 28 percent discount contended for by the Service in its deficiency notice.) These are hardly unimpressive discounts, given that the FLP held only one publicly traded stock.
6. **Caveat: Case has been appealed to Eighth Circuit.** An appeal has been filed with to the Eighth Circuit Court of Appeals, the court that affirmed the Tax Court's decision in *Senda v. Commissioner*. Perhaps the *Holman* saga is not over yet.

B. ... and no indirect gift where gift of LP interests made eleven days after FLP was funded. The opinion in *Gross v. Commissioner*, T.C. Memo 2008-221, was written by Judge Halpern, the same judge who crafted the opinion in *Holman v. Commissioner*, and the decision, in a significantly less complicated scenario, was essentially the same as in *Holman*. G, widowed and wealthy, established a family limited partnership which she believed would encourage her two daughters to work in handling the family wealth while preserving control over the partnership's assets as general partner. After discussions with her daughters, the parties agreed to the outlines of a partnership arrangement under which the daughters would not be able to transfer their LP interests without the consent of the general partner, could not withdraw from or force a dissolution of the partnership. On July 15, 1998, G filed a certificate of limited partnership with the New York Secretary of State. Two weeks later, the daughters each contributed \$10 and G contributed \$100, as they agreed. Beginning in October 1998 G proceeded to transfer more than \$2 million of stock in publicly traded companies, recording her contributions in the partnership books, with the final funding made on December 4, 1998. December 15, 1998—eleven days later—G and her daughters execute a limited partnership agreement including the agreed-upon restrictions, and on the same day G gifted 22.25 percent LP interests to each of her daughters. G filed a gift tax return on which she took a 35 percent combined discount for lack of marketability, lack of control and minority interest.

1. The government argued that the partnership was not formed until December 15, 1998, when the partnership agreement was signed. The court ruled however, that under New York law a partnership, albeit a general partnership was formed when the certificate was filed on July 15. The court rejected both the government's “indirect gift” argument based on *Shepherd v. Commissioner*, 115 T.C. 376 (2000), and the step transaction argument. In *Holman v. Commissioner*, “[w]ithout intending to draw any bright lines, we rejected the Commissioner's argument because of our conclusion that the taxpayers bore a real economic risk of a change in value of the partnership for the 6 days that separated their transfer of the shares to the partnership and the gift. We reach the same result here, where (1) 11 days passed between petitioner's conclusion of her transfer of the Dimar securities to the partnership and her gifts of interests in the partnership to her daughters, and (2) the Dimar securities were mostly, if not all, common shares of well-known companies. The step transaction doctrine does not

cause us to change the actual order of the transactions before us and conclude that petitioner made indirect gifts of 22.25 percent of the value of the Dimar securities to each of her daughters. The form of the transactions here in question accords with their substance.”

2. In a footnote the court noted, as in *Holman*, that [t]he real economic risk of a change in value arises from the nature of the Dimar securities as heavily traded, relatively volatile common stocks. We might view the impact of a 11-day hiatus differently in the case of another type of investment; *e.g.*, a preferred stock or a long-term Government bond.”

XI. Section 2512—Valuation of Gifts

- A. **Gift tax declaratory judgment regulations proposed.** Section 7477, enacted in 1997, permits a taxpayer to file a declaratory judgment action in the Tax Court to obtain a gift tax valuation ruling. Such a proceeding cannot be brought unless “the petitioner has exhausted all available administrative remedies.” On June 9, 2008, the Treasury Department issued proposed amendments to Reg. §301.7477-1, giving further guidance on such a proceeding. The action would be limited to situations in which the taxpayer has no remedy to challenge the Service’s valuation because no gift tax deficiency is assessed and no tax refund is involved. Such a situation can arise where the increased value of a gift is offset by the taxpayer’s \$1 million gift tax exemption equivalent.
- B. **Valuation issues involving Minnesota farmland and partnership interests.** *Astleford v. Commissioner*, T.C. Memo. 2008-128, involving gift tax deficiencies totaling \$4.1 million, addressed several valuation issues. A was the widow of a successful real estate investor in Minnesota who had acquired interests in 41 properties located in Minnesota and California. After D’s death, W owned (either directly or through a marital trust) all 41 parcels as well as real estate interests she had separately acquired. A formed an FLP and gave LP interests to her three children.
 1. **Absorption discount applied to large tract of farmland.** One of the issues involved valuation of a 1,187-acre tract of farmland. On the basis that the average size of a Minnesota farm was a one-quarter section (160 acres), the court recognized an “absorption discount,” concluding that a sale of the entire property would flood the local market for farmland. However, the court reduced taxpayer’s proposed 25 percent discount to 10 percent.
 2. **Partnership interest transferred to FLP was a general partner interest, not an assignee interest.** D held (and bequeathed to A) a 50 percent interest in a real estate general partnership. “The facts in this case establish that in substance the Pine Bend interest transferred by petitioner to AFLP should be treated as a general partnership interest, not as a Pine Bend assignee interest. Because petitioner was AFLP’s sole general partner, petitioner was essentially in the same management position relative to the 50-percent Pine Bend interest whether she is to be viewed as having transferred to AFLP a Pine Bend assignee interest (and thereby retaining Pine Bend management rights) or as having transferred those management rights to AFLP via the transfer of a Pine Bend general partnership interest (in which case she reacquired those same management rights as sole general partner of AFLP). Either way, after December 1, 1997, petitioner continued to have and to control the management rights associated with the 50-percent Pine Bend general partnership interest.”

3. **Control and marketability discounts tied to comparability data from sales of RELPs and REITs.** Another issue concerned lack of control and lack of marketability discounts to be applied to A’s transfer of the 50 percent general partnership interest to the FLP and to A’s transfer of LP interests to her children. Petitioner’s expert relied on comparability data from sales of registered real estate limited partnerships (RELPs), whereas the government’s expert relied on comparability data from sales of publicly traded real estate investment trusts (REITs). After noting that “[w]e decline to declare either RELP or REIT data generally superior to the other,” the court concluded that on the facts presented “[w]e believe that when considering the size, marketability, management, distribution requirements, and taxation of RELPs and REITs, RELPs more closely resemble AFLP and Pine Bend, and we believe that the low trading volume on the RELP secondary market is not so low as to render available RELP data unreliable. We also believe, however, that the large number of REIT sales transactions tends to produce more reliable data compared to the limited number of RELP sales transactions. We believe further that differences between REITs, on the one hand, and Pine Bend and AFLP, on the other, may be minimized given the large number of REITs from which to choose comparables.”
 - a. After giving an extensive review of the experts’ valuation opinions and a detailed analysis of a substantial number of REIT and RELP comparables, the court recognized a 30 percent discount for the Pine Bend partnership interest. With respect to her 1996 and 1997 gifts of LP interests, A had claimed lack-of-control discounts of 45 percent and 40 percent; the court reduced the discounts to 16.3 percent and 17.5 percent. Discounts for lack of marketability were given at 21 percent and 22 percent.

XII. Section 2518—Qualified Disclaimers

- A. **Wife’s partial disclaimer of survivorship interest in joint accounts approved despite some activity after husband’s death.** In Ltr. Rul. 200832018, H and W had two brokerages accounts with Brokerage Firm. H was the sole contributor to Account 1, and H and W contributed equally to Account 2. After H’s death, Brokerage Firm transferred the assets to new accounts: Wife Account 1 and Wife Account 2. W received distributions of \$\$\$ from Wife Account 1 and authorized the purchase of securities by Account 2. W proposes to disclaim of assets in Account 1 (including the income thereon since H’s death) less the \$\$\$ distributed to her. W also proposes to disclaim H’s one-half interest in Account 2 minus H’s one-half interest in the new securities purchased after H’s death. Finally, as the disclaimed interests will pass into trusts in which W has been given testamentary powers of appointment, W proposes to disclaim those powers. The Service gave its blessing to the proposed disclaimers.
 1. The Service noted first that since H had the right to unilaterally withdraw his interest in Account 1 and his one-half interest in Account 2 any gift to W was incomplete until H died, W had nine months from H’s death in which to disclaim. The Service also noted that merely retitling the accounts did not constitute an acceptance of benefits.
 2. As for Account 1, although W had accepted distributions from the account, the \$\$\$ that she received was a severable asset, and W can make a pecuniary disclaimer of the assts originally held in Account 1 minus \$\$\$ and the income earned thereon. Similarly, although W accepted portions of Account 1 by authorizing the

reinvestment of assets, since the newly acquired assets were severable, W could make a qualified pecuniary disclaimer of H's interest in Account 2 less H's interest in the newly acquired assets plus the income earned thereon.

3. Finally, W had to (and did propose to) disclaim her powers of appointment over the trusts to which the assets passed by reason of the disclaimers.

B. Disclaimers involving individual retirement accounts.

1. **This one worked.** In Ltr. Rul. 200839030, D named his wife W as beneficiary of his pension plan and an IRA, and as residuary beneficiary under his will. W disclaimed all of these interests, and as a result the interests passed to the couple's children under D's will. No problem with that, said the Service.
2. **But this one was an unmitigated disaster.** In Ltr. Rul. 200846003, a premarital agreement required D to create a QTIPable trust under her will, to be funded in part with an IRA. True to form, D's will created a QTIPable Trust 1, providing for income at least quarter-annually to Spouse for life. Trust 1 is to terminate on Spouse's death, and the remainder is to pass to Trust 2, which benefits D's children. However, before her death D moved the IRA to an account that named her children as beneficiaries. After D's death, the children disclaimed their interests in the IRA. Under the IRA default beneficiary designation, the IRA passed to D's estate, where it was used to fund Trust 1.
 - a. **Not a qualified disclaimer, meaning a taxable gift.** Since, however, Trust 1 terminates in favor of Trust 2 and the children did not disclaim their interests in Trust 2, the children did not disclaim their entire interest in the IRA. Thus the children did not make a qualified disclaimer, with the result that the children have made a taxable gift.
 - b. **... with the further result being loss of a marital deduction in D's estate.** Moreover, the gift is to Trust 1 under D's will. To qualify as a QTIPable trust, the IRA had to have passed from the decedent. Here, by reason of the disclaimers the IRA passed from the children "and, accordingly, Decedent's estate is not entitled to a marital deduction for the Trust estate of Trust 1."

XIII. Section 2519—Disposition of QTIP Life Estates

- A. **Effect of settlement that resulted in partial collapse of QTIP trust.** In Ltr. Rul. 200844010, a trust for which a QTIP election was made provided for income to S for life, remainder in further trust for D's five children and their descendants. A dispute arose as to investment and management of the trust "[d]ue to different investment philosophies and risk tolerances." Child 1 instituted litigation against S and Bank as co-trustees and the other four children. As the result of a mediated settlement, the QTIP trust is to be divided into five trusts, and the trusts for Children 2-5 are to be converted into unitrusts pursuant to state law. The trust for Child 1 is to be terminated, and W will receive property equal to the actuarial value of her life interest. The balance is to be distributed to Child 1 subject to any gift tax liability resulting from the termination, with W having exercised her §2207A right to recover any resulting gift taxes.
 1. In the ruling, the Service concluded that for §2519 purposes there was no transfer and thus no gift tax consequences with respect to the four "Surviving Settlement Trusts."

The termination of Child 1's Settlement Trust was a transfer for §2519 purposes. W will have made a gift of the value of that trust less the value of W's income interest, with the gift reduced by the amount of the gift tax attributable to the transfer (i.e., net gift treatment).

XIV. Section 2601—Generation-Skipping Transfer Tax

- A. Formula bequest tied to unused GST exemption was a pecuniary bequest that did not share in appreciation.** In Ltr. Rul. 200848009, T's residuary estate passed to a revocable trust that became irrevocable on T's death. The trust provided that after debts and expenses were paid, there was to be set aside for a GST Trust "an amount equal to [T's] GST exemption not allocated to lifetime direct skips." The balance was to be held in two trusts, one for T's wife and the other for T's descendants. At T's death, the trust consisted primarily of T's business interests that were subject to various claims. Because it was not possible to satisfy the outstanding obligations, the trustee continued to administer the trust for X years. With the obligations having been satisfied and the trust assets having substantially increased in value, the trustee wants to distribute a pro rata portion of the increased value to the GST Trust. The trustee has obtained a local court ruling that the formula clause made a fractional share gift and not a gift of a pecuniary amount.
1. No dice, said the Service. Under *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), The local court ruling carries no weight, and the trust made a gift of a pecuniary amount. Thus the amount to be distributed to the GST was frozen as of T's death, and does not share in the appreciation. Moreover, because the funding will be in satisfaction of a pecuniary amount, distributions in kind will trigger gain or loss.
- B. Proposed regulations give guidance as to extensions of time for (i) allocation of GST exemption and (ii) electing out of deemed allocations.** On April 17, 2008, the Treasury Department published proposed regulations relating to the circumstances and procedures under which extensions of time will be granted to allocate GST exemption or to elect not to have a deemed allocation apply to a particular transfer. The proposed regulations will be under §2642(g)(1) and, after final regulations are published, will replace Reg. §301.9100-3 with regard to such requests for relief.
1. Requests for relief will be granted if the taxpayer acted reasonably and in good faith, taking into account such factors as (1) the intent of the transferor or executor to make an allocation or election-out as evidenced by the trust instrument or other instrument of transfer or contemporaneous documents, (2) the occurrence of events beyond the control of the transferor or executor that caused the failure to allocate or elect out, (3) the lack of awareness of the need to make the allocation or election-out, taking into account the experience of the taxpayer or executor and the complexity of the GST issue, and (4) reasonable reliance on a qualified tax professional.
- C. Automatic allocation due to late-filed return produced result that taxpayer wanted.** In Ltr. Rul. 200825032, D's will created a GST-exempt trust, a GST non-exempt trust, and a family trust. The executor made a QTIP election and a reverse QTIP election on a late-filed return. No problem, said the Service, because the elections were made on the first return that was filed. However, because the Form 706 was not timely filed, under §2632(e) and §26.2632-1(d)(2) D's available GST exemption was automatically allocated to trusts for which D was considered the transferor and from which a GST event may occur. As a result, D's available GST exemption was automatically allocated to the family trust and the GST-exempt trust, which is the result the taxpayer wanted.

- D. Erroneous payment of income taxes by beneficiary of GST-grandfathered trust not a constructive addition.** So ruled in Ltr. Rul. 200816008. Pursuant to state law, the trustee allocated 72.5 percent of mineral interest royalties to income and 27.5 percent to trust principal to cover depletion. However, for several years the K-1s sent to B erroneously reported that all of the royalty receipts had been allocated to income and had been distributed to B. For each of these years, B reported all mineral receipts on her personal income tax return and paid tax thereon. B asserted and was granted a reimbursement claim for the amount of income tax she had erroneously paid. That being so, said the Service, there had been no constructive addition that affected the trust's GST-grandfathered status.

XV. Section 2702—Special Valuation Rules: Trust Transfers

- A. Transfer to QPRT followed by sale of remainder not a taxable gift.** In Ltr. Rul. 200840038, a revocable trust established by H and W (who reside in a community property state) purchased a vacation home. H and W had a preexisting irrevocable trust (called in the ruling the "Purchasing Trust") for the benefit of their descendants. H and W propose to establish a trust that meets the requirements of a QPRT for their joint lives, with the remainder on the death of the survivor to pass to the Purchasing Trust. After the trust is established, H and W will transfer the vacation home to the QPRT, and the Purchasing Trust will transfer to H and W cash and marketable securities an amount equal to the value of the remainder interest as determined under the §7520 term interest tables. The Service ruled the transaction will not constitute a taxable gift because the consideration received by H and W will be equal to the value of the remainder interest transferred.
- 1. Will this transfer avoid a gross estate inclusion?** The ruling ends by stating that "[w]e express no opinion on whether the corpus of Trust will be includible in the gross estate of either Husband or Wife under § 2036 or any other provision of the Code."
 - 2. This plan is aggressive but should work—but is it economically viable?** The ruling request and the plan are inspired by the "sale of remainder" transaction that was used in the early '80s, when the interest factor used to value term interests and remainder was 10 percent. (Congress hadn't invented §7520 yet.) Example: In 1985, 59-year-old Winnie, who owns land worth \$500,000, sells a remainder interest in the land to her daughter Donna. Under the 10% term interest tables, the value of a remainder following a life estate in a 59-year-old person was .25 times the principal amount. So, Donna purchases a remainder interest in the land from Winnie for the full \$125,000 value of the remainder interest. The transfer will have been for a full and adequate consideration, with no gift component. On Winnie's death, Donna will acquire the land worth \$500,000 (plus any appreciation from the date of the transaction—the transaction had a "freeze" component) for a purchase price of only \$125,000. Moreover, only the sale proceeds of \$125,000 (and not the value of the property) will be includible in Winnie's gross estate since (after the sale) she had only a life estate.
 - a. The Service didn't like sale-of-remainder transactions, but the courts upheld them.** Estate of D'Ambrosio v. Commissioner, 101 F.3d 309 (3rd Cir. 1996); Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997); Estate of Magnin v. Commissioner, 99-2 U.S.T.C. ¶60,347 (9th Cir. 1999).

- b. **Section 2702 shot down sale-of-remainder arrangements—but only when the remainderman is a “member of the family.”** If the remainderman is “a member of the family,” the grantor-seller ends up with a retained interest—a life estate. As the life estate is not in the form of an annuity or unitrust interest, §2702 applies. In my 59-year-old Winnie example, under today’s law Winnie would be deemed to have made a transfer of \$500,000 minus the \$125,000 consideration received, for a taxable gift of \$375,000.
 - c. If, however, the client does not have descendants (“members of the family” within the meaning of §2702), and the object of the client’s bounty is a nephew or niece, or the child of a friend, or a companion, the sale of remainder transaction is alive and well, according to the decisions cited above. The central problem with the transaction is that the current §7520 interest rate environment (with interest rates in the 2.4 to 4 percent range), tends to make the remainder interest costly. The (substantial) consideration received from the sale will be in the grantor’s gross estate, and the real benefit will come from post-transfer appreciation (if any).
 - d. The taxpayers in Ltr. Rul. 200840038 are using the QPRT exception to execute a sale of remainder that benefits members of the family. As it did in similar rulings on this issue (Ltr. Ruls. 9841017 and 200112023), the Service expressly declined to rule on the applicability of §2036 to the transaction. If on either spouse’s death the Service takes the position that there is a §2036 gross estate inclusion, the estate should lick its chops. With Courts of Appeal in the 3rd, 5th and 9th Circuits having rejected the government’s contention, the Service would be taking a position that is not substantially justified and court costs and attorney’s fees under §7430 should be obtained.
- B. Letter ruling granted for one-year reverse QPRT.** In Ltr. Rul. 200814011, on termination of Mother’s 10-year QPRT, the remainder passed to Son and Daughter, and Mother commenced to lease the residence from them. Son and Daughter now propose to create a one-year QPRT giving Mother the right to occupy “or, upon conversion to an annuity trust, to transfer the annual annuity amount, for one year.” After noting that Rev. Proc. 2007-3, 2007-1 I.R.B. 108, provides that rulings will not ordinarily be issued with respect to QPRTs, “because of the unusual facts presented” a favorable ruling was granted.
- C. Grantor can lease at the end of QPRT term.** The Service continues to grant favorable rulings for QPRTs that give the grantor the option to lease the property at market rates at the end of the QTIP term. Under the rulings, there is no §2036 gross estate inclusion concern as long as “there is no express or implied understanding that Grantor may retain use or possession of Residence whether or not rent is paid.” See 2008 series Ltr. Ruls. 25004 and 22011.
- D. Final regulations—estate tax treatment of GRATs.** Proposed regulations published in June 2007 addressed the estate tax treatment of GRATs, GRUTs and QPRTs if the grantor dies during the trust term was addressed in. Final regulations amending Reg. §20.2036-1 were published on July 14, 2008 with only minor revisions. Adopting the approach taken in Rev. Rul. 76-273, 1976-2 C.B. 268 (involving a CRUT) and Rev. Rul. 82-105, 1982-1 C.B. 133 (involving a CRAT), the regulations provide that the gross estate inclusion will be the amount of trust corpus necessary to yield the annuity or untrust payment, utilizing the §7520 interest rate in the month of the decedent’s death.
- 1. **Eliminates concern that §2039 might apply.** Although it was widely believed that this was the proper result, in T.A.M. 9345035 the National Office indicated that

§2039 (governing annuities) should apply, and that the entire value of the GRAT should be includible in the gross estate. This concern is eliminated by an amendment to Reg. §20.2039-1(e): “Section 2039 shall not be applied to include in a decedent’s gross estate all or any portion of a trust (other than a trust constituting an employee benefit ...) if the decedent retained a right to use property of the trust or retained an annuity, unitrust, or other interest in the trust, in either case as described in section 2036.”

XVI. Section 6166—Extension to Pay Estate Tax, Closely Held Business

- A. Don’t ask for an extension to make a §6166 election, because you’re not going to get it.** In C.C.A. 200848004, the CPA retained to prepare the Form 706 requested an extension of time to file the return, and attached a statement that it was anticipated that the estate would be eligible for a §6166 election. The National Office concluded that the statement attached to the request for an extension was not itself a §6166 election, particularly when it merely stated that it was anticipated that an election would be made.
1. Of far greater import, the National Office concluded that a §6166 election is a “statutory election” and not a “regulatory election.” As a consequence, while Reg. §301.9100-3 allows for additional extensions, “these extensions are only available for regulatory elections” and not statutory elections.