**RECENT DEVELOPMENTS 2010:**

**SELECTED FEDERAL AND ILLINOIS**

**CASES, RULINGS AND STATUTES**

**Fiduciary & Risk Management Association, Inc.**

**25th Anniversary**

**National Risk Management Training Conference**

**Atlanta, Georgia**

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**RECENT DEVELOPMENTS**

**1. ADMINISTRATIVE ISSUES.**

**A. Rev.** **Proc. 2010-40**, 2010-46 I.R.B. at 663 (November 15, 2010) sets forth the inflation-adjusted figures for exclusions, deductions and credits for 2011. In the estate and gift tax area these figures are the following:

* Annual Exclusion: Remains at $13,000
* Foreign Spouse Annual Exclusion: Increases to $136,000
* §2032A Aggregate Decrease: Increases to $1,020,000
* §6601(j) 2% Amount: Increases to $1,340,000

**B. *2010-11 Priority Guidance Plan.***

On December 7, 2010, Treasury and the Internal Revenue Service announced their joint priority guidance plan for 2010-2011. The plan includes the following initiatives:

**GIFTS AND ESTATES AND TRUSTS:**

1. Regulations under §67 regarding miscellaneous itemized deductions of trusts and estates.

**COMMENT:** The Service had published proposed regulations in 2008, not long before the Supreme Court's decision in Knight v. Commissioner, 552 U.S. 181, 128 S. Ct. 782, 169 L. Ed. 2d 652 (2008). The proposed regulations required expenses to be "unique" in order to be outside the 2% limitation on deductions - in effect adopting the rationale of the First Circuit in Knight (also known as Rudkin) that to be outside of the 2% limitation the expenses must be those that could not have been incurred by individuals. The Supreme Court's decision was more lenient -- that the expenses must be those that are not commonly or customarily incurred by individuals to be deductible without regard to the 2% limitation. The Final Regulations will need to make this change. For several years, pending the issuance of Final Regulations, the Service has issued notices that corporate fiduciaries do not need to "unbundle" fees in order to separate investment counseling fees, which presumably are commonly incurred by individuals, from other fees that are not commonly or customarily so incurred. No notice has yet been published for the 2010 tax year.

1. Final regulations under §642(c) concerning the ordering rules for charitable payments made by a charitable lead trust. Proposed regulations were published on June 18, 2008.
2. Guidance concerning adjustments to sample charitable remainder trust forms under §664.
3. Guidance concerning private trust companies under §§671, 2036, 2038, 2041, 2042, 2511, and 2601.
4. Regulations under §1014 regarding uniform basis of charitable remainder trusts.
5. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on April 25, 2008.
6. Final regulations under §2036 regarding graduated retained annuity trusts. Proposed regulations were published on April 30, 2009.
7. Guidance on whether a grantor’s retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor’s gross estate under §2042.

**COMMENT:** PLR 200314009, by negative inference, may indicate how the Service will rule in this matter. In this ruling, the insured did not have the power to purchase, exchange or otherwise deal with or dispose of the principal or the income of the trust estate "for less than adequate and full consideration in money or money's worth." By negative inference, the insured would have the power to substitute assets for full consideration (presumably, equivalent value). The ruling stated that after a reformation to correct a scrivener's error -- dealing with whether the insured could appoint himself as a successor trustee -- the insured did not possess any incidents of ownership under Section 2042 over the insurance policy held in the trust.

1. Guidance providing procedures for filing protective claims for refunds for amounts deductible under §2053.
2. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

**COMMENT:** The Section 2053 Regulations contain no present value requirement for the deduction of attorneys and executors fees that are paid over time.

1. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.
2. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.
3. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.
4. Final regulations under §7520 updating the mortality-based actuarial tables to be used in valuing annuity interests for life, or term of years, and remainder or reversionary interests. Proposed regulations were published on May 4, 2009.
5. Guidance concerning estates of decedents who die during 2010.

**EXEMPT ORGANIZATIONS:**

1. Final regulations under §§170, 507, 509, 6033 & 6043 to implement Form 990 revisions and to modify the public support test. Temporary regulations were published on September 9, 2008.
2. Guidance updating grantor and contributor reliance criteria under §§170 and 509.
3. Guidance under §§501(r) and 6033 on additional requirements for charitable hospitals as added by the ACA.
4. Final regulations under §§509 and 4943 regarding the new requirements for supporting organizations, as added by §1241 of the Pension Protection Act of 2006. Proposed regulations were published on September 24, 2009.
5. Guidance under §4943, as amended by §§1233 and 1243 of the Pension Protection Act of 2006, on excess business holdings rules.
6. Guidance under §4944 on program-related investments.
7. Final regulations under §§4965, 6011, and 6033 on excise taxes on prohibited tax shelter transactions and related disclosure requirements as added by §516 of the Tax Increase Prevention and Reconciliation Act of 2005. Proposed regulations were published on August 20, 2007. • PUBLISHED 07/06/10 in FR as TD 9492.
8. Regulations regarding the new excise taxes on donor advised funds and fund management under §4966 as added by §1231 of the Pension Protection Act of 2006.
9. Regulations under §6033 on group returns.
10. Guidance regarding certain annual information return requirements under §6033.
11. Regulations to update the final regulations under §6104(c) relating to disclosure to state charity agencies for changes made §1224(a) of the by the Pension Protection Act of 2006.
12. Final regulations under §7611 relating to church tax inquiries and examinations. Proposed regulations were published on August 5, 2009.
13. Guidance to facilitate modernizing administrative processes.

**COMMENT:** The priority guidance plan does not address guidance for the estate tax opt-out election, and the allocation of basis on Form 8939, discussed *infra*. However, the IRS have given these issues top priority so that taxpayers will have some guidance relatively early in the year. In this connection, the American Bar Association Section of Real Property, Trust and Estate Law Section of Taxation submitted comments on the draft Form 8939 issued in December. Some of these comments were addressed informally by a person at the Service in an e-mail. The following summarizes some of the issues that were discussed:

* The instructions to Form 8939 will make the filing deadline clear. The draft form 8939 released in December, 2011 does not recite a filing date. Under Section 6075 the filing date is the due date for the last income tax return of the decedent or "such later date specified in regulations prescribed by the Secretary."
* Guidance will address amending Form 8939 and obtaining extensions of time to file.
* The act of filing the Form 8939 may constitute the "opt out" election not to apply the estate tax.
* The Service apparently does not want taxpayers who opt out of the estate tax to file a Form 706 to allocate GST exemption, so the Form 8939 may be revised to allow for GST exemption allocation.

On February 17, 2011, the IRS posted on its website "Information About the 2010 Form 8939." The information is found at <http://www.irs.gov/pub/irs-pdf/f8939.pdf>. The IRS has noted the following:

* 1. The Final Form 8939 will be posted at least 90 days before it is required to be filed.
  2. Instructions are still being drafted and will be issued shortly after the final Form 8939 is published. There will also be a new Publication, 4895, "Tax Treatment of Property Acquired From a Decedent Dying in 2010."
  3. Form 8939 should not be filed with the decedent's final return, nor should the opt-out election be made on the decedent's final income tax return.
  4. Instructions as to how to make the opt-out election will be described on the final Form 8939 as well as in the instructions for Form 8939 and in Publication 4895.
  5. This notice appears to be consistent with the informal statements made by e-mail and recited on the top of page 4 of your outline. No addressed is whether those opting out will have to file a Form 706 to allocate GST exemption. Informally, the Service has indicated that it may not require the filing of a Form 706 in these situations.

Also, on March 2, 2011, the Service announced information concerning Publication 4895. The Publication will be available following the release of both Form 8939 and the instructions for Form 8939. Publication 4895 will provide the following guidance:

* For executors:
  1. How to make the opt-out election;
  2. Were, when and how to file Form 8939;
  3. How to figure the basis increase limit;
  4. How to report the allocation of basis increase;
  5. How to report the allocation of generation-skipping transfer tax exemption; and
  6. What information must be provided to recipients of property.
* For recipients:
  1. What information they should expect to receive from the executor regarding the property they acquired;
  2. What should be done with information received from the executor; and
  3. How to determine holding periods for assets.

**2. NEW FEDERAL AND ILLINOIS ESTATE TAX LEGISLATION.**

1. **Summary of Major Provisions.**  TheTax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (hereinafter, “the 2010 Act”).
   1. **Estate Tax Reimposed.** The estate tax was reimposed with retroactive application estates of persons dying on or after January 1, 2010.
      1. The Applicable Exclusion Amount for decedents was increased to $5,000,000 for deaths occurring in 2010 and subsequent years, with indexing for inflation for years after 2011;
      2. The familiar Section 1014 step-up in basis rules were reimposed and the modified carryover basis regime repealed.
      3. The top marginal estate tax rate is 35%.
   2. **Exclusions Increased; Estate and Gift Tax Unified.** The gift and estate tax Applicable Exclusion Amounts (“AEA”) were reunified, but only for gifts occurring on or after January 1, 2011.
      1. Thus, the AEA for gifts in 2010 remained at $1,000,000;
      2. Beginning in 2011 every person has an additional $4,000,000 of AEA.
      3. The top marginal gift tax rate is 35%. In this connection, the method of computing the gift tax has changed to correct an anomaly under prior law. Many clients had made gifts under prior law that used unified credit calculated at a rate higher than 35%. For example, a client who made gifts before 2010 of $950,000 might think that he could make additional gifts of $50,000 without paying gift tax. However, the gift tax calculation prior to the 2010 Tax Act required the gift tax on prior taxable period to be computed on the basis of the rates effective for those periods. As a result, a gift of $50,000 in 2010 would require the payment of a small amount of tax. The 2010 Tax Act corrected this anomaly by providing that the amount of gift tax credit used for prior periods would be computed on the basis of the rate schedule in effect in the year of the current gift.
   3. **GST Tax Reimposed.** The generation-skipping tax was reimposed with retroactive application to transfers occurring on or after January 1, 2010.
      1. The GST Exemption increased to $5,000,000 for GST transfers occurring in 2010 and subsequent years. The GST Exemption is not indexed for inflation.
      2. The top marginal GST tax rate is 35%, but for transfers occurring in 2010 the GST tax rate is zero.
      3. Retroactively reimposing the GST tax regime to January 1, 2010, but making the tax rate for 2010 GST transfers zero clarified the treatment of GST transfers in 2010 and revived for 2010 and future years the beneficial provisions of EGTRRA that would otherwise sunset in 2011:
         1. It is now clear that the automatic allocation rules – and the election in, election out choices – will apply to transfers occurring in 2010;
         2. Qualified severances and 9100 relief for late allocations remain available;
         3. Taxable distributions made in 2010 from trusts that had an inclusion ratio of greater than zero involve no GST tax;
         4. The “move-down” rule of Section 2653 applies. This is especially important for direct skips in trust that occurred in 2010, due to the concern that post-2010 terminations or transfers from the trust to skip persons might be taxable terminations or distributions.
   4. **Rates Lowered.** The top marginal estate and gift tax rate 2010 and subsequent years is 35%. The tax rate for GST direct skips, taxable terminations and taxable distributions is 35% and the tax rate for direct skips occurring at death is 25.93%.
   5. **Election Out of Estate Tax.** Estates of Decedents Dying in 2010 may elect not to apply estate tax regime and instead apply modified carry-over basis with no estate tax.
      1. The default rule is that the estate tax regime applies, so an affirmative election must be made in order to have the no-estate-tax law apply;
      2. The election must be made within nine months following the date of enactment of the 2010 Act. The law was signed by President Obama on December 17, 2010. Nine months from that date is September 17, 2011, which is a Saturday. Presumably the election must be made by Monday, September 19, 2011.
      3. If the election is made to opt out of the estate tax, by special rule the decedent is still considered the “transferor” for generation-skipping tax purposes. Absent this provision, there would be uncertainty over how the GST regime would apply to an estate electing to opt out of the estate tax, because the definition of "transferor" under Code Section 2652(a)(1) is by reference to property subject to estate tax (where the decedent is the "transferor") or property subject to gift tax (where the donor is the "transferor").
      4. The IRS has not yet issued guidance on what form must be filed to manifest the opt-out election.
      5. If the no-estate-tax approach is desired, note that the allocation of basis is supposed to be made on or before April 15, 2011. In December, 2010, the Service published a draft Form 8939 but there are no instructions and the form has raised many questions. It is believed that the Service will extend the due date of the Form 8939 to correspond with the due date for the opt-out election.
      6. Even if an estate opts out of the estate tax, a Form 706, will still have to be filed in order to allocate GST Exemption. See Treas. Reg. § 26.2632-1(d)(1), which states that the allocation of a decedent's unused exemption is made on the appropriate United States Estate Tax Return. Any portion of the decedent's GST exemption that is not allocated on a timely filed return (including any extension), will be automatically allocated under Code Section 2632(e) and Treas. Reg. § 26.2632-1(d)(2).
   6. **Portability.** Portability of the Applicable Exclusion Amount for married couples is effective for persons dying on or after January 1, 2011.
      1. A person may use his or her own AEA plus the unused AEA of the person’s “last deceased spouse.”
      2. The so-called “deceased spousal unused exclusion amount” (“DSUEA”) may be used on the surviving spouse’s gift tax return during lifetime, or at death.
      3. In order to determine the DSUEA, an estate tax return for the deceased spouse must be filed. This is so even if the deceased spouse’s estate is less than the amount that otherwise would require a return to be filed. The Service has yet to publish guidance on whether a short-form 706 might suffice for fixing the predeceased spouse’s DSUEA.
      4. Remarriage of the surviving spouse may affect the extent to which the DSUEA of the predeceased spouse can be used. See discussion below under “Problems.”
   7. **IRA Charitable Rollover.** The IRA Charitable Rollover provisions of the Pension Protection Act of 2006, allowing persons 70 ½ years of age or older to direct distributions of up to $100,000 from their Individual Retirement Accounts directly to public charities, has been extended for 2010 and 2011. A distribution directly to public charities (not donor-advised funds and not supporting organizations) from the IRA will count toward the participant’s required minimum distribution.
2. **Problems.**
   1. **Opt-Out Election.**
      1. The IRS has not yet published the form for this election. Since the opt-out election must be made on a timely filed return, failure to make the election at the appropriate time will result in the imposition of the estate tax regime.
      2. The modified carryover basis regime of EGTRRA required a return to be filed to allocate basis with the income tax return for the decedent's last taxable year, or such later date specified in regulations prescribed by the Secretary. See Section 6075(a). For decedents dying in 2010, this date would be April 15, 2011 unless the income tax return is extended. Since the opt-out election does not have to be made until September 17 (or 19th, presumably), 2011, there is no sense requiring an allocation of basis before the estate has decided whether the modified carryover basis regime will apply. Presumably the Service will specify a later filing date for the carryover basis return.
   2. **Sunset and Clawback.**
      1. Section 304 of the 2010 Act provides that the sunset provisions of EGTRRA “shall apply to the amendments made by [the 2010 Act]” but changes the sunset date of Section 901(a) of EGTRRA from “after December 31, 2010” to “after December 31, 2012.”
      2. If the 2010 Act sunsets, then under Section 901(b) of EGTRRA, the Internal Revenue Code

. . . shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) ***as if the provisions and amendments described in subsection (a) had never been enacted.***

* + 1. If the $5,000,000 applicable exclusion amount is not permanently extended to $5,000,000, how is the law administered for gifts, estates, and generation-skipping transfers occurring in 2013 and beyond?
       1. Absent additional guidance, many of the issues that concerned practitioners with the EGTRRA sunset are simply postponed to 2013.
       2. Assume a person makes gifts in 2011 or 2012, using his full AEA of $5,000,000, and paying no tax. He dies in 2013, when the AEA has reverted to $1,000,000. The computation of his estate tax includes his adjusted taxable gifts, but the decedent is given credit for “gift tax payable.” Under the current estate tax instructions, the “gift tax payable” is a hypothetical number, which is computed in the following manner:
          1. First, figure each year’s taxable gifts.
          2. Second, figure the tax on each year’s taxable gifts ***using the rate schedule in effect at the death of the decedent*** rather than the rate schedule in effect at the time of the gift. In this second step the tax is computed each year by figuring the tax on cumulative gifts and subtracting the tax figured on gifts through prior periods.
          3. Third, subtract the unused applicable exclusion amount for each year’s gift tax, ***using the applicable exclusion amount in effect for the year the gift was made.***

When the gifts were made, there was no gift tax due to the AEA being $5,000,000. On the estate tax return, therefore, the estate must include the prior gifts of $5,000,000, but the “hypothetical” tax is zero. As a result, there will be estate tax imposed on the value by which the gift exemption used by the taxpayer exceeds the estate tax exemption available at death.

* + - 1. This so-called “clawback” is the product of the current estate tax instructions. Of course, the Service could change the instructions at any time.
      2. One could argue that under the “sunset” provision of the 2010 Tax Act, the Internal Revenue Code is to be applied as if the changes made by EGTRRA had never been enacted. If the changes made by EGTRRA had never been enacted, then the amount of the hypothetical gift tax arguably should be computed by reference to a $1 million AEA, which would eliminate the clawback issue. However, the “as if had never been enacted” language arguably could also mean that the taxpayer should be assessed tax on gifts that exceeded the $1 million AEA.
      3. The “sunset” argument falls apart if Congress in 2013 does not allow the law to sunset, but instead continues the estate tax with an AEA that is more than $1 million but less than $5 million that the 2010 Act now allows.
      4. Also, compare the potential outcomes of two taxpayers, one who makes $5,000,000 of gifts in 2011-2012 and one who does not, if both die in 2013 after the 2010 Act sunsets. If the purpose of the unified system is to eliminate distortions between those who make gifts and those who do not, the so-called claw-back does not appear to be unfair from a policy standpoint. With clawback, both estates are treated exactly the same. Without clawback, the estate of the taxpayer who made gifts obtains the benefit of a $5,000,000 exemption while the estate of the taxpayer who did not make gifts obtains the benefit of only a $1,000,000 exemption. As a matter of tax policy, this is not easily justified.
    1. Even if sunset occurs, clawback should not enter into future gift tax computations, because the gift tax calculation under Section 2502 measures the difference in tax on the current year's cumulative gifts over the prior year's cumulative gifts, using the same rate schedule, and then applies unified credit not previously used.
    2. Also, even if clawback occurs, the client will still have removed future appreciation and income accumulations from his estate. Thus some of the significant advantages of gifts remain.
    3. If sunset occurs and rates increase, the clawback computation may provide a hidden benefit to wealthy clients who made taxable gifts and paid tax when the rates were as low as 35%. Under the estate tax instruction, the “hypothetical” gift tax paid is computed on the basis of rates in effect at death. If the top rate reverts to 55% in 2013, taxable gifts that were made at a 35% rate will be credited to the estate at a 55% rate. An example in the supplemental materials at the 2011 Miami Institute illustrates the effect of a $10,000,000 gift made in 2012. The gift tax, after taking into account the AEA of $5,000,000, is $1,750,000 (35% of the next $5,000,000). If the law sunsets and the donor dies in 2013, the estate tax instructions would produce a credit for gift tax paid of $2,750,000 (55% of the $5,000,000 of gifts after applying the $5,000,000 exclusion available in 2012). The difference -- $1,000,000 – is $5,000,000 x the 20% difference in tax rates.
    4. Clawback could present unusual problems in the following situations:
       1. Tax Apportionment. Absent careful planning, it is likely that any estate tax attributable to the clawback gifts will be charged to the decedent’s residuary estate under most tax payment provisions. If the recipients of the client’s estate are different from the recipients of the gifts that are subject to clawback, the burden of this tax may be perceived as unfairly imposed. For example, assume a person with a $10,000,000 estate makes gifts of $5,000,000 in 2012 and dies in 2013 when the AEA has reverted to $1,000,000 and the 55% rate schedule is again in effect. The estate tax on the decedent’s $5,000,000 of taxable estate and $5,000,000 of adjusted taxable gifts will be $4,795,000, leaving very little to the residuary takers.
          1. But in a sense this does not differ much in principle from the "distortion" that occurs by using the AEA during lifetime, even if there is no clawback. In the example above, assume that the exemptions and rates will remain at $5,000,000/35%. The estate tax is calculated on the basis of the value of the gift added to the value of the estate, but the donees bear none of the estate tax, while the residuary takers under the estate plan bear the burden of all of it.
          2. A difficult problem arises if the client’s probate estate is insufficient to pay the estate taxes due on the clawback amount. From whom does the Service collect? The lien for taxes under Code Section 6324 would not apply to the gift property received by the donees, and the donees, at least as to the gift property, are not transferees of property of a decedent under Code Section 6901.
       2. Loss of Marital Deduction. The estate tax is “tax inclusive” – there is no estate tax deduction for estate taxes that are paid. Assume again that a married person makes $5,000,000 of gifts in 2011-2012 and dies in 2013 after the 2010 Act sunsets. If the married client’s estate is subject to clawback, and the client has employed a “reduce to zero” marital deduction formula, the additional estate tax associated with the clawback will be paid from assets that would otherwise qualify for the marital deduction. Clawback will reduce the marital deduction and involve a “tax-on-tax” computation that will cause the payment of significant federal estate tax on the first death, where none may have been intended. In the above example, if the taxable estate of the decedent, before calculating the marital deduction, were $10,000,000, and $5,000,000 of adjusted taxable gifts made in 2011-2012 were added to this amount, the estate tax would be $4,544,444.46.
    5. Bottom Line: The ability to make additional gifts is very valuable. While clawback is a concern, the issues as to how, or even if, it might apply may remain uncertain for the next two years. Gifts still remove future appreciation and income accumulations from the donor’s estate. The potential for possible clawback taxes should be discussed with clients, especially as they relate to the marital deduction and tax apportionment.
  1. **Basis Allocation for Modified Carryover Basis Property.**

The statute allows the allocation of up to $3,000,000 of basis increase for property that passes to a surviving spouse, either outright or in a QTIP-type trust. The Service has indicated informally that it believes it will be constrained by the wording of the statute to permit spousal basis increase only for property held at death that actually passes to a spouse or to a QTIP-type trust. If this is carried into practice, any post-death sale of an asset, with the allocation of proceeds to the spouse, would not qualify for the basis step-up. This seems to be a ridiculous interpretation of the statutory requirement that the asset pass to the spouse.

* 1. **Portability Issues.**
     1. In order to properly document the DSUEA, one must elect the benefit by on an estate tax return filed for the deceased spouse’s estate, even if gross value of the deceased spouse’s estate would not otherwise require the filing of a return. The requirement to file an estate tax return to quantify this amount in many cases will impose an expensive burden on smaller estates.
        1. The election, once made, is irrevocable.
        2. The election must be made on a timely-filed return. Code Section 2010(c)(2)(5)(A), as amended by the 2010 Act, specifically states that no election may be made if the return is filed after the time prescribed by law (including extensions) for its filing.
        3. Code Section 2010(c)(2)(B) provides that the general statute of limitations will not apply to return that establishes DSUEA. The Service may examine the return of a deceased spouse at any time in order to make a determination as to the amount of DSUEA.
     2. The Service has not issued guidance over whether it may only require a simplified return to document the DSUEA in cases where the deceased spouse’s estate is less than $5,000,000.
     3. Since the DSUEA is determined by reference to the surviving spouse’s “last deceased spouse,” there are difficult issues when a surviving spouse remarries:
        1. Assume that H1, the spouse of W1, dies having used none of her AEA. W1 has $5,000,000 of her own exclusion amount and $5,000,000 of the deceased husband’s DSUEA. W1 remarries H2, a wealthy person who has used all of his $5,000,000 applicable exclusion amount.
           1. If W1 dies before H2, her estate may claim a $10,000,000 exclusion because H1 was her last deceased spouse.

If W1’s estate is not large enough to utilize the full $10,000,000 exclusion, is any unused portion available to H2? The definition of DSUEA limits the exclusion amount to W1’s basic exclusion amount less her taxable estate plus adjusted taxable gifts. H2 is not allowed any benefit of the DSUEA that W1 obtained from her first spouse. This is sometimes referred to as a “privity” requirement.

But the Joint Committee on Taxation Technical Explanation, Example 3, suggests that H2 may obtain some benefit. The Example says that husband died with $2 million of unused exclusion amount. The surviving spouse (W1) then enjoys $7 million of exclusion. W1 remarries H2 and dies with a taxable estate of $3 million. The Example says that H2 now has $4 million of DSUEA. This would be the case if W1’s estate was treated as using $2 million of her DSUEA first and only $1 million of her exclusion amount, leaving $4 million as a carryover. However, this computation cannot square with the definition of DSUEA that applies to H2. The DSUEA for him is W1’s basic exclusion amount (in Example 3, $5 million) less W1’s taxable estate and adjusted taxable gifts (in Example 3, $3 million). The DSUEA for H2 should be $2 million, not $4 million.

* + - * 1. If H2 dies first, W1’s DSUEA will be zero because H2 had no unused exclusion amount at death. W1 has “lost” the $5,000,000 DSUEA unless, of course, she remarries someone who has an unused AEA and survives that spouse. This suggests that a surviving spouse should use the exemption as soon as possible. As discussed below, nothing in the new law allows a person to use DSUEA before using his or her own exclusion.
        2. If W1 makes $5,000,000 of gifts after H1 has died, is she using her basic exclusion amount, the DSUEA of H1, or a portion of both? There is no ordering rule in the statute and a mechanical approach to the gift tax computation suggests that ordering is not allowed. Rather, a person’s AEA is the sum of his or her basic exclusion amount and DSUEA. For example, if W1 has $5,000,000 of her own basic exclusion, and $4,000,000 of DSUEA from H1’s estate, her “applicable exclusion amount” will be $9,000,000. Assume W1 makes gifts of $5,000,000. She will use $5,000,000 of her applicable exclusion amount on her gift tax return. She then remarries H2, who dies having used all of his basic exclusion amount. If W1 now makes $1,000,000 of additional gifts, her gift tax return will compute gift tax on $6,000,000, and subtract the prior gift tax on gifts of $5,000,000, and then apply any additional credit available to W1, but she should have none, since her AEA is $5,000,000 and she has used unified credit based on this amount for her prior gifts.
        3. If W1 makes $10,000,000 of gifts after the death of H1, remarries, and then H2 dies, at W1’s death (assuming she does not remarry) presumably there will be a “clawback” of the $5,000,000 of DSUEA that W1 used. See the discussion above involving the tax apportionment issues that may arise with respect to clawback.
      1. All of the foregoing suggests that remarriage of wealthy clients will involve financial considerations revolving around possible loss of an existing DSUEA or possible acquisition of exclusion from a prospective spouse.
      2. As indicated above, the AEA is adjusted for inflation after 2011. The DSUEA has no inflation adjustment. It remains fixed.
      3. The GST exemption is not portable. The “use it or lose it” rule will mean that portability will not be particularly attractive for large estates that are aimed at generation-skipping planning.
      4. There is no portability of the “exemption” from the estate tax for states, such as Illinois, that still impose such a tax. It would be foolish, it seems, to waste any person’s “exemption” from a state-imposed estate tax.
  1. **Return Issues.**
     1. As noted above, the time for filing an election to opt out of the estate tax regime for estates of decedents who died in 2010 before the enactment of the 2010 Act is September 17 (presumably 19), 2011.
     2. There is no extension of the due date for filing a gift tax return for a 2010 gift. After serveral revisions, the Service released the 2010 Form 709 instructions in March, 2011. The instructions include a worksheet that avoids a possible "glitch" in the tax computation due to the reduction of the tax rate from 45% to 35% in 2010. In computing the gift tax, the amount of the previously "allowable" applicable exclusion amount is subtracted from the tentative tax due. See Code Section 2505(a)(2). The worksheet in the instructions makes it clear that the previously allowable exclusion is computed as if the prior transfers were never taxed at more than 35%. For taxpayers who made prior gifts of more than $500,000 but less than $1,000,000, applying the current rate schedule to prior gifts ensures that the donor will be able to fully utilize any unused applicable exclusion amount in 2010 without incurring gift tax.
     3. The time to file a GST return to report generation-skipping transfers that occurred in 2010 before the date of enactment is also September 17 (presumably 19), 2011. However, the 2010 Act confers no extension of time for filing a return to make a timely allocation of GST exemption, or to elect out of automatic allocations for indirect skip transfers to GST Trusts.
     4. A direct skip transfer in 2010 will result in a deemed allocation of GST exemption under Code Section 2632(b)(1) ***unless the client elects out of the deemed allocation rule on a gift tax return.***
  2. **Planning Issues.**
     1. **Uncertainty Over Sunset Continues.** The temporary nature of the 2010 Act continues to inject uncertainty to estate planning. Congress seems unlikely to revisit the estate tax until late 2012 (an election year), which means that once again planners cannot know with any certainty whether the exemptions will remain at $5,000,000, be reduced to $1,000,000 or be revised to some other number.
     2. **Potential for Clawback.** The “clawback” issues that involve both the use of a person’s AEA, and the DSUEA of a deceased spouse, need to be discussed with clients who intend to make gifts beyond $1,000,000.
     3. **Leveraged Transactions.** The five-fold increase in the gift tax exemption widens the opportunities for wealth-shifting with the very wealthy clients. Gift “seeds” to grantor trusts in the amount of $5,000,000 could support an installment sale of property valued at $45,000,000, if the “seed” gift will represent 10% of the trust corpus. The additional gift exemption will also open up opportunities for increased premium payments for insurance policies owned by irrevocable life insurance trusts.
        1. Grantor Trust. The amount of additional wealth that can be transferred without gift tax because the grantor continues to pay income tax on the transferred property magnifies the benefits of large installment sales. With the possibility of a $10,000,000 "seed" gift, the grantor trust could easily begin with assets of $80-$90,000,000, and appreciate from there. For the ultra-wealthy, the benefit of paying the income tax on a grantor trust offers enormous benefits.
        2. 678 Trust. See PLR 200949012 for a creative way for a grantor to create a trust for a beneficiary who, although not the grantor, will be taxed on all of the income of the trust under Code Section 678. For example, child creates trust for parent under which parent is taxed as the owner under Section 678. Parent can then engage in installment sale of assets with the trust thereby removing future appreciation from his estate but without giving up access to income and principal. One must be mindful of the step transaction doctrine if the "seed" gift to the trust was given to the nominal grantor by the intended beneficiary.
     4. **QPRTs.** Qualified Personal Residence Trusts have not been very popular in the last several years, due to the relatively high remainder value that is caused by low 7520 rates. Even if the 7520 rates remain low, the additional gift tax exclusion will make QPRTs more popular, especially among the moderately wealthy taxpayers who may be more receptive to gift strategies that can take advantage of fractional discounts that do not involve income-producing assets.
     5. **Spousal Lifetime By-Pass Trusts.** Married taxpayers who wish to take advantage of the increased gift exemptions to remove future appreciation from their gross estates might consider establishing a lifetime By-Pass Trust for the benefit of the spouse and the children. Such a trust would remove future appreciation on the gifted assets from the donor's estate tax base, but would not deprive the spouse of access to income. Taking care to avoid the reciprocal trust doctrine, each spouse could create a $5,000,000 for the family on this basis. Moreover, in a state (such as Illinois) which has no gift tax and calculates its death tax without regard to adjusted taxable gifts, the couple could remove $10,000,000 from the estate tax base for state death tax purposes.
        1. This type of planning obviously requires a stable marriage.
        2. It is probably a bad idea for the first deceased spouse to exercise a power of appointment to make the surviving spouse a beneficiary of the trust, with the possible exception of such a trust created by a transferor who lives in a state that allows self-settled trusts to be free from creditors’ claims. The surviving spouse would remain the "transferor" of the trust for estate tax purposes. The enjoyment of the income of the surviving spouse pursuant to the exercise of a limited power of appointment granted to the first deceased spouse -- and exercised -- looks like a retained interest under Section 2036, especially if under state law the original transferor’s creditors could pierce the trust.
     6. **State-Imposed Estate Tax a Concern.** If a state, such as Illinois, imposes a lower threshold for imposing its estate taxes, utilizing a full “reduce to zero” formula could nevertheless produce a significant tax. For instance, in Illinois the threshold for estate tax remains at $2,000,000. The potential Illinois tax on a “reduce to zero” marital deduction formula has increased dramatically. In 2009 an estate plan that created a trust to hold the largest amount that would produce no Federal estate tax ($3,500,000) would result in an Illinois estate tax of $228,200. The Illinois estate tax on an estate that allocates to a by-pass trust the largest amount that will produce zero federal estate tax, without regard to state death taxes, would be $391,600.
        1. A tax of $391,600 on the extra $3,000,000 of assets represents an effective tax rate of 13.053%, which will be comparable to the effective rate on the same $3,000,000 if a state-only QTIP is elected and the $3,000,000 is includible in the surviving spouse’s estate. However, all of the income from the QTIP must be paid to the surviving spouse, and potential state-imposed estate taxes on future appreciation must also be considered. On the other hand, states like Illinois that offer a state-only QTIP may provide a giant loophole: a surviving spouse may move to Florida or some other estate-tax-friendly state, in which case the situs of the QTIP property in the first state (except to the extent it consists of real estate or tangible personal property in that state) will shift to the tax-friendly state.
        2. Assuming that a married person wants to plan for the flexibility of an state-only QTIP, consider the following choices:
           1. **Disclaimer Plan.** Outright distribution to surviving spouse, but any disclaimed property falls into a QTIP Trust. The main disadvantage of this plan (aside from leaving the tax planning to the surviving spouse) is loss of control: the spouse cannot exercise a power of appointment over the disclaimed property.
           2. **Single Trust Plan.** All property passes to a QTIP. Federal and/or state-only QTIP elections are made to the extent advisable for tax planning. The main disadvantage is that all of the income of the trust must pass to the surviving spouse, perhaps unnecessarily increasing his or her estate.
           3. **Clayton-Type Plan.** All property passes to a trust that is eligible for QTIP treatment, but to the extent a QTIP election is not made, the property “flips” to a By-Pass Trust under which income can be accumulated. The main advantage of this approach is that to the extent the estate decides to incur the state-imposed estate tax on the full $5,000,000 of Federal exemption, the income from the entire by-pass amount can be accumulated. See Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992); Treas. Reg. §20.2056(b)-7(d)(3). A possible disadvantage is whether, relying on Clayton and the Treasury Regulations, one can make a state-only QTIP election that does not reduce federal estate tax. In this regard, see Rev. Proc. 2001-38, 2001-2 C.B. 124, which provides that the Service will regard as void QTIP elections where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. Rev. Proc. 2001-38 by its terms does not apply to a partial QTIP election where the fiduciary made the election over more property than was needed to reduce the estate tax to zero. Also, the revenue procedure refers to elections that do not reduce tax, without specifying whether it means federal estate tax or combined federal and state death taxes. Certainly a state-only QTIP election will reduce "estate tax."
           4. **Three-Trust Plan.** Client creates three trusts. One is in the largest amount that will incur no state or Federal estate tax – for example, $2,000,000 in Illinois. The second is in the amount that will incur no Federal estate tax without regard to state-imposed estate tax. -- $3,000,000 in Illinois. The third is for the balance of the estate. The second and third trusts must qualify for the Federal estate tax marital deduction, but the estate may make an state-only QTIP election over the second trust, thus obtaining the benefits of a $5,000,000 Federal exemption but deferring all state-imposed estate tax to the death of the survivor. The main advantage of this plan is that income from the $2,000,000 trust can be accumulated.
           5. **GST Planning.** GST planning will greatly complicate these structures. For instance, in the Three-Trust Plan, any one of the three trusts could be wholly or partially exempt from the GST tax, depending on the relative amounts of the client’s GST exemption and AEA that were used during lifetime. The Three-Trust Plan becomes a ‘Six-Trust” Plan, although in any given scenario there will never be more than 4 trusts created.
     7. **Step-Up in Basis Issues.** If the increase in the AEA to $5,000,000 becomes permanent, a common situation might be a surviving spouse whose estate is less than $5,000,000. In these situations, it might be advisable to somehow add assets to this person’s estate in order to take advantage of basis step-up at death. For example, assume a married person dies and creates a $5,000,000 by-pass trust for the benefit of the surviving spouse. Year later the by-pass trust has grown to $10,000,000 but when the surviving spouse dies her estate is only $1,000,000. Is there a way to add $4,000,000 of assets from the by-pass trust in order to increase the surviving spouse’s estate to her AEA amount and take advantage of the step-up in basis what will occur on her death.
        1. Some practitioners have suggested that the spouse could be given a general power of appointment over the by-pass trust in the smallest amount necessary to increase her taxable estate to $5,000,000, ignoring for this purpose the effect of the charitable and marital deductions. This seems to be a very bad idea. Since a surviving spouse can always “spend down” her estate (by lifetime gifts, charitable gifts, or spendthrift habits) the formula power may result in the spouse possessing a general power of appointment as to a full $5,000,000, or perhaps the entire trust, to cover debts. See, e.g. Estate of Kurz v. Commissioner, 68 F.3d 1027 (7th Cir. 1995), in which the Seventh Circuit affirmed a Tax Court decision holding a decedent's unexercised 5 x 5 power to be includible in the estate. Under the terms of the trust, the wife could not exercise the 5 x 5 power over the Family Trust until the assets of the Marital Trust were depleted. However, the assets of the Marital Trust were subject to the spouse's unlimited right of withdrawal. The estate argued that under Treas. Reg. § 20.2041-3(b) the right to exercise the 5 x 5 power never came into existence because at the spouse's death assets remained in the Marital Trust. Treas. Reg. §20.2041-3(b) states:

For purposes of section 2041(a)(2), a power of appointment is considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised. ***However, a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death.*** For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred. [emphasis added].

The Seventh Circuit, believed that the case was really covered by the first sentence of the quoted regulation, regarding notice, because the conditions were so wholly within the control of the decedent that she could have exercised the powers at any time. If Kurz stands for the principle that conditions to the exercise of a power that are within the control of the power holder do not block the application of Section 2041, then one must be concerned about any condition related to how much the beneficiary spends or gives away during lifetime.

* + - 1. As an alternative, an Independent Trustee could be given the power to confer on the spouse a general power of appointment exercisable over a portion of the trust. Presumably, the power will only be granted if (and to the extent) that the spouse’s estate is expected to be less than the AEA.
      2. As another alternative, and perhaps less complicated than granting a power of appointment, an Independent Trustee could be given discretionary authority to distribute principal to a surviving spouse under a very broad standard, such as “best interests.”
      3. One suggestion that arguably would not require revisiting the estate plan is to grant the spouse a limited testamentary power of appointment over the by-pass trust, and to have the spouse exercise the power in a manner that springs the Delaware Tax Trap of Code Section 2041(a)(3) in a formula amount equal to the unused AEA.
         1. Code Section 2041(a)(3) treats the exercise of a limited power of appointment as a taxable event for estate tax purposes if the exercise creates another power (the "second power") that can be validly exercised so as to postpone vesting, or suspend the absolute ownership or power of alienation of property, without regard to the date of the creation of the first power. A simplified way to think about this difficult language is whether a non-taxable power can be exercised so as to begin a new perpetuities period.
         2. If the trust is governed by a common law Rule-Against-Perpetuities provision, then in states that have perpetuity savings provisions the only way to begin a new perpetuities period may be for the surviving spouse to grant someone a ***presently exercisable general*** power of appointment. This is because in states that follow common-law principles, the exercise of a limited power of appointment must be read as if it were part of the dispositive plan of the creator of the trust. In other words, the exercise of a limited power of appointment "relates back" to the creation of the trust, and the savings provision will cause all interests to vest within the perpetuities period. However, under the common law, the exercise of a limited power to create a presently exercisable general power would permit the perpetuities period to begin again. This is because a presently exercisable power is viewed essentially the same as ownership. See Restatement (Second) of Donative Transfers, Section 1.2. One may also have to distinguish between the exercise of a limited power that grants a presently exercisable general power of appointment, and the exercise of a limited power that grants a testamentary general power of appointment. Under the laws of some states, the granting of a general testamentary power of appointment does not permit the running of a new perpetuities period. See, *e*.*g*., Northern Trust Company v. Porter, 368 Ill. 256, 13 N.E. 2d 487 (1938).
         3. If a presently exercisable power of appointment is viewed essentially as ownership, can granting one spring the Delaware Tax Trap? What vesting is postponed if, for Rule Against Perpetuities purposes, the property is "vested" by virtue of the exercise of the first power? And would the government really care as long as the holder of the second power has the property in his or her estate?
         4. The analysis may change if the state does not follow the common-law Rule Against Perpetuities, but even here the analysis can be complicated and lead to surprising conclusions. For instance, under Illinois law a qualified perpetual trust is one to which, by election, the Rule Against Perpetuities does not apply, ***and*** with respect to which the trustee's power of sale is not limited by the instrument or any provision of law for any period beyond the Rule Against Perpetuities. 765 ILCS 305/3(a-5). In other words, the trust can last forever as long as the trustee's power to alienate the property is not suspended beyond the period of the Rule. Although the language of the Illinois statute is far from clear, it appears that for qualified perpetual trusts Illinois has done away with the "remoteness of vesting" approach to perpetuities issues and substituted an anti-alienation provision. If this is the case, then by definition no exercise of a power of appointment under a perpetual trust can suspend the power of alienation beyond the period of the Rule as measured from the creation of the power. See Estate of Murphy v. Commissioner, 71 T.C. 671 (1979), a case that discussed Section 2041(a)(3) in the context of the Wisconsin Rule Against Perpetuities that was expressed in terms of suspension of the power of alienation instead of remoteness of vesting. Murphy held that Section 2041(a)(3) did not apply because under Wisconsin law the power to alienate the property was not suspended for any period beyond the Rule.
  1. **Disclaimer Issues.**
     1. The period for determining whether to disclaim a gift from the estate of a person dying on or before December 17, 2010 has been extended to September 17, 2011.
     2. However, acceptance of a gift is a bar to a qualified disclaimer.
     3. The extension of the Federal disclaimer period has no effect on state time limitations. In Illinois, there is no time limitation – property can be disclaimed at any time prior to acceptance. In other states, even if the time for disclaimer may have passed, Code Section 2518(c)(3) may apply so that a written instrument that is not effective as a disclaimer under state law may nevertheless be treated as a qualified disclaimer for Federal purposes.
     4. A disclaimer by a child of a 2010 decedent’s gift can be a very effective GST Planning Tool. For example, assume a 2010 decedent establishes a $5,000,000 GST-exempt trust for his only child, with remainder to grandchildren. The balance of the decedent’s estate (say, another $5,000,000) passes to child, either in trust or outright, in a disposition that will be subject to estate tax in son’s estate at his death. Son disclaims the second gift, resulting in the entire amount passing to grandchildren as a direct skip. The direct skip is subject to the generation-skipping tax, but since the skip occurs in 2010 the tax rate is zero. Since the move-down rule of Section 2653 applies, even if the direct skip is in trust, future distributions to the grandchild will not be taxable distributions for GST purposes.
        1. By disclaimer, the son has exempted an additional $5,000,000 from estate tax at his generation, and generation-skipping tax on the transfer to the grandchildren
        2. The above statement is true regardless of whether the estate opts out of the estate tax, although most $10,000,000 estates will undoubtedly opt out in order to avoid estate tax. Regardless of an opt-out, the GST Exemption remains $5,000,000.
        3. ***Anyone disclaiming a 2010 transfer that will result in a direct skip under chapter 13 must consider the allocation rules for GST transfers. At the 2011 Miami Institute the Recent Developments panelists repeatedly warned that the appropriate return must be filed to ensure that GST exemption is not deemed allocated to direct skips, if the goal is to take advantage of the 0% rate, rather than apply GST exemption.***

**3. SELECTED FEDERAL CASES AND RULINGS**

**A. Partnership Valuation Cases: Holman, Fischer. Pierre II and Linton.**

**Holman v. Commissioner, 601 F.3d 763 (8th Cir. 2010).** The Eighth Circuit has affirmed the Tax Court decision in Holman, which involved gifts of limited partnership interests in a partnership that owned one asset – Dell stock. The partnership was formed on November 2, 1999 and was designed to last for a term of 50 years. Funding occurred on November 3, 1999. The taxpayers made gifts of limited partnership interests 6 days after formation, on November 8, 1999. The taxpayers subsequently made gifts in 2000 and 2001. All of the gifts were subject to substantial discounts on account of the nature of the limited partnership units that were the subject of the gifts. The Service audited the gift tax returns and assessed deficiencies.

The IRS raised a number of objections to the discounts, but by the time the case was tried there were three that the Tax Court considered:

1. Under the reasoning of Shepherd v. Commissioner, 283 F.3d at 1261, and Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006), the taxpayers made indirect gifts of stock rather than gifts of partnership interests for the 1999 tax year;
2. Under the step transaction doctrine the taxpayers made indirect gifts of stock rather than gifts of partnership interests for the 1999 tax year; and
3. Section 2703 applied to the restrictions of the partnership agreement and therefore the gifts of partnership interests in 1999, 2000 and 2001 should be valued without any discount for restrictions on transfer under paragraphs 8.4, 9.1, 9.2 and 9.3 of the partnership agreement. These paragraphs generally prohibited limited partners from withdrawing from the partnership, provided for a buy-back if a partner assigned a partnership interest outside a permitted group, and provided that an assignee could become a partner only by meeting certain conditions. These restrictions are by no means uncommon in most family partnership arrangements.

The Tax Court found for the taxpayer on the first two issues, but held that Section 2703 applied to the partnership. As a result, the taxpayer's gifts were valued without regard to the restrictions, which lessened the discounts. The taxpayer appealed the 2703 issue and the Tax Court's determination of value.

Section 2703 provides that for gift tax purposes the value of property transferred is determined without regard to any right or restriction on the property unless the restriction meets all three of the following requirements:

1. It is a *bona fide* business arrangement;
2. It is not a device to transfer the property to members of the person’s family for less than full and adequate consideration in money or money’s worth; and
3. The terms of the restriction are comparable to similar arrangements entered into by persons in an arm’s length transaction.

The Tax Court found that the restrictions of the partnership agreement flunked the first two prongs of Section 2703. The Court also analyzed, at length the third prong, but ultimately issued no ruling regarding the comparability test.

On appeal the Eighth Circuit limited its analysis to the first prong, the "*bona fide* business arrangement" test. Obviously the limited partnership was not engaged in the active conduct of a business -- it was an investment partnership. The taxpayer argued that the Tax Court improperly analyzed the first prong by inquiring as to whether a business existed. Instead, the taxpayer argued, the Court should not have considered whether the partnership itself is an operating or actively managed business, but whether the restrictions in question are a *bona fide* arrangement that serve the "business" objectives of the partnership -- to generate profits through long-term growth. The Eighth Circuit, affirming the Tax Court, stated:

We agree with the Tax Court's conclusion and reject the donor's attempt to characterize the Tax Court's opinion as creating an "operating business nexus." In answering the question of whether a restriction constitutes a bona fide business arrangement, context matters. Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no "business," active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that "maintenance of family ownership and control of [a] business" may be a bona fide business purpose. St. Louis County Bank, 674 F.2d at 1207; see also Estate of Bischoff v. Comm'r, 69 T.C. 32, 39-40 (1977). We have not so held, however, in the absence of a business.

That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., Higgins v. Commissioner, 312 U.S. 212, 217-18, 61 S. Ct. 475, 85 L. Ed. 783, 1941-1 C.B. 340 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to "carrying on a business"); Estate of Thompson v. Comm'r, 382 F.3d 367, 380 (3d Cir. 2004) ("Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.").

One case the donors cite in support of their position is Estate of Amlie v. Comm'r, T.C. Memo 2006-76, 91 T.C.M. (CCH) 1017 (2006). There, the Tax Court found that a buy--sell agreement was a *bona-fide* business arrangement where a fiduciary had entered into the agreement to ensure the ability to sell stock that represented an otherwise illiquid minority interest in a closely held bank. 2006 Tax Ct. Memo LEXIS 76 at 29. The Tax Court viewed this purpose as patently business oriented and likely necessary to ensure that the fiduciary could fulfill his duty of protecting the beneficiary by ensuring the ability to sell the underlying assets. Id.

Here, in contrast, the donors did not enhance the liquidity of an otherwise illiquid asset through their actions nor do they claim their actions were necessary as a matter of business necessity to ensure a market for the assets. The underlying Dell stock is widely held, easily valued, and highly liquid. The donors placed it into the partnership thereby burdening it with illiquidity as part of an overall estate and gift planning process. As such the donor's reliance on Amlie is misplaced. [footnotes omitted]

The Court also distinguished the facts of this case from those in Bischoff v. Commissioner, 69 T.C. 32 (1977), which dealt with a price formula in a buy/sell agreement for a limited partnership. The Tax Court held in that case that the maintenance of family ownership and control was a legitimate business consideration. The majority pointed out that Bischoff concerned the conduct of an active business where interference from outsiders was a major concern. Here, the majority pointed out, there was no real threat of interference with the management of assets.

Having affirmed the Tax Court's holding that Section 2703 applied, the majority then turned to the issue of the marketability discount. The taxpayer's expert had argued for a 35% discount; the government's expert for a 12% discount. The Tax Court ultimately agreed on a 12.5% discount.

The government's expert, in justifying the 12% discount, testified that he believed that there was a natural cap on the discount of the partnership interests, because the Dell stock was highly liquid and its value easily ascertainable. He believed that if outside buyers were to demand too great a discount relative to the then-prevailing price of Dell stock, economically rational insiders (i.e., the remaining partners of the partnership) would have a clear incentive to step into the void and purchase the exiting partner's shares at a lesser discount, thereby providing a cap or ceiling to any potential discount. The taxpayer argued that this analysis violated the willing buyer/willing seller test, by substituting actual partners for hypothetical third-party buyers. The majority disagreed with the taxpayer, as follows:

. . . A buyer possessed of all relevant information would know that (1) the underlying assets are highly liquid and easily priced; (2) the amount held by the partnership could be absorbed by the broader market and represents but a small fraction of the total outstanding market capitalization of Dell corporation; (3) the partnership agreement permits the buying out of exiting partners or dissolution upon unanimous consent of all partners; and (4) there would be little or no economic risk and likely no additional capital infusion necessary for remaining partners to buy out an existing partner.

Against this backdrop, it is not necessary to look at the personal proclivities of any particular partner or the idiosyncratic tendencies that might drive such a specific person's decisions. Rather it is only necessary to examine what is technically permissible in accordance with the agreement and forecast what rational actors would do in the face of a pending sale at a steep discount relative to net asset value. Simply put, the Tax Court did not ascribe personal non-economic strategies or motivations to hypothetical buyers; it merely held that, presented with the opportunity, rational actors would not leave money on the table.

**COMMENT:** Judge Bean dissented, arguing that no part of Section 2703 would apply to the restrictions, and that the Tax Court clearly violated the willing buyer/willing seller test in accepting the "rational actor" test of the government's expert. As to the latter issue, the dissent characterized the Tax Court's analysis as follows:

The Tax Court's analysis violates the hypothetical willing buyer/willing seller test because it assumes the hypothetical buyers own Holman limited partnership interests. *See* Estate of Jung v. Comm'r, 101 T.C. 412, 438 (1993). The court majority asserts that the Tax Court properly cast the hypothetical willing buyer "merely as a rational economic actor," but the Tax Court did more than that. Ante at 21 (emphasis added). The Tax Court effectively plucked rational economic actors out of the existing "thin" private market, placed Holman limited partnership shares in their pockets, and asked them what they would pay for a wishing-to-assign partner's interest in light of the partnership's dissolution provisions. In fact, the Tax Court's analysis is essentially based on the idea that a mere rational economic actor in the existing market would pay *less* than rational actors who already hold Holman limited partnership interests. Courts commit legal error where, as here, they substitute hypothetical buyers for "particular possible purchasers" based on "imaginary scenarios as to who a purchaser might be." Estate of Simplot v. Comm'r, 249 F.3d 1191, 1195 (9th Cir. 2001). [footnotes omitted]

Following the Eighth Circuit's decision in Holman, the District Court for the Southern District of Indiana considered whether Section 2703 would apply to disregard transfer restrictions in a partnership agreement. **Fisher v. United States**, 2010 U.S. Dist. LEXIS 91423 (2010). In Fisher the parents formed a limited partnership to hold undeveloped lakefront land. They subsequently gave limited partnership interests to their children. In a gift tax audit, the Service disregarded the transfer restrictions and assessed gift tax, which the Fishers paid and then instituted a refund action in District Court. The case came before the Court on cross motions for summary judgment as to whether Section 2703 would apply to disregard the restrictions. The District Court granted the government's motion, finding virtually no material difference between the facts of this case and those in Holman:

The facts of this case are analogous to those in Holman. There, two donors created a limited partnership, funded it with common stock from a publicly traded company, and gifted limited partnership shares to their children. 601 F.3d at 765. There was no evidence indicating that the partnership employed a particular investment strategy or that the donors were "skilled or savvy investment managers whose expertise [wa]s needed or whose investment philosophy need[ed] to be conserved or protected from interference." Id. at 770, 771. The donors retained exclusive control of the partnership, and their children could not withdraw from the partnership or assign their interests unless certain transfer conditions were met. Id. at 766. The Eighth Circuit affirmed the Tax Court's conclusion that the restrictions upon the children did not serve a *bona fide* business purpose because the partnership was not a "'business,' active or otherwise." Id. at 770. In so holding, the Holman court distinguished a line of cases where active, ongoing business interests were preserved by the transfer restrictions at issue. See, e.g., id. at 771 ("The underlying asset in [Estate of] Bischoff [v. Comm'r, 69 T.C. 32, 39-40, 1977 WL 3667 (1977) was a pork processing business organized, controlled, and managed by three families who sought to assure their continuing ability to carry on their pork processing business without outside interference, including that of a dissident limited partner.").

Here, as in Holman, there is no evidence that the Fishers had an investment strategy that was preserved by Good Harbor's formation. In addition, the uncontradicted evidence demonstrates that neither the Fishers, nor the Fisher Children made an ongoing investment in the lakefront property to increase its commercial value. See Deposition of James Fisher ("Fisher Dep.") at 14:16-15:20; 19:21-20:23 (establishing that, on occasion, James Fisher and one or more of his siblings (the Fisher Children) would travel to the lakefront property and, while there, engage in discussions about developing the property for the personal enjoyment of the Fisher Children and their offspring); id. at 20:24-25; 18:8-24 (establishing that upon Good Harbor's formation, the Fisher Children did not intend to sell the property); id. at 18:21-19:20; 21:1-13 (establishing that the Fisher Children were contacted by a potential buyer, who initiated the negotiation process for purchasing a portion of the lakefront property). Furthermore, there no indication that the Fishers or the Fisher Children acquired or pursued the acquisition of additional real property as an investment for Good Harbor. Cf. Cent. States, Se. & Sw. Areas Pension Fund v. Personnel, Inc., 974 F.2d 789, 794-96 (7th Cir. 1992) (holding in another context that buying, repairing, advertising, and selling multiple properties annually rose to the level of a "trade or business.")

It is important to keep in mind that the Courts in neither Holman nor Fisher applied Section 2703 to avoid the partnership itself. Rather, the Section was used to disregard restrictions on the transfer of partnership units. In other words, the fight was not over whether there was a gift of a partnership interest (as opposed to a gift of the underlying assets); rather, the fight was over the amount of the discount that would be applied to that interest.

**Pierre v. Commissioner**, **T.C. Memo 2010-106** ("Pierre II"), is a Tax Court memorandum decision that supplements the 2009 full Tax Court decision of 2009 ("Pierre I"). In Pierre I a divided Tax Court held that the check-the-box regulations could not be interpreted so as to ignore the state-law characteristics of a single-member LLC for federal gift tax purposes. The Service had argued that when the donor made gifts of LLC interests in a single-member LLC, she really made gifts of the underlying assets because the entity should be disregarded. The Tax Court held that the state law characteristics of a limited liability company could not be ignored for federal gift tax purposes merely because the taxpayer had made a federal tax election to ignore the entity.

In Pierre II the controversy moved to whether a combination gift and sale that occurred on the same day could be aggregated under the step transaction doctrine. On July 24, 2000, the taxpayer created two irrevocable grantor trusts, one for her son, and the other for her granddaughter. On September 15, 2000, the taxpayer transferred $ 4.25 million in cash and marketable securities to Pierre LLC. Twelve days later, on September 27, 2000, the taxpayer transferred her entire interest in Pierre LLC to the trusts. She gave a 9.5-percent membership interest in Pierre LLC to each of the trusts to use a portion of her then-available gift tax credit amount and her GST exemption and on the same day sold each of the trusts a 40.5-percent membership interest in exchange for a secured promissory note. The LLC interests were subject to substantial discounts for purposes of the gift and the installment sale. Note that each gift/sale involving a child's trust conveyed an aggregate 50% interest in the LLC on the same day.

The Tax Court agreed with the Service that the gift/sale transaction should be collapsed, so that the donor's gift was a 50% LLC interest, reduced by the value of the note received in each installment sale. The Court stated:

Whether several transactions should be considered integrated steps of a single transaction is a question of fact. Senda v. Commissioner, 433 F.3d at 1048. We therefore turn to the facts. The transfers at issue all occurred on the same day. Moreover, virtually no time elapsed between the transfers. Petitioner gave away her entire interest in Pierre LLC within the time it took for four documents to be signed. In addition, the record indicates that petitioner intended to transfer her entire interest in Pierre LLC to the trusts without paying any gift taxes. We find compelling that Mr. Reiner recorded the transfers at issue as two gifts of 50-percent interests in Pierre LLC in the contemporaneous journal and ledger and that he used these records to prepare Pierre LLC's tax return. Mr. Reiner testified at trial, however, that he later discarded these records because they contained inaccuracies, including the characterization of the transfers. We do not so easily ignore Mr. Reiner's contemporaneous description of the transaction.

Petitioner intended to transfer two 50-percent interests to the trusts, but she first gifted small interests in Pierre LLC to use a portion of her then-available credit and her GST tax exemption. We find that petitioner had primarily tax-motivated reasons for structuring the gift transfers as she did. She then sold interests in Pierre LLC in exchange for the promissory notes that were significantly discounted using the 36.55-percent valuation discount. No principal payments have been made on the notes despite the passage of eight years. Further, Pierre LLC has made yearly distributions to the trusts so that the trusts could make the yearly interest payments. Consequently, she transferred $ 4.25 million of assets within Pierre LLC without paying any gift tax. Petitioner intended not just to minimize gift tax liability but to eliminate it entirely.

We find that nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. We also find that the gift transactions and the sale transactions were planned as a single transaction and that the multiple steps were used solely for tax purposes. Accordingly, we hold that petitioner made a gift to each trust of a 50-percent interest in Pierre LLC to the extent the interest exceeds the value of the promissory note executed by the trust.

The effect of aggregating the gift/sale was not terribly expensive for the taxpayer. The taxpayer had calculated combined minority/lack of marketability discounts for the separate gift and sale interests of 36.55% each for gift and sale purposes. This was based on a 10% lack of control discount and a 30% lack of marketability discount. The taxpayer called an expert witness at trial who testified that was he valuing a deadlock (50%) interest rather than a minority interest, the lack of control discount would be reduced slightly from 10% to 8%. He also testified that the lack of marketability discount would be increased to 35%, but the taxpayer did not advocate anything more than the 30% discount originally claimed. The Service did not offer expert testimony because its main argument was that the LLC should be ignored altogether. The Court accepted the 8%/30% discounts, for a combined discount of approximately 35.6%.

**COMMENT:** The failure of the Service to present valuation evidence is a factor that is not likely to be repeated in future cases that involve step transaction issues. Note that in this case the Service did not argue, and the Court did not hold, that the transactions with both trusts had to be cumulated to for gift tax purposes. The transactions with the son's trust were considered one transfer for gift tax purposes and the transactions with the granddaughter's trust was considered another transfer. Since the transaction with each donee conveyed no more than a 50% interest, the real dispute was the difference between a deadlock and a minority interest. The result could be much different, for example, if a grantor gives a 10% interest and sells a 41% interest in voting stock or other control property.

The other important factor to note is that the step transaction doctrine was here applied somewhat differently than the manner in which the doctrine was advanced in Linton v. United States, 638 F. Supp. 2d 1277 (W.D. Wash., 2009). Linton was a "gift on formation" case in the line of Shepherd v. Commissioner, 283 F.3d 1258, Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006), Holman v. Commissioner, T. C. Memo, 2008 Tax Court Lexis #12 (2008) and Gross v. Commissioner, T.C. Memo 2008-221; 2008 Tax Ct. Memo LEXIS 218 (2008). These cases generally arise because the taxpayer (1) cannot establish the proper order of formation of the entity, funding the entity, and gifts of entity interests, or (2) leaves so little time between these steps that these actions invite an attack under the step transaction doctrine. As a result, the Service argues that the taxpayer really gave away interests in the underlying assets rather than in the entity, such that there are no discounts available. In Holman and Gross the Tax Court found that even a short period between funding the entity, and making gifts, could prevent the step transaction doctrine from applying when the assets were subject to fluctuation. What is the proper "cure" period between funding and gifts? There is no definitive answer to this question, especially since the analysis will turn in part on the potential for value fluctuation in the interim period. Same day transactions should be avoided.

Does Pierre II stand for the proposition that every installment sale transaction is susceptible to the step transaction doctrine because these transactions almost always involve two steps in the planning process -- a so-called "seed" gift followed by a sale? The answer should be "no" if there is a sufficient time period between the two events to make each one independent of the other. Pierre II then suggests that there is a second "cure" period to consider in installment sale transactions: the time between the initial gift to the trust, and the sale. Perhaps this will have little effect where the interests donated and sold either are non-voting interests or aggregate a minority position.

**Linton v. United States, 630 F. 3d 1211 (9th Cir. 2011).** The Ninth Circuit has reversed the District Court’s findings in Linton. Although the reversal is not a taxpayer victory – the Ninth Circuit found that the government was not entitled to summary judgment – the appellate court opinion contains important analysis on the application of the step transaction doctrine to strategies that involve the formation, funding and gifting of family-owned entities, such as family limited partnerships.

Linton is a “gift on formation” case in the line of [Shepherd v. Commissioner, 283 F.3d at 1261](https://www.lexis.com/research/buttonTFLink?_m=0a64d3e8e8806973d1c5adebfdc1b281&_xfercite=%3ccite%20cc%3d%22USA%22%3e%3c%21%5bCDATA%5b130%20T.C.%20No.%2012%5d%5d%3e%3c%2fcite%3e&_butType=3&_butStat=2&_butNum=70&_butInline=1&_butinfo=%3ccite%20cc%3d%22USA%22%3e%3c%21%5bCDATA%5b283%20F.3d%201258%2c%201261%5d%5d%3e%3c%2fcite%3e&_fmtstr=FULL&docnum=1&_startdoc=1&wchp=dGLbVzb-zSkAB&_md5=72fff9b77c51ae9f1fd51980e354c746), Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006), Holman v. Commissioner, T. C. Memo, 2008 Tax Court Lexis #12 (2008) and Gross v. Commissioner, T.C. Memo 2008-221; 2008 Tax Ct. Memo LEXIS 218 (2008). These cases generally arise because the taxpayer (1) cannot establish the proper order of formation of the entity, funding the entity, and gifts of entity interests, or (2) leaves so little time between these steps that these actions invite an attack under the step transaction doctrine. As a result, the Service argues that the taxpayer really gave away interests in the underlying assets rather than in the entity, such that there are no discounts available.

In Linton the taxpayer and his spouse did the following all on the same day (January 22, 2003):

1. The taxpayer assigned to his wife 50% of his interests in the FLP;
2. The taxpayer signed a deed conveying undeveloped real property to the FLP;
3. The taxpayer signed letters authorizing the transfer of securities to the FLP;
4. The taxpayer signed an Assignment of Assets to the FLP which he and his wife, as managers of the FLP, also signed;
5. The taxpayer and his wife, as grantors, signed four separate irrevocable trusts for their children, which they left undated but which were signed by the trustee of the trusts;
6. The taxpayer signed four separate documents purporting to assign percentage interests in the FLP to the irrevocable trusts (these were also left undated but were signed by the trustee of the trusts); and
7. The taxpayer’s wife signed four separate documents purporting to assign percentage interests in the FLP to the irrevocable trusts (these were also left undated but were signed by the trustee of the trusts).

The attorney for the taxpayer did not fill in the missing dates until a few months later. He filled in the date of January 22, 2003 but later testified that he made a mistake and that he really meant to date the trusts and the assignments as of January 31, 2003.

The FLP was funded with about $3,580,000 of assets and the assignments to the four irrevocable trusts conveyed 90% of the partnership interests. The taxpayers claimed discounts of 47% on their gift tax returns.

The District Court granted the Service’s motion for summary judgment that the gifts should be valued without discounts. It found, as a matter of law, that the trusts were valid and irrevocable when signed on January 22, 2003, no matter what date was or could have been put on the documents, that the assignments of FLP interests to the trusts were effective as of January 22, 2003, regardless of the date of those assignments, and that the trusts had some trust res as of January 22, 2003, when the assignments were signed. The Court went on to state:

Because the Trusts were created, and gifts of LLC interests were made to the Trusts, on January 22, 2003, either before or simultaneously with the contribution of property to [the FLP], the Court holds that this case is analogous to both Shepherd and Senda, and that the Lintons’ transfers of real estate, cash and securities enhanced the LLC interests held by the Children’s Trusts, thereby constituting indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC.

The District Court could have stopped there, but instead went on at length to discuss the alternate argument advanced by the Service that the step transaction doctrine applied to wipe out any discounts that otherwise could apply. The step transaction discount was discussed both Gross and Holman by Judge Halpern in 2008. In those cases the taxpayer did establish the correct order of formation, funding and gift, but the Service argued that the transactions should be collapsed so as to result in a gift of underlying assets without discount. In each case Judge Halpern analyzed the argument under the “interdependence” step and concluded that the step transaction doctrine could not apply because the FLP had independent significance. The independent significance was demonstrated, according to the Tax Court, by the fact that the FLP interests fluctuated between the date of the FLP funding and the date of the gifts of the FLP interests. In those cases the FLP assets consisted largely of marketable securities; in each case the Court noted that its conclusion might be different if the underlying assets were not subject to fluctuation.

In Linton the District Court found that the step transaction applied under all three iterations of the doctrine. The three tests for the step transaction are the “binding commitment” test, the “end result” test and the “interdependence” test. The binding commitment test applies if at the time of the first step there is a binding commitment to undertake the later step. The end result test asks whether a series of formally separate steps are really pre-arranged parts of a single transaction intended from the start to reach the ultimate result. The interdependence test inquires whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one step would have been fruitless without a completion of the other steps.

The District Court found that the binding commitment test was satisfied because the trusts and the gifts were executed on the same date that they took the “first step” of funding the FLP.

The District Court found that the interdependence test was met because the evidence demonstrated that the taxpayers would not have undertaken the one or more of the steps absent their contemplation of the other steps. Again, this appears to be a misapplication of the doctrine. The issue is not what they taxpayers contemplated, but whether a particular step would be fruitless without the other steps. In any estate planning situation, the formation of a valid entity under state law changes legal relationships in a way that has independent significance regardless of whether later transfer are made.

The District Court’s application of the “end result” test is the most troubling part of its opinion. The Court stated: “The end result test is likewise satisfied because plaintiff’s undoubtedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability, pursuant to which they crafted, with aid of an attorney and tax advisor, a scheme consisting of ‘pre-arranged parts of a single transaction.’”

The Court’s language would seem to bring virtually any tax-planning technique that attorneys and accountants use to minimize their clients’ taxes. The flaw in the Court’s reasoning is that the end result test should not apply unless the series of steps is clearly designed to mask something that without the steps could not be done directly. The Court reasoned here that the end result was the transfer of the underlying FLP assets. However, that was not the end result of the transaction. The end result of the transaction was the transfer of FLP assets themselves, not the underlying assets of the FLP. There was no indication in the facts that the taxpayers intended to terminate the FLP immediately after the transfer. In short, there should be nothing wrong with an end result that accomplishes a valid tax planning objective.

The Ninth Circuit reversed the District Court on the summary judgment order. The Ninth Circuit framed the issue as follows:

The parties have assumed that in determining the character of the Lintons' gifts, the sequencing of two transactions is "critical," Senda v. Comm'r, 433 F.3d 1044, 1046 (8th Cir. 2006), and we do so too, without deciding whether that is always so in cases of this ilk. The transactions at issue are: (1) the contribution of cash, securities, and real property to the limited liability company, and (2) the transfer of LLC interests to the Lintons' children's trusts. If done in that order (and with some lapse of time between the transactions), as the Lintons contend occurred here, the gifts would ordinarily be characterized as gifts of LLC interests, and the value of those LLC interests might be discountable for tax purposes. If, however, the contributions to the LLC occurred after the transfer of LLC interests to the children's trusts, the gifts would ordinarily be characterized as indirect gifts of the particular contributed assets and would not be discountable. See id.

The Ninth Circuit found that by leaving the gift documents undated when they signed them on January 22, 2003, the Lintons created considerable objective uncertainty as to their intent to make the gifts effective *on that date*. The objective manifestation of the intent to make a gift would be whenever the Lintons put the gift documents beyond their retrieval or otherwise objectively manifested an intent to make the gift effective. The Ninth Circuit believed that, on the record before it, the gifts became effective either on January 22, 2003, if the trustee left the meeting with the gift documents in his possession, or months later when the Lintons’ attorney filled in the date of January 31, 2003. Because the record before the Court was insufficient to tell when the Lintons intended to make the gift effective, the government could not be entitled to summary judgment and the case was remanded for the District Court to make that determination.

The Ninth Circuit also rejected an argument by the Lintons that if they had funded the LLC after executing the gift assignments, there could be no gift at all because under the LLC operating agreement the capital accounts of the Lintons – not the trusts – would have been enhanced. This was characterized as the “failed gift” theory. The Ninth Circuit rejected this argument as “too clever” because it was totally at odds with the bookkeeping and tax reporting, and the substantive reality of the situation. In this case, the Ninth Circuit found that the federal tax law’s assessment of the transaction’s substantive realities could not be affected by a technical interpretation of state law.

Finally, the Ninth Circuit reversed the District Court’s decision on the step transaction doctrine. It found that none of the three steps applied. The Court stated:

The step transaction doctrine treats multiple transactions as a single integrated transaction for tax purposes if all of the elements of at least one of three tests are satisfied: (1) the end result test, (2) the interdependence test, or (3) the binding commitment test. True v. United States, 190 F.3d 1165, 1174-75 (10th Cir. 1999). Although the doctrine considers the substance over the form of the transactions, " 'anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury.' " Brown, 329 F.3d at 671 (quoting Grove v. Comm'r, 490 F.2d 241, 242 (2d Cir. 1973)).

The step transaction doctrine has been described as "combin[ing] a series of individually meaningless steps into a single transaction." Esmark, Inc. & Affiliated Cos. v. Comm'r, 90 T.C. 171, 195 (1988). We note as a threshold matter that the government has pointed to no meaningless or unnecessary step that should be ignored. Nonetheless, examining the step transaction doctrine in light of the three applicable tests, we conclude that its application does not entitle the government to summary judgment.

The end result test asks whether a series of steps was undertaken to reach a particular result, and, if so, treats the steps as one. True, 190 F.3d at 1175. Under this test, a taxpayer's subjective intent is "especially relevant," and we ask "whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way." Id. The result sought by the Lintons is consistent with the tax treatment that they seek: The Lintons wanted to convey to their children LLC interests, without giving them management control over the LLC or ownership of the underlying assets. Ample evidence supports this intention. The end result sought and achieved was the gifting of LLC interests. If the transactions could somehow be merged, the Lintons would still prevail, because the end result would be that their gifts of LLC interests would be taxed as they contend.

The interdependence test asks "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (10th Cir. 1991) (quotation marks omitted). Under this test, it may be "useful to compare the transactions in question with those we might usually expect to occur in otherwise bona fide business settings." True, 190 F.3d at 1176.

The placing of assets into a limited liability entity such as the LLC is an ordinary and objectively reasonable business activity that makes sense with or without any subsequent gift. In Holman v. Commissioner, the Tax Court stated that the creation of a limited partnership was not necessarily "fruitless" even if done in anticipation of gifting partnership interests to the taxpayers' children. 130 T.C. 170, 188, 191 (2008) (holding the creation of the limited partnership and the subsequent transfer of partnership interests should not be treated as a single transaction). The Lintons' creation and funding of the LLC enabled them to specify the terms of the LLC and contribute the desired amount and type of capital to it—reasonable and ordinary business activities. These facts do not meet the requirements of the interdependence test.

The binding commitment test asks whether, at the time the first step of a transaction was entered, there was a binding commitment to take the later steps. Comm'r v. Gordon, 391 U.S. 83, 96, 88 S. Ct. 1517, 20 L. Ed. 2d 448, 1968-2 C.B. 148 (1968). The test only applies to transactions spanning several years. True, 190 F.3d at 1175 n.8; Associated Wholesale Grocers, 927 F.2d at 1522 n.6; McDonald's Rests. of Illinois, Inc. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) (rejecting application of the test for transactions spanning six months). Here, the Lintons' transactions took place over the course of no more than a few months, and arguably a few weeks. The binding commitment test is inapplicable.

**B. Annual Exclusion and Gifts of Partnership Interests.**

**Price v. Commissioner,** T.C. Memo 2010-2; 2010 Tax Ct. Memo LEXIS 2; 99 T.C.M. (CCH) 1005, concerned whether a taxpayer could claim an annual exclusion for gifts of partnership interests. The taxpayers, husband and wife, organized a family limited partnership in which each of them, through their revocable living trusts, owned a 49.5% limited partner interest. The general partner, a Nebraska corporation, owned a 1% interest. The sole shareholders of the corporation were the husband and wife, again through their revocable trusts.

The partnership agreement contained a general prohibition on transfer that read in relevant part as follows:

11.1 *Prohibition Against Transfer.* Except as hereinafter set forth, no partner shall sell, assign, transfer, encumber or otherwise dispose of any interest in the partnership without the written consent of all partners; provided, however, a limited partner may sell or otherwise transfer his or her partnership interest to a general or limited partner, or to a trust held for the benefit of a general or limited partner.

The partnership agreement provided that an assignment to anyone not already a partner was effective only to confer on the assignee the right to receive the income distributions to which the assignor otherwise would be entitled; the assignor remained liable for capital contributions, was not relieved from any liability under the partnership agreement, and the assignee had no right to become a substituted limited partner simply by virtue of the assignment. The partnership agreement also provided that in the event of a voluntary or involuntary transfer of a partnership interest, the partnership, and the remaining partners, had an option to purchase the interest from the assignee for its fair market value. Fair market value would be determined by a majority of three appraisers, one selected by the partnership, one by the transferring partner, and a third by the other two appraisers. The agreement did not contain a time deadline for the exercise of an option arising from a voluntary transfer. Under the agreement, partnership profits were shared by the partners according to their proportional partnership interests. Partnership profits were to be distributed to the partners "in the discretion of the general partner except as otherwise directed by a majority in interest of all of the partners, both general and limited." The partnership agreement stated that neither the partnership nor the general partner had any obligation to distribute profits to enable the partners to pay taxes on the partnership's profits.

The partnership was formed in 1997, and in that year, and in every year through 2002, the husband and wife (through their revocable trusts) transferred limited partnership interests to their children, so that, by the end of 2002, the children owned all 99% of the limited partnership interests. The partnership initially consisted of the husband’s interest in an operating company and three parcels of real estate leased to the company. The company was sold in early 1998 and the proceeds invested in marketable securities; the investment real estate was retained, subject to long-term leases.

In this case the partnership had a history of making distributions, although not on a regular, recurring basis. The partnership made distributions from 1997-2002 as follows:

1997 None

1998 $ 7,212

1999 $ 343,800

2000 $ 100,500

2001 None

2002 $ 76,824

The taxpayers claimed annual exclusions for the transfers to their children. The gift tax returns for 2000-2002 were audited and the Service disallowed the annual exclusions under the reasoning of Hackl v. Commissioner, 118 T.C. 279, 294 (2002), *aff’d* 335 F.3d 664 (7th Cir. 2003).

The Court relied on the reasoning of Hackl to deny the annual exclusions. Under Hackl, the Court stated, the taxpayers must:

. . . . establish that the transfer in dispute conferred on the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. [118 T.C. 279, at 293].

The Tax Court in Price first considered whether the done had an unrestricted and noncontingent right to the immediate use, possession or enjoyment of the property itself. In finding that the donees did not have unrestricted and noncontingent rights to the property, the Court rejected several arguments raised by the taxpayer:

1. The taxpayers argued that a donee’s outright ownership of the interest by itself would qualify for the annual exclusion, because the donee could sell the interest to either the general partner or a limited partner. This argument presumes that Hackl was incorrectly decided. The Court refused to reconsider its holding in Hackl:

It is undisputed that under the partnership agreement the donees have no unilateral right to withdraw their capital accounts. Furthermore, section 11.1 of the partnership agreement expressly prohibits partners from selling, assigning, or transferring their partnership interests to third parties or from otherwise encumbering or disposing of their partnership interests without the written consent of all partners. As stated with respect to analogous circumstances in Hackl v. Commissioner, 118 T.C. at 297, transfers subject to the contingency of approval (by the LLC manager in Hackl and by all partners in the instant cases) "cannot support a present interest characterization, and the possibility of making sales in violation thereof, to a transferee who would then have no right to become a member or to participate in the business, can hardly be seen as a sufficient source of substantial economic benefit."

Under the partnership agreement, the donees took only an assignee interest and did not have any rights as substituted limited partners. The Court ruled, however, that even if the donees could be viewed as substituted limited partners, their ownership interests were still subject to conditions that negated substantial economic benefit. Under the partnership agreement, unless all partners consented, the donees could transfer their partnership interests only to another partner or to a partner's trust. In addition, any such purchase would be subject to the option-to-purchase provisions of the partnership agreement, which gave the partnership itself or any of the other partners a right to purchase the property according to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer.

1. The taxpayers next argued that the ability of a limited partner to purchase interests under the partnership agreement, and eventually own enough interests to liquidate the partnership, rendered the transfers present interests. The Court rejected this because it found that the donees were not limited partners, but only assignees, and therefore had no rights other than income rights. Moreover, the Court rejected the idea that a present interest could be founded on future conduct.
2. The taxpayers argued that the ability of a donee to sell the interest to the general partner rendered the gift a present interest. The Court looked behind the general partner and found one of the taxpayers, who engineered the entire series of transactions. It found that the mere ability of a donor to reacquire a gift could not render the gift one of a present interest; otherwise every gift would be so.
3. The taxpayers argued that the Schedules K-1 distributed to the donees enhanced their finances and made them more creditworthy. The Court found no convincing evidence of this, and held that this benefit, even if it existed, was at best highly contingent and speculative and did not constitute a source of substantial economic benefit, particularly in the light of the restrictions on alienation contained in the partnership agreement.

Having found that the donees lacked substantial rights to, or enjoyment over, the property itself, the Court next considered whether the donees had unrestricted and noncontingent rights over the income from the transferred property. Again citing Hackl, the Court stated that the taxpayers must show that: (1) The partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained.

The income flow from the long-term real estate leases was sufficient to show that the partnership generated income at or near the time of the gifts, so the first prong of the three-part test was satisfied. However, the taxpayers were unable to establish either of the other two conditions cited by the Court. The partnership agreement provided that income distributions were in the discretion of the general partner, and therefore the taxpayers could not show that income would flow steadily, or that the income flow could be readily ascertained. The Court observed that the actual distributions did not establish a “steady” income flow because no distributions were made in 1997 and 2001. Furthermore, testimony that the partnership was likely to make annual distributions to permit the partners to cover their income tax liabilities was not sufficient to establish that the donees had any present interest; these distributions were at the discretion of the general partner.

**COMMENT:** One should be able to plan around Price and Hackl without too much difficulty. A donor making an annual exclusion gift of a FLP interest could grant the donee a “put right” (to the partnership and if not exercised perhaps to the donor or to the other partners) for the purchase of the transferred interest for its fair market value. Similar to a *Crummey* right, the put right would lapse if not exercised within a certain time period. One also might consider drafting the partnership to require mandatory tax distributions.

**C. Fractional Interest Valuation.**

**Ludwick v. Commissioner**, T.C. Memo 2010-104, concerns valuation discounts on gifts of undivided interests in real property held by spouses. In Ludwick, a married couple established separate, individual Qualified Personal Residence Trusts as part of an estate planning strategy to limit their overall estate and gift tax exposure.

The Ludwicks each transferred their separate one-half undivided interests in a Hawaiian vacation residence to their respective QPRTs. In calculating the gift tax due on the transaction, they each applied a valuation discount of 30% to their respective shares of the property to reflect the disadvantages associated with owning undivided fractional interests.

In a gift tax audit, the IRS agreed that some discount should be available for lack of control and marketability of such an interest, but disagreed with the taxpayers about the appropriate size of the discount, claiming that it should be limited to the cost of petitioning a court for partition of the property. At trial the IRS argued for an 11% discount.

At the trial, both sides presented expert testimony regarding the amount of the discount. The Court found neither expert persuasive. One of the problems with supporting discounts in residential properties is the lack of sales data on which to base a discount; fractional interests in residences are simply not frequently sold. In this case the Court had difficulty accepting the testimony of the taxpayers' expert, Mr. Hoffman. The Court described the problems with his testimony as follows:

Mr. Hoffman, in his direct testimony, compared the discounts from 69 "undivided interest transactions" between 1961 and 2006. He calculated the mean and median discounts for the set of all the transactions and for three subsets: 16 income-producing properties, 26 parcels of raw land, and 22 transactions involving undivided 50-percent interests. He also provided the range of discounts for all the transactions and for each of those three subsets. He provided no way for us to evaluate his analysis, however. He failed not only to explain how the discounts were calculated (i.e., how did he calculate the underlying fair market value?) but also to provide any measure of the variability or dispersion of his data points (e.g., their standard deviations). Most importantly, he did not provide any of the data; we do not know the specifics of any of the "undivided interest transactions". We have no way to know how comparable those properties were to the one here in issue.

Mr. Hoffman also compared petitioners' property to 10 real property limited partnerships. Yet petitioners' property was never intended to produce income; it was a private vacation home, not a source of revenue. The cash flow statements of the 10 limited partnerships (which held, for instance, apartment buildings and mobile homes) are not relevant.

The Court ultimately settled on a discount of approximately 17% for the value of the undivided interests. Its conclusion was based on its estimate of the operating costs for the property (substantial in this case; $350,000 annually for a vacation home valued at $7.25 million), the costs of selling an interest, and the amount of time it would take to sell an interest.

**COMMENT:** In any fractional interest case, it is crucial to present evidence that the type of property in question is subject to the discount. The taxpayer's failure to present adequate evidence in this case is reminiscent of the taxpayer's failure in Stone v. United States, 2009 U.S. App. LEXIS 6347 (9th Cir. 2009), in which the Ninth Circuit affirmed a District Court decision regarding the appropriate discount for a fractional interest in 19 paintings. The taxpayer had claimed a 44% discount for fractional interest. The appraiser could find no market for fractional interests in art, and analogized the discounts to discounts for fractional interests in real estate and partnerships investing in real estate. The District Court found the analogy unpersuasive, allowed a discount of 2% for costs of selling, $50,000 for legal expenses in enforcing a hypothetical seller’s right of partition, and directed the parties to confer to work out an agreement for the decrease in value that might be occasioned for the time it would take to sell the art. When the parties were unable to reach agreement, and the District Court subsequently determined that the over-all discount allowed to the taxpayer was 5%. The Ninth Circuit affirmed the District Court ruling.

**D. Valuation Discount for Built-In Gains.**

**Estate of Jensen**, T.C. Memo 2010-182. In Jensen the decedent held an 82% interest in a corporation that owned a summer camp. When the decedent died, the estate valued the corporation on a net asset basis, and deducted 100% of the estimated long-term capital gains taxes applicable to the corporation's property. The estate also claimed a 5% discount for lack of marketability. The reduction for estimated federal taxes claimed by the taxpayer on its return was $965,000; this was increased at trial to $1,133,283 to account for state income taxes.

In the estate tax audit, and at trial, the Service argued for a much lower reduction for the estimated long-term capital gains taxes. The Service's expert based the smaller reduction for built-in gains on closed-end funds. The Service also believed that capital gains were speculative and could be avoided through a like-kind exchange, a conversion to S status, and other strategies.

The case arose in the State of New York, and a decision by the Tax Court would be appealable to the Second Circuit. The Second Circuit, in Eisenberg, recognizes a discount for built-in gains, but thus far has not determined whether the discount can be dollar-for-dollar. The taxpayer argued that closed-end funds were an inappropriate comparison, and that the Tax Court should adopt a dollar-for-dollar discount because it believed that the Second Circuit would so hold on appeal. The Tax Court refused to base its decision on what it might think the Second Circuit might do.

The Tax Court, however, rejected the Service's reliance on closed-end funds. Here the taxpayer's corporation invested in a single parcel of real estate that was devoted to one use; closed-end funds invest indirectly in real estate through real estate investment trusts and typically hold multiple investments in various types of real estate such as office complexes, apartment buildings and shopping centers. In addition, the Court found that discounts from a closed-end fund's net asset value are attributable to several factors, including supply and demand, manager or fund performance, investor confidence, or liquidity. The Tax Court also rejected the Service's argument that the built-in tax could be avoided through tax planning. In general, it found that tax planning would serve large to defer, rather than to avoid, the tax.

The Tax Court ended up allowing the taxpayer the full amount of the discount claimed at trial - $1,133,283, but through a somewhat unusual calculation. The Court determined that the tax should be discounted to present value by determining a useful life for the assets, a growth rate and a discount rate. It determined that the real estate would have an effective useful life of 17 years; it increased the value of the assets by 5% and by 7.725% over that period, calculated the capital gains that would apply at the end of the 17 year period, and then discounted those numbers back to present value based on discount rates equal to the two growth rates. In both calculations the present value of the projected tax payments was higher than what the taxpayer had claimed. The Court therefore accepted the taxpayer's claimed discount, because it was within the Court's own "range of values."

**E. Section 2036 and Retained Enjoyment of Tenancy in Common Property.**

**Stewart v. Commissioner**, 617 F. 3d 148 (2nd Cir. 2010), involved the issue of whether a donor's continued occupancy of real property constituted the retention of possession or enjoyment of 100% of the property.

Mrs. Stewart lived with her son in a brownstone in New York City. The bottom two floors were the residential portion and the top three floors were rented for commercial purposes. Mrs. Stewart executed a deed by which she conveyed a 49% fractional interest as tenant in common to the son, keeping the remaining 51% for herself. Following the conveyance, she and her son continued to live in the residence, just as before. Mrs. Stewart also continued to collect, and keep for herself, 100% of the rents from the commercial tenant. She also paid the vast majority of expenses with regard to the property. She died 6 1/2 months after delivering the deed, which was not recorded until after her death.

When Mrs. Stewart died, only 51% of the real property was reported on her estate tax return. On audit the Service asserted inclusion of 100% of the property under Section 2036. The son argued that her retention of rental income and payment of expenses for the brownstone property had to be viewed in the context of another property, in East Hampton, which they owned as joint tenants with right of survivorship. He argued that viewed from this perspective, her retention of the commercial income from the brownstone was at least partially offset by his retention of the East Hampton rental income, and that he and his mother had an oral agreement to settle up at some point. The Tax Court did not give credence to the son's testimony and found evidence of an implied agreement that Mrs. Stewart would enjoy the use and possession of the brownstone income and property. The Court included the entire amount in her estate. The estate appealed the case to the Second Circuit.

In a 2-1 decision, the Appellate Court affirmed in part and reversed in part. It found that as to the commercial portion of the property, Mrs. Stewart indeed retained the income from the property and that therefore 100% of that portion of the property was includible in her estate. As to the residential portion, however, the majority found that although the Tax Court properly found an implied agreement, it erred in concluding, without proper findings, that the terms of that agreement included Mrs. Stewart's retention of the use of the 49% residential interest given to her son. The Court stated:

The Tax Court did not rely on Decedent's continued residence in the Manhattan property for its finding that an implied agreement existed. See Estate of Stewart, T.C. Memo 2006-225, 2006 Tax Ct. Memo LEXIS 230, at 5-7. But the Commissioner seems to rely on it in part. We, however, do not believe that the terms of any implied agreement can be read to provide that Decedent would retain enjoyment of the *residential* portion of Brandon's 49% interest in the Manhattan property.

In residential transfer cases, "[i]n determining whether an implied agreement or understanding existed between the parties . . . . the courts have found two factors to be particularly significant: continued exclusive possession by the donor and the withholding of possession from the donee." Estate of Spruill v. Comm'r, 88 T.C. 1197, 1225 (1987); *accord* Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971). The presence of both those factors is so damning that in cases where a decedent transfers a residential property but continues to live in it to the exclusion of the donee, the estate taxpayer has lost in every case of which we are aware because the taxpayer could not meet its burden. And, if Brandon had not lived in the Manhattan property for the entire time between the transfer and Decedent's death, it would certainly not have been clear error had the Tax Court found an implied agreement that Decedent could have excluded Brandon from the Manhattan property during her life, and thereby had enjoyed the benefits of the residential part of his 49% interest and of his rights as a residential tenant in common.

In this case, however, neither of the two factors stated in Spruill is present. Decedent did not have exclusive possession of, nor did she exclude Brandon from, Brandon's 49% interest in the Manhattan property--or, for that matter, the entire property. Like other courts, we draw a distinction between cases where a decedent retains exclusive possession and withholds possession from the donee on the one hand, and "those cases where a residence jointly occupied by the donor and the donee has been held not includable in the donor's gross estate," Guynn, 437 F.2d at 1150, on the other. This case is of the latter sort. And despite the great burden faced by the taxpayer in all these cases, taxpayers have won in every case of which we are aware when those two crucial factors were favorable. In these cases a transferor's "use of the property by occupancy after the transfer is a natural use which does not diminish [the] transferee['s] enjoyment and possession and which grows out of a congenial and happy family relationship." Estate of Gutchess v. Comm'r, 46 T.C. 554, 557 (1966).

Although co-occupancy of a residential premises by the related donor and donee is highly probative of the absence of an implied agreement and has repeatedly been held to satisfy the taxpayer's burden, we need not and do not hold that that fact alone will always carry the burden as a matter of law. In some future case, a finding of an implied agreement between related co-occupants of residential real property might not be clearly erroneous. But where, as here, the Tax Court has made no specific findings relating to enjoyment of the residential portion of the property, and the Commissioner points to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning the residential portion cannot stand. As a result, Decedent's residential use of part of the Manhattan property does not indicate an implied agreement that she would to any extent retain the substantial economic benefits of the residential portion of Brandon's 49% interest.

The Second Circuit remanded the case for the Tax Court to make the factual determinations necessary to determine the amount of the net income from the son's 49% interest enjoyed by mother. The majority then observed that the Tax Court could calculate the "corresponding proportion" of "the value of the entire property," and include it in the Decedent's gross estate under § 2036.

**COMMENT:** Judge Livingston, dissenting from the majority opinion, believed that the majority misunderstood the import of Gutchess and similar co-occupancy cases. The dissent believed that those cases stood for the proposition that when 100% of a property is given to a close family member, continued occupancy by the donor is not by itself evidence of an implied agreement for retention. Judge Livingston believed that the majority wrongly cited these cases to indicate that co-occupancy demonstrates the *absence* of an implied agreement. Rather than focus on whether the son enjoyed his 49% interest, the dissent believed the court should have focused on whether Mrs. Stewart continued to enjoy the benefits of what she had conveyed. In this regard, it may be instructive to recall that under the common law in a co-tenancy each tenant has an undivided right to occupy the whole of the property. Stewart will probably have very limited effect as a planning tool and will probably be of dubious application outside of the Second Circuit.

**F. Section 2035 and Gift Tax Paid on 2519 Disposition.**

**Estate of Morgens v. Commissioner,** 133 T.C. 402 (2009) a reviewed Tax Court decision, considered whether Section 2035(b) requires the inclusion in the gross estate of gift taxes paid by the trustee of QTIP Trusts when the surviving spouse has disposed of the income interest. Section 2519 provides that a disposition of the income interest results in a gift of the entire interest, less the income interest (which itself is treated as a gift under Section 2511). In Morgens the disposition of the income interest in two QTIP trusts resulted in the payment of approximately $9.973 million of gift taxes on the transfers under Section 2519. The spouse had entered into a contractual arrangement with the ultimate beneficiaries for their payment of the gift tax on the property. The spouse died within three years of the dispositions.

Section 2035(b) provides as follows:

The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 *by the decedent or his estate* on any gift made *by the decedent or his spouse* during the 3-year period ending on the date of the decedent's death. [emphasis added]

The executor of the estate claimed that the gift tax liability was not the obligation of the donor or her estate, but instead was the obligation of the donees. The executor's main argument revolved around Code Section 2207A(b), which provides that a donor who becomes liable for tax on a Section 2519 transfer has the right to recover the tax from the donees. This right of recovery, the executor argued, evidences the fact that the tax is really payable by the donees rather than by the donor. The executor also pointed to the General Explanation of the Economic Recovery Tax Act of 1981, which introduced QTIP. The General Explanation stated that Congress recognized that the burden of tax resulting from a deemed transfer under section 2519 should be "borne by the persons receiving that property and not by the spouse or the spouse's heirs."

The Tax Court disagreed with the taxpayer, basing its decision on the underlying assumption of the QTIP regime that the entire QTIP is first deemed to pass to the surviving spouse and the surviving spouse, in turn, is deemed to transfer the QTIP either at his or her death or *inter vivos*. Because of such deemed ownership of QTIP and inclusion in the transfer tax base of the surviving spouse, the gift tax on a Section 2519 disposition is the obligation of the spouse, notwithstanding Section 2207A(b). The Court stated:

We agree that Congress intended that as between QTIP recipients and the surviving spouse, it is the QTIP recipients who should bear the ultimate financial burden for transfer taxes. See H. Rept. 97-201, supra at 160, 1981-2 C.B. at 378. However, we do not believe that by allocating the financial burden for gift tax to recipients of QTIP, Congress shifted to them liability for the gift tax. Section 2207A(b) does not provide that the donees of QTIP should be liable for the applicable gift tax. Rather, section 2207A(b) refers to the right to recover the gift tax. The estate's argument would read section 2207A(b) out of the gift tax architecture. Section 2502(c) clearly provides that gift tax is the liability of the donor: "The [gift] tax imposed by section 2501 shall be paid by the donor." Section 25.2511-2(a), Gift Tax Regs., also provides that "the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor". The donee is liable only if the gift tax is not paid by the donor when due. 21 Sec. 6324(b). It is the donor who must file a gift tax return and pay the tax on or before April 15 of the year following the year in which a gift was made. Secs. 6019, 6075(b), 6151(a). Any gift tax, if not paid, can be assessed against the donor within 3 years after the gift tax return is filed. Sec. 6501. [footnote omitted]

The Court also agreed with the Service that the arrangement in this case was really no different from a net gift situation, where the donees' payment of the gift tax does not prevent inclusion of the tax in the donor's estate if death occurs within three years. See Estate of Sachs v. Commissioner, 88 T.C. 769, 778 (1987), *affd.* in part and *revd. i*n part on another ground, 856 F.2d 1158 (8th Cir. 1988).

**COMMENT:** A "net gift" disposition of a QTIP trust under Section 2519 may become more frequent due to the increase in gift tax exemption to $5,000,000 in 2011 and 2012. A QTIP disposition under Section 2519 is best effected when the spouse is expected to live for 3 years, so as to avoid the gross-up of the gift tax paid under Section 2035.

**G. Rescissions and Reformations of Gifts Affecting Federal Tax Consequences.**

**Breakiron v. Gudonis**, 2010 U.S. Dist. LEXIS 80888 (D.C. Ma. 2010), concerned the ability of a taxpayer to rescind disclaimers that were executed on the basis of faulty legal advice. Craig's parents owned a home in Nantucket as tenants in common. In 1995 each parent created a 10-year QPRT with remainder (if the parents were living at the end of the reserved term) in each trust to pass equally to Craig and his sister Lauren. The QPRTs ended in 2005 and the property was deeded to Craig and Lauren. In early 2006 Craig sought legal advice about how best to transfer his remainder interest to his sister. The attorney incorrectly advised him that as long as he disclaimed within 9 months following the end of the QPRTs, his disclaimer would be qualified and the property would pass to Lauren with no transfer tax imposed on Craig. Relying on this advice, Craig signed and delivered a disclaimer for each trust interest. The disclaimers, to be qualified, had to be executed and delivered within 9 months of the transfer creating Craig's interest, which of course took place in 1995. Craig was 10 years late with his disclaimers.

The IRS eventually filed a lien for gift tax due in the amount of $2.3 million. Meanwhile, Craig, being advised that the earlier legal advice was faulty, initiated a reformation and rescission action in the Massachusetts state courts. The United States was joined as a party, and the case was removed to the Federal District Court.

The District Court, looking to Massachusetts substantive law, had little difficulty in granting Craig rescission in order to void the gift tax assessment. The Court reasoned as follows:

Under Massachusetts law, a written instrument may be reformed or rescinded in equity on the grounds of mistake when there is "full, clear, and decisive proof" of the mistake. Simches v. Simches, 423 Mass. 683, 687-688, 671 N.E.2d 1226 (1996) (citations omitted). Similarly, Massachusetts has recognized that a disclaimer may be reformed or rescinded if it was executed based on a mistake which frustrated the purpose for which the disclaimer was executed. See Kaufman v. Richmond, 442 Mass. 1010, 1011, 811 N.E.2d 987 (2004) (reforming disclaimer where intent of disclaimant was to minimize tax consequences for disclaimant's children). The touchstone of the inquiry is the intent of the disclaimant.

Here, there is no question but that under Massachusetts state law, Craig is entitled to rescind his disclaimer. There is "decisive evidence of the [disclaimant's] intent to minimize transfer tax consequences." Kaufman, 442 Mass. at 1011. First, by their express terms, the disclaimers state that they were "intended to be ... Qualified Disclaimer[s] pursuant to 2518 of the Code." See Docket # 1, Exhibit F, Affidavit of Craig Breakiron, Exhibits 1 & 2. Second, Craig has submitted an affidavit stating that such was his intention at the time. See Docket # 1, Exhibit F, Affidavit of Craig Breakiron ¶ 8. Third, he has submitted an affidavit from his attorney, who stated that Craig communicated his intention at the time he executed the disclaimer. See Docket # 1, Exhibit G ¶ 3. The government does not dispute that this was his intent. The disclaimers are inconsistent with Craig's intent and are therefore now rescinded. This rescission is granted *nunc pro tunc*, as of the date of their execution on April 16, 2006.

Having decided that rescission was appropriate, the Court then considered the crucial question of whether a reformation or rescission that is valid under state law would alter the Federal tax consequences of the original transaction. It first identified two lines of cases that have considered this issue. One line generally holds that if the United States is not a party to the state law action, the reformation or rescission is binding on the parties but not on the United States. The second line of cases, mainly in the gift tax area, believes that a transfer cannot be a completed gift under the gift tax regulations if the transaction can be rescinded.

In this case, the United States was a party to the action, so the District Court was able to reconcile the two lines of cases, and held that the rescission did change the Federal tax consequences of the transaction.

**COMMENT:** At the 2011 Miami Institute, there was much discussion over whether Breakiron might be useful for a donor who would like to rescind a gift in 2010 that resulted in gift tax payment. These unfortunate donors, thinking that the gift tax rate would increase to 45% in 2011, were nonplussed to learn in late December that the rate not only stayed at 35% for 2011 and 2012, but that the increased exemption in 2011 might have eliminated any tax whatsoever. Is the failure to properly predict a potential change in Federal tax law a mistake that can support rescission? If so, should the United States be joined to the state law action? One of the leading cases holding that a state law reformation cannot alter the Federal tax consequences of a transaction when the United States is not a party was decided by the Seventh Circuit. *See* Van Den Wymelenberg v. United States, 397 F.2d 443, 445 (7th Cir. 1968), in which the taxpayers' attempt to alter defective 2503(c) trusts was held to be ineffective to change the Federal gift tax consequences. If rescission of a gift seems unlikely, perhaps a disclaimer could be explored. Assuming that there has been no "acceptance" -- a hard fact to overcome -- a disclaimer by a donee could result in the donee being considered deceased, in which case an outright gift would arguably be incomplete.

**PLR 201002013** permitted a trust to be reformed on account of scrivener's error. The ruling involved a joint trust which on the first spouse's death divided into a By-Pass Trust, a Marital Trust and a Survivor's Trust. The joint trust then provided that on the death of the surviving spouse, unless the trustee determined that other provisions had been made for such payment, the surviving spouse's debts, expenses and death taxes would be paid from the By-Pass Trust. The surviving spouse sought to reform the joint trust, but was concerned that the reformation would be respected for federal tax purposes. The facts of the ruling described the support offered for the error and also discussed the inconsistent and potentially contradictory language of the joint trust which would give rise to the reformation:

In affidavits, Spouse and Attorney represent that it was the Decedent's and Spouse's intent as Trustors of Trust to minimize estate taxes, including maximizing the use of the unified credit. Accordingly, the By-Pass Trust should have been drafted to ensure that an amount equal to the remaining credit shelter amount in the estate of the first spouse to die passed to the beneficiaries without tax and without subsequent inclusion in the surviving spouse's gross estate.

In order to correct the error in the Trust and to accurately reflect the intent of the Trustors, on Date 4, Spouse, as the co-Trustor of Trust, filed a petition with Court seeking authorization to modify Trust *nunc pro tunc*. Spouse, as the surviving Trustor, has stated that it is, and was at all times, Spouse's intent and desire that the assets of the By-Pass Trust be administered so as to avoid taxation at Spouse's death. To support the assertion that the reference to the By-Pass Trust was a scrivener's error, Spouse provided the following arguments. First, Section 3.01 pertains to the payment of the expenses of the first spouse to die and directs the trustee to pay the debts, expenses, and death taxes of the first spouse to die and charge the payment of such items against the By-Pass Trust. Section 4.01, on the other hand, pertains to expenses of the surviving spouse but contains the same language contained in section 3.01. Spouse asserts, and Attorney confirms, that the language in Section 4.01 was copied from Section 3.01 but improperly edited and, therefore, the reference to the By-Pass Trust, rather than the Survivor's Trust, remained.

Second, the language in the second paragraph of Section 4.01 contradicts the language in the first paragraph in Section 4.01. The second paragraph directs the Trustee not to use "any insurance proceeds, qualified retirement plan distributions, or other assets otherwise excludable from federal estate tax to pay debts, expenses, death taxes, or any other obligations enforceable against the Surviving Trustor's estate." The phrase "other assets otherwise excludible" would necessarily include assets in the By-Pass Trust. This language contradicts the directive to the trustee to pay these items from the By-Pass Trust.

Finally, the language of Section 4.02 provides that "[t]o whatever extent the then remaining balance of the Survivor's Trust has not been effectively appointed by the Surviving Spouse pursuant to the above general power of appointment and not consumed for the payment of debts, expenses, and taxes, the Trustee shall distribute the Survivor's Trust, including any additions made to the trust by reason of such death, such as from the Surviving Spouse's Will or life insurance policies on the Surviving Spouse's life, as set forth in Section 4.04 hereinbelow." This language suggests that the Survivor's Trust should bear the debts, expenses and taxes incurred due to the death of the Surviving Spouse.

The State court granted a an order for modification of the trust. The Service found that the documentation submitted by the spouse strongly indicated that the decedent and the spouse did not intend to have any control over the By-Pass Trust and that the provision directing the payment of the survivor's debts, expenses and taxes from that trust was an error of the draftsperson. Further, the local court found that the reformation of the trust did not defeat a material purpose. In short, the modification was consistent with applicable state law that would be applied by the highest court of the state in question. See Commissioner v. Estate of Bosch, 387 U.S. 456, 87 S. Ct. 1776, 18 L. Ed. 886 (1967).

**H. Debts, Administration Expenses and Section 2053: Keller, Stick and Naify.**

**Keller v. United States**, 2010 U.S. Dist. LEXIS 96465 (D.C. SW Tex.) concerned the deductibility under Code Section 2053 of attorney, accountant and fiduciary fees. This case is a further proceeding in the extraordinary case reported last year wherein a District Court in Texas found that a partnership, that was not funded until a year after the decedent died, was sufficient to support substantial discounts, leading to a refund of federal taxes. The Court also permitted the deduction of approximately $52,000,000 of interest on a Gragin loan.

In Keller the District Court granted most of the various fees that were requested, over the objection of the Service, for the work done by the attorneys and accountants. In many cases the Court relied on the affidavit of the executor that the work was properly incurred in the administration of the estate. However, the Court would not approve the following significant fee requests:

1. The Court would not approve a deduction for a contingency fee agreement for the payment of $2,400,000 to the accountants. The contingency agreement was entered after the Court had entered in Findings of Fact and Conclusions of Law that the estate was entitled to a refund. This contingent claim was on top of approximately $2.278 million in fees paid -- and approved by the Court -- for work done. The Court conceded that additional accounting work for the estate was required, but found that the contingency arrangement was not necessary to the administration of the estate.
2. Similarly, the Court would not approve a deduction for a contingency fee agreement entered into with the attorneys after its refund order. The fee claim was for $9,470,606 and was on top of approximately $2.636 million in attorneys fees approved for work done. The Court again found that the contingency arrangement was not a necessary expense to the settlement of the estate.
3. Finally, the court disallowed a deduction for the payment of $9,000,000 in fiduciary fees to three family members. The Court found that a non-family member (whose fee of $3,000,000 was approved in full by the Court) had done virtually all of the work on behalf of the fiduciaries. Moreover, the fee amounts payable to the family members had the look of disguised distributions to heirs, since $6,000,000 was payable to the decedent's daughter and $3,000,000 to each of two grandchildren.

**Estate of Stick**, 2010 T.C. Memo 192, reminds us that *Graegin* loans must meet the general requirements of Section 2053 in order for the interest to be deductible on the estate tax return. In Stick the decedent's trust, on November 17, 2004, borrowed $1,500,000 from the decedent's foundation at 5.25% interest, with the principal payable at the end of 10 years. The facts do not so state, but presumably the note prohibited pre-payment of the principal. The estate deducted $646,250 of interest on the estate tax return, and also claimed interest deductions on its 2004, 2005 and 2006 fiduciary income tax returns. The Service challenged the 706 deductions on two grounds: first, that under Code Section 642(g), by claiming the interest on the fiduciary return, the taxpayer was not entitled to claim the interest as an estate tax deduction; and second, that in any case the Graegin loan was not necessary because the liquid assets of the estate exceeded its expenses. The Tax Court sustained the Commissioner's assessment as follows:

Respondent's first argument is that section 642(g) prohibits the estate from claiming a deduction under section 2053 for the interest expense because the trust claimed income tax deductions for the same expense. Section 642(g), however, was promulgated to disallow an income tax deduction to an estate or any other person (which includes a trust) unless the estate waives its right to the section 2053 estate tax deduction. That section was not intended to address or pertain to the estate's entitlement to an estate tax deduction. See Estate of Keitel v. Commissioner, T.C. Memo. 1990-416; Rev. Rul. 81-287, 1981-2 C.B. 183, 184.

Respondent next argues that the estate is not entitled to an interest deduction under section 2053 because it had sufficient liquid assets to pay its estate tax liabilities and its funeral and administration expenses (obligations) without borrowing to pay those obligations.

Section 20.2053-3(a), Estate Tax Regs., provides that the amount of deductible administration expenses is limited to those expenses which are actually and necessarily incurred in the administration of the estate. See also Estate of Todd v. Commissioner, 57 T.C. 288 (1971).

The estate did not present evidence as to the amount of its State estate tax liability and did not provide a computation of its Federal estate tax liability without the interest expense deduction. There was no showing that it was actually necessary to borrow in order to meet its obligations. Having failed to show the necessity to borrow, the estate has not shown that respondent's determination was in error. See Rule 142; Welch v. Helvering, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112 (1933).

In addition, on the basis of the information available in the stipulated record, it appears that the estate did have sufficient liquidity to meet its obligations. The estate tax return reported liquid assets totaling $1,953,617. Excluding the interest expense, the estate reported funeral and administration expenses of $162,740 and would have had a Federal estate tax liability approximating $1,367,861. Although the amount of the estate's State estate tax liability was not established in the record, on brief, it was indicated that its liability was $193,198. Adding these three figures together, the estate would have had total obligations of only $1,723,799. Thus, the estate's liquid assets appear to have exceeded its obligations by $229,818.

Accordingly, we hold that the estate is not entitled to an administration expense deduction for interest under section 2053.

In **Naify v. U.S.**, U.S. Dist. Lexis 101312 (N.D. CA 2010), the decedent had attempted to avoid California Income Tax on certain notes that were converted to stock. The conversion was effected by a non-California corporation that was considered an S corporation for Federal purposes but a C corporation for California purposes. The conversion to stock occurred in early 1999. The decedent died in April, 2000 and his 1999 return was filed in October, 2000. His federal income tax return for 1999 reported approximately $835 million of income, but his California return reported income of $629 million, due largely to the exclusion of the income from the conversion of the notes.

On July 6, 2001, the decedent's estate received notice that its 1999 California return was being audited. On July 18, 2001, the estate filed its estate tax return. The estate took the position that it was potentially liable for the full amount of the California income tax, and therefore claimed a deduction of $62 million as a claim. The claim was later settled for approximately $26 million. The Service allowed that amount as deduction on the return; the taxpayer paid the resulting deficiency in tax and filed a claim for refund.

In the District Court, the United States moved for judgment on the pleadings. The District Court granted the motion, on the basis of the following:

For the following reasons, this Court GRANTS the Government's motion. First, this Court concludes that the value of the disputed claim was not ascertainable with reasonable certainty on the date of the Decedent's death. Therefore, it was not deductible under 26 C.F.R. § 20.2053-1(b)(3) (2008), which provides that "[n]o deduction may be taken upon the basis of a[n] . . . uncertain estimate." Second, 26 C.F.R. § 20.2053-1(b)(3) also provides that only an estimated claim that "will be paid" may be deducted. While this phrase has not been exhaustively interpreted by courts, this Court concludes that the Estate's claimed refund fails to satisfy that standard. Third, Ninth Circuit precedent suggests that, in this type of case, the IRS is permitted to consider post-death events in assessing the value of a claim. Fourth, and finally, based upon positions taken by the Estate leading up to its settlement of its tax liability with California, the Estate is judicially estopped from seeking relief based upon an irreconcilable position.

The District Court discussed the issue of whether a potential liability is simply too vague and uncertain to be deductible under Section 2053, regardless of whether it can be valued:

But it cannot be that simply because one can assign a probability to any event and calculate a value accordingly, any and all claims are reasonably certain and susceptible to deduction. To so hold would read the regulatory restriction out of existence. The regulation clearly provides that one can deduct a claim on a return only if it is "ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate." 26 C.F.R § 20.2053-1. The regulation therefore explicitly contemplates that some claims will be simply too uncertain to be taken as a deduction, regardless of the fact that it is always possible to come up with some estimate of a claim's value.

This is just such a claim. As explained above, the facts alleged in the Complaint reveal that the claim here was not ascertainable with reasonable certainty. Leading up to Naify's death, he and his associates went to great length to avoid California tax. When he died, it was uncertain whether he had succeeded or not. Indeed, the players in the operation were well aware that the plan may or may not succeed. Therefore, any estimate made at the time of death of the value of the claim was inherently uncertain. While the Estate is undoubtedly correct that an expert or odds-maker can assign a probability to the relevant intervening facts as of the day of death - (1) the audit, (2) the outcome of the audit, (3) the possibility of settlement - that does not make the expected value reasonably certain. [footnote omitted]

**I. Transferee Liability.**

**Upchurch v. Commissioner**, 2010 T.C. Memo 169 (2010). Upchurch involved some interesting discussion on the extent of transferee liability under Code Section 6901. Mrs. Upchurch died in 2000, with a will that left certain real property to her three natural children, and to the two children (Bruce and Carl) of her predeceased husband. Prior to her death, she had subdivided the real property into two parcels, and then conveyed one parcel to one of her natural children, and the other to another natural child and his spouse. After her death, Bruce and Carl filed suit against the executor of the estate, the three natural children, and the spouse of the transferee child, alleging that the quitclaim deeds were not sufficient to deprive her estate of ownership, and that the transfers violated certain fiduciary duties that the three natural children supposedly owed to their mother. The suit was settled by written agreement among the parties. The settlement provided that Bruce and Carl would file claims in the probate estate for $53,500 each, and that this amount would be paid to each claimant and his attorney. The payments were made directly to the attorney, who kept his contingent fee payment of $17,833, and remitted the balance of $35,667 to each plaintiff.

The estate got around to filing its estate tax return in 2003, long after the payments to the two plaintiffs were made. It deducted the payment of $107,000 to the plaintiffs as a claim against the estate. After filing the estate tax return, the estate then distributed most of its assets. On audit the Service disallowed several deductions, including the claim for $107,000, and imposed additional taxes of $46,758.12, together with interest of $7,162.53 and disallowance of a prior credit of $151.18. The persons then representing the estate jointly signed a Form 890 agreeing to the tax and interest. The Service, being unable to collect any funds from the estate or the three natural children, in March, 2007 mailed the following notice to each of Bruce and Carl:

The determination of the estate tax liability of the Estate of Judith D. Upchurch, Deceased, 1305 Lewis Avenue, Winthrop Harbor, IL 60096, discloses a deficiency in the amount of $46,758.12, as shown on the attached statement. This amount, plus interest as provided by law, up to $53,500.00 constitutes your liability as transferee of assets of the estate of the decedent and will be assessed against you. This is your NOTICE OF LIABILITY, as required by law.

Bruce and Carl each filed a petition with the Tax Court. In November, 2007, the Service assessed a 25% failure to pay penalty against the estate in the amount of $11,727.32. In February, 2008, the cases were consolidated and were eventually disposed of under Rule 122 without a trial.

Bruce and Carl first argued that they were not transferees of the estate; rather, they argued, they were transferees of the named defendants. This argument was undermined by both their complaint and their settlement agreement. The Court stated:

. . . But Bruce and Carl argue that the individual defendants in the estate litigation (i.e., Rodney, Ronald, Laura, and Robin), not Judith's estate, should be considered the transferors of the property they received. They reason that if their lawsuit had resulted in a judgment, the individual litigants, not Judith's estate, would have been liable for and would have paid the damages. This last premise, we think, is dubious. One of the defendants named in the lawsuit was the executor of Judith's estate. Thus, the estate was at least potentially liable for any future judgment. Even if we were to accept the premise that the individual defendants would have been solely liable for a judgment, this does not change the fact that a "transfer" took place from Judith's estate to Bruce and Carl. The $53,500 payments were actually made by Judith's estate to Bruce and Carl. The payments were compelled by the settlement agreement, which expressly required Bruce and Carl to file a $53,500 claim against Judith's estate, and which expressly required Judith's estate to pay the claim. Thus, the record establishes that Bruce and Carl received property from Judith's estate. It may be that Bruce and Carl mean to argue that the transfer from Judith's estate should be recharacterized as two transfers: (1) constructive payments from the estate to the individual defendants, and (2) payments from the individual defendants to Bruce and Carl. Although it may be appropriate to deconstruct a transfer into two transfers for some federal tax purposes, this treatment should not be afforded here in applying transferee liability principles. We consider the transfers to have been made from Judith's estate to Bruce and Carl. But even if we were to consider the transfer in question to be in reality separate transfers, such a characterization would not relieve Bruce and Carl of liability for the estate tax. The reason is that a transferee of a transferee is also liable. See sec. 6901(c)(2); Bos Lines, Inc. v. Commissioner, 354 F.2d 830, 835 (8th Cir. 1965) ("the tenor of numerous decisions we have examined makes it convincingly clear that the term 'transferee', as used in the statute, encompasses a 'transferee of a transferee'"), *affg.* T.C. Memo. 1965-71. Therefore, transfers from Judith's estate to the individual defendants followed by transfers from the individual defendants to Bruce and Carl would still burden Bruce and Carl with liability for the estate tax. [footnotes omitted]

Bruce and Carl also argued that they could not be transferees because they received the $107,000 in exchange for consideration -- namely, their claims. The Tax Court reasoned, however, that the settlement payment they received was a substitute for what was given to them under the will, and therefore for tax purposes the settlement would be treated as a transfer from the estate to a beneficiary, rather than an exchange for consideration.

Next, Bruce and Carl argued that in order for transferee liability to attach, they must be liable under Illinois law for the taxes of the estate, and that their liability under Illinois law is predicated on the Service having filed a petition in the probate court requesting a return of estate funds. In support of their position, Bruce and Carl cited Berliant v. Commissioner, 729 F.2d 496 (7th Cir. 1984). The Tax Court distinguished Berliant as follows:

Bruce and Carl deny that they are liable as transferees under Illinois equity principles because they claim that according to Berliant v. Commissioner, 729 F.2d 496 (7th Cir. 1984), an estate tax transferee liability case, the IRS was required to file a petition in the probate court requesting an order to return funds. It is true that the Court of Appeals for the Seventh Circuit in Berliant v. Commissioner, supra at 499-500, held that under Illinois statutory law (as then in effect), the IRS was required to file a probate petition requesting a return of funds to establish transferee liability for unpaid estate taxes. But the Court of Appeals expressly noted that it was not necessary for the IRS to prove Berliant's liability under Illinois law because it could prove Berliant's liability at equity. Id. at 500.

The transferee in Berliant was held liable as a transferee for the Federal estate tax because such liability was required by principles of Illinois equity: "As a matter of equity, Illinois has long imposed on estate transferees liability to creditors of the estate." Id. at 500 (citing Union Trust Co. v. Shoemaker, 258 Ill. 564, 101 N.E. 1050, 1053 (1913)). Bruce and Carl have failed to distinguish their cases from Berliant or the Illinois equity principles applied in Berliant. We hold that Illinois equity principles establish transferee liability for the estate's tax deficiency of $46,758.12 at issue in these cases.

Bruce and Carl also argued that if they were liable as transferees, they could only be liable to the extent of what they received from their attorney after he deducted his 1/3 contingency fee, rather than being liable for the full $53,500 that each received. The Tax Court found that transferee liability attaches to the full payment, before reduction for fees:

The United States Supreme Court has addressed a similar issue in a way instructive here. In Commissioner v. Banks, 543 U.S. 426, 430, 125 S. Ct. 826, 160 L. Ed. 2d 859 (2005), the Supreme Court held that the amount of damage payments includable in a plaintiff's gross income should not be reduced by the contingent fee paid to the plaintiff's attorney. The Court reasoned that "In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation." Id. at 435. It explained further that "although the attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions." Id. at 436. It concluded that the plaintiff relied on the attorney "to realize an economic gain, and the gain realized by the . . . [attorney's] efforts is income to the . . . [plaintiff]." Id. at 437. Similarly, Bruce and Carl ultimately controlled the entire litigation process to enforce their rights under the will. They authorized the payment to their attorney. Thus, the property procured by their agent, Zagoras, is attributable to them even though Zagoras's fee did not pass directly through Bruce and Carl's hands. The limit of transferee liability of each of Bruce and Carl is therefore the total payment made to each of them ($53,500 each), including the portion paid to Zagoras as his fee.

The Tax Court then considered the Service's calculation of interest. The Service argued that at least a portion of interest should be calculated under Illinois law, which presumably resulted in a higher rate than the Federal calculation. The Court first looked to its decision in Estate of Stein v. Commissioner, 37 T.C. 945, 959 (1962), which bifurcated the calculation of interest into two periods separated by the date when the notice of liability is issued. As to the first period -- before the date that the notice of liability is issued to the transferee -- there is a distinction between cases where the transferred assets exceed the total liability of the transferor, and cases where the transferred assets are less than the total liability of the transferor. In Stein, the transferred assets were insufficient to pay the transferor's total liability. Interest in that case was not assessed against the full deficiencies because the transferee's liability for such deficiencies was limited to the amount actually transferred to him. Interest may be charged against the transferee only for the use of the transferred assets, and since this involves the extent of transferee liability, it is determined by state law. The second period -- the calculation of interest after the notice of liability is issued to the transferee -- is always a matter of Federal law.

In this case, the tax deficiency of $46,758.12 was less than the amount received, $53,500. Therefore, under the reasoning of Stein, the calculation of interest both before and after the notice of liability was issued was a matter of Federal law. The federal rate applied, and interest was calculated from the date that the estate tax return was due.

**COMMENT:** As noted above, the Service had imposed a failure to pay penalty of $11,727.32. This was not included in the notice of liability that the Service issued to Bruce and Carl and therefore the Tax Court ruled that it had no jurisdiction to adjudicate whether Bruce and Carl were liable as transferees for that amount also. Had they been liable, the combination of penalty and tax would have exceeded what each received from the estate, thus causing the pre-notice interest calculation in Stein to be determined differently.

**J. Credit for Tax on Prior Transfers.**

**Estate of LeCaer v. Commissioner,** 2010 U.S. Tax Ct. LEXIS 30; 135 T.C. No. 14 (2010). LeCaer concerned several issues involving the credit for prior transfers under Code Section 2013. The husband died first, creating a QTIP trust and a residuary trust which gave the wife a life estate. The wife died three months later. The husband's estate tax return reported a taxable estate of $1,995,000 in a year when the applicable exclusion amount was $1,500,000, and also when a state pick-up tax applied. The estate paid $200,810 in Federal estate taxes and $24,190 in Nevada estate taxes. On the wife's subsequent return, her estate claimed the full $225,000 of tax paid.

In computing the credit for prior transfer, the wife's estate apparently ignored completely the statutory language and simply claimed the full amount of tax that was payable. On audit the Service conceded that the wife's estate was allowed a credit for the tax on the prior transfer, but that the limitations of Section 2013(b) and (c) apply. Specifically, the credit is limited to the lesser of the tax attributable to the transferred property in either estate.

The limitation under Section 2013(b), which applies to the estate of the first to die, directs that the calculation under that subsection shall be an amount that bears the same ratio to transferor's estate tax as the value of the transferred property bears to the transferor's taxable estate, reduced by any estate taxes paid. The executor argued that in computing this amount, the denominator of the fraction should be reduced by the "applicable exclusion amount" since this amount effectively was not subject to tax. This would have the effect of greatly increasing the portion of tax that could be claimed as a credit. The Court rejected this argument on the plain language of the statute:

Section 2051 defines "taxable estate" as the gross estate minus certain enumerated deductions (for example, a marital deduction). Section 2013(b) does not authorize deducting from the taxable estate of the transferor the applicable exclusion amount or any other amount besides death taxes.

The executor also attempted to claim the credit for the Nevada estate tax paid. The statute, however, explicitly refers to a credit for the "amount of the Federal estate tax paid."This would ignore (1) the fact that the property transferred was a life estate in the residuary trust, and (2) the actual amount of property on which the tax was based included the applicable exclusion amount. The Tax Court also rejected the executor's argument that the property transferred from the husband to the wife was the full $495,000 that was subject to tax. The wife received a life estate in the residuary trust; therefore, the value of her life estate constituted the transferred property.

Finally, the executor claimed that when the wife's estate tax return was filed, it overstated her assets by the $225,000, being the tax that the husband's estate owed. However, the taxpayer could not produce evidence that this amount was actually paid from the wife's assets, and therefore her estate's claim for a deduction or a credit was denied.

**K. Powers of Appointment: Delaware Tax Trap.**

**PLR 201029011** concerned an exercise of a power of appointment that did not spring the Delaware Tax Trap. In this ruling, "Father" had created a grandfathered GST trust for his spouse. The spouse had no powers of appointment and did not make any additions to the trust before she died. On the spouse's death, the trust divided into separate GST trusts for the Father's children, including "Daughter" (referred to in the ruling as "Decedent"). Daughter had a testamentary power of appointment exercisable in favor of her issue. Daughter exercised the power by will, directing that the appointed property would be administered under the terms of Daughter's revocable trust, pursuant to a separate provision entitled the "Family Trust" and which apparently dealt only with the appointed property.

The Family Trust assets were apportioned into separate shares, one for each living child of Daughter and her husband, and one for the descendants, collectively, of each deceased child of Daughter and her husband. Each share created for a living child of Daughter (hereinafter, "primary beneficiary") was held in further trust (a "Primary Beneficiary's Trust").

Each Primary Beneficiary's Trust was designed to continue as a GST exempt trust, with the primary beneficiary also having a testamentary power of appointment exercisable in favor of the descendants of the Daughter and her husband, but excluding the primary beneficiary, the primary beneficiary's estate, the creditors of the primary beneficiary or the creditors of the primary beneficiary's estate.

The question presented was whether Daughter's exercise of her power of appointment "sprung" the Delaware Tax Trap: did she create a power exercisable by her grandchildren which could extend the vesting beyond the Rule Against Perpetuities limits of the Parent's original estate plan? If she did, the exercise of her power of appointment would be taxable in her estate under Code Section 2041(a)(3). In addition, the exercise of the general power of appointment would result in an addition to otherwise grandfathered GST trusts.

In this case, the Daughter's exercise of her power of appointment did not spring the trap. The ruling stated that the class of persons permitted to take under a Primary Beneficiary's power of appointment was

. . . further limited by Decedent's power of appointment granted to her from Father's will with respect to the descendants of Decedent living at Decedent's death. Thus, the class of persons that may take under a primary beneficiary's power of appointment consists of Child 1, Child 2, Child 3, Child 4, Child 5, Grandchild 1, Grandchild 2, Grandchild 3 and Grandchild 4. Any unappointed balance of the [Primary Beneficiary's] Trust is to be distributed to the primary beneficiary's living descendants, by right of representation. If the primary beneficiary has no living descendants, the [Primary Beneficiary's] Trust is to be distributed to the living descendants of Decedent and Husband, by right of representation.

Daughter's Family Trust further provided that:

. . . unless sooner terminated, each [Primary Beneficiary's] Trust created under Article Sixth will terminate 21 years after the death of the last survivor of the descendants of Father, who were living at the Father's death.

All principal and undistributed income will be distributed to the income beneficiaries in the proportions that they were entitled to receive income at the time of termination.

The ruling recited the following reasoning for its conclusion that Section 2041(a)(3) was not implicated:

Under the terms of each [Primary Beneficiary's] Trust, the trust estate will be appointed by the primary beneficiary of the [Primary Beneficiary's] Trust, or will be distributed within a period measurable from the date of creation of the original power of appointment granted to Decedent under Father's will. That is, each [Primary Beneficiary's] Trust must terminate no later than 21 years after the death of the last survivor of those descendants of Father who were living at the date of death of Father. Thus, Decedent's power has not been exercised in a manner that may postpone or suspend vesting of Father's Trust corpus for a period measured from the date of creation of the power extending beyond any life in being plus 21 years.

Further, the testamentary exercise of Decedent's power of appointment under her will did not create another power which can, under State law, be exercised in a manner that postpones the vesting of any estate or interest, or suspends the absolute ownership or power of alienation of the property of any trust held under [Primary Beneficiary's] Trust for a period without regard to the date of the creation of Decedent's power of appointment.

**COMMENT:** The discussion in the facts of the limitation to descendants of Father living at Daughter's death is odd. A Rule Against Perpetuities limitation would consider descendants living at Father's, not Daughter's death. Also there was no discussion of the applicable State law that may have affected the exercise of the Primary Beneficiary's power of appointment. Practitioners wishing to avoid inadvertently spring the trap of Section 2041(a)(3) might consider limiting the duration of the new trust that is created, but also requiring the vesting of any property interest that is created by the exercise of a further power of appointment conferred in the terms of the new trust. Consider:

Despite any other provision, 21 years after the death of the last to die of all of the descendants of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, who were living at his death, any trust interest ***or property held*** pursuant to this Article ***or created pursuant to the exercise of any power of appointment granted under this Article*** shall terminate, vest and be distributed. Distribution under this paragraph shall be to the income beneficiaries in the proportions in which they are entitled to receive the income or, if their interests are indefinite, to the income beneficiaries in equal shares.

Perhaps in this ruling the document was construed to mean that a Primary Beneficiary could only appoint outright to the class of persons living at Father's death. Or perhaps applicable State law required the vesting. In any case, exercising powers of appointment to create further powers carries important considerations.

**L. Section 2041 and Lapse of Right to Income.**

**PLR 201038006** dealt with the Section 2041 estate tax consequences of a trust beneficiary who allows an unrestricted right to income lapse.

Under the facts of the ruling, the beneficiary, who also was the sole trustee of the trust, had an unrestricted right for a period of years to pay to himself all of the income from the trust:

During each of the first [x] taxable years of this trust ending after the date of this agreement the trustee shall distribute annually to [Taxpayer] all or any portion of the income of the Trust Estate as [Taxpayer], acting alone, shall direct. The right to withdraw income under this [section of Trust] shall be noncumulative and shall lapse as to each taxable year on the last day of the taxable year to which the right of withdrawal applies.

During the term of this trust the trustee may also distribute to or for the benefit of [Taxpayer] and the issue of the Settlor, or any of them, . . . such amounts from income or principal of the Trust Estate as the trustee determines to be necessary for the health, education, support or maintenance of the recipient.

[U]pon the death of [Taxpayer], the Trustee shall divide and distribute the Trust Estate as [Taxpayer] shall appoint by . . . will. . . . The power of appointment hereby granted to [Taxpayer] may only be exercised in favor of any or all of the issue of the Settlor or one or more organizations described in [ § ] 501(c)(3) of the Internal Revenue Code of 1986, as amended.

Income not distributed within 15 months of receipt was added to principal. The taxpayer asked for rulings on (1) whether the taxpayer was the owner of income portion of the trust under Sections 671 and 678 during the first "x" years of the trust, and (2) to what extent the corpus of the trust would be includible in the taxpayer's gross estate under Section 2041.

There was no question that the taxpayer would be considered the owner of the income portion under Sections 671 and 678 of the Code during the first "x" years. The ruling did not discuss the Section 678 issues that might apply to the discretionary authority of the taxpayer/beneficiary right to pay income to himself under an ascertainable standard after "x" years.

Regarding the power of appointment issue, the Service noted that Section 2041(a)(2) provides that the value of the gross includes the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038. The decedent's unrestricted right during "x" years to take the income was a general power of appointment. The lapse of that power, to the extent it exceeded the $5,000/5% safe harbor, constituted a release to a trust in which the decedent retained an income interest. The release was equivalent to a transfer to such a trust, causing the released property to be includible in the decedent's estate. The Service concluded:

Taxpayer's power to direct the distribution of annual income to Taxpayer for an x-year period constitutes a general power of appointment within the meaning of § 2041(b)(1). A transfer of property owned by Taxpayer to Trust would be includible in Taxpayer's gross estate under §§ 2036 and 2038. Accordingly, regardless of Taxpayer's date of death, the gross estate will include the lapse of any annual income withdrawal right during the x-year term to the extent of the excess of the income not withdrawn over the greater of $5,000 or 5 percent of the income. Section 20.2041-3(d)(3); Estate of Noland v. Commissioner, T.C. Memo 1984-209.

**COMMENT:** The Service did not directly rule on how to compute the magnitude of the inclusion of property in the gross estate when lapses occur over several years, but the ruling did discuss Treas. Reg. § 20.2041-3(d)(4) and (5) at some length. The inclusion resulting from a lapse as to any single year would first be computed:

Section 20.2041-3(d)(4) provides, in part, that the purpose of § 2041(b)(2) is to provide a determination, as of the date of the lapse of the power, of the proportion of the property over which the power lapsed which is an exempt disposition for estate tax purposes and the proportion which, if the other requirements of §§ 2035 through 2038 are satisfied, will be considered as a taxable disposition. Once the taxable proportion of any disposition at the date of lapse has been determined, the valuation of that proportion as of the date of the decedent's death (or, if the executor has elected the alternate valuation method under § 2032, the value as of the date therein provided), is to be ascertained in accordance with the principles which are applicable to the valuation of transfers of property by the decedent under the corresponding provisions of §§ 2035 through 2038. For example, if the life beneficiary of a trust had a right exercisable only during one calendar year to draw down $50,000 from the corpus of a trust, which he did not exercise, and if at the end of the year the corpus was worth $800,000, the taxable portion over which the power lapsed is $10,000 (the excess of $50,000 over 5 percent of the corpus), or 1/80 of the total value. On the decedent's death, if the total value of the corpus of the trust (excluding income accumulated after the lapse of the power) on the applicable valuation date was $1,200,000, $15,000 (1/80 of $1,200,000) would be includable in the decedent's gross estate. However, if the total value was then $600,000, only $7,500 (1/80 of $600,000) would be includable.

The effect of lapses over several years would be aggregated:

Section 20.2041-3(d)(5) provides, in part, that if the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the proportion of the property over which the power lapsed that is treated as a taxable disposition will be determined separately for each such year. The aggregate of the taxable proportions for all such years, valued in accordance with the above principles, will be includable in the gross estate by reason of the lapse. The includable amount, however, shall not exceed the aggregate value of the assets out of which, or the proceeds of which, the exercise of the power could have been satisfied, valued as of the date of the decedent's death (or, if the executor has elected the alternate valuation method under §2032, the value as of the date therein provided).

The Service did not discuss the effect of the lapse of any power of withdrawal over income after "x" years. However, since the taxpayer's rights in those years were limited by an ascertainable power, there could be no general power of appointment, and hence no lapse of such a power that would be considered a release. Under Treas. Reg. §20.2041-3(d)(4), if income accumulated after "x" years is to be excluded from the computation of what is included, the accounting becomes nightmarish.

**M. Loss Carryforward of Insolvent Estate.**

**CCA 201047021.** An insolvent estate entered into a settlement agreement with the United States whereby all of the property of the estate would be conveyed to the government in satisfaction of certain unpaid tax liabilities of the decedent. According to the facts recited in the advice:

The Settlement Agreement provided that the Estate was to be deemed insolvent and that the United States was to receive all the proceeds of the Estate less outstanding administrative expenses. Accordingly, under the terms of the Settlement Agreement, none of the individual testamentary beneficiaries are entitled to receive any property.

Had the estate been solvent, the residuary property would have passed to 4 individuals pursuant to the estate planning instruments. In the last tax year of the estate, there was an unused capital loss carryover. Do the 4 individuals get the benefit of the loss carryover?

Treas. Reg. §1.642(h)-1(a) provides the general rule that capital loss carryovers, on the termination of an estate or trust, are allowed to the "beneficiaries succeeding to the property of the estate or trust." Treas. Reg. §1.642(h)-3(a), in turn, provides that the beneficiaries who succeed to the property of the estate or trust are those who bear the burden of any loss for which a carryover is allowed. The Regulations then make a distinction between testate and intestate estates. Succeeding beneficiaries in intestate estate are heirs and next of kin to whom the estate is distributed, or in the case of an insolvent estate, to whom it would have been distributed had the estate been solvent. In testate situations, the term generally refers to the residuary beneficiaries, although in some circumstances specific legatees whose legacies abate, and those receiving fractional shares, may be included. The portion of the regulations discussing testate situations does not explicitly mention insolvency.

In this case, the chief counsel determined that the 4 beneficiaries were not entitled to the loss carryover, because the settlement agreement supposedly terminated their interests as beneficiaries. The opinion stated:

Section §1.642(h)-3(a) states carryovers and excess deductions pass only to “beneficiaries succeeding to the property of the estate or trust” who are “those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed . . . .” In the present case, the individual beneficiaries of the Estate should no longer be considered beneficiaries after the Estate entered into the Settlement Agreement to transfer all the proceeds of the Estate to the United States. This is a distinguishable situation from that set forth in the allocation example. Beneficiaries in that example received a loss carryover despite not receiving any property, but could have received property if the estate had sufficient funds. Here, as a legal matter, the individual beneficiaries could no longer receive anything. Any losses incurred by the Estate were to the detriment of the United States rather than the individual beneficiaries. Therefore, the Estate’s beneficiaries should not be entitled to any of the Estate’s unused loss carryovers under § 642(h)(1).

**COMMENT:** The chief counsel's advice is unnecessarily harsh in view of the regulations that explicitly say that heirs at law bear the burden of losses in an insolvent intestate estate. The Regulations do not contain any examples where a creditor of the estate is recognized as the person who bears the burden of losses for purpose of claiming loss carryovers. Could this have been avoided if the settlement agreement provided that the estate agreed to transfer assets to the extent of the liabilities asserted by the United States, so that if "hidden" assets appeared, or the estate bought a winning lottery ticket, the residuary takers would receive something? Under circumstances of insolvency, such fine distinctions serve no useful purpose.

**N. Disclaimers.**

**Estate of Tatum v. United States**, 2010 U.S. Dist. LEXIS 107594 (S.D. Miss. 2010) is a stark reminder that one must carefully consider the effects of disclaimers. In Tatum, father died and left his residuary estate to his son and two grandchildren. The son was the sole heir of the father. The father's will expressly provided that if either the son or a grandson predeceased, that person's residuary share would pass to his descendants, *per stirpes*. The son disclaimed and procured a probate court order that the effect of the disclaimer was that his share passed to his descendants. Tatum did not disclaim his intestate share of the estate. He assumed that the effect of the disclaimer would be to pass his interest under the terms of the will to his descendants. However, Mississippi law -- which applied in this case before Mississippi had adopted the Uniform Disclaimer of Property Interest Act -- caused the disclaimed property to pass by intestacy. Having not disclaimed his intestate share, the son was found to have made a large taxable gift to his children. The government prevailed in this case on a summary judgment motion.