

# **DISHING THE DIRT ON PLANNING FOR REAL ESTATE INVESTORS**

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## DISHING THE DIRT ON PLANNING FOR REAL ESTATE INVESTORS

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### I. INTRODUCTION.

#### A. Real Estate Owners and Family Businesses.

1. Real estate owners share all of the problems of the family business owner, in addition to the unique problems of owning real estate. However, real estate presents some opportunities that other family businesses do not share.
2. There are three basic goals of estate and gift tax planning for real estate: (a) the reduction of estate and gift taxes upon transfer; (b) the deferral of the estate and gift tax burden; and (c) the provision of the necessary liquidity to pay the taxes imposed on an illiquid asset.
3. Furthermore, while taxes cannot be ignored when planning for real estate, additional goals for the real estate owner, which can be as important as tax planning, include (a) creditor protection, (b) retention of control over the real estate by the client, (c) management succession, and (d) economic support of the family.

#### B. Valuation Discounts. The estate planning goals means that the planner for a real estate owner will be grappling with the discounts in valuation available to limited partnerships and limited liability companies, since the real estate owner will already be using these entities for business purposes. These discounts are much more easily obtained for the real estate owner, in light of the real estate assets held in the entity (as opposed to passive stock portfolios), but the extent of these discounts will still be subject to attack by the Service.

#### C. Management Succession. The issue of management succession is complicated for the real estate owner because the management and investment of real estate calls for knowledge and experience that many family members, other than the real estate owner, often do not possess. In addition, there are not many outside professionals with such knowledge and experience to whom the family can turn, upon the death or retirement of the real estate owner.

#### D. Lack of Diversification and Liquidity. Finally, clients who own real estate usually own only real estate. It is what they know and understand and they generally put any cash flow they receive from their properties back into their properties (or into new properties), to the extent they don't need it for personal consumption purposes.

#### E. Overview.

1. The purpose of this outline is to examine planning opportunities available to maximize the tax and non-tax efficiencies of liquidity events.
2. Part I (Sections II through XI) focuses on the basics of valuing property for estate and gift tax purposes, including the use of fractional interest, minority, and marketability discounts to achieve substantial transfer tax savings.
3. Part II (Sections XII through XIII) explains how proper planning and implementation will decrease the risk that the IRS challenges a taxpayer's valuation for gift or estate tax purposes,

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<sup>1</sup> I am grateful to my co-panelist, Sarah M. Johnson, and my law partner, Daniel J. Durst, for their thoughtful comments and edits to these materials. In addition, I want to thank my assistant, Tammy L. Bracey, for her assistance in formatting these materials and preparation of the table of contents.

including the use of defined value clauses in transfer documents, including recent decisions from federal circuit courts upholding this strategy.

4. Part III (Sections XIV through XIX) discusses wealth transfer planning techniques that can be well suited for real estate related investments, including a discussion of grantor retained annuity trusts, sales to defective grantor trusts (including the use of self-canceling installment notes or private annuities), beneficiary defective trusts, sale/leasebacks, and personal residence trusts, and explains how clients may use these estate planning vehicles to maximize transfer tax efficiencies.
5. Part IV (Sections XX through XXIV) reviews methods to reduce the estate tax on real estate related assets and strategies to provide for the payment of estate tax including a discussion of Code §§ 6161 and 6166, *Graegin* loans, and life insurance.
6. Finally, Part V (Sections XXV through XXVII) concludes by offering some practical considerations when guiding clients through the planning process.

## **PART I - VALUATION**

### **II. VALUATION BASICS.**

#### **A. Introduction.**

1. The applicability and amount of valuation discounts (and premiums) are some of the most frequently litigated areas in estate and gift tax planning. The inherently subjective nature of valuation lends itself to frequent disputes between taxpayers and the Internal Revenue Service (the “Service”).
2. In *Estate of Aufer v. Commissioner*, T.C. Memo 1998-185 (1998), Judge Laro wrote:

Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous. Today, valuation is a highly sophisticated process. We cannot realistically expect that litigants will, will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear. We must provide guidance on the manner in which we resolve valuation issues so as to provide a road map by which the Commissioner, taxpayers, and valuation practitioners can comprehend the rules applicable thereto and use these rules to resolve their differences. Clearly articulated rules will also assist appellate courts in their review of our decisions in the event of an appeal.

#### **B. Fundamental Concepts of Transfer Tax Valuation.**

1. Fair Market Value. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. *United States v. Cartwright*, 411 U.S. 546 (1973). *See also*, Treas. Reg. §§ 20.2031-1(b) and 25.2512-1.
2. Willing Buyer – Willing Seller.
  - a. The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. *See, e.g., Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981); *Propstra v. United States*, 680 F.2d 1248 (9<sup>th</sup> Cir. 1982).
  - b. The “willing buyer-willing seller” principle is an objective test rather than a subjective test. The court in *Estate of Watts v. Commissioner*, T.C. Memo 1985-595 (1985),

explained that the test requires the transaction be analyzed from the viewpoint of a hypothetical seller whose only goal is to maximize his profit on the sale of his interest.

- c. In *Morrissey v. Commissioner*, 243 F.3<sup>rd</sup> 1145 (9<sup>th</sup> Cir. 2001), *rev'g Kaufman v. Commissioner*, T.C. Memo 1999-119 (1999), the Ninth Circuit held that the Tax Court erred in not considering actual sales of closely-held company stock in arms' length transactions occurring 2 months after the decedent's death. Even though the sales were among related parties, they were not closely related and had little incentive to make a gift.
- d. In *Mitchell v. Commissioner*, 250 F.3<sup>rd</sup> 696 (9<sup>th</sup> Cir. 2001), the Ninth Circuit reversed the Tax Court's determination of value for a 49.04% interest of the estate of John Paul Mitchell in his hair care products company. The Tax Court erred in using the company's acquisition value (which implied control), as opposed to the company's publicly-traded value (which would imply a lack of control discount).

3. Gift Tax Valuation.

- a. Code § 2512 discusses the valuation of gifts. It provides that "if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."
- b. Gift transfer taxes are imposed only on what is received by the transferee, not on what was owned by the transferor. *See*, Tech. Adv. Mem. 9449001.

4. Estate Tax Valuation.

- a. Code § 2031 discusses the valuation of assets held in the gross estate. It provides that "[t]he value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."
- b. Estate transfer taxes are imposed on what was held by the decedent at his date of death and passed to his estate, not on what is transferred to the beneficiaries.

5. Sum of the Parts is Generally Less Than the Whole. The value of a partial interest in a corporation or partnership rarely equals the pro rata net asset value of the entity in its entirety due to the legal rights and relationships that are established in the entity's organizational documents and the application of state law to the interests being valued.

C. Valuation Methodology.

- 1. General Methodology. The valuation of a business interest or real estate interest is typically a three-step process:
  - a. First, the value of 100% of the underlying asset is determined.
  - b. Second, the fractional ownership interest is applied to the value of the underlying asset to determine the aliquot value of the ownership interest.
  - c. Third, valuation discounts or premiums are applied to the ownership interest to determine its fair market value. If more than one discount is applied, the discounts are multiplicative. In other words, rather than adding the two discounts together and applying them to the fractional interest, the first discount is applied to the fractional interest, and the second discount is applied to that resulting value to arrive at the fair market value.
- 2. Determination of Underlying Asset Value. The first step in valuing an interest is to value the whole asset. The valuation of the whole asset depends on the nature of the asset involved.

- a. For certain assets where there is a readily available market, such as publicly-traded securities, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond. Treas. Reg. § 25.2512-2(b)(1).
- b. For other assets, such as stock in a closely-held business or a limited partnership interest in a limited partnership, there are numerous valuation methodologies to determine the value of the underlying asset. The most frequently used valuation methodologies include the following:
  - i. Capitalization of Earning Power;
  - ii. Capitalization of Cash Flow;
  - iii. Capitalization of Dividends;
  - iv. Capitalization of Gross Revenue; and
  - v. Asset or Book Value.
- c. Rev. Rul. 59-60, 1959-1 C.B. 237, is the most authoritative pronouncement by the Service as to the approach, methods, and factors to be considered in valuing shares of closely-held business entities for estate and gift tax purposes. Rev Rul. 59-60 acknowledges that opinions as to value may differ widely and each case is unique, such that no generally applicable valuation formula or approach can be devised. Among the factors to be considered are the following:
  - i. The nature of the business and the history of the enterprise from its inception.
  - ii. The economic outlook in general and the condition and outlook of the specific industry in particular.
  - iii. The book value of the stock and the financial condition of the business.
  - iv. The earning capacity of the company.
  - v. The dividend-paying capacity.
  - vi. Whether or not the enterprise has goodwill or other intangible value.
  - vii. Sales of the stock and the size of the block of stock to be valued.
  - viii. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.
- d. The Service extended the application of Rev. Rul. 59-60 to partnership interests in Rev. Rul. 65-192, 1965-2 C.B. 259.
- e. Real estate interests are typically valued based on one or more of the following valuation methodologies:
  - i. Market approach;
  - ii. Income approach; and
  - iii. Cost approach.



3. Determination of Aliquot Value. The next step is simply accomplished by apply the percentage ownership interest to the value of the underlying asset. For example, if John owns 25% of a business whose underlying value is \$1,000,000, the underlying value of a 25% aliquot interest is \$250,000.
4. Application of Discounts or Premiums. The last step is to apply valuation discounts or premiums to the underlying asset. The applicability of valuation discounts is recognized by Rev. Rul. 59-60 which states that once the value of the underlying asset is determined, discounts should be applied to minority ownership interests for lack of control and lack of marketability.
  - a. The most frequently discussed valuation discounts include:
    - i. Fractional interest discounts;
    - ii. Minority interest discounts;
    - iii. Lack of marketability discounts;
    - iv. Capital gains or *General Utilities* discounts;
    - v. Blockage discounts;
    - vi. Key person discounts; and
    - vii. Securities laws discounts.
  - b. The most commonly discussed valuation premiums include:
    - i. Control premiums;
    - ii. Voting premiums; and
    - iii. Swing-vote premiums.
  - c. Each of these discounts and premiums will be discussed in greater detail, *infra*.

### III. FRACTIONAL INTEREST DISCOUNTS.

#### A. Introduction.

1. A fractional interest discount is the discount applied to the ownership of an undivided interest in an asset, such as a co-tenancy interest. In a co-tenancy, each co-tenant or co-owner of the property has the right to possess and use the joint property, so long as the rights of the other co-owners are not adversely affected. Because of the lack of immediate control and the problems associated with dealing with co-owners, the hypothetical willing buyer would discount the fractional interest being acquired.
2. Unlike owners of closely-held businesses that do not have the unilateral right to realize their pro rata share of the underlying value of the business's assets by causing a dissolution of the business, owners of undivided interests in real estate generally do have the power to partition. However, partitioning property is expensive and, depending upon the location of the property, partitioning may be unavailable due to the local zoning laws.
3. In determining the value of the real estate, particular attention must be paid to the specific type of property involved. For example, in *Estate of Williams*, T.C. Memo 1998-59 (1998), the Court allowed a 44% discount for an undivided one-half interest in timberland; *see also*, *Estate of Sels*, T.C. Memo 1986-501 (1986) (60% discount applied to timberland interest). By contrast, in *Estate of Brocato v. Commissioner*, T.C. Memo 1999-424 (1999), a 20% discount was applied to fractional interests in 9 apartment buildings in San Francisco.

B. Analyzing the Fractional Interest Discount.

1. There are a number of factors that support a fractional interest discount. See Hall, "The New Paradigm: Life After the Elimination of Valuation Discounts," Vol. 76, No. 5, *Taxes*, 43, May 1998. These factors include:
  - a. Owners of undivided interests have unlimited liability.
  - b. Undivided interests require unanimous consent for all decisions.
  - c. It is difficult to use an undivided interest as collateral for a loan because creditors are reluctant to accept such an interest as collateral.
  - d. Each owner has the right to use the property, subject to the rights of the other owners, although profits, if any, are shared and distributed in proportion to ownership interests.
  - e. Each owner has the right to sue for partition.
2. Problems Associated with Partition Suits.
  - a. Usually a partition suit takes from two to five years and there is no guarantee of success, which would discourage an investor who contemplated suing for a partition after purchasing an interest.
  - b. The partition suit necessitates the payment of legal fees, engineers and surveyor's fees.
  - c. There is no guarantee that the partitioned property would be able to be sold in a timely manner.
  - d. The sale price may be affected by the fact that it is a court sale.
3. In 54 documented undivided interest transactions, one study found the average discount to be 35%. Patchin, "Market Discounts for Undivided Minority Interests in Real Estate," 3 *Real Estate Issues* 14 (Fall/Winter 1988).
4. In a more recent study, the average discount in 24 transactions was 47%. See Humphrey and Humphrey, "Unsyndicated Partial Interest Discounts," *The Appraisal Journal* (July 1997).

C. Case Law Supporting Fractional Interest Discounts.

1. *Estate of Henry v. Commissioner*, 4 T.C. 423 (1944). The Tax Court awarded a 10% discount for a fractional 1/3 interest in undeveloped farm land.
2. *Estate of Campanari v. Commissioner*, 5 T.C. 488 (1945). The Tax Court allowed a 12.5% discount for a 1/3 interest in real estate. The Tax Court based the award on the fact that the purchaser of a minority interest subjected himself to the wishes of other owners and had no control in the management, operation, or leasing of the properties. Furthermore, it was difficult to find a buyer of a minority interest and could only do so when they could obtain all of the fractional interests making up the whole parcel.
3. *Estate of Eggleston v. Commissioner*, 6 T.C.M. 400 (1947). Tax Court allowed a 36% discount for a 1/7th interest in commercial real estate located in Pittsburgh.
4. *Estate of Tishman v. Commissioner*, 59-1 U.S.T.C. Par. 11875 (E.D. Va. 1959). Decedent owned 1/2 interest in real estate located in Richmond, Virginia. Taxpayer's expert said that a discount of 15% to 50% was merited. District Court held that a 15% discount was applicable.

5. *Estate of Whitehead v. Commissioner*, T.C. Memo 1974-53 (1974). The decedent owned a ½ interest in a ranch. The estate put on evidence as to the chilling effect of sales of a fractional interest, testimony regarding legal costs involved in partition suits, testimony from an engineer regarding surveying costs, and testimony from a real estate broker, appraiser and rancher regarding the effect on the market value of undivided interests in Texas ranch land. The Court awarded a 20% discount.
6. *Propstra v. Commissioner*, 680 F.2d. 1248 (9<sup>th</sup> Cir. 1982). The Ninth Circuit held that the value of decedent's undivided one-half community interest in real property should be discounted by 15% to account for relative unmarketability of the fractional interest. *Propstra* is particularly significant because the Court rejected government's "unity of ownership" theory that estate must prove that interests in property were likely to be sold separately. The Court did not assume that the decedent's interest would be sold together with the other undivided interest held by surviving spouse. Therefore, the decedent's interest was valued at less than one-half of the value of the entire parcel of real property.
7. *Estate of Sels v. Commissioner*, T.C. Memo 1986-501 (1986). The Tax Court awarded a 60% discount for fractional interests in 11 tracts of timberland.
8. *Mooneyham v. Commissioner*, T.C. Memo 1991-178 (1991). Taxpayer gave an undivided one-half interest in real estate located in Sunnyvale, California to her brother. Taxpayer attempted to disavow her first valuation and use a second valuation. The Tax Court applied a 15% discount to the one-half interest as found in taxpayer's first appraisal.
9. *Pillsbury v. Commissioner*, T.C. Memo 1992-425 (1992). A majority interest in real estate was entitled to a discount since its holder would still need the consent of the minority owner to exercise all ownership rights. Thus, the Tax Court allowed the 15% discount used on the estate tax return in valuing a decedent's 77% undivided interest in real property. *Pillsbury* represents a good planning opportunity because the 77% interest in the real estate was held by a marital trust, while the other 23% interest was held in a credit-shelter trust. *Cf.*, Priv. Ltr. Rul. 9050004.
10. *Lefrak v. Commissioner*, T.C. Memo 1993-526 (1993). The court applied a combined 20% minority discount and 10% lack of marketability discount, after holding that the transfers were transfers of fractional interests in real estate and not partnership interests because of the formalities in the case; i.e., the partnership was created after the real estate was transferred to family members, apparently to avoid local taxes on the transfer. The court also rejected the Service's position that no discount was available because the owners were family members.
11. *Cervin v. Commissioner*, T.C. Memo 1994-550 (1994), *rev'd and rem'd on other issue*, 79 AFTR 2d 97-2487 (1997). The court allowed a 20% discount for an undivided 50% interest in a 657.3-acre farm and homestead in Texas. The court noted a partition of the real estate would involve substantial legal costs, appraisal fees, and delay, and any partition would require an agreement among interest owners as to the relative value of the land.
12. *Barge v. Commissioner*, T.C. Memo 1997-188 (1997). The court allowed a 27.8% discount for a gift of a 25% interest in 44,972 acres of timberland. The court determined the discount by taking into account the delay a partition suit would involve, the present value of the income that would be generated from the property during the delay, and the present value of the proceeds as a result of the partition suit, and deducted from these amounts the present value of the partition costs.
13. *Estate of Williams v. Commissioner*, T.C. Memo 1998-59 (1998). The Tax Court adopted the taxpayer's contention that a 44% discount should be applied to the value of undivided one-half interests in Florida timberland that were gifted during the decedent's lifetime and that passed at the decedent's death. The Tax Court accepted the taxpayer's 44% combined discount based upon a lack of marketability discount of 20% and a lack of control discount of 30%. The taxpayer's witnesses included a real estate appraiser who appraised the underlying assets, a business appraiser who determined the applicable discounts, a real estate attorney who testified about the partition issues and costs associated with fractional interests, and a banker who testified about the unwillingness of banks to provide financing for loans secured by fractional interests.

14. *Estate of Brocato v. Commissioner*, T.C. Memo 1999-424 (1999). The Tax Court applied a 20% fractional interest discount to 9 multiple-dwelling properties in San Francisco's Marina district. Interestingly, the Court also allowed an 11% blockage discount for 7 of the 9 properties because they competed with each other and the simultaneous sale of all 7 properties would artificially depress the market.
15. *Estate of Busch v. Commissioner*, T.C. Memo 2000-3 (2000). The Tax Court applied a 10% fractional interest discount to an undivided one-half interest in real estate located in Alameda County, California.
16. *Estate of Baird v. Commissioner*, T.C. Memo 2001-258 (2001). The Tax Court applied a 60% discount to 16 undivided fractional interests in timberland. Court recognized the limited market for timberland, delay in selling a partial interest, and the fact that under Louisiana law, fractional interest holders with less than an 80% interest cannot control the use of the timber without consent of the other owners.
17. *Estate of Forbes v. Commissioner*, T.C. Memo 2001-72 (2001). QTIP trust holding a 42% undivided interest in real estate received a 30% discount.
18. *Temple v. United States*, 423 F. Supp. 2d 605 (ED Tex. 2006). Interests in LLC valued at substantial discounts, because even if interest holder could compel LLC's liquidation, he or she would receive undivided interest in real estate, which would be difficult to partition.
19. *Ludwick v. Commissioner*, TC Memo 2010-104 (2010). Tenant in common interests in a residence in Hawaii that were transferred to QPRTs received a 17% fractional interest discount.

#### IV. MINORITY INTEREST AND LACK OF MARKETABILITY DISCOUNTS.

##### A. Minority Interest Discounts.

1. A lack-of-control discount, also referred to as a minority interest discount, is appropriate when valuing an interest in an entity that does not give the holder of the interest the right to decide when distributions of earnings will be made, when the entity will be liquidated, and other issues that affect the financial benefits of ownership in the entity.
  - a. In an operating business, lack of control may also mean the interest holder will not be assured of being an officer or employee of the entity.
  - b. In the context of a family limited partnership or LLC, which usually involves passive investments, the lost opportunity to be an employee of the entity may not be financially significant.
2. The rights associated with control have been more particularly stated as follows:
  - a. Elect directors and appoint management.
  - b. Determine management compensation and perquisites.
  - c. Set policy and change the course of business.
  - d. Acquire or liquidate assets.
  - e. Select people with whom to do business and award contracts.
  - f. Make acquisitions.
  - g. Liquidate, dissolve, sell out, or recapitalize the company.

- h. Sell or acquire treasury shares.
- i. Register the company's stock for a public offering.
- j. Declare and pay dividends.
- k. Change the articles of incorporation or bylaws.

S. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely-held Companies*, 55-56 (1989), cited in *Estate of Murphy v. Commissioner*, T.C. Memo 1990-472 (1990).

3. For many years, the Service challenged a minority interest discount because of the theory of family attribution – i.e., minority interests held by a family should be aggregated to form a controlling block because the family is more likely to act as one unit. The Service consistently lost on this issue. See, e.g., *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982); and *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).
4. In Rev. Rul. 93-12, 1993-1 C.B. 202, the Service abandoned the family attribution theory. Rev. Rul. 93-12 involved a gift by a 100% shareholder of a corporation of 20% of his stock to each of his five children. The Service ruled that the family's control of the entity would not be considered in valuing the 20% interests. The Service stated:

For estate and gift tax valuation purposes, the Service will follow *Bright*, *Propstra*, *Andrews* and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as a part of a controlling interest. Consequently, a minority discount would not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest. This would be the case whether the donor held 100% or some lesser percentage of the stock immediately before the gift.

B. Lack of Marketability Discount.

1. A lack-of-marketability discount takes into account the fact that an owner of an interest in a non-publicly-traded entity will have more difficulty than an owner of an interest in a publicly-traded entity in finding a willing buyer and, in order to sell the interest, may incur expenses, such as legal, accounting, and syndication fees. The fact that there is not a readily accessible market to sell interests in a closely-held business substantially increases the risks of ownership due to the inability to achieve liquidity within a short period of time.
2. In *Mandelbaum v. Commissioner*, T.C. Memo 1995-255 (1995), Judge Laro of the Tax Court listed the following elements of value as factors that have to be taken into account in determining the appropriate discount for limited marketability:
  - a. The value of the corporation's privately traded securities vis-a-vis its publicly-traded securities (or, if the corporation does not have stock that is traded both publicly and privately, the value of a similar corporation's public and private stock);
  - b. An analysis of the corporation's financial statements;
  - c. The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends;
  - d. The nature of the corporation, its history, its position in the industry, and its economic outlook;

- e. The corporation's management;
  - f. The degree of control transferred with the block of stock to be valued;
  - g. Any restriction on the transferability of the corporation's stock;
  - h. The period of time for which an investor must hold the stock to realize a sufficient profit;
  - i. The corporation's redemption policy;
  - j. The cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees.
3. The price of shares of stock or other publicly-traded interests already reflects a lack-of-control discount, but does not reflect a lack-of-marketability discount because they are sold on a recognized exchange and by definition are marketable.
  4. Minority interest and lack of marketability are often applied at the same time. However, a lack of marketability discount may be applied to a majority or controlling interest in an entity. *See, e.g., Estate of Colley v. Commissioner*, T.C. Memo 1980-107 (1980) (25% lack of marketability discount applied to 100% interest); *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34 (1993) (15% lack of marketability discount applied to 100% interest); *Estate of Luton v. Commissioner*, T.C. Memo 1994-539 (1994) (20% lack of marketability discount applied to 78% interest); *Gray v. Commissioner*, T.C. Memo 1997-67 (1997) (15% lack of marketability discount applied to 82.49% interest). *Cf., Estate of Cloutier v. Commissioner*, T.C. Memo 1996-49 (1996) (no marketability discount).
  5. Similarly, where a controlling block of closely-held stock is transferred, a lack of marketability discount may be applied simultaneously with a control premium. *See, e.g., Estate of Desmond v. Commissioner*, T.C. Memo 1999-76 (1999) (30% lack of marketability discount and 25% control premium applied to decedent's 81.93% interest in closely-held stock).

C. Case Law Supporting Minority Interest and Marketability Discounts.

1. *The Northern Trust Company v. Commissioner*, 87 T.C. 349 (1986). In valuing closely-held stock held in trusts of a corporation engaged in various businesses, the Tax Court discounted the stock value by a 25% minority position discount and another 20% discount for lack of marketability. The Tax Court refused to increase the minority position discount to 35% on the basis of the taxpayers' statistical showing that, on the average, investors pay a 35% premium for stock representing control of corporations.
2. *Estate of Campbell v. Commissioner*, T.C. Memo 1991-615 (1991). The Decedent owned one-third of the common stock of a corporation engaged in raising crops and cattle and making fertilizer. In addition, the corporation had substantial real estate holdings. The Tax Court applied a 35% marketability discount and a 34% minority interest discount, which combined to equal a 57% overall discount.
3. *Estate of Berg v. Commissioner*, 976 F.2d 1163 (8<sup>th</sup> Cir. 1992). A 20% minority interest and a 10% lack of marketability discount was applied to the decedent's 26.92% interest in a real estate holding company.
4. *Estate of Lauder v. Commissioner*, T.C. Memo 1994-527 (1994). In valuing the stock in a family-owned cosmetics company, the Tax Court applied a 40% discount to reflect lack of liquidity of the stock. In a prior decision, the Tax Court ignored restrictions contained in a buy-sell agreement; therefore the Tax Court determined the fair market value of the stock to be significantly more than the amount paid to the estate and reported on the estate tax return. Experts testifying on behalf of the estate suggested discounts ranging up to 90%. However, the court said such discounts are better suited to investments that pose enormous financial risks and present no market, public or

private, for liquidating the investment. In contrast, the decedent had enjoyed long-term financial success and was positioned as an industry leader.

5. *Estate of McCormick v. Commissioner*, T.C. Memo 1995-371 (1995). The Tax Court applied 18% to 32% minority interest discounts and 20% to 22% lack of marketability discounts to general partnership interests in two general partnerships holding real estate used for ranching and farming activities. The Court allowed such discounts, notwithstanding the fact that the general partner, under North Dakota law, could have caused a dissolution of the partnership.
6. *Estate of Barudin v. Commissioner*, T.C. Memo 1996-395 (1996). The Tax Court applied a 19% minority interest discount and a 26% lack of marketability discount to a 1/48<sup>th</sup> limited partnership interest in a limited partnership holding encumbered rental real estate in Manhattan.
7. *Furman v. Commissioner*, T.C. Memo 1998-157 (1998). The Tax Court applied a combined 40% discount for lack of marketability and lack of control to gifts of stock in a Burger King franchisee. The Court also allowed a 10% key-person discount discussed, *infra*.
8. *Estate of Brookshire v. Commissioner*, T.C. Memo 1998-365 (1998). The Tax Court applied 40% lack of marketability discount to date-of-death value of decedent's minority share of closely-held family grocery business stock subject to a stock-purchase agreement. The Taxpayer used two experts. The first expert considered the corporation's increased competition and decreased income in the fiscal year preceding decedent's death in determining stock's value before discount. The second expert's discount figure was supported by lack of ready market on which to sell stock, restrictive buy-sell agreements, lack of transactions involving large blocks of stock similar in size to decedent's, and fact that decedent's stock reflected minority interest.
9. *Estate of Marmaduke v. Commissioner*, T.C. Memo 1999-342 (1999). The Tax Court applied a 30% marketability discount to decedent's 22% interest in closely-held business. No mention of minority interest discount.
10. *See also, Estate of Strangi v. Commissioner*, 115 T.C. 35 (2000); *Shepherd v. Commissioner*, 115 T.C. 30 (2000); *Estate of Dunn v. Commissioner*, 2000 T.C. Memo 2000-12 (2000); *Estate of Weinberg v. Commissioner*, 2000 T.C. Memo 2000-51 (2000); *Estate of Klauss v. Commissioner*, T.C. Memo. 2000-191 (2000); *Janda v. Commissioner*, T.C. Memo 2001-24 (2001); *Estate of Jones v. Commissioner*, 116 T.C. 11 (2001); *Wall v. Commissioner*, T.C. Memo 2001-75 (2001); *Estate of Paul Mitchell v. Commissioner*, 87 AFTR2d 2001-881 (9<sup>th</sup> Cir. 2001).

## V. OTHER DISCOUNTS – BLOCKAGE AND KEY PERSON.

### A. Blockage or Market Absorption Discount.

1. When valuing publicly-traded securities, reference is typically made to the market price at the time of valuation. When a large block of property is being valued, the proper approach is to value the block as a whole, as if all the items were offered for sale at the moment of transfer, and not on an item-by-item basis. The law of supply and demand supports the application of a blockage discount where the sale of an exceptionally large block of one type of property may generate less proceeds than if the seller were to sell each piece of that block separately at the market price. The market may only handle so many pieces of one type of property in a limited time, and, when the tendered number of a single type of property is greater than the number that the market can absorb, the market is unable to handle the exceptionally large block. Thus, a seller desiring to sell such a large block at one time may be forced to sell the block at a price per piece that is less than the quoted price for each piece.
2. Blockage discounts are specifically addressed under Treas. Reg. §§ 20.2031-2(e) and 25.2512-2(e); however, the regulations suggest a very limited role for blockage discounts by stating that they are only available in "certain exceptional cases." The case law is substantially more liberal and accepts blockage discounts where the taxpayer adequately demonstrates the appropriateness of the discount. *See, e.g., Helvering v. Maytag*, 125 F.2d 55 (8<sup>th</sup> Cir. 1942), *cert. denied*, 316 U.S.

689 (1942); *Bull v. Smith*, 119 F.2d 490 (2d Cir. 1941); *Richardson v. Commissioner*, 151 F.2d 102 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946); *Havemeyer v. U.S.*, 59 F. Supp. 537 (Ct. Cl. 1945), *cert. denied*, 326 U.S. 759 (1945); *Standish v. Commissioner*, 8 T.C. 1204 (1947), *acq.*, 1947-2 C.B. 4; *Rushton v. Commissioner*, 498 F.2d 88 (5th Cir. 1974); *Estate of Smith v. Commissioner*, 57 T.C. 650 (1972), *aff'd*, 510 F.2d 479 (2d Cir. 1975), *cert. denied*, 423 U.S. 827 (1975); *Robinson v. Commissioner*, 50 T.C.M. 89 (1985); *Gillespie v. U.S.*, 23 F.3d 36 (2d Cir. 1994).

3. In *Estate of Foote v. Commissioner*, T.C. Memo 1999-37 (1999), the Tax Court applied a 3.3% discount applied to a 2.2% block of Applied Power, Inc., a publicly-traded stock.
4. A “blockage” discount is typically used to describe the discount applied to the sale of a large block of stock, whereas a “market absorption discount” is typically used to refer to the sale of other types of property. For example, market absorption discounts have been applied to artistic and literary items including the following:
  - a. *Calder v. Commissioner*, 85 T.C. 713 (1985) (market absorption discount applied to gifts of a large number of works of art created by one artist);
  - b. *Estate of Smith v. Commissioner*, 57 T.C.650 (1972) (market absorption discount applied to 425 works of art created by and kept in sculptor’s collection), *aff'd. on other grounds* 510 F.2d 479 (2d Cir. 1975);
  - c. *Estate of O’Keeffe v. Commissioner*, T.C. Memo. 1992-210 (market absorption discount applied to approximately 400 works or groups of works of art);
  - d. *Rimmer v. Commissioner*, T.C. Memo. 1995-215 (market absorption discount applied to charitable contribution of collection of sheet music containing approximately 85,000 pieces);
  - e. *Jarre v. Commissioner*, 64 T.C. 183 (1975) (market absorption discount applied to charitable contribution of large collection of original music manuscripts and other related material);
  - f. *Skripak v. Commissioner*, 84 T.C. 285 (1985) (market absorption discount applied to charitable contribution of large collection of books);
  - g. *Epping v. Commissioner*, T.C. Memo. 1992-279 (market absorption discount applied to charitable gift of mainly animal mounts); and
  - h. *Estate of Miller v. Commissioner*, T.C. Memo. 1991-515 (market absorption discount applied to donation of animal trophies), *aff'd. without published opinion* 983 F.2d 232 (5th Cir. 1993).
5. Market absorption discounts have also been applied to real estate, including the following cases:
  - a. *Estate of Sturgis v. Commissioner*, T.C. Memo. 1987-415 (20% market absorption discount applied to 11,298.86 acres of undeveloped land);
  - b. *Carr v. Commissioner*, T.C. Memo. 1985-19 (30% market absorption discount applied to 175 developed lots; no discount applied to 437.5 undeveloped lots);
  - c. *Estate of Folks v. Commissioner*, T.C. Memo. 1982-43 (20% market absorption discount applied to five leased lumberyards with the same tenant and in the same geographical area);
  - d. *Estate of Grootemaat v. Commissioner*, T.C. Memo. 1979-49 (15% market absorption discount applied to undeveloped lots totaling 302 acres);



- e. *Estate of Auker v. Commissioner*, T.C. Memo 1998-185 (1998) (6.189% market absorption discount applied to apartment complexes); and
- f. *Estate of Brocato v. Commissioner*, T.C. Memo 1999-424 (1999) (In addition to 20% fractional interest discount, 11% blockage discount awarded for 7 of 9 multiple tenant dwellings in San Francisco's Marina District).

B. Key Person Discount.

- 1. Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform services for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee.
- 2. Rev. Rul. 59-60 explains that in valuing the stock of a closely-held business, the loss of a key person may have a depressing effect upon the value of such business. The ruling also states that the loss of the key person and the absence of management succession potentialities should be taken into consideration in analyzing the future expectancy of the business. However, the ruling further explains that consideration must be given to whether the business is of a type that will not be impaired by the absence of the individual and whether the loss to the business is either adequately covered by life insurance or mitigated by the ability to employ competent management for the same consideration that was paid to the decedent.
- 3. The Tax Court has rejected the Service's assertion that the loss of a key person can be offset by life insurance proceeds and other factors. In *Estate of Rodriguez v. Commissioner*, T.C. Memo 1989-13 (1989), the court rejected the Service's assertion that no adjustment was necessary merely because the business held a life insurance policy on the key person's life. In the court's opinion, this understated the importance of the key person.
- 4. In *Estate of Feldmar v. Commissioner*, T.C. Memo. 1988-429 (1988), the Court rejected the Service's assertion that no key person discount should be applied because the loss of the decedent's services was more than compensated by insurance, on the basis that insurance proceeds are more in the nature of a non-operating asset and thus would not enter into a going concern valuation. The *Feldmar* court held that an investor would expect a 35% discount for the loss of a key employee "because (the business) suffered a serious loss when (the) decedent took to his grave his considerable expertise." The Court reduced the discount to 25% to account for the possibility of the business finding a new leader to replace the decedent.
- 5. Other cases involving the application of a key person discount include: *Estate of Huntsman v. Commissioner*, 66 T.C. 861 (1976); *Estate of Mitchell v. Commissioner*, T.C. Memo 1997-461 (1997); *Estate of Yeager v. Commissioner*, T.C. Memo. 1986-448; *Furman v. Commissioner*, T.C. Memo 1998-157 (1998).

VI. SWING-VOTE PREMIUM, VOTING PREMIUM, AND CONTROL PREMIUM

A. Swing Vote Premium

- 1. A swing vote premium may be applied in cases where, as a result of the ownership percentages of other shareholders, the holder of the subject shares is able to combine his voting power with another shareholder and effectively control the corporation. A swing vote premium has not been addressed in the context of limited partnerships, but it is likely that the analysis applicable to voting shares of a corporation will be equally applicable to general partner interests in limited partnerships.
- 2. One of the first cases to address the issue of a swing vote premium in the context of a corporation was *Estate of Winkler v. Commissioner*, T.C. Memo 1989-231 (1989). In *Winkler*, the Tax Court found that a 10% block of voting stock had special characteristics that enhanced its value when 40% of the stock was owned by the transferor's family and 50% by members of another family.

The 10% block of stock was subject to a 10% premium instead of a minority interest discount as argued by the estate.

3. In Tech. Adv. Mem. 9436005, the Service ruled that a swing vote premium should be applied to gifts of 30% interests in a corporation to the children of the donor. The Service reasoned that the block of stock enabled the transferee to join with another related owner of an interest in the entity to form a majority interest.
4. The application of the swing vote concept has been broadly criticized for two reasons.
  - a. First, pursuant to the willing buyer-willing seller concept, it is difficult to conceive that an arms-length buyer without any prearranged agreement, would attach additional value to a minority interest.
  - b. Secondly, the use of this concept totally ignores the transfer tax concept that valuation applies to the asset being transferred, not the speculative value of what is created following the event of transfer.

B. Voting Premium – *Estate of Simplot*, 112 T.C. 13 (1999), reversed, 249 F3d. 1191, 2001 (9<sup>th</sup> Cir.)

1. In *Simplot*, the corporation had two classes of stock: Class A voting (of which there were 76,445 shares outstanding) and Class B nonvoting (of which there were 141,288,584 shares outstanding). The decedent and two of his siblings each owned 18 shares (or 23.55%) of voting stock, and a fourth sibling owned the remaining 22,445 shares. If a Class A voting shareholder wanted to sell his Class A voting stock, the stock first had to be offered to the corporation for a period of 180 days, and then (if the corporation declined to exercise its right to purchase the stock) to the other Class A voting shareholders for an additional 180 days.
2. The Tax Court valued a decedent's voting stock of a closely-held corporation by adding, to each voting share's pro rata share of the equity value of the corporation, a voting rights premium expressed as 3% of the corporation's *total* equity value (including both voting and nonvoting stock). In so holding, the court rejected the estate's argument that the premium, if any, to be accorded to the voting rights should be expressed in terms of a percentage of the *nonvoting* stock only. The Tax Court said that the Class A shares, on a per-share basis, were far more valuable than the Class B shares because of the former's inherent potential for influence and control of the corporation. Through ownership of the decedent's voting shares, a hypothetical buyer would gain access to the "inner circle" of the corporation, and, by having a seat at the Class A shareholders' table, over time, the hypothetical buyer potentially could position itself to play a role in the corporation. The court agreed with IRS's expert that, on the valuation date, a hypothetical buyer would consider the likelihood that one day the decedent's block of voting shares potentially could become the largest block of voting shares because the record revealed that the decedent's siblings intended, upon their deaths, to pass their Class A shares to their children, and thereafter no shareholder (other than the hypothetical buyer) would own 18 shares of voting stock. Moreover, it was foreseeable on the valuation date that, after the deaths of the decedent's siblings, younger generation family members would be more likely to sell their voting shares to outsiders than their parents would. At that time, the hypothetical buyer would benefit from the right of first refusal restriction on the voting stock.
3. The Tax Court also noted that the corporation had an extreme ratio of nonvoting to voting shares: 1,848.24 to one. The court agreed with IRS's expert that the disparate ratio of nonvoting to voting stock in this case was particularly important because it dramatically increased, on a per-share basis, the value of the Class A shares.
4. The Tax Court stressed that it was not valuing a premium for *controlling* voting power, but rather a premium for *voting rights*. The court said that the premium for controlling voting power would be substantially greater than the premium it determined for voting rights.
5. The Ninth Circuit reversed.

- a. The Ninth Circuit believed that the Tax Court departed from the hypothetical willing buyer standard because the Tax Court believed that “the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value.” The Ninth Circuit believed the Tax Court relied on “imagined facts” and said, “In violation of the law the Tax Court constructed particular possible purchasers.”
- b. The Ninth Circuit also determined that the Tax Court’s premium calculation was incorrect. The Tax Court calculated the premium that all the Class A shares as a block would command and then divided this premium by the number of Class A shares. The Ninth Circuit said, “... the Tax Court valued an asset not before it -- all the Class A stock representing complete control. There was no basis for supposing that whatever value attached to complete control a proportionate share of that value attached to each fraction of the whole....”
- c. The final error was that even a controlling block of stock should not be valued at a premium for estate tax purposes, unless the IRS can show that a purchaser would be able to use the control in a manner that assured an increased economic advantage worthy of a premium. The Ninth Circuit noted, “No seat at the table was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with Simplot. If these businesses enjoyed special advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders.”
- d. The Ninth Circuit said that much of the IRS’ argument was devoted to speculation as to what might happen after the valuation date, noting, “Speculation is easy but not a proper way to value the transfer at the time of the decedent’s death. [citation omitted]. In Richard Simplot’s hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share.”

C. Control Premium.

1. If shares of a block of stock constitute actual voting control of the corporation, those shares may possess an additional measure of value because the shares in the block control the corporation. “Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation’s capital structure, and decide whether to liquidate, merge, or sell assets.” *See, Estate of Newhouse v. Commissioner*, 94 T.C. 193, 251-52 (1990), *nonacq.*, 1991-1 C.B. 1. As such, determining the fair market value of a controlling interest may require adjustment to reflect a “control premium.”
2. The gift and estate tax regulations maintain, in both the publicly-traded and closely-held contexts, that the degree of control represented by a block of stock is relevant to valuation. Treas. Regs. §§ 20.2031-2(e) and (f) and 25.2512-2(e) and (f). Rev. Rul. 59-60 states that “[t]he size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation’s stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.”
3. Case Law Involving the Application of a Control Premium to More Than a 50% Interest.
  - a. *Estate of Salisbury v. Commissioner*, T.C. Memo 1975-333 (1975). The Tax Court applied a 38.1% premium for control in valuing a 52% voting interest in a family corporation engaged in manufacturing animal health products. This percentage was based on an expert witness’s research of premiums paid in mergers and acquisitions in the valuation year.
  - b. *Estate of Desmond v. Commissioner*, T.C. Memo 1999-76 (1999) The Tax Court applied a 25% control premium to decedent’s 81.93% interest in closely-held corporation.

- c. *Estate of Feldmar v. Commissioner*, T.C. Memo 1988-429 (1988). The Court concluded that investors would be willing to pay a 15% premium for a controlling block of shares. However, the court also correctly concluded that the control premium should be offset by a discount for loss of a key person.
  - d. *Oman v. Commissioner*, T.C. Memo 1987-71 (1987). The Court determined that a control premium of 20% should be applied when valuing a 75% interest in a closely-held corporation because a purchaser would have been able to liquidate the company and control the management and policies of the company.
  - e. *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978). The court determined that a control premium was not appropriate in valuing a block of 80% of the outstanding stock that was held by the decedent and her husband as community property. The court based its conclusion on its opinion that the State of Washington, where the decedent was domiciled, followed the “item theory” of community property, which provides that each spouse has an undivided interest in each community asset as opposed to an undivided interest in the community property as a whole, which is the case in an aggregate theory state.
4. Case Law Involving a 50% Interest.
- a. *Wheeler v. United States*, (1995, DC TX) 77 AFTR 2d 96-1405, *rev'd on other issue* (1997, CA5) 80 AFTR 2d 97-5075, 97-2 USTC. A federal district court allowed a 10% minority discount for a decedent's 50% interest in voting stock in a closely-held corporation. The remaining 50% of the voting stock and all of the non-voting stock was owned equally by decedent's two sons at the time of his death. Although a minority interest is generally thought of as being less than 50%, the minority discount for tax purposes is given based on lack of control. A shareholder with 50% of the stock can block action by other shareholders but does not have a sufficient interest to control corporate affairs. Where indications of value are based upon control or complete ownership, a discount must be applied to provide indications of value for a minority or *less-than-controlling* interest.
  - b. *Obermer v. United States*, 238 F. Supp. 29 (HI 1964). The value of a husband's 50% interest in a corporation owned 50-50 by him and his wife was discounted 33-1/3% partly because his 50% interest couldn't force liquidation of the corporation.
5. Case Law Involving Less Than a 50% Interest.
- a. *Estate of Schneider-Paas v. Commissioner*, T.C. Memo 1969-21 (1969). The Tax Court applied a control premium where a 39% ownership in a German close corporation, under the charter and bylaws, assured the owner of at least the vice-chairmanship.
  - b. In *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 251-52 (1990), *nonacq.*, 1991-1 C.B. 1., the decedent's ownership interest was less than 50%. The Tax Court held that a control premium was not supportable even though the decedent owned the largest block of stock (44.44%). The decedent did not have effective control because he could not accomplish any of the following: unilaterally direct corporate action; select management; decide the amount of distributions; rearrange the corporation's capital structure; or decide whether to liquidate, merge, or sell assets.
  - c. *Estate of Wright v. Commissioner*, T.C. Memo 1997-53 (1997). The Tax Court rejected the Service's argument that a control premium should be applied where the decedent owned 23.8% of the outstanding stock of a closely-held corporation, with 9.4% being the most shares owned by any other shareholder. The Service argued that a control premium was justified, because the decedent's block of stock could control one member of the board of directors and thereby “substantially influence” corporate action and cause the sale of the corporation's assets. But the Tax Court, relying on its decision in *Newhouse*,

said that more than “substantial influence” is required before a control premium may be applied. The Court also noted that IRS, in treating the decedent’s holding as part of a hypothetical 51% controlling interest, had effectively ignored the requirement in the corporation’s articles of incorporation of a 66-2/3% super majority for decisions regarding the merger, consolidation, dissolution, or sale of all or substantially all of the corporation’s assets.

## VII. VALUATION DISCOUNT PLANNING OPPORTUNITIES AND PITFALLS.

### A. Valuation for Gift Tax Purposes v. Valuation for Estate Tax Purposes.

1. Although the estate tax and the gift tax are generally construed *in pari materia*, there are some material differences in the administration of the two taxes.
  - a. The estate tax is an excise tax on the aggregation of all of the assets in the decedent’s estate.
  - b. By contrast, the gift tax is imposed on the property passing from the donor to each donee; it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where a donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift.
  - c. Accordingly, the value of property that is the subject of multiple simultaneous gifts may be different from the value of that same property if that property were included in the donor’s gross estate at his death.
  - d. For example, X owns 100% of the stock of ABC Corp. X wants to transfer 25% of the stock to each of his four children. If X gifts the stock to each of his children, each 25% block of stock should be entitled to a minority interest discount and possibly a lack of marketability discount. If X bequeaths 25% of his stock to each of his four children, X is treated as owning 100% of the stock and no valuation discounts are available.
  - e. There is ample case law supporting this principle. See, e.g., *Rushton v. Commissioner*, 498 F.2d 88, 93 (5th Cir. 1974), *affg.* 60 T.C. 272 (1973); *Calder v. Commissioner*, 85 T.C. 713, 720- 721 (1985); *Standish v. Commissioner*, 8 T.C. 1204, 1209 (1947); *Clause v. Commissioner*, 5 T.C. 647, 649-650 (1945), *affd. per curiam* 154 F.2d 655 (3d Cir. 1946); *Avery v. Commissioner*, 3 T.C. 963 (1944); *Phipps v. Commissioner*, 43 B.T.A. 1010 (1941), *affd.* 127 F.2d 214 (10th Cir. 1942); *Adair v. Commissioner*, T.C. Memo. 1987- 494 (1987); and *Hipp v. Commissioner*, T.C. Memo. 1983-746 (1983).
2. The Sliver Gift Cases – *Murphy* and *Frank*.
  - a. *Estate of Murphy v. Commissioner*, T.C. Memo 1990-472 (1990). For many years, the decedent owned and controlled (through a general power of appointment) 51.41% of the stock of a closely-held corporation. Eighteen days before her death, the decedent transferred shares representing 0.88% of the stock to each of her children. After her death, the remaining 49.65% of the stock was distributed to her children. The Tax Court denied a minority discount because the decedent had transferred shares shortly before her death in order to reduce her interest below 50%. The Tax Court found that the decedent had a controlling interest in the corporation and that the pre-death transfer lacked substance because there was a clear understanding between the decedent and her children to maintain family control of the business. The Tax Court observed:

The rationale for allowing a minority discount does not apply because decedent and her children continuously exercised control powers. For example, decedent remained as chairman of the board after the transfer of stock to her children. A minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax.

- b. *Estate of Frank v. Commissioner*, T.C. Memo 1995-132 (1995). Anthony Frank owned 50.3% of the stock of Magton, Inc. a closely-held corporation in the hotel business in New Jersey. His wife, Margaret owned 13.57% of the stock. Two days before Anthony's death, his son, Anthony, Jr., acting pursuant to a power of attorney, gifted 18.16% of the stock owned by Anthony to Margaret. Margaret died 15 days after Anthony. At the time of their respective deaths, Anthony owned 32.14% of Magton and Margaret owned 31.73% of the stock of Magton.
    - i. The Tax Court held that the transfers of stock were valid transfers and each of decedents died possessed of only a minority interest in Magton. The Court then applied successive 30% lack of marketability and 20% minority interest discounts, thereby discounting the collective 64.87% block of stock owned by Anthony and Margaret by 45%.
    - ii. In a twist on the adage "Pigs get fat and hogs get slaughtered", the Court observed that "[i]f tax avoidance was the sole motive, a substantially smaller number of shares could have been transferred. We find it unnecessary to decide this dispute over the motive for the transfer.... As a general rule, we will respect the form of a transaction. We will not apply substance over form principles unless the circumstances so warrant." The "pigs" in *Murphy* did not fare nearly as well as the "hogs" in *Frank*.
    - iii. Query whether Rev. Rul. 93-12, which was promulgated in the interim made a difference? In that Ruling, the donor owned all of the single outstanding class of stock in a corporation and transferred all of the shares by making simultaneous gifts of 20% of the shares to each of the donor's five children. The ruling holds that the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.
  - c. *See also, Estate of Cidulka v. Commissioner*, T.C. Memo 1996-149 (1996).
3. Gifts and Swing Vote Premium.
- a. Tech. Adv. Mem. 9449001. The donor owned 100% of the X Corporation stock. The corporation had only one class of common stock outstanding. The donor subsequently transferred all of the stock in the corporation by making equal gifts of the stock to each of his 11 children. After the transfer, the corporation stock was owned by 11 individual shareholders, each of whom owned less than 10% of the outstanding stock. The Service concluded:

Whether the donor owns 100% of the corporation or owns a lesser controlling interest prior to the transfer, and whether the donees are family members or various third parties, are not determining factors in valuing a block of stock transferred to a donee or in deciding whether a separate gift is subject to a minority interest discount. The percentage of control represented by the block transferred to the donee (**including potential swing-vote value**) as well as other financial data and factors effecting the fair market value of the transferred stock must be included in the valuation for gift tax purposes. (Emphasis supplied).
  - b. *See also*, Tech. Adv. Mem. 9436005 and the discussion, *supra*, regarding the application of a swing vote premium.
4. Gifts and the Effect on Blockage Discounts.
- a. Tech. Adv. Mem. 9719001. The donor created three trusts for the benefit of his children. Each trust was further subdivided into three more trusts. Therefore, a total of nine trusts were in existence. The donor contributed a block of stock in a publicly-traded company to the trusts. The donor argued that this was a gift of one block of stock, or in the worst

case, a gift of 3 smaller blocks of stock. The Service ruled that, although the trusts could have been structured so that there was a total of only three separate gifts, one trust for the benefit of each grandchild, the donor chose the form of transfer, thereby creating nine separate trusts and nine separate gifts. Consistent with the form chosen, the donor reported nine separate gifts on the gift tax return. The Service concluded that, for purposes of applying the blockage discount in valuing the gifts, the transfers by the donor will be treated as nine separate gifts, each consisting of 1/9<sup>th</sup> of the block of stock. Each separate 1/9<sup>th</sup> gift of shares is considered separately as to its effect on the market to determine whether any discount is applicable.

- b. Treas. Reg § 25.2512-2(e) provides that, if several gifts of blocks of the same stock are made to different donees on the same day, the blockage discount rule must be applied separately to each block, and not to the total of shares given away that day. Thus, the blockage discount rule is applied separately to each block, and not to the total of shares given away that day. The Service ruled that gifts to an individual, and to a trust for that individual, may be aggregated in applying the blockage discount rule. *See*, Priv. Let. Rul. 8049015.

5. *Estate of Bosca v. Commissioner*, T.C. Memo 1998-251 (1998). The decedent owned 50% of the voting stock of a closely-held corporation. The decedent's two sons each owned 25% of the voting stock and 50% of the non-voting stock. The corporation's capital structure was recapitalized and the father exchanged his 50% voting stock for non-voting stock. As a result of the recapitalization, the two sons owned 100% of the voting stock. The Tax Court held that the father's exchange of the voting stock for non-voting stock was a "deemed" gift of the difference in value between the voting stock transferred to the corporation and the non-voting stock received. The silver lining to the dark cloud of *Bosca* is that the Tax Court correctly ruled that the "deemed" gift should be valued as two separate 25% gifts, as opposed to a gift of a 50% block.

#### B. Valuation for Inclusion Purposes v. Valuation for Deduction Purposes.

1. Assets are valued for estate tax inclusion purposes based upon the value of the assets included in the decedent's estate. Assets are valued for estate tax deductibility purposes based upon the value of the property interest passing in a manner that qualifies for the estate tax marital or charitable deduction. The often cited example of this principle is the decedent who owns 100% of the stock of a closely-held business worth \$10,000,000. The decedent leaves 50% of her estate to her husband in a manner that qualifies for the estate tax marital deduction under Code § 2056 and 50% of her estate to a charity which qualifies for the estate tax charitable deduction under Code § 2055. The stock is included in the decedent's estate at \$10,000,000; however, for estate tax deduction purposes, each 50% interest may be discounted for lack of marketability and lack of control. Assuming a combined 35% discount, the value of the marital deduction is determined as follows:  $(50\% \times \$10,000,000) \times (1 - 35\%) = \$3,250,000$ ; the charitable deduction is determined similarly. Therefore, with a gross estate of \$10,000,000 and combined estate tax marital and charitable deductions of \$6,500,000 (\$3,250,000 + \$3,250,000), there is a taxable estate of \$3,500,000. *See*, Pennell, "Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice", 1996 *U. Miami Philip E. Heckerling Inst. Est. Planning* § 9.02.
2. *Ahmanson Foundation v. United States*, 706 F.2d 1424 (7<sup>th</sup> Cir. 1983). The decedent owned 100% of the stock of a holding company with 1 voting share and 99 non-voting shares. The decedent left the 1 voting share to his son and the 99 non-voting shares to a charity. The Court refused to value the voting and non-voting stock separately in the gross estate. The Court found that 100% of the stock should be valued for inclusion purposes, and then a 3% reduction should be applied to the value of the non-voting shares passing to charity. The reduction in the value of the assets passing to charity had the effect of reducing the charitable deduction and increasing the taxable estate.
3. *Chenoweth v. Commissioner*, 88 T.C. 1577 (1987). The decedent owned 100% of the stock of a closely-held corporation. The decedent specifically bequeathed 51% of the stock to his wife, with the balance passing to his daughter from a prior marriage. The decedent's estate claimed a 38.1% control premium applied to the 51% block of stock, which under Florida law, gave the surviving spouse complete control over the corporation.

- a. The Court was persuaded by the reasoning in *Ahmanson* and concluded that a control premium should be applied to the value of the 51% block of stock passing to Mrs. Chenoweth.
- b. Interestingly the court noted the following:

While we would tend to agree that the sum of the parts cannot equal more than the whole -- that is, that the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100% interest of the decedent, as reported for purposes of section 2031 -- it might well turn out that the sum of the parts can equal less than the whole -- that is, that the control premium which is added to the majority block passing to decedent's surviving spouse might be less than the proper minority discount to be attributed to the shares passing to decedent's daughter.

4. Tech. Adv. Mem. 9005004. This Ruling is essentially the reverse of *Chenoweth*. In this case, the decedent left 49% in trust for his wife and 51% in trust for his son. The Service ruled that the value of the interest passing to the marital trust should be valued as a separate interest in property and could, therefore, be subject to a minority interest discount. This will have the effect of reducing the marital deduction and increasing the value of the taxable estate.
5. Tech. Adv. Mem. 9403005. At the time of his death, the decedent owned a block of 400 preferred shares in a closely-held corporation and a block of 37,728 common shares. Together, the two blocks of stock represented control of the corporation; separately they represented non-controlling interests. The decedent left the preferred stock to his wife and the common to his children. The Service ruled that "[i]f, as in the present case, a minority interest block of stock passes to the surviving spouse, a marital deduction may be taken for only for the value of the block as such. However, in accordance with the holdings in the *Ahmanson* and *Chenoweth* cases, the value of the same property for purposes of inclusion in the gross estate under Code § 2031 may be different if the decedent, at the time of death, possessed a controlling interest block of stock.
6. *Estate of DiSanto v. Commissioner*, T.C. Memo 1999-421 (1999). The decedent owned a controlling interest in a closely-held corporation that he left to his wife. His wife disclaimed her right to inherit a certain amount of the stock, the result being that the only asset in the decedent's residuary estate that the wife could inherit was a minority interest in the stock. The Tax Court, relying on *Chenoweth*, held that the estate must compute the value of the marital deduction based on the minority interest the spouse was entitled to receive after she executed the disclaimer, not based on the value of the controlling interest he willed to her.
7. *Schwan v. Commissioner*, T.C. Memo 2001-174. Alfred Schwan, founder of a frozen food company, left 2/3rds of the voting and non-voting stock to a private foundation. The shares were subject to a redemption agreement with the Company. The Tax Court held, at a summary judgment hearing, that while the interests may be aggregated for inclusion purposes, for deduction purposes, the interests may be valued separately. Consequently, there may be a mismatch between valuation for inclusion and deduction purposes and additional tax may be due.

C. Aggregation of Interests.

1. In some cases, property may be included in the gross estate under separate estate inclusion provisions. For example, a decedent may own 30% of the stock of a closely-held business in a revocable trust and 30% of the stock outright. The stock held in the decedent's revocable trust is includible in her estate under Code § 2038. The 30% interest owned outright is includible in her estate under Code § 2033. The question that arises is whether the two interests, includible under two separate provisions of the Code, should be valued separately or aggregated for valuation purposes. If the two 30% blocks of stock are valued separately, a minority interest discount may be warranted. If the two 30% blocks of stock are aggregated to form a 60% block, a control premium may be warranted.



2. The aggregation of interests theory is typically applied in the estate tax context. Nevertheless, practitioners should be cognizant of its application when planning gifts to family members and structuring the ownership of assets during lifetime.
3. Aggregation of Non-QTIP Property.
  - a. In Rev. Rul. 79-7, 1979-1 C.B. 294, the Service ruled that (i) a 30% stock interest transferred by the decedent within three years of death (includible in the gross estate under the former provisions of Code § 2035) and (ii) a 30% stock interest owned by the decedent at the time of his death (includible in the gross estate under Code § 2033) should be aggregated for valuation purposes, thereby disallowing a minority interest discount.
  - b. In Tech. Adv. Mem. 8330004, the Service ruled that the decedent was granted a general power of appointment in a trust when he was granted the option to purchase the stock from the trust on extremely favorable terms. The Service, relying on Rev. Rul. 79-7, also ruled that the stock includible in his estate under Code § 2041(a)(2) must be aggregated with the stock of the same corporation includible in his estate under Code § 2033 in determining its fair market value.
  - c. In Tech. Adv. Mem. 9403002, the Service ruled that (i) a block of stock held in the decedent's revocable trust and includible in his gross estate under Code § 2038 and (ii) a block of stock owned by the decedent outright and includible in his gross estate under Code § 2033 should be aggregated for valuation purposes. *See, also, Estate of Babbitt v. Commissioner*, 87 T.C. 1270 (1986).
4. Aggregation of QTIP Property and Other Property.
  - a. *Estate of Bonner v. Commissioner*, 84 F.3d 196 (5<sup>th</sup> Cir. 1996). The decedent died owning fractional shares in several pieces of real property with the remaining ownership interests being held in a QTIP trust established by his wife at her death. The executor of the decedent's estate applied a 45% discount in valuing the separate fractional interests. The Commissioner argued that the fractional interests in the real property should be aggregated for valuation purposes. The Fifth Circuit, relying on its prior holding in *Estate of Bright*, concluded that the fractional interests in the assets should not merge into a 100% fee ownership by the estate. The court stated that "the statute does not require, nor logically contemplate that in so passing, the QTIP assets would merge with other assets." The court also relied on the decedent's lack of control over the disposition of property. The *Bonner* court stated:

The estate of each decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions.... Mrs. Bonner controlled the disposition of her assets, first into a trust with a life interest for Bonner and later to the objects of her largesse. The assets, although taxed as if they passed through Bonner's estate, in fact were controlled at every step by Mrs. Bonner, which a tax valuation with a fractional interest discount would reflect. At the time of Bonner's death, his estate did not have control over Mrs. Bonner's interests in the assets such that it could act as a hypothetical seller negotiating with willing buyers free of the handicaps associated with fractional undivided interests. The valuation of the assets should reflect that reality.
  - b. *Estate of Mellinger v. Commissioner*, 112 T.C. 4 (1999). At the time of her death, the decedent owned 27.8671% of the issued and outstanding stock of Frederick's of Hollywood, Inc. The decedent's predeceased husband established a QTIP trust for her benefit that also contained 27.8671% of the issued and outstanding stock of Frederick's of Hollywood, Inc. Mrs. Mellinger's estate valued the two blocks as minority interests

and applied a 31% discount. The Service attempted to aggregate the two blocks of stock in Mrs. Mellinger's estate to form a 55.7342% controlling block. In an extremely well-written and well-reasoned opinion, the Tax Court found nothing in the statute or the regulations that (i) the decedent should be treated as the owner of QTIP property for valuation purposes or (ii) that QTIP assets should be aggregated with other property in the estate for valuation purposes. The Tax Court noted that such a result would be inconsistent with the general system of estate tax inclusion since, unlike the provisions of Code §§ 2035, 2036, and 2041 which require estate tax inclusion where the decedent retains the power of disposition or control over the assets, at no time did Mrs. Mellinger possess, control, or have any power of disposition over the Frederick's of Hollywood shares in the QTIP Trust. The Tax Court reviewed the legislative history of Code § 2044(c) and found nothing to suggest that the surviving spouse should be treated as the owner of QTIP property or that such QTIP property be aggregated with any other assets included in the decedent's estate under Code § 2033.

- c. *Estate of Nowell v. Commissioner*, T.C. Memo 1999-15 (1999). On the same day that the Tax Court decided *Estate of Mellinger*, the Tax Court ruled in *Estate of Nowell v. Commissioner*. The issue in *Nowell* was virtually identical to the issue in *Mellinger* – whether certain partnership interests included in the gross estate pursuant to Code § 2044 should be aggregated, for valuation purposes, with partnership interests in the same partnerships includible in the decedent's gross estate under Code § 2038. The Tax Court, relying on its decision in *Mellinger*, rejected the Commissioner's arguments and did not aggregate the interests.
- d. *Estate of Lopes v. Commissioner*, T.C. Memo 1999-225 (1999). The Commissioner attempted, as it did in *Mellinger* and *Nowell*, to argue that the fractional interests in real estate held in a QTIP Marital Trust should be aggregated with the fractional interests in the same parcels of real estate includible in the surviving spouse's estate. The Tax Court, in a motion for summary judgment, observed that it had already “rejected the same aggregation argument advanced by [the Commissioner] in *Estate of Mellinger* and in *Estate of Nowell v. Commissioner*. We find no factual or legal distinction that would result in a different conclusion in this case.”
- e. Action on Decision 1999-006, 1999-35 I.R.B. 314. Given the strong analysis and logic employed by the *Mellinger* court, followed by the rapid-fire succession of *Nowell* and *Lopes*, it was not particularly surprising that the Commissioner acquiesced in the decision in *Mellinger*. In Action on Decision 1999-006, the Commissioner acquiesced in the result of *Mellinger*. The AOD states:

[W]e agree with the Tax Court's opinion that closely-held stock held in a QTIP trust should not be aggregated, for valuation purposes, with stock in the same corporation held in a revocable trust and includible in the decedent's gross estate. The Tax Court's decision in this case is consistent with the Service's position regarding the valuation of minority interests passing to QTIP trusts. The proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest. Cf. *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987); see also Rev. Rul. 84-105, 1984-2 C.B. 197.

- f. For a more detailed discussion, see, Aghdami, “Valuation Discount Opportunities After *Mellinger*, *Nowell* and *Lopes*”, *Probate & Property*, March/April 2000.

## VIII. PLANNING WITH ENTITIES.

### A. Introduction.

1. The transfer of an interest in a limited partnership or limited liability company (LLC) may result in a reduction in value for transfer tax purposes of the assets being transferred because of valuation discounts for lack of control and lack of marketability.
2. For example, if an older family member desires to transfer to a younger family member 10% of his or her IBM stock worth \$1,000,000, a direct transfer of the actual shares to the younger family member or to a trust for his or her benefit would be a taxable gift of \$100,000.
3. On the other hand, if the older family member transferred \$1,000,000 worth of real estate to an LLC and received all the LLC interest in exchange (assuming the LLC is formed in a state that recognizes a single-member LLC) and he or she then gives a 10% interest in the LLC to the younger family member, the value of the gift for gift tax purposes may be less than \$100,000. How much less will depend on the lack-of-control and lack-of-marketability discounts a business appraiser would attribute to a 10% interest in an LLC owning real estate worth \$1,000,000. For purposes of simplicity, this example ignores the step-transaction risk. See, e.g., *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2001) and *Pierre*, discussed *infra*.
4. In most estate planning situations involving real estate and other passive investments, including marketable securities, the value of the underlying assets is usually worth more than the value of the entity as a going concern. Therefore, a restriction in the organizing documents on the right of an owner to cause a liquidation of the entity or to have his or her interest redeemed at a price equal to a pro rata share of the value of the entity's assets will be important in ensuring that the interest is entitled to a lack-of-control discount, assuming the restriction is not disregarded for federal transfer tax purposes.

### B. Valuing Interests Held in Specific Entities.

1. Desirable characteristics for claiming lack-of-control discounts include:
  - a. The lack of management or voting rights;
  - b. The absence of a right to require the entity to redeem the owner's interest (a put right); and
  - c. Restrictions on the owner's ability to transfer ownership rights to a third-party.
2. The applicable sections of the Code that impact the ability to take a lack-of-control discount or that affect the ability to qualify for the annual gift tax exclusion or to avoid inclusion in the transferor's estate include:
  - a. Code § 2503(b), which allows the annual exclusion only if the gifted interest is a present interest;
  - b. Code § 2036(a)(1), which requires the inclusion of property in the transferor's estate if the transferor retains the possession or enjoyment of, or the right to the income from, the property;
  - c. Code § 2036(a)(2), which requires the inclusion of property in the transferor's estate if the transferor has retained the right to designate the persons who will possess or enjoy the property or the income from the property;
  - d. Code § 2036(b), which requires inclusion of shares of stock in a closely-held corporation in the estate of the transferor who retains the right to vote the shares;

- e. Code § 2038, which requires the inclusion of property in the transferor's estate if the transferor has retained the right to alter, amend, revoke, or terminate the transferred interest;
- f. Code § 2701, which applies special valuation rules when an older family member transfers a junior or residual equity interest to a younger family member and retains a senior or preferred equity interest;
- g. Code § 2702, which values certain transfers of interests in trust.
- h. Code § 2703, which ignores a right or restriction for valuation purposes if it is not commercially reasonable;
- i. Code § 2704(a), which treats a lapse of a voting or liquidation right as a taxable gift, if the lapse occurs during the transferor's life, or as part of the gross estate, if the lapse occurs at death; and
- j. Code § 2704(b), which ignores an applicable restriction (a limitation on the right of an owner to liquidate his or her interest if it is more restrictive than state law) for valuation purposes.

C. Corporations.

- 1. The amount of valuation premium or lack-of-control discount attributable to an interest in a corporation is directly related to the percentage of voting stock one owns and the rights such ownership percentage carries under state law.
  - a. For example, for a corporation whose going concern value exceeds its liquidation value, a higher premium will apply to the ownership of more than two-thirds of the voting stock than to the ownership of less than two-thirds if state law requires a vote of more than two-thirds of the shares to liquidate the corporation.
  - b. Furthermore, a premium will apply to the ownership of more than 50% of the voting stock if the owner can thereby control the election of the corporation's board of directors.
- 2. If the value of the underlying assets of a corporation exceeds the going concern value, there should be no premium applied to a majority or controlling interest. However, a minority or non-controlling interest will be entitled to a valuation discount.
- 3. A shareholder of a corporation does not have a right to have his or her interest redeemed under state law unless there is an agreement giving him or her such a right.
- 4. A shareholder of a corporation has the right to transfer his or her interest to a third-party without any restriction unless there is an agreement imposing restrictions on transferability.

D. Limited Partnerships.

- 1. In the case of a limited partnership, valuation issues will differ for general and limited partners.
  - a. An individual who owns only a limited partnership interest will have no right to participate in the management of the partnership, regardless of how much of an interest he or she holds.
    - i. For example, in a limited partnership with a 1% general partner and a 99% limited partner, the general partner has the sole legal right to control the day-to-day affairs of the partnership. However, as a practical matter, an individual who owns 99% of the partnership interests as a limited partner may be in a position to exercise effective control over the 1% general partner. As the limited

partner's percentage of the partnership declines and the number of other limited partners increases, his or her effective control may also diminish.

- b. A limited partner in a limited partnership, depending upon state law, also may not have a right to have his or her interest redeemed until the end of the term of the limited partnership as set forth in the certificate of limited partnership. Setting such a term in the certificate of limited partnership could therefore trigger a lack-of-control discount for limited partnership interests. There is a possibility, though, that the Service could view the term as an "applicable restriction" under Code § 2704(b) (although this would be an extreme expansion of the section's reach) and ignore it for valuation purposes. Some states have avoided this issue by specifically depriving a limited partner of a right to withdraw from the partnership, thereby ensuring that the restriction will be factored into the limited partnership interest's value. Code § 2704(b)(3)(B).
  - c. A limited partner does not have the right to transfer all his or her ownership rights in the partnership to a third-party without the consent of some or all of the other partners, depending upon state law.
2. A general partner may be entitled to have his or her interest redeemed by the partnership at any time, although he or she may be subject to liability for a premature withdrawal.
- a. However, in a family-controlled limited partnership, the potential liability may be disregarded as an applicable restriction under Code § 2704(b) for purposes of valuing the general partnership interest.
  - b. In partnerships with more than one general partner, any one general partner would no longer have control, but would still have the right to have his or her interest redeemed.
  - c. If a general partner in a limited partnership also owns a limited partnership interest, the issue arises as to whether he or she can cause the partnership to redeem both his or her general partnership interest and limited partnership interest.
  - d. A general partner does not have the right to transfer all his or her ownership rights in the partnership to a third-party without the consent of some or all of the other partners, depending upon state law.

E. Limited Liability Companies (LLCs).

- 1. In a member-managed LLC, a member will have control under the default rule of most state LLC statutes if he or she owns more than 50% of the membership interests entitled to vote.
- 2. However, in most states voting and nonvoting membership interests can be created so that nonvoting membership interests can be given to younger family members to achieve the same lack-of-control reduction in value achievable in a corporation through nonvoting stock.
  - a. Because the special valuation rule in Code § 2704(b) applies only to liquidation rights, and not to voting rights, giving nonvoting membership interests to younger family members should depress the value of the membership interests for transfer tax purposes.
  - b. In a manager-managed LLC, a non-member-manager's interest should be worth proportionately less than a member-manager's interest because only the managers have a right to participate in the management of the LLC.
- 3. A member of an LLC may or may not have a right to have his or her interest liquidated depending upon state law.
- 4. In most states a member of an LLC cannot transfer all his or her ownership rights to a third-party without the consent of some or all of the remaining members, depending upon state law.

F. Investment Company Rules.

1. Transfers of property to certain entities considered “investment companies” can result in income taxation to the transferor. To avoid the recognition of gain on a transfer of appreciated securities to a partnership or LLC, the transfer must not be treated as a transfer to an investment company as described in Code §§ 351 or 721(b). Under Code § 351(e)(1) transfer of property will be considered a transfer to an investment company if: (i) the transfer results directly or indirectly in diversification of the transferor’s interest; and (ii) the transferee is a corporation, partnership or LLC where more than 80% of the value of the assets are held for investment and are cash, stocks or securities (whether or not readily marketable).
2. A corporation or partnership will be considered an investment company if:
  - a. The contribution had the effect of diversification of the investor’s assets (diversification generally results if two or more persons contribute non-identical assets to the same entity); and
  - b. The transferee was (i) an entity classified as a regulated investment company, (ii) an entity classified as a real estate investment trust, or (iii) an entity in which more than 80% of the value of the assets were held for investment and were marketable securities.
3. For example, assume “A” and “B” form a partnership. “A” contributes \$100,000 of a publicly-traded stock in one corporation and “B” contributes \$100,000 of stock in a different publicly-traded company. Here, both tests would be met and the partnership would be considered an investment company. First, diversification of the partners’ investments is deemed to have occurred through combining their assets in an entity in which they each now have a right to 50% of the partnership’s various assets rather than a right to the individual stocks that they contributed. Second, marketable securities constitute greater than 80% of the assets contributed. As a result, “A” and “B” must recognize gain as if their respective stocks were sold by them to the partnership at the stock’s fair market value.
4. Prior to the Taxpayer Relief Act of 1997 (TRA ‘97), marketable securities were defined as stock in securities traded on a securities exchange or regularly traded or quoted on the over-the-counter market. Under new Code § 351(e), contributions of property to a corporation and partnerships that were non-taxable under pre-TRA ‘97 may now result in taxable gain due to the expansion of the definition of “securities”. The term “marketable securities” has now been replaced with a term “stock and securities.” Instead of limiting the 80% test to marketable securities, additional classes of property are now treated as “stock and securities” for purposes of this test. Under the new definition, items such as money, closely-held stock, debt instruments, options, future contracts, foreign currency and interest in precious metals are considered together with marketable securities in determining whether an entity is an investment company.
5. Under the Treasury Regulations for Code § 351, there are exceptions to the general rule that diversification results when non-identical assets are transferred to an entity by one or more persons. Under one exception, if the amount of non-identical assets contributed constitutes an insignificant or *de minimis* portion of the total value of the assets contributed, the insignificant securities are disregarded in determining whether diversification has occurred. Although the regulations do not specify what exact amount will be considered “insignificant” or “*de minimis*”, the example provided in the regulations indicates that less than 1% constitutes a *de minimis* amount.
6. For example, taxpayers A and B contributed \$10,000 worth of the same class of stock in a publicly-traded corporation in exchange for 50 shares each of a new corporation. Taxpayer C then contributed \$200 of other marketable securities in exchange for one share of the new corporation. C’s contribution of securities worth \$200 represents a 0.99% of the total assets contributed. While it is true that A and B have had some diversification to their investment through the contribution by C, the regulations indicate that C’s contribution of less than 1% is considered insignificant and,

thus no diversification would result. The regulations do not say whether diversification would have been present if C's contribution had equaled or exceeded 1%.

7. The diversification issue may also be avoided if marketable securities contributed to an entity are already diversified in the hands of its contributors. This is often referred to a "multi-stock exception." For example, the multi-stock exception would apply if partners form a new partnership to which each partner contributed mutual funds. Since these securities are already in a diversified portfolio, diversification would not occur upon funding of the partnership. A portfolio will already be diversified if (i) not more than 25% of the value of the assets contributed by each transferor are securities of one issuer; and (ii) not more than 50% of the assets contributed by each transferor are securities of five or fewer issuers.
8. This new definition of "securities" may have a serious impact on the initial funding of FLPs and FLCs. Prior to the passage of TRA '97, transferors could avoid the investment company status by transferring real estate or closely-held business interests with marketable securities so that the marketable securities constituted less than 80% of the entity's assets. However, under the new definition of securities, closely-held business interests will constitute a "security" under the 80% test. If the family does not own significant non-securities, such as real estate, then forming a family partnership without incurring income taxation may be a challenge. One option is to qualify for the *de minimis* exception by having one family member contribute more than 99% of the assets and for the others to contribute a total of less than 1%. Likewise, the multi-stock exception should be considered. The change in the expansion of the definition of securities applies to all transfers made after June 8, 1997.

#### G. Single Members LLCs.

1. Under the check-the-box regulations, a single-member LLC that does not elect to be treated as a corporation is considered a disregarded entity for federal tax purposes (Treas. Reg. § 301.7701-2(b)(1)(ii)).
2. A disregarded entity's property and activities are treated in the same manner as those of a sole proprietorship—that is, as if they belonged to the owner of the entity.
3. In *Pierre v. Commissioner*, 13 T.C. No. 2 (2009), the taxpayer transferred interests in a single member LLC that she had formed to two trusts for the benefit of her children. The question before the court was whether the interests being transferred were transfers of LLC interests (subject to valuation discounts) or a transfer of a proportionate share of the assets owned by the LLC.
  - a. The Tax Court said that to conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court.
  - b. The Court concluded that transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.
4. In a second decision, *Pierre v. Commissioner*, TC Memo 2010-106, the Tax Court applied the step transaction doctrine to the gift and sale transactions in the case and slightly reduced the lack-of-control discount from 10% to 8%, but sustained a 30% lack of control discount, for a combined 35.6% discount.

#### H. Multi-Party Disregarded Entities.

1. In some cases, a client will form an entity, such as a limited partnership with multiple owners, but the owners are disregarded for income tax purposes, resulting in a disregarded entity.

2. In Rev. Rul. 2004-77, the IRS concluded that, if an eligible entity has two owners under local law, but one of the owners is, for federal tax purposes, disregarded as an entity separate from the other owner of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.
3. Consider a structure where client forms a single member LLC as the general partner of a limited partnership and also holds the limited partnership interests individually. Under Rev. Rul. 2004-77, this is a disregarded entity for income tax purposes.
4. The client later gifts or transfers the limited partnership interests to a grantor trust. For income tax purposes, the limited partnership remains a disregarded entity, since the single member LLC and the grantor trust are deemed to be owned by the client/grantor.
5. This structure may be helpful in preserving income tax attributes for the client while facilitating wealth transfer planning opportunities.

## IX. IRS CHALLENGES TO FAMILY LIMITED PARTNERSHIPS AND LLCs

- A. IRS Initiates Attacks On Family Limited Partnerships. In 1997, the Service initiated its attack on FLPs and LLCs through a series of Technical Advice Memoranda. *See, e.g.,* TAM 9842003 (July 2, 1998); TAM 9736004 (June 6, 1997); TAM 9735003 (May 8, 1997); TAM 9730004 (Apr. 3, 1997); TAM 9725002 (Mar. 3, 1997); TAM 9723009 (Feb. 24, 1997); TAM 9719006 (Jan. 14, 1997). The TAMs involved situations where (a) liquid assets, such as marketable securities, were transferred to a limited partnership or LLC; (b) the transferor was elderly; and (c) the transfer was carried out by third parties (such as children) as agents under a power of attorney or as trustees.
- B. The Service's Arguments. The Service advanced the following arguments in challenging the use and validity of FLPs, each of which will be discussed in greater detail, below:
  1. Disregarding the entity.
  2. Code § 2703.
  3. Code § 2704.
  4. Gift upon formation.
  5. Code § 2036.
  6. Gift of a future interest.
  7. Indirect gifts.
- C. Disregarding the Entity.
  1. The Service's Argument. The Service claimed that the formation of an FLP should be treated as a single testamentary transaction and therefore disregarded for transfer tax purposes. The Service cites the Tax Court case of *Estate of Murphy v. Commissioner*, in which the court held that a minority interest discount was not applicable to stock of a closely held corporation owned by the decedent although the decedent owned slightly less than 50% of the stock at her death. T.C. Memo 1990-472. At the urging of her accountant, Mrs. Murphy had transferred a 1.76% interest to her children 18 days before her death specifically to reduce her interest below 50%.
  2. *Church v. United States* 268 F.3<sup>rd</sup> 1063 (5<sup>th</sup> Cir. 2001), *aff'd per curiam* 85 AFTR2d 2000-804 (W.D. Tex. 2000) suggests that threshold for a validly formed partnership is extremely low. The taxpayer and her two children formed a limited partnership two days before her death.
    - a. The corporate general partner had not been formed prior to her death, the limited partnership certificate had not been filed with the state, and assets had not been validly



transferred to the partnership. Mrs. Church transferred \$1.5 million of assets (real estate and marketable securities) to the partnership in exchange for a 62% interest; her partnership interests were valued at \$617,600.

- b. The Service argued that Church did not effectively convey the securities to the partnership before she died. Alternatively, the Service also argued that Church made a taxable gift when forming the partnership, represented by the difference between the value of the assets she contributed and the value of the partnership interest she received.
  - c. The District Court ruled in the estate's favor, rejecting the government's arguments. As to the securities, the court found that Church did not hold legal title; she had an equitable beneficial interest because legal title was held by a brokerage house. Further, the court found that Church clearly expressed her intent to relinquish her beneficial interest when she executed the partnership agreement. On the gift issue, Judge Garcia wrote that the government's argument "confuses the market value of the assignee interest passing at death with the value of the Partnership interest Mrs. Church received in return for her contribution. The two interests are not comparable. More importantly, the Government ignores the fact that this was a pro rata partnership that did not confer a financial benefit on, or increase the wealth of, any partner." Furthermore, the court found that there was no donee and no gratuitous transfer. Judge Garcia also held that the partnership was not a sham as the government contended, finding that the partnership had bona fide business purposes and was not formed to reduce estate taxes. The court noted that Church did not have the unilateral right to amend or revoke the partnership agreement and that the partners had no express or implied agreement that Church could continue to use or possess partnership property within the meaning of Code § 2036.
3. *See also, Kerr v. Commissioner*, 292 F.3d 490 (5<sup>th</sup> Cir. 2002), *aff'g* 113 T.C. 443 (1999), *Strangi I*, 115 T.C. 35 (2000), *Jones v. Commissioner*, 116 T.C. 11 (2001), and *Knight v. Commissioner*, 115 T.C. 36 (2000).

D. Code § 2703.

1. Statutory Language. Under Code § 2703(a), for purposes of estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to any right or restriction relating to the property. Code § 2703(b) states that a right or restriction will not be disregarded if the following requirements are met:
  - a. The right or restriction is a bona fide business arrangement;
  - b. The right or restriction is not a device to transfer the property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and
  - c. At the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arms-length transaction.
2. The Service's Argument. The Service argues that the use of a partnership structure to hold assets is, in and of itself, a restriction with respect to the property and should be disregarded. The Service also argues that the exceptions to Code § 2703(b) should not apply because the use of a partnership is a "device to transfer property" for a less than full and adequate consideration.
3. *Strangi I*, 115 T.C. 35 (2000), the decedent's son-in-law, acting pursuant to a power of attorney formed a family limited partnership funded largely with marketable securities. The decedent owned a 99% limited partnership interest and 47% of the corporate general partner. The Court found that the decedent retained effective control over the partnership. Nevertheless, the Court ruled that the decedent formed a valid partnership and that Code § 2703(a)(2) did not operate to disregard the limited partnership. *See also, Church*, 268 F3d 1063 (5<sup>th</sup> Cir. 2001).

E. Code § 2704.

1. Statutory Language. Code § 2704(b) provides that an “applicable restriction” on the right of a donee to liquidate his or her interests may be disregarded for gift and estate tax purposes, thereby increasing the value of the gift or the size of the federal gross estate. An “applicable restriction” is a limitation on the ability to liquidate or dissolve the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction.
2. The Service’s Argument. The Service contended that under Code § 2704(b) any limitations on the right to liquidate the interests that were more restrictive than the state’s default rule would be disregarded.
3. *Kerr v. Commissioner*, 292 F.3d 490 (5<sup>th</sup> Cir. 2002), *aff’d* 113 T.C. 443 (1999). The Tax Court held that a couple transferred limited partnership interests, not assignee interests, to two grantor retained annuity trusts (GRATs), but that they were entitled to apply liquidity discounts in valuing those interests because Code § 2704(b) did not apply. The Fifth Circuit affirmed that the Tax Court properly held the dissolution and liquidation provisions in the partnership agreements were no more restrictive than the limitations under Texas law, and were not applicable restrictions.
4. *Harper v. Commissioner*, T.C. Memo 2000-202 (2000). The analysis employed by the Tax Court in *Kerr* was adopted by Judge Wells in *Harper*, a family limited partnership case involving marketable securities, where the decedent’s revocable trust held 99% limited partnership and her two children collectively held a 1% general partnership interest.

F. Gift Upon Formation.

1. The Service’s Argument. The Service has argued that, if valuation discounts are appropriate in valuing limited partnership interests, the value that is “lost” by the taxpayer is a deemed gift of an equivalent amount to the other partners. For example, assume a taxpayer gifts an asset having a value of \$1,000,000 to an FLP. The 99% limited partnership interest is discounted by 35%. The Service argues that the reduction in value of the taxpayer’s 99% limited partnership interest, as compared to its aliquot share of the underlying assets, constitutes a gift of \$350,000, an amount equal to the amount of the reduction. *See, e.g., Estate of Trenchard v. Commissioner*, T.C. Memo 1995-232 (1995) and *Estate of Bosca v. Commissioner*, T.C. Memo 1998-251 (1998).
2. Taxpayer Arguments.
  - a. The gift tax is an excise tax on the privilege of *transferring* property; it is an excise tax on the *transfer*, not on the subject of the gift. Treas. Reg. §§ 25.2511-2 and 25.2511-1(h)(1). Before the gift tax can be assessed, a transfer and a transferee must exist. On creation of a partnership, no person becomes a transferee, and without a transferee, there is no basis for the assessment of the gift tax.
  - b. Value appears and disappears and that fact does not mean that a transfer has occurred from one person to another. If A, B, and C each contribute \$100 to form a corporation and receive 1 share of stock in return, the value of A’s stock is presumably valued at less than \$100 because A does not possess the right to liquidate the corporation and receive a return of his investment. This diminution in value does not mean that A has made a taxable gift to his children, B and C. There is no transfer to B and C. B and C’s shares are also valued at less than \$100.
3. The Service has been largely unsuccessful with respect to the gift upon formation argument. *See, e.g., Jones v. Commissioner*, 116 T.C. 11 (2001), *Church v. United States* 268 F.3<sup>rd</sup> 1063 (5<sup>th</sup> Cir. 2001), *Kerr v. Commissioner*, 292 F.3d 490 (5<sup>th</sup> Cir. 2002), *Shepherd*, 115 TC 376, *aff’d* 283 F.3d 1258 (11<sup>th</sup> Cir. 2002) and *Strangi I*, 115 T.C. 35 (2000).

X. CODE § 2036 AND IRS VICTORIES.

A. Statutory Provisions. Code § 2036(a) provides as follows:

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death –

1. the possession or enjoyment of, or the right to the income from the property, or
2. the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

B. The Service's Argument Under Code § 2036(a)(1).

1. The Service has been most successful under Code § 2036(a)(1) involving the retention of "possession or enjoyment" of property. Retention of possession or enjoyment may take place by express or implied understanding, and need not be under a legally binding agreement.
2. The Service has been successful in cases where the following "bad facts" were present:
  - a. Most of a decedent's assets were transferred to the partnership, without sufficient assets remaining outside of the partnership for the decedent's needs.
  - b. The decedent's continued occupancy of a residence transferred to the partnership without contemporaneous payment of rent.
  - c. Commingling of personal and partnership assets.
  - d. Disproportionate distributions.
  - e. Use of partnership funds for personal expenses.
  - f. Timing of distributions, where partnership distributions were based on the decedent's personal needs.

C. The Service's Argument Under Code § 2036(a)(2).

1. In *Strangi*, the Service argued under Code § 2036(a)(2) that the decedent retained a right in conjunction with other persons to designate the persons who will enjoy the property or the income therefrom.
2. Taxpayers and their counsel, up to that time, relied on the decision of the U.S. Supreme Court in *Byrum* to shield them from Code § 2036(a)(2).

D. The Exception for a "Bona Fide Sale for an Adequate and Full Consideration."

1. Taxpayers have had mixed results in arguing that the exception for a "bona fide sale for an adequate and full consideration" should shield them from the application of Code § 2036.
2. The cases that have considered the bona fide sale exception are discussed in greater detail, *infra*.

E. *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242.

1. The decedent formed a separate limited partnership with each of her three children and transferred a substantial percentage of her interests in the limited partnerships to family members, using the

annual exclusion to avoid taxable gifts. Afterwards, she deposited income from the partnerships in her personal account, in which she deposited income from other sources, and used the account to pay her personal expenses as well as partnership expenses.

2. The Service once again argued that the limited partnership interests should be disregarded based on its Code § 2703 analysis. However, the Tax Court decided that the transferred interests should be included in the decedent's estate under Code §§ 2036(a) and 2038 and decided the case in favor of the Service without invoking Code § 2703.
3. The Court found that there was an implied agreement that the decedent would retain the economic benefits of the property and, therefore, because the decedent had transferred property and retained the right to enjoyment of the income from the property until her death, the transferred limited partnership interests were includible in her estate under Code § 2036(a)(1). The *Schauerhamer* case points out the importance of complying with all the formalities under state law and the terms of the operative agreements to ensure that the entity will be recognized under state law and the property transferred to the entity will not be includible in the transferor's estate under Code §§ 2036(a) and 2038.

F. *Estate of Reichardt v. Commissioner*, 114 T.C. 9 (2000).

1. The Tax Court held that property transferred by an individual to a family limited partnership was includible in his gross estate because he retained possession and enjoyment of it, and the right to its income.
2. In June 1993, shortly after having been diagnosed with terminal cancer, Charles formed a revocable living trust and a family limited partnership. He appointed himself and his children as co-trustees and authorized each trustee to act on behalf of the trust. The trust was the partnership's only general partner. Charles transferred all of his property (except for his car, personal effects, and a small amount of cash) to the partnership, including the property in which he had a life interest. He signed deeds individually and on behalf of his wife's estate transferring property to the trust and then signed deeds as trustee transferring the property to the partnership. He deposited over \$20,000 of partnership funds to his personal checking accounts. He lived in one property before and after he transferred it to the trust and partnership. No rent was paid to the trust or partnership for use of the residence. Charles gave each of his two children a 30.4% interest in the partnership on October 22, 1993. He died on August 21, 1994 and his estate did not include any of the assets transferred to the trust and partnership. It did include his 34.46% limited partnership interest and his 1% general partnership interest.
3. The Service determined that the assets transferred to the partnership should have been included in his estate.
4. The Tax Court noted that, for purposes of Code § 2036, a transferor retains the enjoyment of property if there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable. The Tax Court found that Charles did not curtail his enjoyment of the transferred property after he formed the partnership. It said that nothing changed except legal title. Charles managed the trust which managed the partnership. He was the only trustee to sign the articles of limited partnership, the deeds, the transfer of lien, and any document which could be executed by one trustee on behalf of the trust. He was the only trustee to open brokerage accounts or sign partnership checks. Furthermore, the Tax Court found that Charles commingled partnership and personal funds. He deposited some partnership income in his personal account and he used the partnership's checking account as his personal account. He lived at the same property without paying rent before or after he transferred it to the trust and to the partnership.
5. The estate maintained that Charles' fiduciary duties as a general partner and trustee precluded him from retaining enjoyment of the assets. The Tax Court disagreed. It said that these duties did not deter Charles from continuing to possess and enjoy the house in which he lived or the other assets he conveyed to the partnership. The court also stressed that the children, as co-trustees, did nothing to preclude him from doing so. This suggested to the court that Charles and his children

had an implied agreement to allow him to continue to enjoy partnership property for life. The estate also argued that Charles received full and adequate consideration for the transferred property. The court disagreed, finding that the children gave nothing to Charles or the partnership when he transferred property to the trust.

G. *Harper v. Commissioner*, T.C. Memo 2002-121 (2002).

1. The taxpayer formed a family limited partnership. However, the taxpayer failed to observe the formalities of the partnership, commingled funds, etc.
2. The Court reviewed four missteps by the taxpayer: (1) commingling of funds, (2) the delay in transferring assets to the FLP, (3) a history of disproportionate partnership distributions, and (4) the testamentary characteristics of the arrangement. The Court concluded that Code § 2036(a) applied and that all discounts should be disallowed.
3. The Tax Court's view of these cases is instructive: "Hence we are again met with an example of indifference by those involved toward the formal structure of the partnership arrangement and, as a corollary, towards the degree of separation that the Agreement facially purports to establish ... we find equally compelling indicia of an implied understanding or agreement that the partnership arrangement would not curtail decedent's ability to enjoy the economic benefit of assets contributed to HFLP ... decedent did not divest himself economically of the contributed assets ... We additionally take note of decedent's advanced age, serious health conditions and experience as an attorney."

H. *Estate of Abraham v. Commissioner*, T.C. Memo. 2004-39 (Feb. 18, 2004).

1. The decedent, received three significant properties from the estate of her deceased husband. The decedent's children, her guardians and guardians ad litem entered into a court-approved plan to rearrange the decedent's financial affairs to reduce estate taxes. The plan required that the three properties be transferred to three family limited partnerships, each having a corporate general partner the stock of which would be owned by a trust for the decedent. The children were not to receive partnership income until the general partner had set aside sufficient sum to pay for the partnership's administration and the support of the decedent. The corporate presidents (the decedent's guardians ad litem), ran the partnerships, acting in a fiduciary capacity for the decedent, and they had complete discretion to determine how much money decedent needed from the partnerships to meet her needs. The decedent initially held a 98% limited partnership interest in two of the partnerships, the corporate general partners each held a 1% interest, and one of the decedent's daughters each held a one-percent interest. The decedent initially held a 99% limited partnership interest in the other partnership, and the corporation held the remaining 1%. The decedent later gave 30% limited partnerships to three of her children, two in exchange for cash transfers and the third in exchange for the settlement of certain claims.
2. The Service stated that the value of the properties was includible in the decedent's gross estate under Code § 2036(a), because the decedent had retained the lifetime income and beneficial enjoyment of those assets. The court stated that the decedent continued to enjoy the right to support and maintenance from all the income of the partnerships, because the decree that authorized the creation of the partnerships stated that the decedent's needs for support were contemplated first from the partnership income, and only thereafter, could the children receive their proportionate shares of income from the partnerships. The decedent's support needs were actually treated as an obligation of the partnerships. The court also noted that one of the decedent's children admitted the existence of a pre-arrangement to maintain the status quo with respect to her mother's financial situation.

I. *Estate of Hillgren v. Commissioner*, T.C. Memo. 2004-46.

1. The decedent became the limited partner of a family partnership. The decedent retained a 99.95% capital interest in the partnership and a 75% profits interest, and she gave her brother, Marc, the remaining interests as general partner. The decedent contributed seven properties to the partnership, though she did not actually change the title to the properties or formally assign to the

partnership the leases on the properties for five months. The agreement allowed the decedent's brother to act for the partnership without disclosing the existence of the partnership, and he did, in fact, do so. The partnership was "designed generally to be invisible to the public and to persons with whom the decedent and [Marc] Hillgren did business." The partnership agreement stated that the partnership need not have a separate bank account, and that it could use the accounts of the decedent's revocable trust and proprietorship. Initially, the partnership records included among its assets the decedent's residence, and the partnership paid the mortgage and property taxes on that residence. An adjusted journal entry posted after the decedent's death removed the residence and related expenses from the partnership's books. There were no minutes of meetings of the partners and the certificate of limited partnership was not filed with the Secretary of State until nearly two years after the decedent's death. The decedent's brother, as the general partner, had sole discretion regarding partnership distributions, and during the five months that the partnership existed during the decedent's lifetime, all distributions were made to or for the benefit of the decedent; none were made to the brother. The distributions were made in amounts to enable the decedent to pay her living expenses, and she was dependent on the partnership cashflow to cover those expenses. The partnership also paid the costs of the decedent's estate, including estate tax installments. The partnership assets were managed by a corporation that had as its sole purpose managing properties owned by various entities controlled by the decedent's family. The same person managed the properties before and after the formation of the partnership. The decedent and her brother did enter into a business loan agreement covering four of the seven properties held by the partnership. The agreement was a complex document that included a contract for services provided by decedent's brother, who facilitated forbearance and extensions of other loans, an agreement for the brother's personal guarantee of certain loans, an agreement extending a \$1 million line of credit to the decedent, and a security agreement encumbering three properties. The business loan agreement gave the brother authority, for 29 years, to determine whether to sell any of four properties subject to the agreement, and granted him an irrevocable power of attorney for duration of her ownership of properties. The decedent's estate reported the decedent's 99.5% partnership interest at \$2,266,000, based on an independent appraisal that claimed discounts for lack of control and marketability.

2. The Tax Court agreed with the Service that the value of the partnership assets should be included in the decedent's gross estate under Code § 2036(a), with no discounts for the existence of the partnership itself. In particular, the court noted that: (a) the proximity of the creation of the partnership to the death of the decedent (five months), and the fact that the decedent had earlier attempted suicide and did, in fact, die by suicide, suggests that the transaction was testamentary in nature; (b) the management of the assets remained the same both before and after creating the partnership, suggesting an agreement to retain the beneficial enjoyment of those assets; (c) the argument that the partnership was created as a premarital asset protection device fails, because the decedent broke up with her boyfriend and apparent marriage candidate before the creation of the partnership [The court also noted that the estate made "inconsistent representations during discovery and during trial" regarding whether the boyfriend was even aware of the partnership.]; (d) there was no solid evidence that the decedent and her brother negotiated at arm's length over the terms of the partnership or the contributions of services to be made by the brother; (e) the decedent's brother was both general partner of the partnership and trustee of the decedent's revocable trust, which held the decedent's interest in the partnership; (f) the brother ignored the terms of the partnership agreement when "it suited him"; (g) funds were commingled; (h) the partnership form was ignored frequently; (i) the decedent's psychiatrist testified that the decedent had not expected that the partnership would change her relationship with her brother or her role in the management of the partnership assets; (j) the decedent had planned to transfer her residence to the partnership; (k) the decedent received all of the partnership income distributions. The court held, however, that the business loan agreement was a bona fide contract that would be taken into account by any buyer of the four properties to which it related. The business loan agreement, the court stated, restricted the control over those properties and reduced their marketability, justifying discounts of 55% for one property, 35 to 40% for three others, and an additional five percent for lack of voting rights.

- J. *Estate of Virginia A. Bigelow*, TC Memo 2005-65. The Tax Court held that rental real estate transferred from a decedent's revocable trust to a family limited partnership (FLP) had to be included in her gross

estate under Code § 2036(a) because she had retained, for her life, the right to the property's rental income and its economic benefit under an implied agreement that the court found to have existed.

K. *Estate of Strangi v. Commissioner*, 417 F.3<sup>rd</sup> 479 (5<sup>th</sup> Cir. 2005); *aff'g* T.C. Memo. 2003-145 (May 20, 2003), *on rem'd from Gulig v. Commissioner*, 293 F.3<sup>rd</sup> 279 (5<sup>th</sup> Cir., 2002), *aff'g in part, rev'g in part, Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000).

1. Decedent's son-in-law acting under a durable power of attorney, created a Texas family limited partnership and transferred to it most of the decedent's personal and investment assets. Decedent received a 99% limited partnership interest and 47% of the stock of the corporate general partner. Decedent's family owned 52% of the rest of the stock of the general partner, and an unrelated charity owned one percent of the stock. Decedent died two months later.
2. The Tax Court initially held that: (a) the creation of the partnership was not a taxable gift; (b) the partnership had economic substance; (c) the terms of the partnership agreement were not restrictions on the transfer the underlying assets, under Code § 2703(a)(2); and (d) the Service claim that the decedent had retained control over the transferred partnership assets was not raised in a timely manner. The Fifth Circuit affirmed the Tax Court on the substantive issues, but stated that the Service could argue the application of Code § 2036(a), because its motion was made early enough to prevent prejudice to the taxpayer.
3. On remand, the Tax Court held that the partnership assets transferred by the decedent were includible in his gross estate, because he had retained their beneficial enjoyment, under Code § 2036(a)(1). The court noted particularly that: (a) the decedent was in very poor health when he established the partnership; (b) the partnership paid many of the decedent's personal expenses, including personal in-home health care, surgery for the decedent's care-giver, funeral expenses, estate administration expenses, and related debts of the decedent's estate, and a specific bequest to the decedent's sister (the court was not swayed by the partnership having treated these expenses as advances and having made corresponding distributions to the general partner, because the decedent's 99.43% interest meant that no significant distributions were actually made to anyone else); (c) the decedent continued to live in his residence after transferring it to the partnership and the decedent only accrued rent that was not actually paid for more than two years; (d) the decedent's 99.43% interest made the arrangement seem testamentary, rather than a true joint enterprise; and (e) the documents were forms provided by a private group, with little, if any, input from other family members.
4. The Tax Court also stated that the partnership assets could be included in the decedent's gross estate under Code § 2036(a)(2), because he controlled their beneficial enjoyment. The court noted that the general partner could (i) unilaterally determine partnership distributions, and (ii) could, acting with the other partners, terminate the partnership and cause its assets to be distributed. The court noted that Regulations § 20.2036-1(b)(3) taxes a decedent with respect to powers that are exercisable only with the consent of others.
5. The Tax Court also rejected the estate's reliance on *United States v. Byrum*, 408 U.S. 125 (1972), because: (a) the control was vested in someone who was the decedent's son-in-law, his attorney, and his attorney-in-fact; (b) the partnership held primarily investment assets, whereas the corporations in *Byrum* were operating businesses whose ability to distribute dividends was subject to business exigencies not relevant to the Strangi partnership; (c) the other stockholders in *Byrum* were largely unrelated to the decedent; (d) there was an independent trustee in *Byrum*, who could decline to distribute to the beneficiaries any amounts distributed by the *Byrum* corporations; and (e) the fiduciary duties held by directors and shareholders in *Byrum* were not relevant in Strangi, because the few holders of other interests were unlikely to enforce them.
6. The Fifth Circuit held that the Tax Court properly concluded that Code § 2036 required a decedent's estate to include assets transferred by him during his life to a family limited partnership (FLP). The Fifth Circuit concluded that the record supported the Tax Court's conclusion that Strangi and the other shareholders of Stranco (i.e., the Strangi children) had an implicit agreement by which Strangi would retain the enjoyment of his property after the transfer to SFLP because:

- a. SFLP distributed over \$100,000 from '94 to '96 to pay for funeral expenses, estate administration expenses, specific bequests and various personal debts that Strangi had incurred. The Fifth Circuit said that these repeated distributions provide strong circumstantial evidence of an understanding between Strangi and his children that "partnership" assets would be used to meet Strangi's expenses.
  - b. Strangi continued to live in his residence after its transfer to SFLP. The estate responded by noting that SFLP charged Strangi rent on the home. The Fifth Circuit pointed out that although the rent charge was recorded in SFLP's books in '94, the estate made no actual payment until '97. The Appeals Court said that, even assuming that the late rent payment was not a belated attempt to recast Strangi's use of the house, such a deferral, in itself, provides a substantial economic benefit. Thus, the Tax Court did not err in considering Strangi's continued occupancy of his home as evidence of an implied agreement.
  - c. Strangi lacked liquid assets after the transfer to pay his living expenses.
7. As for the second argument, IRS conceded that the "adequate and full consideration" requirement was satisfied because Strangi received a proportional interest in the partnership in exchange for the assets he transferred to it and partnership formalities were followed. However, it argued that the transfer was not a bona fide sale and the Fifth Circuit agreed. The Appeals Court said that a sale is bona fide if, as an objective matter, it serves a substantial business or other non-tax purpose. In this regard, the Tax Court found that Strangi's transfer of assets to SFLP lacked a substantial non-tax purpose. While the estate proffered five discrete non-tax rationales for Strangi's transfer of assets to SFLP, the Tax Court rejected each of them as factually implausible. The Fifth Circuit held that these findings were not clearly erroneous. Thus, it held that the bona fide sale exception did not apply.
  8. Unfortunately for practitioners, the Fifth Circuit, having resolved the case on the Code § 2036(a)(1) issue, did not answer the Code § 2036(a)(2) issue.

L. *Turner v. United States*, 382 F3d. 382 (3<sup>rd</sup> Cir. 2004).

1. The Third Circuit Court of Appeals held that the estate of an individual who transferred \$2.8 million in securities and other assets to two family limited partnerships in exchange for pro-rata partnership interests had to include the full date of death value of the transferred assets under Code § 2036.
2. In 1993, Theodore Thompson, his daughter Betsy T. Turner, and her husband George Turner, formed the Turner Partnership and Turner Corporation. Mr. Thompson contributed \$1,286,000 in securities, along with notes receivable from Betsy's children totaling \$125,000, in exchange for a 95.4% limited partnership interest in the Turner Partnership. George contributed \$1,000 in cash and real property valued at \$49,000 in exchange for a 3.54% limited partnership interest. Turner Corporation, the sole general partner, held the remaining 1.06% interest. Shares in Turner Corporation were issued to Mr. Thompson (490 shares or 49%), Betsy (245 shares or 24.5%), George (245 shares or 24.5%), and an unrelated tax-exempt entity (20 shares or 2%). Mr. Thompson and his son Robert Thompson formed the Thompson Partnership on April 30, 1993, and the Thompson Corporation on April 21, 1993. Mr. Thompson contributed \$1,118,500 in securities, along with notes totaling \$293,000, in exchange for a 62.27% limited partnership interest. Robert contributed mutual funds worth \$372,000, and a ranch property appraised at \$460,000 in exchange for a 36.72% limited partnership interest. Thompson Corporation, as general partner, held the remaining 1.01% interest. Mr. Thompson and Robert each held 49% of Thompson Corporation and an unrelated third party held the remaining 2% interest. As of July 1993, Mr. Thompson, then age 95, had transferred \$2.8 million in assets—\$2.5 million in the form of marketable securities—to the Turner and Thompson Partnerships. He retained \$153,000 in personal assets, and received an annual income of \$14,000 from two annuities and Social Security. At the time of transfer, he had annual expenses of \$57,202, and an actuarial life expectancy of 4.1 years.



3. The Turner Partnership assets consisted primarily of marketable securities contributed by Mr. Thompson, which the partnership continued to hold in his brokerage account with minimal post-transfer trading. The Turner Partnership engaged in several business transactions, although none produced economic gains. The Turner Partnership also made loans to members of the Turner family. Although the partnership formally charged family members interest on these loans, interest payments were often late or not paid at all, and loans were frequently reamortized. But the partnership never pursued enforcement action against any of its debtors nor made loans to anyone outside the Turner family. Like the Turner Partnership, most of the Thompson Partnership assets consisted of marketable securities contributed by Mr. Thompson and Robert Thompson and there was little post-transfer trading. In 1993, each partnership made cash distributions of \$40,000 to Mr. Thompson which he used to provide holiday gifts to family members. In 1995, the Thompson and Turner Partnerships made cash distributions to him of \$45,500 and \$45,220 respectively. During the same time period, he made gifts of interests in both partnerships to individual family members. In March 1995, the Thompson Partnership distributed \$12,500 to Mr. Thompson to pay for some personal expenses.
4. Mr. Thompson died on May 15, 1995. On May 27, 1995, the Turner and Thompson Partnerships respectively sold \$347,000 and \$350,000 in securities to partially fund bequests in his will and pay his estate taxes. Mr. Thompson's estate tax return reported that he held a 87.65% interest in the Turner Partnership and a 54.12% interest in the Thompson Partnership valued at \$875,811 and \$837,691 respectively, and that his shares in Turner Corporation and Thompson Corporation were worth \$5,190 and \$7,888 respectively. The estate calculated these values by applying a 40% discount rate to the net asset value of the partnerships and corporations for lack of control and marketability.
5. In January 1999, the Service issued a notice of deficiency in the amount of \$707,054, adjusting the taxable estate from \$1,761,219 to \$3,203,506 after disallowing the claimed discounts. The estate went to Tax Court. In an amended answer to the estate's petition, the Service contended that the full fair market value of the assets transferred by Mr. Thompson to the partnerships should be returned to his gross estate under Code § 2036(a) because he retained control and enjoyment over the transferred assets during his lifetime.
6. The Tax Court found that the family partnerships were validly formed and properly recognized for federal estate tax purposes but nevertheless included the transferred assets in the estate under Code § 2036(a). The Tax Court found an implied agreement existed at the time of transfer that Mr. Thompson would retain lifetime enjoyment and economic benefit of the transferred assets. In support of this finding, the Court noted that both Betsy and George Turner had sought assurances from financial advisors that Mr. Thompson would be able to withdraw assets from the partnerships to make gifts to family members, and that the partnerships in fact made such distributions to him. The Tax Court also determined that the transfers did not qualify for the full and adequate consideration exception because the transactions were not motivated by legitimate business concerns. According to the Tax Court, the family partnership was a mere "recycling of value" and Mr. Thompson's receipt of a partnership interest in exchange for his testamentary assets was not full and adequate consideration.
7. After reviewing the record, the Third Circuit found no clear error in the Tax Court's finding of an implied agreement between Mr. Thompson and his family that he would continue to be the principal economic beneficiary of the contributed property, which was sufficient to trigger Code § 2036(a)(1). The Third Circuit stressed that, as the Tax Court had found, Mr. Thompson did not retain sufficient assets to support himself for the remainder of his life, as calculated at the time of transfer. It said that this fact supported the implied understanding with the children. The Third Circuit said that Mr. Thompson's *de jure* lack of control over the transferred property did not defeat the inference of an implied agreement under the circumstances of the case.
8. The Third Circuit also agreed with the Tax Court that there was no transfer for consideration within the meaning of Code § 2036(a). The Third Circuit stressed that neither partnership had engaged in any valid, functioning business enterprise. Although the partnerships did conduct some economic activity, these transactions did not rise to the level of legitimate business operations.

9. The Third Circuit also emphasized that the form of the transferred assets—predominately marketable securities—was significant to its holding. Other than favorable estate tax treatment resulting from the change in form, the Court said that it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in a family limited partnership with no ongoing business operations. In short, the Third Circuit said that where the transferee partnership does not operate a legitimate business, and the record demonstrates that the valuation discount provides the sole benefit for converting liquid, marketable assets into illiquid partnership interests, there is no transfer for consideration within the meaning of Code § 2036(a).
  10. The Third Circuit also concluded that there was no bona fide sale within the meaning of Code § 2036 because there was no discernible purpose or benefit for the transfer other than estate tax savings.
  11. The Court implied that the case at hand was different from *Kimbell*, where the Fifth Circuit found that there was both full and adequate consideration and a bona fide sale for a transfer of assets to a family limited partnership where the transferred assets were working oil and gas interests and the transfer was motivated by a desire to achieve centralized management and protection from personal environmental liabilities.
- M. *Estate of Korby*. In *Estate of Korby v. Commissioner*, 2006 U.S. App. LEXIS 30087 (Dec. 8, 2006), the Eighth Circuit affirmed the Tax Court’s holding that the value of an FLP was included in the decedents’ estates under Code § 2036(a)(1).
1. Husband and wife funded an FLP with marketable securities worth roughly \$1,850,000 in return for a 98% limited partnership interest, which they distributed equally to irrevocable trusts for the benefit of their four sons. These assets represented almost all of the couple’s assets, except for their home, their right to receive social security checks, and various other assets which they retained in a living trust. When the couple died (within months of each other), the Service took the position that the full value of the FLP assets was includible in the couple’s estates, and a deficiency of approximately \$2.1 million was assessed.
  2. As one would expect, the Tax Court agreed with the Service, and the Eighth Circuit affirmed, based on the following factors:
    - a. Despite the couple’s increasing expenses (due to medical reasons), they retained only their home and relatively few other assets. The FLP paid some of the couple’s living expenses directly, and made significant payments to the living trust, which paid the balance of the expenses. Neither the Tax Court nor the Eighth Circuit bought the estates’ argument that payments to the living trust were “management fees.”
    - b. The bona fide sale for full consideration exception to Code § 2036 did not apply. In affirming this conclusion of the Tax Court, the Eighth Circuit made the following statements (citing other Circuits):
      - i. A transfer is typically not a bona fide sale when the taxpayer stands on both sides of the transaction.
      - ii. The transaction must be made in good faith, requiring an examination as to whether there is potential benefit other than the estate tax advantages that might result from holding assets in a partnership.
      - iii. If there is no discernible purpose or benefit of the transfer other than estate tax savings, the sale is not “bona fide” within the meaning of Code § 2036.
- N. *Estate of Erickson*. In *Estate of Hilda E. Erickson et al. v. Commissioner*, T.C. Memo 2007-107 (April 30, 2007), the Tax Court held that (1) the decedent had an implied agreement with the partners of a family limited partnership (“FLP”) that decedent could retain the right to possess or enjoy assets transferred to the partnership, and (2) the transfer of assets by decedent (acting through the decedent’s agent under a power

of attorney) to the partnership in exchange for a pro rata limited partnership interest was not a bona fide sale.

1. The decedent in *Erickson* suffered from Alzheimer's. Four months prior to decedent's death, the decedent's two daughters, as general partners, and the decedent (acting through one of her daughters as the decedent's attorney-in-fact under a durable power of attorney), the decedent's credit shelter trust (with the decedent's daughter who was her attorney-in-fact signing as a trustee) and the decedent's son-in-law, as limited partners, executed a limited partnership agreement. The partners delayed in funding the partnership. Shortly before the decedent's death and with the decedent's health rapidly failing, her attorney-in-fact daughter rushed to fund the partnership with most of the decedent's liquid assets.
2. Decedent (acting through her daughter as her attorney-in-fact) made substantial gifts to her grandchildren of limited partnership interests only a few days before the decedent's death. Following the decedent's death, the partnership (1) purchased the decedent's residence, (2) made loans to some of its partners, and (3) "redeemed" the limited partnership interest owned by the decedent's estate. The executor of the decedent's estate used the proceeds from the purchase by the partnership of the decedent's residence and limited partnership interest to pay the decedent's tax liabilities and administration expenses.
3. The Tax Court held that the value of the assets transferred to the partnership by the decedent's daughter, as the decedent's attorney-in-fact, were includible in the decedent's gross estate under Code § 2036(a)(1). The Tax Court reasoned that the decedent made an implied agreement with the other partners to retain possession and enjoyment of the assets transferred to the partnership. The Court noted that the possession and enjoyment of one's assets includes the assurance that the assets will be available to pay debts and expenses after death. The Court found the following facts especially troubling evidence of an implied agreement:
  - a. The partners delayed transferring assets to the partnership.
  - b. The estate needed liquid funds from the partnership to meet its liabilities.
  - c. The partnership had little practical effect during the decedent's life.
  - d. The decedent made substantial gifts of limited partnership interests a few days before her death.
  - e. The decedent had declining health from the inception of the partnership.
4. The Tax Court also held that the transfer of assets to the partnership was not a bona fide sale that would exempt it from inclusion under Code § 2036(a)(1). Although the Court noted that the decedent received a pro rata partnership interest in exchange for the transfer of assets, it held that the estate failed to show that the partnership was formed for a legitimate and significant nontax reason. The estate offered the testimony of both daughters to demonstrate the various non-tax purposes for the partnership (creditor protection, centralized management, facilitating gift giving, etc.).
5. However, the Court rejected these reasons espoused by the daughters, in light of 1) the delay in funding, 2) the estate's dependence on the partnership to help pay the estate's liabilities and 3) the almost unilateral nature of establishing the partnership (one of the two daughters acted in various capacities in signing the partnership agreement).
6. As with most 2036(a)(1) cases, *Erickson* presented "bad facts" that ultimately led to estate tax inclusion. In that regard, its holding does not add anything new to the 2036(a)(1) line of cases. However, the Court's reasoning for rejecting the creditor protection benefits of the partnership merits a brief mention. The court held that "[a] creditor who sought funds from the Partnership, however, would have a significant asset base from which to recover from the Partnership, over \$2 million." Yet, the creditor protection at issue was not, as the Court suggested, for claims against the partnership (which a creditor clearly could satisfy from the partnership assets), but rather for

claims against the individual partners (which, if the partnership were structured appropriately, could not be satisfied from the underlying assets of the partnership).

O. *Estate of Gore*. As in *Erickson*, the Tax Court in *Estate of Sylvia Gore, et. al. v. Commissioner*, T.C. Memo 2007-169 (June 27, 2007) rejected a poorly funded and administered FLP structure and included the assets transferred by the decedent to the partnership in the decedent's gross estate.

1. In *Gore*, the decedent purported to withdraw assets from a marital trust established by her deceased husband and then transfer the assets to a limited partnership. The capital accounts in the partnership were then to be allocated in equal shares to the decedent's revocable trust and to irrevocable trusts for the decedent's two children.
2. Although the decedent executed an "assignment" document, the actual titling of assets was not transferred to the partnership until after the decedent's death. Moreover, the decedent continued to receive interest and dividend income from the assets purportedly assigned to the partnership.
3. The Court held that, under applicable state law, the decedent had effectively withdrawn assets from the marital trust based on the execution of the assignment document. However, the Court held that the decedent had not effectively transferred to the partnership the assets that she had withdrawn from the marital trust and, therefore, included the marital trust assets under Code §§ 2033 and 2036(a). The Court reasoned that based on the retention of powers and interest in these assets, the decedent continued to exercise ownership, dominion, and control over the marital trust assets until her date of death. The Court pointed to an unbelievable lack of attention to the formalities in funding and administering the partnership and rejected partnership accounting records prepared by the decedent's C.P.A. long after the fact that attempted to "properly" characterize the activities surrounding the partnership.

P. *Estate of Bigelow*. Similarly, in *Estate of Bigelow v. Commissioner*, 2007 U.S. App. LEXIS 22030 (September 14, 2007), the Ninth Circuit affirmed the Tax Court's holding that real property transferred to an FLP was includable in the gross estate of the decedent/transferor (the "decedent"), because an implied agreement existed between the decedent and her children that the decedent would retain income and economic enjoyment from the transferred asset.

1. In affirming the Tax Court, the Ninth Circuit also held that the parenthetical "bona fide sale for adequate and full consideration" exception in Code § 2036(a) did not apply.
2. In *Bigelow*, the decedent created a revocable trust (the "trust") and transferred her interest in her principal residence to the trust. The decedent and her son (who also acted as her attorney-in-fact) were the trustees of the trust. The trust then exchanged the residence for rental property. In order to repay two existing mortgages on the residence, the trust obtained a loan secured by the rental property (the "loan"). The trust also obtained a line of credit (the "line of credit") secured by the rental property. The line of credit subsequently was drawn down by the trust, in part to make cash gifts to the decedent's children and grandchildren.
3. The trust then contributed the rental property to an FLP; however, the \$450,000 in loan/line of credit liabilities were not transferred to the FLP and remained liabilities of the trust, for which the decedent was personally liable. Although the partnership agreement did provide that the transferred rental property would be encumbered by the loan and line of credit, the decedent agreed to hold the partnership harmless for these obligations.
4. Despite decedent's personal obligation to make the loan payments, the partnership made each payment (the trust made payments toward the line of credit). The decedent's capital account, however, was not reduced to reflect these payments until after her death, and at that time, the account was reduced only to reflect the extent to which the payments were applied to loan principal, even though most of the payments (especially in the beginning) were applied to interest.
5. The FLP also paid some of the decedent's living expenses, and there were forty transfers of funds between the trust and the FLP within a 28 month period. Furthermore, before creation of the FLP, the decedent's monthly cash flow was \$950. After creation of the FLP, the decedent had a monthly

shortfall of \$1,200. This shortfall eventually grew to \$4,800 per month after the decedent's long-term care insurance expired.

6. Not surprisingly, the Ninth Circuit held that the decedent maintained cognizable economic benefit from the property she transferred to the FLP, because she and her children maintained an implied agreement that she would have access to income from the property. The court based its conclusion on the following bad facts:
  - a. When the decedent transferred the rental property to the FLP, the liabilities associated with the property (i.e., the loan and the credit line), were not transferred;
  - b. The FLP made payments on the loan and line of credit, but the decedent's capital account was not debited until after her death, and at that time, the payments applied to interest were not reflected;
  - c. The decedent's children knew that her long-term care insurance was set to expire. Further, the children testified that they never intended to provide for the decedent with their own money, but they were committed to her care and maintaining her standard of living. In the absence of an expectation that the FLP would supplement the decedent's monthly income as necessary, however, the transfer of her major asset to the FLP would have impoverished her; and
  - d. The partnership formalities were not observed.
7. The court then considered whether the transfer of the property to the FLP was a "bona fide sale for adequate and full consideration" within the meaning of Code § 2036(a). The decedent's estate urged the court to adopt the three pronged test for "adequate and full consideration" set forth by the Fifth Circuit in *Kimbell*, 371 F.3d 257 (5th Cir. 2004): 1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership; 2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and 3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.
8. The *Bigelow* court conceded that the inter vivos transfer of real property to an FLP that inherently reduces the fair market value of the resulting partnership interests does not "per se" disqualify the transfer from the Code § 2036(a) exception. The court, however, stated that the estate must demonstrate more than a proportional exchange and show a "genuine" pooling of assets. The court also emphasized that the question of whether adequate and full consideration exists cannot be gauged independently from the non-tax-related business purpose involved in creating the FLP (and of course, intra-family transfers automatically are subject to heightened scrutiny). Ultimately, the transaction at issue in *Bigelow* was not executed in good faith, because 1) the transfer resulted in the decedent becoming impoverished; 2) the partnership formalities were not respected; and 3) the transfer did not create a potential non-tax benefit for the decedent. The lesson here is that if a client transfers his or her primary income-producing asset to an FLP, it will be difficult, if not impossible, to argue down the road that there was a legitimate, non-tax reason underlying the transaction.

Q. Astleford, T.C. Memo 2008-128.

1. On 8/1/96, Mrs. Astleford formed the Astleford Family Limited Partnership ("AFLP") to facilitate the continued ownership, development, and management of various real estate investments and partnership interests she owned and to facilitate gifts that she intended to make to her three adult children. On the same day, Mrs. Astleford transferred to AFLP ownership of an elder care facility. Also on the same day, Mrs. Astleford gave each of her three children a 30% limited partner interest in AFLP and retained for herself a 10% general partner interest.
2. On 12/1/97, Mrs. Astleford made additional capital contributions to AFLP by transferring to AFLP a 50% interest in Pine Bend Development Co. ("Pine Bend"), a general partnership, and her

interest in 14 other real estate properties. The Pine Bend general partnership agreement did not contain any provisions relating to the transfers of interests in Pine Bend or whether such transferred interests would be general partner or assignee interests. Pine Bend owned 3,000 acres of land of which 1,187 acres consisted of agricultural farmland ("Rosemount property").

3. As a result of the additional capital contributions made on 12/1/97, Mrs. Astleford's general partner interest in AFLP increased significantly, and her children's respective limited partner interests in AFLP decreased significantly. However, also on 12/1/97, Mrs. Astleford gave to each of her three children additional limited partner interests in AFLP. These gifts had the effect of reducing Mrs. Astleford's AFLP general partner interest back down to approximately 10% and increasing the children's AFLP limited partner interests back up to approximately 30% each.
4. On audit of the 1996 and 1997 gift tax returns, the IRS increased the fair market value of a number of the properties that were transferred to AFLP and also decreased the discounts for lack of control and lack of marketability that were applied to the interests transferred.
5. There were three issues before the court: first, the value of the Rosemount property; second, whether the 50% Pine Bend interest should be valued as a general partner interest or as an assignee interest; and third, the amount of the discount for lack of control and lack of marketability that should apply to the gift of the 50% Pine Bend general partner interest and to the gift of the AFLP limited partner interests.
6. With respect to the Rosemount property, the valuation expert for Mrs. Astleford applied an absorption discount based on his opinion that a sale of the entire Rosemount property would flood the local market for farmland and would therefore reduce the per-acre price at which the Rosemount property could be sold. Believing that the Rosemount property would sell over the course of four years and would appreciate 7% each year, the expert performed a cash flow analysis using a present value discount rate of 25%.
7. The IRS's expert did not apply an absorption discount since he concluded that the entire Rosemount property likely could be sold in a single year without an absorption discount based on the fact that in 1970, the 3,000 acres of land (including the Rosemount property) had been purchased by Pine Bend in a single transaction. The IRS's expert also concluded that even if an absorption discount was appropriate, the 25% present value discount rate used by Mrs. Astleford's expert was excessive. The IRS's expert argued that the present value discount rate should track the 9.2% rate of return on equity which farmers in the area actually earned.
8. The court believed that due to the size of the Rosemount property in relation to the number of acres sold each year in the area, it was unlikely that all 1,187 acres of the Rosemount property would be sold in a single year without a price discount. However, the court also believed that the present value discount rate of 25% used by Mrs. Astleford's expert was unreasonably high because it relied on statistics relating to developers of real estate who expect greater returns given the greater risks involved in development. Since over 75% of the Rosemount property was leased to farmers, these rental payments would provide a source of future income to a prospective purchaser. The court found that given this low level of risk, a 10% rate of return would be sufficient to induce a purchase of the Rosemount property.
9. With respect to Pine Bend, the parties disputed the nature of the interest transferred by Mrs. Astleford to AFLP and therefore the appropriate amount of the discount for lack of control and lack of marketability that should apply. Because the other 50% general partner of Pine Bend did not consent to Mrs. Astleford's transfer of her general partner interest in Pine Bend to AFLP, Mrs. Astleford's expert treated the 50% Pine Bend interest transferred to AFLP as an assignee interest and applied a 5% discount. The position of Mrs. Astleford's expert was based on applicable state law that provided that a holder of an assignee interest has only a profits interest but no influence on management.
10. The court agreed with the IRS that the substance-over-form doctrine applied to treat the interest in Pine Bend that Mrs. Astleford transferred to AFLP as a general partner interest. The court based its conclusion on its finding that since Mrs. Astleford was the sole general partner of AFLP, she

was essentially in the same management position relative to the 50% Pine Bend interest whether she is to be viewed as having transferred to AFLP a Pine Bend assignee interest (and thereby retaining Pine Bend management rights) or as having transferred those management rights to AFLP as a result of the transfer of a Pine Bend general partner interest (in which case she reacquired those same management rights as sole general partner of AFLP). The court also noted that the transfer documents treated Mrs. Astleford's Pine Bend transfer as a transfer of all of her rights and interests in Pine Bend, thereby suggesting that a general partner interest—not an assignee interest—was transferred.

11. Next, the court addressed the amount of the discount for lack of control and lack of marketability that should apply (1) to the limited partnership interests in AFLP given to Mrs. Astleford's three children, and (2) to the 50% Pine Bend general partnership interest she transferred to AFLP. In determining these discounts, Mrs. Astleford's expert relied on data for real estate limited partnerships ("RELPs") while the IRS's expert relied on data for real estate investment trusts ("REITs"). The court did not believe that either the RELP data or the REIT data was superior to the other. According to the court, RELPs more closely resembled AFLP, and the RELP secondary market is not so low as to render the available RELP data unreliable. However, the court also said that the large number of REIT sales transactions tended to produce more reliable data compared to the limited number of RELP sales transactions. In addition, the court stated that the differences between REITs and AFLP may be minimized given the large number of REITs from which to choose comparables. But REITs sometimes trade at prices higher than net asset value. The court recognized that this fact does not mean that a lack of control discount is nonexistent but suggests that a REIT's share price is in part affected by two factors, one positive (the liquidity premium) and one negative (lack of control). Therefore, in analyzing REIT comparables and their trading prices, the court found it is appropriate to quantify and then to reverse out of the trading prices, any liquidity premiums that are associated with REIT comparability data. The court stated that this calculation results in a REIT discount for lack of control that can be applied to the partner interests gifted.
12. To determine the appropriate liquidity premium to apply to the REIT, the court examined the difference in average discounts in private placements of registered and unregistered stock—reasoning that the difference represents pure liquidity concerns since a public market is available to owners of registered stock but not to the owners of unregistered stock. After performing these calculations, the court applied a lack of control discount of 16.17% for the 1996 gifts and a discount of 17.47% for the 1997 gifts of AFLP by Mrs. Astleford to her children.
13. With respect to the discount for lack of marketability, the expert for Mrs. Astleford applied a discount of 15% and the IRS expert applied a discount of 21.23% for the 1996 gifts. The court, without any discussion, used the higher discount applied by the IRS expert. For the 1997 gifts, the court applied a lack of marketability discount of 22%. In valuing the 50% Pine Bend general partner interest, the IRS's expert concluded that because the Pine Bend partner interest was simply an asset of AFLP, the discounts he applied at the AFLP level obviated the need to apply an additional and separate discount at the Pine Bend level. The court disagreed and held that a 30% combined discount for lack of control and lack of marketability was appropriate. In a footnote, the court mentioned that the Tax Court has rejected multiple discounts in the context of tiered entities where the lower level interest constituted a significant portion of the parent entity's assets. However, in this case, the 50% Pine Bend interest constituted less than 16% of the net asset value of AFLP and was only one of 15 real estate investments that were held by AFLP.

R. Estate of Powell v. Commissioner, 148 T.C. No. 18 (2017).

1. Nancy Powell's son, Jeffrey Powell, acting on her behalf, transferred \$10 million in cash and securities to NHP Enterprises LP (NHP), a limited partnership, in exchange for a 99% limited partner interest. NHP had been formed two days earlier. NHP's limited partnership agreement gives him, as general partner, sole discretion to determine the amount and timing of partnership distributions. That agreement also allows for the partnership's dissolution with the written consent of all partners.
2. Nancy died seven days later, on August 15, 2008.

3. At this point, since Nancy Powell did not live in the 5<sup>th</sup> Circuit, we know the outcome. Taxpayer loses. But, here is where bad facts make bad law...
4. The IRS issued a notice of deficiency
5. The court reasoned that Nancy's ability, acting with NHP's other partners, to dissolve the partnership was a right "to designate the persons who shall possess or enjoy" the cash and securities transferred to NHP "or the income there from," within the meaning of Code § 2036(a)(2). The court further held that because Nancy's NHP interest was transferred, if at all, less than three years before her death, the value of the cash and securities transferred to NHP was includible in the value of her gross estate to the extent required by either Code § 2036(a)(2) or Code § 2035(a).
6. The court also held that neither Code § 2036(a)(2) nor Code § 2035(a) (whichever applied) required inclusion in the value of Nancy's gross estate of the full date-of-death value of the cash and securities transferred to NHP. The court determined that only the excess of that value over the value of the limited partner interest that Nancy received in return was includible in the value of her gross estate under Code § 2043(a).
7. Although the terms of each section, read in isolation, would require that result, those sections must be read in conjunction with Code § 2043(a), which complements the bona fide sale exception to the inclusionary rules provided in Code § 2035 through Code § 2038. If a transfer depletes a decedent's estate to any extent, the bona fide sale exception will generally not apply. But if the decedent receives some consideration, Code § 2043(a) limits the required inclusion to the amount by which the transfer depletes the decedent's estate.
8. Because the estate did not challenge IRS's contention that Jeffrey had no legitimate and significant nontax reason for creating NHP, the transfer of cash and securities to the partnership was "not a bona fide sale for an adequate and full consideration in money or money's worth," regardless of the value of the limited partner interest issued in exchange for those assets. Therefore, Code § 2043(a) limited the amount includible in the value of decedent's gross estate, by reason of Code § 2036(a)(2) (either alone or in conjunction with Code § 2035(a)).
9. Seven judges joined in an opinion that concurred in result only with the majority opinion. The concurring opinion rejected the majority's reasoning that Code § 2036(a) did not require "the inclusion in the value of decedent's gross estate of the full date-of-death value of the cash and securities," while admitting that the statute, "read in isolation, would require that result." The concurring opinion found no "double inclusion" problem- i.e., including the \$10 million in the her estate via Code § 2036(a)(2) and again via her partnership interest, which would be separately includible as property of the estate under Code § 2033. Rather it found that the decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the \$10 million was notionally placed. Once that \$10 million is included in her gross estate under Code § 2036(a)(2), it seemed perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the \$10 million of cash and securities. The concurring opinion concluded that there was no double-counting problem if Code § 2036(a)(2) was read as it always had been read, to disregard a "transfer with a string" and include in the decedent's estate what she held before the purported transfer-the \$10 million in cash and securities.

S. Other Cases Favorable to the IRS.

1. *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115.
2. *Estate of Rector v. Commissioner*, T.C. Memo 2007-367.
3. *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278.



4. *Estate of Jorgensen v. Commissioner*, T.C. Memo 2009-66, aff'd, 431 Fed. Appx. 544 (9th Cir. 2011).
5. *Estate of Miller v. Commissioner*, T.C. Memo 2009-119.
6. *Estate of Malkin v. Commissioner*, T.C. Memo 2009-212.
7. *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51.
8. *Estate of Beyer v. Commissioner*, T.C. Memo 2016-183.

T. IRS Appeals Settlement Guidelines.

1. In UIL No. 2031.01-00 (Oct. 20, 2006), the Service issued Appeals settlement guidelines on discounts and other key issues related to transfers of family limited partnership and family limited liability company interests ("FLP"). (The guidelines appeared in the January 31, 2007 issue of BNA's Daily Tax Report.)
2. Background. Many taxpayers have transferred passive assets (such as marketable securities and cash) to FLP's and LLCs as a means to involve younger generations in the investment decision-making process and to protect these assets from creditors and spouses of the taxpayers' chosen beneficiaries. Because of the significant valuation discounts associated with FLP interests, the Service has aggressively challenged the use of FLPs in this context with varying degrees of success.
3. The Service initially challenged whether the FLP was a valid entity for tax purposes. In doing so, it applied theories such as substance over form, step-transaction analysis, and lack of business purpose to set aside the transaction for estate and gift tax purposes and include the full value of the assets in the decedent's gross estate. However, the Courts regularly rejected these arguments unless the facts demonstrated that the taxpayers had not respected the FLP as an independent legal entity or otherwise treated the FLP assets if they belonged to the taxpayer.
4. When the FLP could not be set aside for tax purposes, the Service shifted its focus to lowering the valuation discounts claimed for lack of marketability and minority interest attributes.
5. The Service continues to be concerned with three areas of abusive practices in connection with FLPs. These are: 1) cases where the taxpayer treats the FLP assets as his own assets and/or pays personal expenses from the partnership; 2) cases where the taxpayer fails to follow the formalities of the FLP; and 3) cases where excessive discount is taken in valuing the FLP, especially when the FLP's assets consist of stocks and bonds and other passive assets. In the Service's view, "these practices are often tax-avoidance in nature, and therefore looked upon as tax shelters."
6. Summary of Issues. The settlement guidelines address four issues. For each issue, the guidelines summarize the Service's position, the taxpayer's position, and provide a detailed discussion of applicable case law. Unfortunately, the specific criteria that the Appeals Officers are directed to focus on in their analyses have been omitted from public disclosure. Notwithstanding, the guidelines provide an excellent summary of the current state of FLPs from the Service's perspective.
7. The four issues addressed in the guidelines are as follows.
  - a. Whether the fair market value of transfers of FLP interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.
  - b. Whether the fair market value at date of death of Code § 2036 or Code § 2038 transfers should be included in the decedent's gross estate.

- c. Whether there is an indirect gift of the underlying assets, rather than the FLP interests, where the transfers of assets to the FLP (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.
- d. Whether an accuracy-related penalty under Code § 6662 is applicable to any portion of a tax deficiency.

#### XI. CODE § 2036 CASELAW AND TAXPAYER VICTORIES.

- A. *Estate of Wayne C. Bongard*, (2005) 124 TC No. 8. The Tax Court held that stock in an operating company transferred by an individual to a holding company organized as a limited liability company (LLC) was not includible in his gross estate under Code § 2036(a) because the transfer was a bona fide sale for full and adequate consideration. However, the Court then held that membership units in the LLC transferred by the individual to a family limited partnership (FLP) were includible in his estate under Code § 2036(a). This transfer did not qualify for the sale exception and the Court found that there was an implied agreement whereby the individual retained an interest in the units transferred.
- B. *Estate of Stone v. Commissioner*, T.C. Memo. 2003-309 (Nov. 7, 2003).
  - 1. The decedents, husband and wife, together created five family limited partnerships, to hold various businesses and investments that the decedents owned. The decedents had initially been drawn to the family limited partnership as a means of settling disputes among their children regarding the management of various assets, but their estate planning attorney had later explained to them how these devices could also reduce their estate tax liabilities. They created the five partnerships, in consultation with their children. Each of their children became a general partner, together with the parents, in one or more of the partnerships, and participated actively in the operations of the partnership. The children each contributed their own assets to buy their shares of the partnerships, though some of these assets had originally been given to the children by their parents. The parents' attorney consulted with the attorneys for the children in selecting the terms of the partnerships, though the parents' attorney drafted the agreements.
  - 2. After both parents died relatively close together, the Service asserted that the value of the partnership assets should be included in the decedents' estates under Code § 2036(a)(1), as a transfer with a reservation of beneficial enjoyment.
  - 3. The Tax Court disagreed, and held that Code § 2036(a)(1) did not apply, because the decedents had transferred their assets to the partnerships in bona fide sales for adequate and full consideration. The court distinguished its contrary holdings in several other cases, noting that: (a) all of the partners transferred their own assets to the partnership in exchange for their proportionate interests, though some of those assets were the results of prior gifts from the decedents; (b) upon the termination or dissolution of each of the partnerships, the partners were entitled to distributions from each such partnership in amounts equal to their respective capital accounts; (c) each partner was represented in the decision-making by separate counsel; (d) the decedents retained enough assets outside the partnership to provide for their own needs and support; (e) creating the partnership was motivated at least partially by nontax business concerns; and (f) the decedents' children became general partners and participated actively in managing the partnerships. Cf. *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Thompson v. Commissioner*, T.C. Memo.2002-246; *Estate of Harper v. Commissioner*, T.C. Memo.2002-121; *Estate of Strangi v. Commissioner*, T.C. Memo.2003-145.
- C. *Kimbell v. United States*. (5<sup>th</sup> Circuit 2004) 93 AFTR 2d 2004-2400.
  - 1. Ruth A. Kimbell died in March 1998 at the age of 96. When she died, Mrs. Kimbell held interests in three entities: (1) the R.A. Kimbell Living Trust ("Trust"), (2) the R.A. Kimbell Management Co., LLC ("LLC"), and (3) the R.A. Kimbell Property Co., Ltd. ("Partnership"). Trust was created by Mrs. Kimbell in 1991 and fully revocable by her before her death. Thus, its interests and Mrs. Kimbell's interests were treated as one for tax purposes. Mrs. Kimbell and David Kimbell were co-trustees, and David Kimbell was paid a monthly fee to manage Trust. LLC is a Texas limited liability company established in January 1998. It was owned 50% by Trust, 25% by David

Kimbell and 25% by his wife (Mrs. Kimbell's daughter-in-law). David Kimbell was the manager of LLC. Partnership is a Texas limited partnership created on January 29 1998 (two months before Mrs. Kimbell's death) by Trust and LLC, which contributed 1% of the capital of Partnership and was its general partner. Trust contributed 99% of the capital and yet was only a limited partner. Partnership had a term of 40 years (i.e., until Mrs. Kimbell would have been 136 years old). As Mrs. Kimbell had a 50% interest in LLC through her ownership of Trust and a 100% interest in Trust, her real interest in Partnership was 99.5%.

2. After Mrs. Kimbell died, David Kimbell, as her executor, filed estate tax returns with the Service, which audited them and found that the value of Mrs. Kimbell's 99% interest in Partnership was \$2.463 million, not \$1.257 million as reported. David Kimbell paid the increased taxes and ultimately went to district court seeking a refund of \$837,089, claiming that the Service had overvalued the estate.
3. At the District Court, David Kimbell argued that Mrs. Kimbell's transfer of assets to Partnership was a bona fide sale for an adequate and full consideration in money or money's worth. The district court disagreed. It said there was no credible evidence that Partnership's formation was the product of an arm's length transaction between unrelated parties. The court said that there weren't even two parties because ownership interests in Partnership were held by two entities: 99% by Trust, which was wholly-owned by Mrs. Kimbell, and 1% by the LLC, which was 50% owned by Trust. The court said that even if Partnership resulted from a bona fide sale, David Kimbell didn't establish that Mrs. Kimbell received adequate and full consideration for the sale. Mrs. Kimbell, through Trust, contributed 99% of the capital for Partnership and in return received a 99% interest in Partnership. Mrs. Kimbell received no consideration other than the interest in Partnership. David Kimbell, before becoming the general partner of Partnership, was already managing both Trust, which contributed 99% of the assets of Partnership and LLC which contributed the other 1% (of which 0.5% were from Trust). David Kimbell argued that Mrs. Kimbell "irrevocably" transferred her assets to Partnership and thus qualified under the retained income or rights exception. The district court rejected this argument. Mrs. Kimbell (through Trust), although formally a limited partner, owned 99% of Partnership, and an additional 0.5% of Partnership through her 50% interest in LLC. Under the partnership agreement, Mrs. Kimbell, as a limited partner with a 99% interest in Partnership, could at any time remove the general partner, and either appoint herself or someone she chose to be the new general partner, who could then distribute the income back to Mrs. Kimbell. Thus, Mrs. Kimbell retained the right to the income from the property. Accordingly, the district court found the transfer to be includible in Mrs. Kimbell's estate under Code § 2036.
4. The Fifth Circuit said that for Mrs. Kimbell's transfer to Partnership to qualify as a bona fide sale, it had to be a sale in which she actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. For the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to ensure that the sale is not a sham transaction or disguised gift.
5. The Fifth Circuit concluded that Mrs. Kimbell's transfer was for full and adequate consideration because:
  - a. The interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to Partnership,
  - b. The assets contributed by each partner to Partnership were properly credited to their respective capital accounts, and
  - c. On termination or dissolution of Partnership the partners were entitled to distributions from it in amounts equal to their respective capital accounts.
6. The court in *Kimbell* noted with regard to the immediate decrease in value of the decedent's assets after the partnership was formed that, "The business decision to exchange cash or other assets for

a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security, and preservation of assets, capital appreciation, and avoidance of personal liability."

7. The sale was "bona fide" in *Kimbell* because:
  - a. The transferor actually parted with his interest in property transferred in exchange for a partnership interest. Put differently, the transferor did not use partnership assets in the same way both before and after the transfer.
  - b. Mrs. Kimbell retained sufficient assets outside of the partnership for her support. Partnership formalities were followed, and partnership assets were not used for personal expenses.
  - c. There were significant nontax reasons for the arrangement (and therefore it was not a disguised gift or sham). These included: (a) protection of Mrs. Kimbell from personal liability in connection with working oil and gas interests; (b) partnership assets could continue intact, and could be passed down to family members without being broken up; and (c) the arrangement provided centralized management and a mechanism to appoint successors to the decedent's son, who was currently managing the partnership.
- D. *Estate of Charles Porter Schutt, et al. v. Commissioner*, TC Memo 2005-126. Code § 2036(a) and Code § 2038 didn't require inclusion in gross estate of stock transferred by decedent through revocable trust to 2 Delaware business trusts (DBTs): transfers qualified as bona fide sales for adequate and full consideration. Bona fide sales finding was supported by credible evidence that DBTs were formed by decedent and his related family trust co. primarily for legitimate non-tax purpose of preserving decedent's "buy and hold" investment strategy and protecting wealth tied up in core stockholdings. Other bona fide sales evidence included facts that stock was actually transferred, negotiations were held at arm's length, there was no commingling of assets, and decedent wasn't financially reliant on DBT distributions. And, adequate/full consideration was also shown by DBTs' foregoing non-tax purpose, plus facts that proportionate interests were received, capital accounts were properly credited, distributions would require negative capital account adjustments, and liquidating distributions would be made in accord with capital account balances.
- E. *Mirowski v. Commissioner*, T.C. Memo 2008-74 (2008), in which the Tax Court held that assets transferred to a limited liability company ("LLC") were not includable in the decedent's gross estate under Code § 2036(a) in spite of the fact that the decedent both formed the LLC and made gifts of interests in the LLC within 30 days of the decedent's death.
  1. The court found a legitimate and significant nontax purpose in the fact that Mrs. Mirowski wanted to ensure the joint management of the family's assets by her daughters and eventually her grandchildren. The record demonstrated that Mrs. Mirowski wanted her daughters, and eventually her grandchildren, to work together, remain closely knit, and be jointly involved in managing the investments derived from the royalties received from the patents and the business matters relating to the patents, including any litigation arising with respect to the patents.
  2. The court acknowledged that maintenance of the bulk of the family's assets in a single pool of assets made possible investment opportunities would not be available if Mrs. Mirowski were to have made a separate gift of a portion of her assets to each of her daughters or to each of her daughters' trusts.
  3. The court found that Mirowski's lifetime gift of an equal interest in the LLC to each of her daughters' trusts enabled Mrs. Mirowski to ensure that her daughters and eventually her grandchildren would continue to hold respective interests of equal worth in the bulk of the family's assets.
  4. The court recognized that Mrs. Mirowski formed the LLC and transferred assets to it in order to provide additional protection from potential creditors. However, the court viewed these purposes

as theoretical since at the time of trial, none of Mrs. Mirowski's daughters had been married more than once, nor had any of her daughters ever been separated from her spouse because of marital problems.

5. The court also found that Mrs. Mirowski received interests in the LLC proportionate to the value of the property she transferred, that her capital account was properly credited, and that in the event of a liquidation and dissolution of the LLC, Mrs. Mirowski had the right pursuant to the governing documents of the LLC to a distribution of property from the LLC in accordance with her capital account.

F. In *Estate of Purdue v. Commissioner*, T.C. Memo 2015-249, the Tax Court found in favor of the taxpayer with respect to three hotly contested gift and estate planning issues involving family limited liability companies.

1. Beginning in 1995, Robert and Barbara Purdue were advised by their estate planning attorney to create an LLC to take advantage of valuation discounts available for non-marketable, non-controlling interests in such entities and to achieve various other nontax purposes. On August 2, 2000, the Purdues created the Purdue Family LLC (the "LLC"). In November 2000, the Purdues funded the LLC with income-producing assets, including \$22 million of marketable securities (held in five separate accounts at three different firms) and an undivided one-sixth interest in a commercial building. In return, the Purdues received one hundred percent of the membership interests in the LLC. Although Mrs. Purdue had some serious, long-term health issues, it was believed that Mr. and Mrs. Purdue did not suffer from any life-threatening diseases at the time the LLC was created.
2. Mr. and Mrs. Purdue created the Purdue Family Trust (the "Trust") on November 24, 2000. The beneficiaries of the Trust were the Purdues' descendants and the spouses of their descendants. The Trust provided *Crummey* withdrawal rights to the beneficiaries.
3. During the spring of 2001, the LLC engaged a wealth management firm to provide coordinated investment advice to the LLC. The Purdues and their children agreed to the investment strategy proposed by the wealth management firm. Beginning in 2001, the Purdue children met annually with the family's estate planning attorney and representatives of the wealth management firm to review family accounts and assets, ratify and approve LLC and Trust distributions, hear investment presentations, and receive legal updates and advice. The parties kept minutes of their annual meetings.
4. Mr. Purdue died unexpectedly on August 3, 2001. Mr. Purdue's will established a bypass trust and GST exempt and GST non-exempt qualified terminable interest property (QTIP) trusts for the benefit of Mrs. Purdue.
5. From 2002 to 2007, Mrs. Purdue made annual exclusion gifts of LLC interests to the Trust. (By the time of Mrs. Purdue's death, approximately twenty percent of the LLC interests had been transferred to the Trust.) During those years, the Trust made distributions to the Purdue children of nearly \$2 million, largely representing dividends received from the LLC.
6. Mrs. Purdue died November 27, 2007. The assets of Mrs. Purdue's estate (the "Estate") were valued in excess of the estate tax applicable exclusion amount. The assets of the two QTIP trusts also were taxable in the Estate. The Estate and the QTIP trusts borrowed funds from some of the Purdue children to pay the Estate's and QTIP trusts' tax liabilities, and the Estate deducted the interest charged on the loan on the estate tax return.
7. In 2012, the IRS issued notices of deficiency to the Estate. The IRS assessed \$3,121,959 of additional estate tax and a total of \$925,807 of gift tax for the years 2001, 2002, and 2004-2007.
8. To support its tax adjustments, the IRS first argued that Mrs. Purdue's contribution of assets to the LLC was a transfer with a retained interest. (In essence, the IRS argued that the assets should be included back in the Estate for estate tax purposes because Mrs. Purdue retained the income from the assets transferred to the LLC.) The Estate argued in response that Mrs. Purdue's contributions

to the LLC were bona fide sales for adequate and full consideration, qualifying for an exception to the retained interest rule.

9. To satisfy the bona fide sale for adequate and full consideration exception, the Court held that Mrs. Purdue must have had a legitimate and significant nontax reason for creating the LLC (the “bona fide prong”) and that she must have received an LLC interest proportional to the value of the property she contributed (the “adequate and full consideration prong”).
10. To satisfy the bona fide sale prong, the Court found that a significant nontax purpose for the creation of the LLC was “to consolidate investments into a family asset managed by a single adviser.” The Court pointed specifically to the consolidation of the Purdues’ marketable security accounts under the advice of a single wealth management firm. The Court found that other factors further supported its finding of a bona fide sale: (1) the Purdues were not financially dependent on the LLC; (2) the LLC’s funds were maintained separate from the Purdues’ funds, and other LLC formalities were observed; (3) assets were actually transferred to the LLC; and (4) the Purdues were believed to be in good health at the time of the creation of the LLC. The Court also found that Mrs. Purdue received a proportional LLC interest for her contributions, thus satisfying the adequate and full consideration prong. The Court found that Mrs. Purdue had satisfied the bona fide sale for adequate and full consideration exception, despite also being motivated by the transfer tax savings available through valuation discounts.
11. The IRS next argued that Mrs. Purdue’s gifts from 2002 to 2007 of interests in the LLC did not constitute “present interest” gifts that qualify for the annual exclusion from gift tax. The Estate responded that the donees received a present interest because of the income produced by, and regularly distributed from, the LLC.
12. For a right to income to satisfy the “present interest” annual exclusion gift requirement, there must be income that flows steadily to the donees and can be reasonably ascertained. The Estate showed that the LLC generated income through the commercial building it owned and dividend-paying marketable securities; that the Estate was required to make distributions for its members to pay their income tax liabilities; and that the LLC’s anticipated income was readily ascertainable or could be estimated. The Estate further showed that the Trust, from 2000 through 2008, actually distributed almost \$2 million. Based on those facts, the Court found that Mrs. Purdue’s gifts of LLC interests were gifts of present interests qualifying for the annual exclusion.
13. The IRS’s final argument was that the loan made by the Purdue children to the Estate and QTIP trusts was not necessarily incurred, and therefore the interest on the loan could not be deducted on the estate tax return. The Court, however, found that the loan was necessary because other means of obtaining the required funds were not available. Specifically, a distribution from the LLC to the Estate could not be made to pay the tax because one of the Purdue children refused to approve the distribution. Accordingly, the interest on the loan was deductible because the loan was bona fide and necessary to pay the estate tax.
14. The *Estate of Purdue* case is a reminder that family limited partnerships and limited liability companies can be powerful wealth management and transfer planning tools for high net worth individuals and families when properly administered. The case also can be taken as a warning that the IRS continues to litigate issues involving family limited partnerships and limited liability companies. To withstand IRS scrutiny, it is critical that clients, with the help of their advisors, engage in such planning thoughtfully and follow through thoroughly.

G. Other Cases Favorable to Taxpayers.

1. *Church v. United States*, 2000-1 USTC ¶60,369 (W.D. Tex. 2000)
2. *Bongard v. Commissioner*, 124 T.C. 95 (2005)
3. *Estate of Miller v. Commissioner*, T.C. Memo 2009-119
4. *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009)

5. *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009)
6. *Estate of Black v. Commissioner*, 133 T.C. 340 (2009)
7. *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21
8. *Estate of Joanne Stone v. Commissioner*, T.C. Memo 2012-48
9. *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73

## **PART II – MANAGING VALUATION RISK**

### **XII. OBTAINING FINALITY WITH RESPECT TO VALUATION ISSUES.**

#### **A. Gift Tax Final Regulations.**

1. Final regulations relating to changes made to the Internal Revenue Code (Code) §§ 2001, 2504, and 6501 by the Taxpayer Relief Act of 1997 and the Internal Revenue Service Restructuring and Reform Act of 1998 allow a taxpayer to adequately disclose a gift or other transfer and commence the statute of limitations for revaluing the gift. In determining the amount of a decedent's adjusted taxable gifts for estate tax purposes, a gift made after August 5, 1997 that was adequately disclosed on a gift tax return may not be revalued.
2. For gift tax purposes, the value of a gift made after August 5, 1997 may not be adjusted after the statute of limitations has run if the transfer was adequately disclosed on a gift tax return. Treas. Reg. § 25.2504-2(b).
3. The value of a gift is finally determined for gift tax purposes if:
  - a. The value is shown on a gift tax return, or on a statement attached to the return, and the Service does not contest the value before the statute of limitations has run;
  - b. The value is specified by the Service before the statute of limitations has run with respect to the gift and such specified value is not timely contested by the taxpayer;
  - c. The value is finally determined by a court of competent jurisdiction; that is, when the court enters a final decision, judgment, decree or other order passing on the valuation that is not subject to appeal; or
  - d. The value is determined pursuant to a settlement agreement entered into between the taxpayer and the Service that is binding on both. A settlement agreement includes a closing agreement, a compromise agreement, or an agreement entered into in settlement of litigation involving the amount of the taxable gift. Treas. Reg. § 20.2001-1(c), (d).

#### **B. Disclosure Requirements.**

1. A transfer will be adequately disclosed on a gift tax return with respect to a transfer made after December 31, 1996, only if it is reported in a manner adequate to apprise the Service of the nature of the gift and the basis for the value so reported. Treas. Reg. § 301.6501(c)-1(f)(2).
2. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed if the return or a statement attached to the return provides the following information:
  - a. A description of the transferred property and any consideration received by the transferor;
  - b. The identify of, and relationship between, the transferor and the transferee;

- c. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust or a copy of the trust instrument;
- d. A detailed description of the method used to determine the fair market value of property transferred, including:
- (1) Any relevant financial data.
  - (2) A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.
  - (3) In the case of a transfer of an interest that is actively traded, the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date.
  - (4) In the case of a transfer of an interest in an entity (e.g., a corporation or partnership) that is not actively traded, a description of any discount claimed in valuing the entity or any assets owned by such entity.
  - (5) If the value of the entity or interests in the entity is properly determined based on the net value of the assets held by the entity, the taxpayer must demonstrate that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets or furnish:
    - (a) A statement regarding the fair market value of 100% of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity);
    - (b) The pro rata portion of the entity subject to the transfer; and
    - (c) The fair market value of the transferred interest as reported on the return.
  - (6) If the entity that is subject to the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the same information is required for each entity, if the information is relevant and material in determining the value of the interest.
  - (7) In lieu of the above information an appraisal of the transferred property that meets the following requirements:
    - (a) The appraisal is prepared by an appraiser who satisfies all the following requirements:
      - i) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;
      - ii) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued; and
      - iii) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in Code §2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and
    - (b) The appraisal contains all of the following:



- i) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;
- ii) A description of the property;
- iii) A description of the appraisal process employed;
- iv) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;
- v) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;
- vi) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;
- vii) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and
- viii) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

e. A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

3. Completed transfers, all or a portion of which are reported as not constituting a transfer by gift (other than a transaction in the ordinary course of business), will be considered adequately disclosed if the same information is provided as is required for a transfer that is treated as a gift, plus an explanation as to why the transfer is not a transfer by gift.

Treas. Reg. § 301.6501(c)-1(f)(2), (3), (4).

4. Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will start the running of the statute of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift.

a. For example, if an incomplete gift is reported as a completed gift on a gift tax return and is adequately disclosed, the period of assessment of the gift tax will begin running when the return is filed.

b. On the other hand, if the transfer is reported as an incomplete gift, whether or not adequately disclosed, the period for assessing a gift tax with respect to the transfer will not commence to run even if the transfer is ultimately determined to be a completed gift.

(1) In that situation, the gift tax with respect to the transfer may be assessed at any time, up until three years after the donor files a return reporting the transfer as a completed gift with adequate disclosure.

Treas. Reg. § 301.6501(c)-1(f)(5).

5. If a husband and wife elect split-gift treatment, the disclosure requirements are satisfied for the gift deemed made by the consenting spouse if the return filed by the donor spouse satisfies the disclosure requirements. Treas. Reg. § 301.6501(c)-1(f)(6).

C. Adequate Disclosure Under Chapter 14. Treas. Regs. Section 301.6501(c)-1(e)(2) provides a slightly different disclosure standard for Chapter 14 than that provided for Chapter 12. A transfer of property valued under the rules of section 2701 or section 2702 or any taxable event described in § 25.2701-4 of this chapter will be considered adequately shown on a return of tax imposed by chapter 12 of subtitle B of the Internal Revenue Code only if, with respect to the entire transaction or series of transactions (including any transaction that affected the transferred interest) of which the transfer (or taxable event) was a part, the return provides

1. A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;
2. The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transaction; and
3. A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date.

D. Adequate Disclosure of Compensation to Family Members.

1. Completed transfers to members of the transferor's family that are made in the ordinary course of operating a business are deemed to be adequately disclosed, under Treas. Reg. § 301.6501(c)-1(f)(2), even if the transfer isn't reported on a gift tax return, if the transfer is properly reported by all parties for income tax purposes.
2. For example, in the case of salary paid to a family member employed in a family-owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. *See*, Treas. Reg § 301.6501(c)-1(f)(4).
3. The exception only applies to transactions conducted in the ordinary course of operating a business. It doesn't apply, for example, in the case of a sale of property (including a business) by a parent to a child.
4. For example, A owns 100% of the stock of X Corporation, a company actively engaged in a manufacturing business. B, A's child, is an employee of X and receives an annual salary paid in the ordinary course of operating X Corporation. B reports the annual salary as income on B's income tax returns. During the year, A transfers property to family members and files a gift tax return reporting the transfers. But A doesn't disclose the salary payments made to B. Because the salary payments were reported as income on B's income tax return, the salary payments are deemed to be adequately disclosed. The transfer of property to family members, other than the salary payments to B, reported on the gift tax return must satisfy the adequate disclosure requirements under Treas. Reg. § 301.6501(c)-1(f)(2) in order for the statute of limitations to begin to run with respect to those transfers.

### XIII. DEFINED VALUE GIFTS.

- A. The Internal Revenue Service will almost always scrutinize significant transfers of "hard-to-value" assets. Reasonable people (and, of course, unreasonable people) can differ on the value of certain assets (e.g., a family limited partnership interest). From the Service's point of view, scrutiny of those assets may represent a significant revenue opportunity.

- B. One approach that may reduce the chance of an audit of a transfer of a hard-to-value asset, or a gift tax surprise if an audit does occur is to utilize a formula defined value transfer. A formula defined value transfer may increase the retained interest of the donor (as in the case of a grantor retained annuity trust); may define the portion of the property interest that is transferred or may provide that a defined portion of the property transferred passes to a “tax-sheltered recipient.”
- C. For example, a transfer may provide that an undivided part of a “hard-to-value” asset, which exceeds a defined value of the transferred entity interest, will pass either to a grantor retained annuity trust, the transferor’s spouse, a charity, or a trust in which the grantor has retained an interest that makes the gift incomplete.
- D. The IRS argues that such clauses should not be respected because they would make fair administration of the gift tax difficult, given the Service’s limited resources available for gift tax audits, especially considering the finality that now can be obtained through gift reporting with adequate disclosure under Code § 6501(c)(9).
- E. “Formula defined value” clauses should be distinguished from “savings” clauses like the ones discussed in Revenue Ruling 86-41, 1986-1 C.B. 442 and in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In Rev. Rul. 86-41, the IRS said that a clause that increased the consideration to be paid for the transferred property or that caused a portion of the transferred property to revert to the transferor were conditions subsequent that are not effective to avoid a taxable gift from being made on the transfer of the property. By contrast, formula clauses defining the amount of the transfer or the identity of the transferee are ubiquitous in the transfer tax context. In fact, such arrangements are specifically permitted in the tax law. If an adjustment occurs in a formula defined value clause, a change in the identity of the transferee may occur (e.g., the credit shelter trust owns less of the asset and the marital trust owns more of the asset). If an adjustment occurs in an adjustment clause, the initial transfer is partially unwound and the identity of the transferee does not change (e.g., the transferee pays an additional amount for the asset). Adjustment clauses were found to be against public policy in *Procter* because, if such clauses were effective, the result of an audit of the gift tax return could never result in a deficiency. Although the same public policy argument applies to formula defined value clauses, they are so commonly used that an argument that they are void is not persuasive. Moreover, the public policy argument could be addressed by deliberately structuring the formula to produce a small deficiency on audit.
- F. *King v. United States*, 545 F.2d 700 (10th Cir. 1976) involved a taxpayer who transferred closely held stock to trusts established for his children in return for a purchase price purportedly equal in value to the transferred stock. The transfer documents included a price-adjustment clause, providing that, in the case of IRS revaluation of the transferred stock, the stock purchase would be similarly adjusted, thereby ensuring that there was full and adequate consideration for the sale. After the IRS challenged the initially determined value of the stock, the parties went to court, with the enforceability of the price-adjustment clause being a key issue. The price-adjustment clause was upheld by the district court and by the Tenth Circuit on appeal. In upholding the clause, the Tenth Circuit focused on the fact that an independent appraiser was used and that the transfer terms were negotiated by the taxpayer’s attorney and the trustee of the children’s trusts, evidencing an arm’s-length transaction, meant to be for fair market value, without donative intent. Because it was at arm’s-length, the transaction was presumed to have been “made for adequate and full consideration in money or money’s worth” under Treas. Reg. § 25.2512-8. Although this ruling provided some support for price-adjustment clauses, the focus on the arm’s-length nature of the transfer meant the decision was not a blanket approval of such clauses.
- G. In FSA 200122011, the IRS attacks a defined value clause that it assumes was executed without “[any] evidence of arm’s length negotiations” and which the IRS assumes “the transactional documents were accepted by charity as presented”. The IRS concludes the possibility of “any additional transfer to charity under the formula clause was illusory.” The IRS also states that

Though *Procter* involved a savings clause as opposed to a formula clause, the principles of *Procter* are applicable to this case. If formula clauses like the one at issue actually function to require payment of any increased value to the charitable donee, these clauses would be similar in effect to savings clauses in that they re-characterize the transaction in a manner that would render any adjustment nontaxable. A valuation increase resulting from an examination would serve only

to increase the charitable deduction, but would not otherwise generate any gift tax deficiency. Moreover, the adjustment would substantiate a claim for an increase in the income tax charitable deduction claimed by the donor. The sole justification for the Commissioner's examination would be to insure that charity received all that it was entitled to under the transfer documents. This would place federal tax administrators in the position of policing charitable transactions, a role more appropriately performed by the states' attorneys general.

- H. Commentators, like Stacy Eastland, have argued that the IRS analysis misses several key points, including: (i) the IRS does have a "revenue incentive" to examine a charity's actions in agreeing to the amount of a formula gift, because the charity and the "offending" individual will be subject to IRS sanctions (which potentially increases Treasury revenue), if there is any excess benefit to that individual; (ii) state attorneys general do have a duty to enforce the formula; (iii) the charity has a fiduciary duty under state property law to enforce the formula (and, as noted above, it is clear law that federal gift tax consequences follow state property law); (iv) assuming the charity does engage in arms length negotiations, it is irrelevant whether the formula clause "works," because under gift tax valuation cases and the IRS's own regulations, it is clear arms length negotiations are the best evidence of value; (v) as noted above, the IRS itself mandates formula clauses for charitable split interest trusts and grantor retained annuity trusts, both of which involve the same public policy considerations; (vi) as noted above, the IRS has long accepted formula marital deduction clauses and formula pecuniary disclaimers, which have no more (or less) public policy considerations than formula gifts to charity; and (vii) there is a key distinction between savings clauses such as the one discussed in *Procter* and defined value formula clauses (e.g. marital deduction clauses). One distinction is that the price adjustment clause involves a condition subsequent. In addition, in some defined value formula clauses, the identity of the recipient could change (which is clearly not in the donor's best interest.)

I. Defined Value Clauses in the Charitable Context.

1. *Succession of McCord v. Commissioner*, 120 T.C. No. 13 (2003), rev'd, 461 F.3d 614 (5th Cir. 2006).
  - a. In *McCord*, the taxpayers formed a Texas limited partnership with themselves and their four sons each acquiring certain general and limited partnership interests. Six months after the limited partnership was formed, the taxpayers transferred a 41% limited partnership interest to the following transferees: (1) their sons, (2) irrevocable GST-exempt trusts for the benefit of their sons, and (3) two named charities. The assignment agreement transferred portions of this 41% interest to the sons, the trusts, and the charities according to the sequential operation of several valuation clauses. First, the trusts for the sons would receive partnership interests with a total value equal to the taxpayers' remaining GST exemption. Second, the sons would receive partnership interests equal in value to \$6.9 million reduced by the amount allocated to the sons' trusts. Third, one of the named charities (the Shreveport Symphony) would receive a partnership interest equal in value to \$134,000. Finally, any remaining interest in the partnership would be transferred to the other named charity (the Community Foundation of Texas). The terms of the assignment agreement stated that it was the donees' responsibility to determine their respective shares of the transferred partnership interest.
  - b. In a Confirmation Agreement signed two months later, all of the donees (including the charities) resolved the valuation issues by agreeing on an appraised value of the transferred partnership interests. The Confirmation Agreement set out the exact percentage interests in the partnership that each donee would receive. All of the donees were independently represented in negotiations and each also had the right to retain their own appraisers. Sometime later, the IRS assessed a \$2 million gift tax deficiency, which the taxpayers challenged in the Tax Court.
  - c. The Tax Court initially held that the value allocation formula was inapplicable, holding that the subsequent Confirmation Agreement was binding on the taxpayers, despite the value allocation clause contained in the original assignment agreement. In its ruling, the Tax Court focused on the fact that the assignment agreement did not specifically state that the allocation of the partnership interests among the donees would be based on the fair market value of the partnership interests "as finally determined for federal gift tax purposes."

d. On appeal, the Fifth Circuit overruled the Tax Court and upheld the validity of the value allocation clause. The Fifth Circuit distinguished the facts of *McCord* from prior cases that involved more suspicious fact patterns and noted that the Confirmation Agreement was reached after an arm's-length negotiation among the independent attorneys representing each donee. Unlike the prior cases, the Fifth Circuit here did not see any evidence of a pre-arranged determination regarding how the percentage of partnership interests should be allocated. The Fifth Circuit sharply rebuked the Tax Court for relying on the Confirmation Agreement to determine the value of the property transferred. *Succession of McCord v. Commissioner*, 461 F.3d 614, 627 (5th Cir. 2006). Finally, the Fifth Circuit stressed “the immutable principle that the value of a gift must be determined as of the date of the gift” and should not be affected by the donees’ post-gift actions. *Id.*

2. *Christiansen v. Commissioner*, 130 T.C. No. 1 (2008), concerned a defined-value disclaimer. The decedent left her estate to her daughter. Under the will, 75% of any disclaimed assets would pass to a charitable lead annuity trust (CLAT) and 25% to a private foundation (the “Foundation”). The principal assets of the estate were 99% limited partnership interests in two partnerships. The daughter disclaimed a fractional share of the estate exceeding \$6.35 million, based on values “as finally determined” for estate tax purposes.

a. The IRS challenged both the valuation of the partnership interests and the effect of the formula disclaimer on the size of the charitable deduction the estate was entitled to receive. Before trial, the parties reached agreement on the values of the limited partnership interests. The agreement increased the gross estate from \$6.51 million to \$9.6 million and increased the value of the properties passing to the CLAT and the Foundation. The issue for the court was whether a charitable deduction would apply to the additional value passing to charity.

b. A majority of the Tax Court held that the disclaimer was not qualified for the 75% passing to the CLAT because the daughter was a contingent remainder beneficiary of the CLAT. Judge Swift and Judge Kroupa (the trial judge) dissented from this portion of the opinion. Both believed the disclaimer was qualified. Regarding the 25% passing to the Foundation, the Tax Court unanimously validated the formula disclaimer and allowed a charitable deduction. The court noted that the transfer was the result of a disclaimer governed by Treas. Reg. § 20.2055-2(c), which relates back to the decedent’s death as if it had been part of the will. The court also stated:

The regulations speak of the contingency of “a transfer” of property passing to charity. The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen’s death (other than the execution of the disclaimer)—it remains 25 percent of the total estate in excess of \$6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn’t mean the transfer itself was contingent in the sense of being dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the day Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future. Our Court is routinely called upon to decide the fair market value of property donated to charity—for gift, income, or estate tax purposes. 130 T.C. No. 1, at 30.

c. The court rejected the IRS’s public policy argument, noting that it was “hard pressed to find any fundamental public policy against making gifts to charity—if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving.” *Id.* at 32–33. Rejecting the IRS’s *Procter* analogy, the court noted:

This case is not *Procter*. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the [CLAT], and the Foundation. If the fair market value of the estate assets is

increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case. Id. at 33–34

- d. The court added that a charity's directors, as well as executors of an estate, owe fiduciary duties that are enforceable by the IRS and the state's Attorney General.
3. In *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (June 15, 2011), the Tax Court examined a part gift and part sale transaction in which the taxpayers transferred non-voting common shares in a closely held company to two trusts for the benefit of their children, with the excess passing to a donor advised fund under a defined value clause.
    - a. The defined value clause provided that (i) each taxpayer would transfer a total of 403,342 company shares, (ii) the trusts would take company shares with a fair market value equal to \$14,732,846, and (iii) the donor advised fund would receive any remaining shares in the event the value of the shares were increased for federal gift tax purposes.
    - b. The taxpayers obtained an appraisal of the shares prior to the gift. The trusts also obtained an independent appraisal of the shares, and the donor advised fund retained independent counsel to review the trusts' appraisal. The donor advised fund concluded that the appraisal was fair and reasonable.
    - c. After the taxpayers filed their gift tax return claiming a \$50,000 charitable deduction and a \$1,414,581 taxable gift, the IRS claimed that the defined value clause should be disregarded because it was not negotiated in an arm's length transaction and was void as against public policy.
    - d. The Tax Court found that a familial relationship, by itself, was not sufficient to create a non-arm's length transaction as a matter of fact. The Tax Court explained that the donor advised fund assumed a real economic risk of loss as recipients of the stock and that it performed due diligence by independently examining the stock's appraisal. Moreover, the Tax Court found that defined value clauses do not frustrate national or state policy, and, in fact, actually encourage charitable giving. Consequently, the Tax Court held for the taxpayers.
  4. In facts similar to *Hendrix*, the Tax Court in *Petter v. Commissioner*, T.C. Memo. 2009-820 (Dec. 7, 2009), rejected the IRS's public policy attack on defined value clauses.
    - a. *Petter* involved the transfer of separate blocks of LLC units in gift and sale transactions. A portion of the transferred assets passed to grantor trusts for the donor's children equal to the donor's remaining gift exemption amount (for the gift transactions) and the amount of notes given by the trusts (in the sale transactions), using values as finally determined for federal gift tax purposes. The balance passes to charities. The result is that an agreement by the IRS with the taxpayer on the valuation of the LLC units (using a 35% discount) resulted in a shift of more units to the charities, but did not result in any additional gift taxes.
    - b. The court discussed four major reasons that the defined value clauses in this case do not violate public policy: (1) there is a general public policy encouraging charitable gifts; (2) there are other potential sources of enforcement of the gift and sale transactions other than gift tax audits; (3) the mootness and declaratory judgment concerns mentioned in *Procter* are not appropriate; and (4) the existence of other formula clauses authorized in regulations suggest that there is no general public policy against lifetime transfers by formula clauses.
    - c. The IRS appealed the Tax Court's decision in *Petter* to the Ninth Circuit on the grounds that the taxpayer's increased charitable deduction should be disallowed because it was subject to a condition precedent, i.e., that the IRS audit the taxpayer's return and increase the per-unit value of the transferred LLC units. The Ninth Circuit upheld the defined

value clause, finding that the taxpayer unconditionally transferred the LLC units to the charities involved. The only open question, the Ninth Circuit explained, was the value of the units transferred, and not the transfers themselves. Interestingly, the IRS withdrew its appeal of the Tax Court's public policy rationale, perhaps signaling an end to the IRS's attack of defined value clauses on public policy grounds.

d. In *Petter*, the Court noted that “savings clauses are void, but formula clauses are fine.”

5. Although sound arguments exist for a taxpayer to assert that the public policy holding in *Procter* and its progeny should not be followed in today's world given the broad approval granted to a variety of formula clauses in IRS pronouncements, practitioners should be cautious when using adjustment clauses that cause property to be returned to the donor (or deemed never transferred) similar to those used in *Procter* and *Ward*. Defined-value planning, however, involves a different structure than addressed by the courts in *Procter* and its progeny because no condition subsequent is present.
6. Practitioners should be aware that the charitable techniques of *McCord* and *Christiansen* are different from each other in terms of the effect of a successful IRS challenge to value. A *McCord*-type of defined-value formula (a transfer of interests of a specific dollar value to noncharity donees with the remainder to charity, not based on values as finally determined for transfer tax purposes) turns on the state law property rights transferred. If, after the transfer, the donees reach an arm's length agreement regarding the allocation of the interests among themselves under the formula, a successful IRS challenge to the value of the interests transferred does not change that allocation. On the other hand, a *Christiansen*-type of defined-value formula (a transfer of interests of a specific dollar amount to noncharity donees with the remainder to charity, based on values as finally determined for transfer tax purposes) is affected by a successful IRS challenge to the value of the interest transferred. Under that type of a clause, if the value of the interest transferred is increased, the size of the interest passing to charity is likewise increased. That increase applies for state law purposes whether or not an additional charitable deduction is ultimately allowed. For a *McCord*-type of defined-value formula, both the IRS and the courts will examine any pre-transfer dealings with the charity. It is important for the taxpayer to be able to demonstrate that the transaction with the charity was at arm's length and that there was no pre-arranged deal between family members and the charity providing that the charity would receive a specific interest in the entity transferred. As the Fifth Circuit noted in *McCord*:

Neither the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement—not so much as an implicit, “wink-wink” understanding—between the Taxpayers and any of the donees to the effect that any exempt donee was expected to, or in fact would, accept a percentage interest in MIL with a value less than the full dollar amount that the Taxpayers had given to such a donee two months earlier. *McCord*, 461 F. 3d at 620.

7. In this regard, as highlighted by *Hendrix*, it is also helpful for the charity to have its own counsel review the transaction and, if the charity deems appropriate, obtain its own valuation analysis.
8. With testamentary defined-value transfers involving charities, it is often difficult to set a formula in the will because the value of the estate is a moving target. Thus, clients may prefer dollar value formula disclaimers like the one used in *Christiansen*. This type of formula allows, but does not require, the children to disclaim assets to a charity selected by the decedent in his or her will. Charitable disclaimer planning like *Christiansen* generally requires all beneficiaries of the estate to act together. If all do not disclaim, the defined-value structure will have a “leak” that leads to estate tax if valuation is successfully challenged by the IRS, because not all of the increase in value passes to charity. Careful consideration should also be given to the drafting of debts, expenses, and tax allocation provisions, because the boilerplate of many wills simply allocates those obligations to the residue of the estate.
9. For clients without the requisite charitable intent, or worried about family members negotiating with the charity over the percentage interests received by each donee in a *McCord*-type transaction, a defined-value transfer using a GRAT might be considered. The structure would

consist of a transfer of interests equal to a specific dollar amount to non-GRAT donees, with the remainder passing to a GRAT based on values as finally determined for transfer tax purposes. In the event of a successful valuation challenge by the IRS, the increased value would result in a larger transfer to the GRAT and, as required by Code § 2702, increase the annuity owed to the donor. This type of transaction is similar to the consideration adjustment structure used in *King*. The difference is that, in a *King* transaction, the property transferred to each recipient does not shift as it would in the case of a GRAT; rather, the amount the recipient is required to pay is based on the value of the property as finally determined for transfer tax purposes. What might make the GRAT more desirable than the consideration adjustment provision in *King* is that the Regulations under Code § 2702 offer some comfort if faced with a *Procter* argument. In addition, if the GRAT is not a “zeroed-out” GRAT, a successful IRS challenge would result in some additional tax being due, which would make it difficult for the IRS to argue, as it did in *Procter*, that the clause violated public policy.

10. See Porter and Dyer, *Defined-Value Transfer Planning After McCord and Christiansen*, 22 PROBATE & PROPERTY No. 5 (September/October 2008).
11. The *Christiansen* decision was affirmed by the Eighth Circuit, 586 F.3d 1061 (8<sup>th</sup> Cir. 2009) and confirmed that use of a formula disclaimer, based on values as finally determined for federal estate tax purposes, neither renders the amount of the federal estate tax charitable deduction subject to an impermissible contingency nor violates public policy. The result is to allow the estate tax charitable deduction for the portion of the disclaimed property passing directly to a qualified charity as a result of a valuation increase on audit.

#### J. Planning with *Wandry*.

1. In *Wandry v. Commissioner*, T.C. Memo 2012-88, the taxpayers gave membership interests in a family LLC having a specific dollar amount, with the understanding that the value would later be determined and the number of units to be transferred would be adjusted based on the value using the following language.
 

“I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows: [Here each donor listed children and grandchildren with corresponding dollar amounts.] Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date.
2. The IRS argued that the gifts exceeded the taxpayers’ gift tax exclusions and the taxpayers were liable for the tax imposed by section 2501. The IRS further argued that the “adjustment clause” used by the taxpayers was contrary to public policy.
3. The Tax Court cited prior cases in which it had drawn a distinction between a “savings clause,” which a taxpayer may not use to avoid the tax imposed by section 2501, and a “formula clause,” which is valid. A savings clause is void because it creates a donor that tries “to take property back.” On the other hand, a formula clause is valid because it merely transfers a “fixed set of rights with uncertain value.” The Tax Court concluded that the gift documents do not allow for petitioners to “take property back.” Rather, the gift documents correct the allocation of Norseman membership units, and thus the clauses at issue were valid formula clauses. The Tax Court also had the following to say regarding the IRS’s public policy concerns: “In *Estate of Petter* we cited Congress’s overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a ‘severe and immediate’ public policy concern.”
4. Following the decision in *Wandry*, the IRS filed an appeal with the 10th Circuit but in October 2012 withdrew it without explanation. In the Action on Decision, the IRS reiterated its long-held position that “the final determination of value for federal gift tax purposes is an occurrence beyond the taxpayers’ control.” A gift is complete for federal tax purposes when the donor parts with



dominion and control and any power to change its disposition, the IRS said, citing Regs. Sec. 25.2511-2(b). IRB 2012-46 (November 13, 2012).

- K. Adequate Disclosure of Defined Value Gifts. The IRS has not acquiesced to the use of formula clauses. Consequently, their use should be included on an adequate disclosure statement pursuant to Treas. Reg. § 301.6501(c)-1(f)(2) to start the statute of limitations running. The Regulations require a statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer. The formula gift clauses may be contrary to Regs. Sec. 25.2511-2(b).

### **PART III – WEALTH TRANSFER PLANNING TECHNIQUES**

#### **XIV. GIFTS.**

A. Generally.

1. An outright gift is the simplest and purest estate freezing technique. After the property is transferred (complete for gift tax valuation purposes), the value is established for estate and gift tax purposes at its date of gift.
2. An annual exclusion of \$15,000 per donee is available to donors if the gift is a “present interest” in property and the gift has an “ascertainable value.” In addition to the \$15,000 per donee annual exclusion gift, each individual may currently gift up to \$5,600,000 without the payment of a gift tax, although gifts in excess of \$15,000 expend the donor’s unified credit and require the filing of a gift tax return (Form 709).
4. To avoid estate or gift taxes at each generation, the outright gift may skip one or more generations (i.e., to grandchildren, great grandchildren, etc.) Anything other than the \$15,000.00 annual exclusion gift will attract a generation skipping transfer (“GST”) Tax of 40% or further reduce what remains of the donor’s \$5,600,000 GST Tax exemption.
5. Gifts within the annual exclusion amounts allow wealth diversion to younger family members totally free of transfer taxes.
6. Outright gifts are an estate freezing as well as an estate reduction technique, since post-gift appreciation is removed from the donor’s estate and the adjusted taxable gift rule requires that gifts be included in the estate at their date of gift values.
7. Income shifting is possible among the family income tax brackets, since post-gift income attributable to the gifted properties will be taxed to the donees rather than to the donor.
8. If the donor survives at least three years after completing a taxable gift, substantially less transfer tax will be paid on a lifetime gift than when the transfer occurs at the transferor’s death. Since the gift tax is assessed only against the value of the transfer actually passing to the donee, the resulting gift tax paid is therefore removed from the donor’s estate for estate tax purposes. An outright gift is a tax-inclusive transfer as compared to the tax-exclusive transfer that results at date of death, since the estate tax is assessed against the entire taxable estate (including the amount that is paid in estate taxes).

B. Disadvantages.

1. Outright gifts do not allow for any retained control over the property which has been gifted by the donor. Furthermore, without an entity, outright gifts do not permit management protection for the donee by the donor.
2. The gifted property will not receive a new basis (hopefully, stepped-up) at the donor’s death.
3. Donors may not retain any “beneficial enjoyment” rights in the gifted property.

C. Annual Exclusion Gifts - *Hackl v. Commissioner*, 118 T.C. No. 14 (2002).

1. In 1995 and 1996 Albert and Christine Hackl gave their children and grandchildren membership units in Treeco, a limited liability company that Albert formed to hold and operate tree farming properties. When Albert bought the timberland, he sought to provide investment diversification in the form of long-term growth and future income. The land he bought had little or no existing salable timber. Albert and Christine gave interests in the company to family members in 1995. The couple reported the gifts on their gift tax returns and elected to treat them as made one-half each by Albert and Christine under Code § 2513. They also treated the gifts as qualifying for Code § 2503(b)'s \$10,000 annual exclusion. The couple continued the gifting program in 1996, but transferred membership units in Treeco to their minor grandchildren's trust. The couple treated the 1996 gifts as they had the 1995 gifts. At the time of the gifts, Albert correctly anticipated that Treeco and several successor entities would generate losses and make no distributions for many years. The IRS disallowed the exclusions for 1996.
2. The Tax Court, deciding in the Service's favor, noted that the dispute turned on whether the transfers amounted to gifts of a present or future interest. Because the gifts failed to confer substantial present economic benefit by reason of use, possession, or enjoyment of the property or the income from the property, the court concluded that they failed to qualify for the Code § 2503(b) exclusion. In reaching its decision, the court rejected the Hackls' argument that when a gift takes the form of an outright transfer of an equity interest in property, no further analysis is needed or justified. The court held that to follow this logic was to sanction exclusions for gifts based only on "conveyancing form," without inquiring into whether the donees received rights that differed from those that would have come from a traditional trust arrangement. In examining the facts and circumstances of the Hackls' case, the court held that any economic benefit the donees could have ultimately obtained from their receipt of Treeco units was future, not present.
3. The Tax Court based its decision primarily on the terms of the LLC Operating Agreement. The terms discussed by the Tax Court included the authority given to Mr. Hackl as manager, the inability of members to withdraw their capital accounts, the inability of members to sell interests to outsiders, and the inability of members to compel distributions. The Court concluded, "...the terms of the Treeco Operating Agreement foreclosed the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the ownership units."
4. See also, *Fisher v. United States*, 105 AFTR 2d. 2010-1347 (S.D. Ind. March 11, 2010) and *Price v. Commissioner*, T.C. Memo. 2010-2. For a more detailed discussion, see, Johnson and Mensch, "The *Fisher-Price* Aftermath: Toying Around with Annual Exclusion Gifts of FLP and LLC Interests", ABA Section of Taxation May Meeting (2011).
5. One possible work-around to the Hackl problem is to give the gift recipient a Crummey withdrawal power or a 30-day put right to redeem the gifted interest for cash or entity assets; however, such solutions reveal the problem of competing goals: To achieve Code § 2503(b) annual exclusion treatment, the donor sacrifices possible valuation discounts.

D. Indirect Gifts.

1. In *Senda*, T.C. Memo 2004-160, the donors (a husband and wife) created two FLPs (FLP I and FLP II). The donors signed the FLP I agreement on April 1, 1998. The partnership agreement provided that a .01% limited partnership interest was initially held in trust for each of the donors' three minor children. On December 28, 1998, the donors contributed 28,500 shares of MCI WorldCom stock to FLP I by transferring the stock from their joint brokerage account to the brokerage account of FLP I. By fax dated December 28, 1998, the donors informed their accountant that they had transferred stock to FLP I, and sought advice as to what percentage of partnership interests they should transfer to the children. On that same day, the husband gave each child (or trust for that child) a 29.94657% limited partnership interest in FLP I, and the wife gave each child (or trust for that child) a 0.0434% limited partnership interest in FLP I. The certificates of ownership reflecting the transfers were not prepared and signed until several years later.

2. The donors signed the FLP II agreement on December 17, 1999. As with FLP I, the partnership agreement provided that a .01% limited partnership interest was initially held in trust for each of the donors' three minor children. On December 20, 1999, the donors contributed 18,477 shares of MCI WorldCom stock to FLP II by transferring the stock from their joint brokerage account to the brokerage account of FLP II. On that same day, the donors gave to each child, in trust, a 17.9% limited partnership interest in FLP II. By fax dated December 22, 1999, the donors informed their accountant that they had transferred stock to FLP II, and sought advice as to the percentage of partnership interests they should transfer to the children to maximize their annual gift tax exclusions and use all of their remaining unified credits. On Jan. 31, 2000, the donors gave to each child, in trust, an additional 4.5% limited partnership interest in FLP II.
3. On their 1998, 1999, and 2000 gift tax returns, the donors reported the transfers as gifts of partnership interests to their children. The values of the partnership interests were determined by multiplying the value of the transferred stock (as to which there was no dispute) by the percentage of the partnership interests transferred to the children, and then applying lack of marketability and minority interest discounts.
4. The Service conceded that the Jan. 31, 2000 gifts were gifts of partnership interests, not gifts of stock. But the Service argued that the December 28, 1998 transfer of stock to FLP I, and the December 20, 1999 transfer of stock to FLP II, coupled with the transfer of limited partnership interests to the donors' children, were indirect gifts of the stock to the children. Thus, the Service argued that the stock, not the partnership interests, had to be valued for gift tax purposes. According to the Service, "the transitory allocations to [the donors'] capital accounts, if such allocations even occurred at all, were merely steps in integrated transactions intended to pass the stock to the [donors'] children in partnership form."
5. The Tax Court agreed with the Service, saying that the donors had presented no reliable evidence that they contributed the stock to the FLPs before they transferred the partnership interests to their children. The court said that the donors were "more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs," and noted that the husband, as general partner, did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax returns. The tax returns were prepared months after the transfers of the partnership interests, and thus were unreliable in showing whether the donors transferred the partnership interests to the children before or after they contributed the stock to the partnerships. The same was true of the certificates of ownership reflecting the transfers of the partnership interests, which were not prepared until at least several weeks after the transfers. And the letters that the donors faxed to their accountant after they had funded the partnerships did not establish—as the donors contended—that the donors first funded the partnerships and then transferred the partnership interests to their children. The faxes established only that the donors had funded the partnerships; they did *not* show what the partnership ownership interests were immediately before the funding, or how the stock was allocated among the partners' capital accounts at the time of the funding. The court concluded that the value of the children's partnership interests was enhanced upon the donors' contributions of stock to the FLPs. Thus, the transfers were indirect gifts of stock to the children.
6. In *Holman v. Commissioner*, 130 T.C. 12 (2008), the Tax Court rejected the indirect gift theory advanced in *Senda*. In this case, gifts of LP interests were gifted to children six days after the entity was formed. The LP held stock of Dell Computer. The Court found that the stock transfers were clearly made to the partnership in advance of the gift of the LP interests; in addition, the Court declined to apply the step-transaction doctrine to these transfers.
7. In *Gross v. Commissioner*, T.C. Memo 2008-221 (2008), the Tax Court again rejected the indirect gift theory. In this case, marketable securities were contributed to the FLP and interests were transferred to the taxpayer's daughters 11 days later. The Court focused on the real economic change in value of the underlying securities during the intervening 11 day period. It is noteworthy, that unlike marketable securities, real estate or other long term assets may not change in value quite so quickly.

## XV. LOANS AND GUARANTIES

### A. Loans.

1. A loan from a business to a shareholder, employee, or other person is subject to scrutiny under Code § 7872, which provides rules applicable to “below market loans” (BML). Code § 7872 requires the imputation of interest in the case of certain loans where stated interest is less than the applicable federal rate (AFR) appropriate to the loan. Code § 7872 was enacted to block perceived loopholes which the IRS had been only partially successful in closing.
2. The first of these was the gift loan. Persons of means had been making interest-free loans to the objects of their bounty. While the donees often used the loan proceeds to purchase homes or other items, they were free to invest the proceeds and to retain the after-tax income. In view of the fact that there were no specific Code provisions addressing such transactions (since they did not involve the sale or exchange of property), the donors for many years contended that these transactions did not give rise to any gift tax even though the donees received a direct and measurable economic benefit from the interest-free use of the money. Economically, these transactions were indistinguishable from arrangements under which the donor directs the payment of the income from property owned by the donor to designated persons. In this type of situation, the assignment of income doctrine requires that the income from the property be taxed to the property owner, or, where a grantor trust is used, to the grantor. In a series of cases culminating in *Dickman v. Comr.*, 690 F.2d 812 (11<sup>th</sup> Cir. 1982), the IRS persuaded the courts that interest-free loans of this type resulted in gifts, measured generally by the amount of interest that could have been derived from investing the loan proceeds at market rates. In these cases, however, the IRS did not raise the question of whether the donor, in addition to the gift tax, should also be subject to tax on the income arising, or deemed to have arisen, from the use of the loan proceeds. In these circumstances, there was no question as to whether the donee was entitled to deduct any deemed interest payments to the lender.
3. Another perceived loophole was presented in cases involving interest-free loans from corporations to their shareholders. In these cases, the IRS focused on the economic benefit enjoyed by the borrower which it sought to characterize as equivalent to a distribution with respect to stock. In these cases, the IRS was unsuccessful primarily because it was unable to counter the argument that if the borrower were to be treated as receiving income in the amount of the interest forgone by the corporate lender, the borrower also must be allowed an equivalent deduction for the interest that would have been payable had such interest been charged. In these cases, the IRS apparently never sought to impose a tax on the corporate lender on the theory that the transaction was the equivalent of a distribution of the interest from funds invested at the corporate level. In one case, the IRS successfully contended that a corporate distribution resulted from the sale of corporate assets to shareholders where the funds to make the purchase were made available to the shareholder by an interest-free term loan. The Tax Court held that the amount of the distribution was equal to the excess of the property’s fair market value over the present value of the payments due under the loan terms discounted at market interest rates.
4. Finally, interest-free loans made by an employer to an employee (or made to an independent contractor by a person for whom the contractor performs services) could be used as a means of compensation. In such cases, which seem largely to have escaped concerted IRS scrutiny, the result is generally relatively tax neutral. The payment of compensation in this form, however, avoids the payment of employment taxes. Further, where such a loan is a term loan, the borrower receives the benefit in the year of the loan, but any deemed interest payments would be deductible over the term of the loan in which case there would not be a matching offset of income and deductions.
5. Code § 7872 was enacted to close these perceived loopholes by recharacterizing any interest-free or below market loan of the types discussed above, together with any other such loan which was or could be availed of to avoid tax, as an arm’s-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable federal rate. Specifically, Code § 7872 results in the parties being treated as if:

- a. The borrower paid interest to the lender that may be deductible by the borrower and is included in income by the lender; and
- b. The lender –
  1. Made a gift subject to the gift tax (in the case of a gratuitous transaction),
  2. Paid a dividend or made a contribution to capital (in the case of a corporation/shareholder loan),
  3. Paid compensation (in the case of a loan to a person providing services), or
  4. Made some other payment characterized in accordance with the substance of the transaction.

B. Guaranties.

1. Code § 2501(a)(1) taxes donors for completed gifts made during the taxable year. It is clear that a guarantor makes a taxable gift when he is forced to repay a debt upon the primary debtor's default. What remains unclear is whether the guarantor makes a taxable gift when he makes the initial guaranty. In other words, is the guaranty, because it bestows an economic benefit on the borrower, a taxable gift the moment the guaranty is made, or does the guaranty only become taxable when the obligation is realized? As explained below, until the IRS answers this question definitively, loan guarantors must tread lightly.
2. In 1960, the Tax Court held that a guaranty was not a completed gift and therefore not subject to gift tax because the guarantor's obligation to pay the debt was contingent on the primary debtor's default. *Bradford v. Commissioner*, 34 T.C. 1059 (1960), *acq.* 1961-2 C.B. 4. The IRS has taken the opposite view and in 1990 issued Private Letter Ruling 9113009, which stated that a parent's guaranty of his children's debts was subject to gift tax on the date the guaranty was effective. I.R.S. Priv. Ltr. Rul. 9113009 (Dec. 21, 1990). The IRS reasoned that the guaranty bestowed a present economic benefit on the children because it allowed them to secure a loan on more favorable terms than they could have otherwise obtained without the guaranty. *See id.* The IRS also stated that the parent would make an additional gift if the children defaulted on the loan and the parent was required to repay the children's debt. *See id.*
3. In 1993, the IRS withdrew the controversial view it advanced in Private Letter Ruling 9113009, but made no further comment on the immediate gift tax consequences of loan guarantees. *See* I.R.S. Priv. Ltr. Rul. 9409018 (Dec. 1, 1994). To date, the IRS and the Tax Court have provided no further guidance, although the tax treatment of guarantees is on the 2017-2018 IRS Priority Guidance Plan.
4. It is prudent to pay a guarantor a commercially reasonable guaranty fee in order to avoid the argument that the guaranty is a gift to the obligor with respect to the credit enhancement.

XVI. INSTALLMENT SALES, SELF-CANCELING NOTES, AND PRIVATE ANNUITIES.

A. Installment Sale.

1. An alternative to an outright gift is a sale of the business owner's entire interest in the business in exchange for an installment note.
2. If the business owner's basis in the transferred interest is significantly lower than its fair market value, recognition of capital gain can be deferred over the entire period of the installment note under Code § 453.
3. A major advantage of the installment sale technique is the ability to set a relatively low interest rate on the promissory note payments and avoid the possibility that the transaction will be re-characterized as a bargain sale. In *Frane*, 98 T.C. 554 (1992), the Tax Court held that the Code §

7872 rates will apply to determine whether or not an installment note will be valued at less than face value for the purposes of the application of the gift tax.

4. If the installment sale technique is utilized, care must be taken to coordinate the balance of the transferor's estate plan with the installment note technique. For example, upon the transferor's death, the fair market value of the note will be included in his or her estate. Assuming that the note is left to the obligor under the note, the tax apportionment provisions of the estate plan might provide that the obligor bear the transfer tax liability attributable to the note.
5. If the property transferred has a fair market value significantly in excess of its basis, the untaxed portion of the gain will be taxed to the transferor's estate (and reportable on the fiduciary income tax returns filed for the estate or trust) if the installment note is forgiven upon the transferor's death, or transferred to the obligor as a consequence of transferor's death. *Frane v. Commissioner*, 98 T.C. 341 (1992), *reversed in part and affirmed in part*, 998 F.2d 567 (8th Cir. 1993). The capital gain so recognized will constitute an item of income in respect of a decedent under Code §§ 453B(f)(1) and 691(a)(2).
6. The transferor may desire to elect out of the installment method at the time the sale is consummated, and recognize all capital gain liability in the year of sale. This will eliminate the future taxation of the unrecognized gain as income in respect of a decedent. Effectively, if the transferor is subject to a 40% estate tax, the government will be paying 40% of the income tax liability attributable to the gain recognized in the year of sale.
7. If the transferor desires, he may utilize the \$ 15,000 gift tax annual exclusion to forgive a portion of the installment note payments each year (up to \$30,000 per year if the transferor is married and the gift splitting election under Code § 2513 is made for all gifts made during the applicable calendar year). However, if the forgiveness of the note payments is part of a prearranged plan, the Service could argue that the transaction constitutes a bargain sale. See, e.g., Rev. Rul. 77-299, 1977-2 C.B. 343. The forgiveness of payments will cause recognition for income tax purposes of the gain element inherent in the forgiven payment.
8. Assuming that the purchaser of the business interest materially participates in the business, and that the business is carried on as a partnership or S corporation, it is likely that the purchaser will be able to deduct the interest paid on the promissory note, and will not be subject to the investment interest limitations of Code § 163(d). See Code § 163(d)(5)(A); Priv. Ltr. Rul 9037027.
9. Advantages.
  - a. All future appreciation in the value of the property sold is removed from the transferor's estate.
  - b. Assuming that the purchaser remains solvent, the transferor is guaranteed a fixed revenue stream for the term of the installment note.
  - c. The purchaser of the business interest immediately receives a basis in the business interest equal to the purchase price, even though the payment of the purchase price will be deferred over the period of the note. If the sale is structured as a sale to a "defective" grantor trust, however, the trust will assume the seller's basis in the business interest.
  - d. In the current low interest rate environment, the interest rate payable under the note need not exceed the applicable federal rate under Code § 7872. This results in minimizing the growth of the transferor's estate from his or her receipt of interest payments. In addition, when the transferor dies, the appraised value of the installment note should reflect a significant discount for the low interest rate payable under the note, provided that the note is left to someone other than the obligor.
10. Disadvantages:

- a. The transferor's estate will forego a basis step-up on the transferor's death in the installment note received in exchange for the business interest.
- b. The purchaser must continue to make the installment payments, even if the value of the purchased asset declines in the period following the sale.
- c. If the transferor is dependent upon the installment note payments, and the purchaser subsequently is unable to make the payments, or receives a discharge in bankruptcy, the transferor may not have any recourse other than a security interest in the assets sold which may have become worthless.

B. Self-Canceling Installment Note.

1. A self-canceling installment note (SCIN) is defined as a debt obligation that by its terms is extinguished at the death of the seller-creditor, with the remaining note balance cancelled automatically. The primary advantage of a SCIN over a straight installment sale is that if the seller dies prior to the expiration of the installment term, the remaining value of the installments are totally excluded from the seller's estate. Moreover, the SCIN provides an advantage over a private annuity (discussed, *infra*) in that the seller does not incur the tax risk of living well beyond the installment term, thereby increasing the seller's gross estate by continued annuity payments.
2. To compensate the seller for the risk of cancellation, the SCIN must contain a "risk premium," which may be reflected either in the purchase price of the assets or the interest rate of the note. Consequently, for the SCIN to be beneficial from an estate planning standpoint, either of the following must occur:
  - a. The return on the asset that is sold must exceed the interest rate on the SCIN.
  - b. The seller must die before his or her life expectancy.
3. A SCIN may be classified as either an installment sale or a private annuity for income tax treatment and valuation purposes. If the maximum term of the SCIN exceeds the life expectancy of the seller (as determined under Reg. 1.72-9), the SCIN is classified as a private annuity. If the installment term does not exceed the seller's life expectancy, the SCIN is classified as an installment sale. The differences between these two methods are discussed below. In most situations, the preference is to structure the SCIN so that it is treated as an installment sale.
4. Estate tax consequences.
  - a. The primary advantage of a SCIN for estate tax purposes is that the cancelled notes or contract payments are not included in the estate of the seller. Therefore, if the seller suffers a premature death, the SCIN may provide substantial estate tax savings. Also, even if the seller lives for the entire installment period, the sale of the property freezes the value of the asset and removes any appreciation on such property from the estate of the seller.
  - b. Because current interest rates are relatively low from a historical perspective (even after allowing for an interest rate risk premium), the use of a SCIN with an asset that has the potential for substantial appreciation may provide significant estate tax savings.
  - c. Code § 7520(c)(3) requires the Secretary to update the mortality tables every 10 years. The last update to Table 2000CM, found in Treas. Reg. § 20.2031-7, was issued in 2009, and another update should be issued in 2019. Each revision to the actuarial tables reflects slightly longer life expectancies. Because the longer life expectancies reduce the likelihood of a seller dying before the end of the installment term, the risk premium required should be less with each update.
  - d. Treas. Reg. 25.7520-3(b)(3) provides that the mortality component described in Section 7520 of the Code may not be used to determine the present value of an annuity, income,

remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the gift. An individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year. Treas. Reg. §25.7520-3(b)(3). If the individual survives for eighteen months or longer after the transfer, that individual shall be presumed to have not been terminally ill at the date of the transfer unless the contrary is established by clear and convincing evidence. *Id.*

5. Gift tax consequences.

- a. GCM 39503 states that the sale for a SCIN is not subject to gift tax if the sales price and length of payment are reasonable when compared with the value of the property transferred. The SCIN must contain a risk premium reflected as either an increase in the sales price or a higher interest rate in order to account for the possibility that the seller will die prior to the end of the installment term. If the fair market value of the property exceeds the SCIN's value, the seller has made a gift of the excess.
- b. When valuing a SCIN classified as a private annuity, the IRS has taken the position that the transfer tax mortality tables and discount rates determine the value of the SCIN and whether a gift has been made. This valuation method is relatively simple as the IRS provides actuarial tables for the shorter of one life or a term of years.
- c. On the other hand, if the SCIN is classified as an installment sale, GCM 39503 states that the facts-and-circumstances approach may be used. This implies that some flexibility may be allowed in valuing the SCIN for gift tax purposes. From a transfer tax standpoint, this flexibility may allow the installment payments to be less than under the transfer tax tables. The downside to this approach, however, is the subjectiveness of the valuation, and the corresponding possibility that the IRS may object to such valuation.

6. Income Tax Treatment.

- a. Transferor's treatment of gain. Assuming the SCIN is treated as an installment sale, gain recognized by the transferor who receives the SCIN is reported over the period during which payments are received. Each payment is divided into a return of basis, capital gain (assuming capital asset), and interest income. The amount of each item is determined by assuming that the maximum price will be received and by allocating these amounts proportionally to each installment payment. This method of reporting effectively allows the seller to defer capital gain over the period payments are received. Any gain remaining at the seller's death, however, is recognized by the decedent's estate.
- b. Capital gain on cancellation. Assuming the SCIN is treated as an installment note, recent case law and IRS rulings clearly indicate that based on Code § 453B(f), capital gain is recognized at death when a self-cancellation provision becomes operative. Historically, there was a question as to whether the gain is recognized on the decedent's final return or by the decedent's estate.
- c. Frane. The Eighth Circuit, in *Estate of Frane*, held that the capital gain should be treated as income in respect of a decedent (IRD) under Code § 691(a)(5)(A)(iii), which provides that "any cancellation of such an obligation occurring at the death of a decedent shall be treated as a transfer by the estate of the decedent..." Therefore, the gain is recognized on the estate income tax return and the tax liability resulting from the cancellation of the SCIN cannot be deducted as a debt of the estate on the estate tax return. In addition, losses from the decedent not used during his or her lifetime cannot be used to offset the gains realized by the decedent's estate on the cancellation of the SCIN.
- d. Basis of property. The law is not entirely clear with respect to the buyer's basis in the property, as the installment sale rules do not address this issue with respect to a SCIN. GCM 39503, however, concludes that the buyer's basis in property acquired in an installment sale is the full face value of the note. This appears to be the correct result as



the decedent must recognize capital gain on the SCIN. The courts, however, have not specifically addressed this issue.

- e. Based on GCM 39503, installment treatment is advantageous to private annuity treatment for purposes of determining the buyer's basis. If the SCIN is treated as an annuity, the buyer's basis for determining gain during the seller's lifetime is only the present value (using IRS tables) of the right to receive payments. Thus, the basis should initially equal the purchase price of the asset. The buyer's basis increases only when the aggregate annuity payments exceed the projected present value of the payments. Accordingly, on the cancellation of a SCIN treated as an annuity, the buyer's basis is fixed. On the other hand, if the SCIN is treated as an installment sale, the buyer's basis is the face amount of the note.
  - f. Buyer's interest deduction. GCM 39503 also provides that, subject to other limitations, the interest paid by the buyer is fully deductible. These other limitations, however, apply to the type of property used in a SCIN transaction. For instance, if a SCIN is used to purchase investment property, the interest may be deducted only to the extent of the buyer's net investment income from all sources, unless a passive activity is involved. Investment income is defined as income from dividends, annuities, or royalties not derived in the ordinary course of a trade or business. Any investment interest not deductible may be carried forward to the following year.
  - g. Passive Activity. If the investment is also a passive activity, the interest deduction is generally limited to investment income of the particular investment. The passive loss rules in Code § 469 provide that the losses and credits from a passive activity cannot be used to offset income from nonpassive activities. Passive activities are defined as trades or businesses in which the taxpayer does not materially participate. In contrast, if the SCIN is treated as an annuity, the purchaser gets no interest deduction.
  - h. Security or guarantees. An advantage to a SCIN over other types of transactions such as private annuities is that the transferor may take certain security or guarantees without jeopardizing the installment sale treatment. If a transferor receives security for a private annuity, the entire gain is taxable at the time of the transfer.
  - i. Sale of marketable securities. The sale of marketable securities is not eligible for installment reporting for income tax purposes. The sale of a partnership interest that owns marketable securities for a SCIN, however, should qualify for installment treatment if the selling partner could not have sold or caused the sale of the publicly-traded securities.
- 7. *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), acq. in result, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under §2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note."
  - 8. In *Estate of Costanza v. Comm'r*, 320 F.3<sup>rd</sup> 595 (6th Cir. 2003), the Sixth Circuit excluded from a decedent's gross estate the unpaid balance on a self-cancelling installment note (SCIN) given by a decedent's son in payment for certain assets bought from the decedent. The court reversed the Tax Court, which had stated that the SCIN was not a bona fide transaction. The Sixth Circuit stated that the estate had proven that there was a genuine expectation that the debt would be paid and collection would be enforced.
  - 9. The IRS Chief Counsel Office weighed in on the treatment of SCINs in Chief Counsel Advice 201330033. The taxpayer entered into various estate planning transactions including transfers of stock in exchange for preferred stock, stock transfers to GRATs, and sales of stock for notes. The CCA addresses the sale transactions. The sale transactions included some "standard" note transactions and some SCIN transactions. The CCA related to *Estate of Davidson*, T.C., No. 13748-13, stipulated decision, 7/6/15.

10. In *Davidson*, the IRS stipulated to estate and generation-skipping taxes totaling about \$321 million instead of the \$2.8 billion it had sought from the estate of owner Bill Davidson. The IRS further stipulated to \$3.5 million of the \$10 million in gift taxes that it had claimed were owed by Bill's widow, Karen. The Service based its \$1.9 billion estate tax deficiency and \$900 million gift and generation-skipping tax deficiency on the assertion that Bill made transfers to trusts for his grandchildren of self-cancelling installment notes (SCINs) in reliance on an unrealistic life expectancy.

C. Private Annuities.

1. A private annuity is a transfer of property from an annuitant (the transferor) who is not in the business of issuing annuities, to an obligor (the transferee) in exchange for the obligor's promise to make periodic payments of fixed amounts for the remainder of the annuitant's life or other specified period. Private annuities also can be structured to have a joint and survivor provision.
2. The annuitant purchases the annuity by transferring money or other property to the obligor. The obligor may be an individual, corporation, trust, foundation, or other entity.
3. The most advantageous and common use of private annuities is for intrafamily transfers with the annuitant being the parent and the child being the obligor. Other common private annuity situations involve the redemption of stock by a closely-held corporation in exchange for the annuity. Private annuities may, however, also be established between unrelated parties.
4. The tax consequences of private annuities are described in Rev. Rul. 69-74 (but see Prop. Regs. § 1.72-6 and Prop. Regs. § 1.1001-1, discussed, *infra*). The gain realized on a private annuity is the excess of the present value of the annuity over the annuitant's basis. The annuitant's income tax treatment is governed by Code § 72. Part of each annuity payment is a tax-free return of capital, while the remainder is subject to taxation.
5. Capital asset property. If the property used to fund the annuity is a capital asset, the gain (e.g., excess present value of annuity over basis in asset) is capital gain. Any excess fair market value over the present value of the annuity received is a taxable gift to the obligor. Gain is reported over the term of the annuity or the annuitant's life expectancy. Tables containing life expectancy factors are in Treas. Reg. § 1.72-9.
6. All annuity transfers after 1986 may not exclude more than the annuitant's investment in the contract as tax-free return of income. Once the annuitant fully recovers his or her investment in the contract, the balance of the payments received are fully taxable as ordinary income. Before 1987, there was no limitation on the exclusion ratio, i.e., if the annuitant outlived his or her actuarial life expectancy, a portion of the payments would still be tax-free. For annuity transfers taking place after July 1, 1986, if the annuitant dies before recovering his or her full investment in the contract, Code § 72(b)(3) provides that the unrecovered amount can be taken as a deduction on the decedent's final return. There was no such rule for transfers before July 2, 1986.
7. Depreciable property. If depreciable personal property used in a trade or business is transferred instead of capital gain property, the depreciation must be recaptured under Code § 1245. If real property is transferred, the recapture must be reported under Code § 1250. These provisions require income recognition of the depreciation recapture in the year the property is first transferred in exchange for the annuity. The obligor's basis for depreciating the property received in exchange for the annuity can change as annuity payments are made. Prior to the annuitant's death, the property's unadjusted basis starts at the value of the prospective payments. Once payments equal the value of the annuity on the date of the transaction, additional payments are added to basis. After the annuitant's death, however, the obligor's unadjusted basis is the total of annuity payments actually made.
8. Unfortunately for the obligor, the actual price paid for the annuity property cannot be determined until the annuitant's death. Thus, payments made by the obligor during the annuitant's life are treated as capital expenditures for tax purposes. The obligor cannot deduct any part of the payment as interest, even though the annuitant must pay tax on the interest part of each payment. The

obligor can, however, increase his or her basis in the transferred property as payments are made. If the obligor disposes of the property after the annuitant's death, the obligor's unadjusted basis in the property is the total payments made. If the property used to fund the annuity is sold before the annuitant's death, the obligor has a "split" basis for determining gain or loss. The unadjusted basis for determining gain is the total annuity payments made up to the time of disposition and the present value of the prospective payments still to be made (as determined under Code § 7520). The unadjusted basis for determining loss is the total payments made up to the time of sale. If the sale price is less than the adjusted basis for gain and more than the adjusted basis for loss, neither the gain nor the loss is recognized.

9. Gift taxes. One of the more common uses of private annuities for family transfers is to include a gift element in the annuity contract. This allows parents, grandparents, or other relatives to transfer property to children, make gifts, and still ensure their own financial well being. When property is transferred for less than its full consideration, the Service treats the portion of the transfer that is less than the property's fair market value as a gift. If a gift is not intended, the fair market value of the transferred property must equal the present value of the annuity. Thus, the property should be appraised if it is not easily valued on public markets. Further, consulting with an actuary can help avoid any surprise partial gifts and tax penalties. When part of a private annuity transaction is treated as a gift, the donor-annuitant's basis (i.e., investment in the contract) cannot exceed the present value of the prospective annuity payments that will be made. If depreciable and nondepreciable property are used, the basis for the gift portion is allocated between the two properties proportionally. Suppose the obligor is the one making the gift. The obligor's basis is limited to the value of the property received for purposes of determining both depreciation and gain or loss (i.e., the obligor gets a zero basis for the gift portion of the property).
10. Estate taxes. To avoid inclusion of the transferred property in the annuitant's gross estate, an annuitant must not retain a security interest in the transferred property. If an annuitant retains a security interest that allows repossession of the property on the obligor's default, the annuitant may have this property included in his or her estate under Code § 2036, as a transfer with a retained life estate.
11. Advantages. For annuitants who die prematurely, private annuities are a low transfer tax way to avoid having property taxed in the estate under Code § 2036. Aside from this (and for those who expect to live out their life expectancies), the greatest benefit of a private annuity is to a transferor (the annuitant) who wants to keep ownership of certain property within the family, while having the security of a fixed income for life. Further, the annuitant can remove any future appreciation on the transferred property from his or her gross estate. Property transferred within three years of the annuitant's death should not be included in the annuitant's gross estate, provided a life estate or security interest was not retained that would cause inclusion under Code §§ 2036, 2037, 2038 or 2042.
12. Disadvantages. The most precarious aspect of entering into a private annuity agreement is the annuitant's life expectancy. The uncertainty of death may cause difficulties. If the annuitant dies prior to his or her actuarial life expectancy, the obligor's basis may be lower than it would have been had the property been inherited. In the alternative, if the annuitant outlives his or her actuarial life expectancy, the annuity payments may exceed the value of the contract or the estate tax value assigned to the assets had it been retained by the estate. An annuitant who outlives his or her actuarial life expectancy will have to pay income tax on the entire realized gain. Further, if the annuitant does not spend the payments, they will increase his or her estate, perhaps by more than the underlying property would be worth if the annuitant outlives his or her life expectancy. An additional risk to the annuitant is that the obligor may predecease him or her—jeopardizing the receipt of future payments. Because annuity payments are usually made from after-tax dollars, with part of the payments being included in the annuitant's income as interest, a private annuity may increase the overall tax burden to the parties involved. Even though the annuitant receives interest income, the obligor cannot take the interest expense deduction for any portion of the annuity payment. If the property used to fund the annuity is of a very high economic value, it may place a financial burden on the obligor to make such high annuity payments.

13. On October 18, 2006, the Department of Treasury issued Prop. Regs. § 1.72-6 and Prop. Regs. § 1.1001-1 that eliminate the income tax advantages of selling appreciated property in exchange for a private annuity. The proposed regulations require the seller's gain to be recognized in the year the transaction is effected rather than as payments are received. The proposed regulations generally would apply for transactions entered into after Oct. 18, 2006, but certain transactions effected before Apr. 19, 2007 would continue to be subject to the old rules. Under the proposed regulations, the following would occur when an annuity contract is received in exchange for property (other than money):
- a. The amount realized attributable to the annuity contract would be the fair market value (as determined under the valuation tables issued under Section 7520) of the annuity contract at the time of the exchange;
  - b. The entire amount of the gain or loss, if any, would be recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and
  - c. For purposes of determining the initial investment in the annuity contract under Section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract would equal the amount realized attributable to the annuity contract (the fair market value of the annuity contract).

For an exchange of property for an annuity contract that is in part a sale and in part a gift, the Proposed Regulations apply the same rules that apply to any other such exchange under Section 1001. Prop. Regs. § 1.1001-1(j)(1). The Proposed Regulations provide that, for purposes of determining the investment in the annuity contract under Section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract would be the portion of the amount realized on the exchange that is attributable to the annuity contract (which is the fair market value of the annuity contract at the time of the exchange). (Reg. § 1.72-6(e)(1)) The annuitant's investment in the contract would be reduced in subsequent years under Section 72(c)(1)(B) for amounts already received under the contract subsequent to the exchange and excluded from gross income when received as a return of the annuitant's investment in the contract. The Proposed Regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company and those issued by a taxpayer that is not an insurance company. Instead, they provide a single set of rules that leave the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract. The Proposed Regulations apply for exchanges of property for an annuity contract after October 18, 2006. Thus, they wouldn't apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. For certain transactions, the Proposed Regulations apply for annuity contracts received in exchange for property after Apr. 18, 2007. The delayed effective date would apply for transactions in which (i) the issuer of the annuity contract is an individual; (ii) the obligations under the annuity contract are not secured, either directly or indirectly; and (iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

14. In *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278, the Tax Court held that assets transferred from the decedent within three years of the decedent's death to newly formed family limited partnerships, followed by close-in-time exchanges of FLP interests for private annuities, were includible in the decedent's gross estate because they were not bona fide sales for adequate consideration. In addition, the Court determined that the decedent had retained impermissible designation and amendment powers with respect to the annuities within the meaning of Code §§ 2036(a)(2) 2038(a)(1).
15. In *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, the Tax Court held that the decedent's sale of interests in a limited partnership to her children in exchange for a deferred private annuity was a valid sale for full and adequate consideration that had economic substance.

## XVII. PARTNERSHIP FREEZES AND GRATS

### A. Partnership Freezes

1. Section 2701 was enacted in 1990 as a part of Chapter 14 and addresses the technique of partnership freezes between family members. On the most basic level, a partnership freeze (prior to 1990) was a technique wherein two classes of partnership interests would be issued; one of which carried a non-cumulative preferred return on what was most often the partner's capital account (but had no rights to participate in the growth of the entity) and the other, a non-preferred interest, carried the remaining value of the entity, taking into account the entity's requirement to pay the preferred return. Prior to 1990, when these interests were valued, the majority of the value was found to be in the preferred interest and the non-preferred interest had no (or little) value. As a result, the non-preferred interest could be transferred at little or no gift tax cost, and the future appreciation in the entity would thereafter be in the donee's hands, while the donor continued to receive a stream of income from the entity, through its payment of the preferred return. Upon the death of the donor, the only asset includible in his or her estate was the value of the preferred return, which was discounted in light of its non-cumulative nature. All of the appreciation in the entity would therefore escape inclusion in the donor's estate because it was in the hands of the donee in the form of the non-preferred interest.
2. Section 2701 provides that if the preferred interest does not meet certain requirements set forth in the Section, then such interest will be valued at zero. Thereafter, if any transfer is made of any non-preferred interest, the value deemed to have been transferred shall be based on the "subtraction method" of valuation, calculated as follows:
  - a. The value of all property contributed to the partnership (or the value of all interests in the partnership) is determined (as though it were held by one individual).
  - b. The value of the preferred interest is subtracted from the value determined above:
    - (1) If the preferred interest does not meet the requirements of Section 2701, the value is deemed to be zero.
    - (2) If the preferred interest meets the requirements of Section 2701, the value is determined based on normal valuation methodology, with the exception that any value attributable to most liquidation, put, call or conversion rights (other than rights that must be exercised at a specific time and at a specific amount) attached to the preferred interest, are valued at zero.
  - c. The remaining value (after the subtraction) is allocated proportionately among the non-preferred interests (including the non-preferred interests held by holders of preferred interests).
  - d. In a transfer subject to Section 2701, the value of all non-preferred interests, together, must equal at least 10% of the value of all partnership interests, plus the value of any, indebtedness of such entity to the family. Accordingly, notwithstanding the valuation of preferred interests that meet the requirements of Section 2701, if such interests make up more than 90% of the value of the entire entity, the excess of such value over the 90% amount must be allocated proportionately to the non-preferred "junior" entity interests.
  - e. If the value allocated to each non-preferred interest is greater than the amount contributed (or the consideration paid) by the owner of the non-preferred interest, a gift has been made.
3. Accordingly, to avoid the gift that would result from the value of the preferred interest to be deemed to have been zero, the preferred interest should either meet the requirements of Section 2701 or the transaction must fit into one of the Section's exceptions, which are as follows:

- a. If market quotations for the preferred interest are readily ascertainable, Section 2701 does not apply.
  - b. If the transferor retains an interest (i) in the same class as the transferred interest or (ii) that is proportionally the same as the transferred interests, Section 2701 does not apply.
  - c. Section 2701 only applies when (i) there is a transfer, to or for the benefit of a member of the transferor's family who is in the same or lower generation as the transferor, of an equity (non-preferred) interest in the entity, (ii) after the transfer, the transferor or a family member who is in the same or higher generation as the transferor holds retains a "distribution right" (the payment of which is in the discretion of the entity), and (iii) the entity is controlled by the family (pursuant to the application of certain attribution rules set forth in the Section). For this purpose, "control" means either holding 50% of the capital or profits of the entity or holding the general partner or the manager interest in the entity.
  - d. **Qualified Payments**
    - (1) If the distribution right is deemed to be a "qualified payment" then it will be valued at its fair market value, rather than zero, for purposes of these rules. A qualified payment is one that is paid on a periodic basis that is cumulative and determined at a fixed rate.
    - (2) If the distribution right is deemed not to be a "qualified payment", the transferor or family member holding the right may elect to treat the right as a qualified payment and the election is irrevocable.
    - (3) Once a payment is deemed (or elected) to be a qualified payment, there is an additional consequence to such characterization. If the payments are in arrears by four years or more, then the payments shall be deemed to have been made when due and such payments shall be deemed to have been reinvested as of such date at the discount rate used in determining the value of interest. Such deemed amount will be a deemed transfer subject to estate or gift taxes, either when the transferor makes a gift (or sells) his or her interest in the entity or at his or her death.
  - e. If the distribution right is a right to receive a guaranteed payment (pursuant to Section 707(c)) of a fixed amount, then such rights are not subject to the rules of Section 2701.
4. See Private Letter Ruling 200114004 for a partnership freeze using a FLLC that was approved by the Service.

**B. Grantor Retained Annuity Trust.**

1. A Grantor Retained Annuity Trust or "GRAT" is an irrevocable trust into which the client makes a gift of property and retains an annuity payable for a term of years. If the client survives the term, any property remaining in the trust passes without any additional gift tax to the remaindermen, or to trusts for their benefit.
2. For gift tax purposes, the value of the gift upon creation of a GRAT is determined by subtracting the value of the retained interest from the value of the property gifted to the GRAT. The retained interest is valued using the "Applicable Federal Rate" ("AFR") promulgated by the Treasury pursuant to Code § 7520 for the month in which the gift is made. If the client has enough remaining applicable exclusion, no gift tax will be due. Generally, if the assets transferred to the GRAT appreciate or produce income at a rate higher than the AFR, the transaction will successfully leverage the gift tax exemption.

3. For purposes of valuing a gift to a GRAT, Code § 2702 provides that if a person transfers an interest in trust to or for the benefit of a member of his or her family and the transferor or an “applicable family member” retains an interest in the trust, then for purposes of determining the value of the interest transferred, any retained interests in the trust that are not “qualified interests” are valued at zero. An “applicable family member” includes the transferor’s spouse, an ancestor of the transferor or the transferor’s spouse, and the spouse of any such ancestor. Both the annuity for a fixed term of years retained by the client and the remainder transferred to the remaindermen are qualified interests. However, the reversion retained by the client is not a qualified interest, and therefore its value is treated as zero. Because the value of the gift upon creation of a GRAT is determined by subtracting the value of the qualified interests retained by the client, the value of the reversion is effectively reflected in the remainder value transferred to the remaindermen. In effect, the value of the reversion is subject to gift tax as if it had been transferred to the remaindermen, although it was actually retained by the client. Thus, the gift to the remaindermen is the present value of the amount actuarially expected to remain in the GRAT at the end of the term, plus the value of the reversion.
4. Notwithstanding the benefits of the GRAT technique, there are two negative features. First, if the client dies prior to the end of the GRAT term, some or all of the trust assets are included in the client’s estate. The client typically retains a reversionary interest in the GRAT so that the property will pass as part of his or her estate if he or she does not survive the GRAT term. Second, the client cannot allocate generation-skipping transfer (“GST”) tax exemption to the trust until the end of the GRAT term, thus precluding use of the GRAT to leverage the GST tax exemption.
5. The Walton case, *Walton v. Commissioner*, 115 T.C. No. 41 (2000), held that Ex. 5 of the Treasury Regulations is an invalid interpretation of Code § 2702. This case opens the door to creating GRATs with unlimited amounts of value without a gift tax.
6. When considering the transfer of a closely-held business interest to a GRAT, consider the collateral valuation issues associated with contribution and distribution of those business interests. For example, client contributes 100% of the stock of a closely-held business, valued at \$10 million, to a 3 year *Walton* style GRAT in March 2008 (3.6% Code § 7520 rate). The GRAT, by its terms must distribute 35.76154% of the initial value of the assets contributed to the GRAT. Here is a situation (somewhat analogous to the *Ahmanson Foundation* and *Chenoweth* line of cases), where the taxpayer can potentially get whipsawed on the valuation. A contribution of 100% of the stock of company to the GRAT will not generate a discount for lack of control, but an in-kind distribution of a 35.76154% interest in the same shares will certainly generate such a discount. The result being that more shares need to be distributed out of the GRAT, thereby negating its efficacy.
7. Also, when considering a GRAT funded with an interest in a pass-through entity, such as an S corporation or an LLC, consider providing for quarterly GRAT payments, which will allow the grantor to receive distributions from the GRAT that parallel the grantor’s estimated tax payment obligations.

## XVIII. SALE TO GRANTOR TRUST AND BENEFICIARY DEFECTIVE TRUSTS

### A. Sale to “Defective” Grantor Trust.

1. The sale to a grantor trust, also commonly referred to as a “defective” grantor trust, has become one of the primary leveraging techniques in the estate planning lawyer’s arsenal. A defective grantor trust is a trust that Subpart E of Subchapter J of the Code treats as being owned by the grantor but that is not included in the grantors gross estate. It is also possible to draft and fund a trust so that the beneficiary is the owner of the trust for income tax purposes under Code § 678, but this article does not discuss the use of that technique. Because the grantor is the owner of the trust for income tax purposes, he or she must report all trust income, deductions and credits on his or her personal income tax return. Code § 671-677.
2. A defective grantor trust has three primary benefits.

- a. First, the grantor's payment of income taxes on income earned by the trust is the functional equivalent of a tax-free gift to the trust by the grantor.
  - b. Second, because the trust pays no income taxes while the grantor is living, its assets accumulate income tax-free. For example, assuming a 40% income tax rate, a defective grantor trust that earns income at a rate of 10% per year would have the entire amount of this income remaining in the defective grantor trust. On the other hand, if the trust were not a defective grantor trust, it would have only 6% of the earnings remaining in the trust after taxes.
  - c. Finally, because the Code treats the grantor as the owner of the trust for income tax purposes, the IRS disregards transactions between the grantor and the trust for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184.
3. Before the client sells the discounted assets to the defective trust, it is important that he or she give assets to the trust that have a fair market value of at least 10% of the value of the assets that the client plans to sell to the trust. The purpose for independently funding at least 10% is to decrease the likelihood that Code § 2036(a)(1) will apply to the sales transaction and cause those assets to be returned to the client's taxable estate. If the trust owns little or no assets independent of the sales transaction, there is a greater danger that the IRS could recast the transaction as a disguised transfer with a retained interest.
  4. The client should file a gift tax return allocating GST exemption to the trust so that it is wholly exempt from generation-skipping taxes. If the gift is less than the client's applicable exclusion amount under Code § 2505, no gift tax will be due. After the gift, the client enters into a sales agreement with the trustee of the trust whereby the trustee agrees to purchase limited partnership interests or other assets subject to a valuation discount, such as minority interests in a business. The client conveys those assets to the trust in exchange for a promissory note with a face value equal to the fair market value of the assets. If the purchase price equals the fair market value of the purchased assets, there will be no taxable gift or transfer subject to the GST tax. Thus, no additional gift or GST exemption must be allocated to the trust.
  5. The parties will structure the promissory note to pay the client interest for a term of years with a balloon payment of principal at the end of the term, using the Code § 1274 interest rate for the month of the sale so that there is no imputed gift under Code § 7872. The payments from the trust to the client are usually very low in comparison to the income earned by the asset being sold to the trust. The Code § 1274 rate is typically low, and that low rate applies to the discounted value of the asset sold rather than against the pro rata value.
  6. In Revenue Ruling 2004-64, the Service discusses the estate tax effect of a tax reimbursement clause contained in a defective grantor trust – i.e., a trust that is treated as owned by a grantor for income tax purposes, but whose assets are excluded from the grantor's estate for estate tax purposes.
    - a. Situation 1- No Right to Income Tax Reimbursement. Payment of income tax by grantor will not be a gift to trust or trust beneficiaries.
    - b. Situation 2 - Mandatory Income Tax Reimbursement Clause Will Cause Estate Tax Inclusion Under Code § 2036. IRS will not apply this to Trusts created before October 4, 2004.
    - c. Situation 3- Discretionary Reimbursement Provision (Whether Exercised or Not) Will Not Cause Estate Tax Inclusion Under Code § 2036.

This ruling confirms a position which many taxpayers and practitioners believed to be correct. This ruling is the first formal pronouncement by the IRS which confirms this view.

7. In Revenue Ruling 2007-13, the Service addressed the transfer for value issues when a life insurance policy is transferred to a defective grantor trust. This Ruling addresses the question of



whether the transfer of a life insurance contract on the grantor's life to a grantor trust is a transfer for a valuable consideration within the meaning of Code § 101(a)(2) of the Internal Revenue Code, and if so, is a transfer to the insured within the meaning of Code § 101(a)(2)(B)?

- a. The facts of the Ruling are fairly straightforward. In Situation 1, Trust 1 and Trust 2 are grantor trusts, both of which are treated as wholly owned by the Grantor under subpart E of Part I of subchapter J of the Internal Revenue Code. Trust 2 owns a life insurance contract upon the life of the Grantor. Trust 2 transfers the life insurance contract to Trust 1 in exchange for cash. In Situation 2, the facts are the same as in Situation 1, except that Trust 2 is not a grantor trust.
- b. Code § 101(a)(1) provides that, except as otherwise provided in §§ 101(a)(2), 101(d), and 101(f), gross income does not include amounts received under a life insurance contract if such amounts are received by reason of the death of the insured. Code § 101(a)(2) provides, generally, that if a life insurance contract, or any interest therein, is transferred for a valuable consideration, the exclusion from gross income provided by § 101(a)(1) shall not exceed an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee. The term "transfer for a valuable consideration" is defined for purposes of § 101(a)(2) in § 1.101-1(b)(4) of the Income Tax Regulations as any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Code § 101(a)(2)(B) provides that § 101(a)(2) does not apply to a transfer of a life insurance contract or any interest therein to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.
- c. In Rev. Rul. 85-13, 1985-1 C.B. 184, a grantor acquired the corpus of a trust in exchange for the grantor's unsecured promissory note. The ruling concludes that the grantor is considered to have borrowed the corpus of the trust and, as a result, is treated as the owner of the trust under § 675(3). Because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes. In addition, because the grantor is therefore considered to own the purported consideration both before and after the transaction, the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes.
- d. The Ruling concludes that, in Situation 1, because the Grantor is treated as the owner of both Trust 1 and Trust 2 for federal income tax purposes, the Grantor is treated as the owner of all the assets of both trusts, including both the life insurance contract and the cash received for it, both before and after the exchange. Accordingly, in Situation 1 there has been no transfer of the contract within the meaning of Code § 101(a)(2).
- e. In Situation 2, because the Grantor is treated as the owner of all the assets of Trust 1 but not of Trust 2 for federal income tax purposes, the Grantor is treated as the owner of the cash (but not the life insurance contract) before the exchange, and as the owner of the life insurance contract (but not the cash) after the exchange. Accordingly, in Situation 2 there has been a transfer of the life insurance contract for a valuable consideration within the meaning of § 101(a)(2). Nevertheless, the transfer for value limitations of § 101(a)(2) do not apply, because the transfer to Trust 1 is treated as a transfer to the Grantor, the insured, within the meaning of § 101(a)(2)(B).
- f. This ruling is consistent with Private Letter Rulings issued by the IRS, including, Priv. Ltr. Ruls. 200636086 (September 8, 2006); 200606027 (February 10, 2006); 200518061 (May 6, 2005); 200514001 and 200514002 (April 8, 2005); 200247006 (November 22, 2002), and 200228019 (April 10, 2002).
- g. The benefit of this planning is two-fold. First, as the Ruling clearly states, the transfer of a policy to a grantor trust will qualify for the exception to the transfer for value rules. The second, more interesting planning implication, is that the policy can be sold to a grantor trust for full and adequate consideration and escape the three-year rule of Code § 2035.

- h. Consider the following situations where this type of planning may be useful:
1. Grantor owns a policy on her life, whether issued yesterday or 10 years ago, and sells it to her grantor trust to avoid the three-year rule. How so? The three-year rule does not apply to transfers for adequate and full consideration. Code § 2035(d). No transfer-for-value problem because the sale is disregarded.
  2. Grantor Trust 1 owns a policy on grantor's life, but planning is better served if the policy is in Grantor Trust 2. Sell the policy to Trust 2, either for cash or a promissory note. If both trusts are grantor trusts, there are no income tax consequences whatsoever. If only Trust 2 is a grantor trust, there is no transfer-for-value violation because the transfer-to-insured exception is met (although there may be taxable gain when Trust 1 is not a grantor trust).
  3. Grantor-insured's employer or qualified plan owns a policy on grantor's life. In both cases, taxable income to the grantor-employee *and* the three-year rule can be avoided with a sale of the policy to the grantor trust (adequate and full consideration exception). In addition, there is no transfer-for-value problem because it is a transfer to the insured.
  4. A and B own policies on the other's life for cross purchase buy-sell purposes. When the arrangement is terminated, A can sell the policy on B's life to B's grantor trust, and vice versa. No three-year rule (adequate and full consideration exception) and no transfer-for-value (transfer-to-insured exception) although there may be taxable gain on the sale.
8. In Notice 2007-73, the IRS described two "transactions of interest" involving a grantor trust where the grantor trust status was "toggled" off and then "toggled" on. The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction. The notice identifies this transaction, and substantially similar transactions, as transactions of interest for purposes of Treas. Reg. § 1.6011-4(b)(6) and Code §§ 6111 and 6112. The notice also alerts persons involved with these transactions to certain responsibilities that may arise from their involvement with these transactions. It does not appear that turning off the grantor trust status of a trust is with respect to a transaction of interest.
- a. When grantor trust status terminates during the grantor's lifetime, the grantor is deemed to have transferred to the trust all of the assets in the trust and all of the liabilities of the trust. *Madorin v. Commissioner*, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), Ex. (5); Rev. Rul. 77-402, 1977-2 C.B. 222.
  - b. If the liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred to the trust, the grantor will recognize gain on the difference. Treas. Reg. § 1.1001-2(a)(1). This section provides that the "amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."
  - c. If, however, the liability was incurred by reason of acquisition of the property, the liability will not be included in the amount realized. Treas. Reg. § 1.1001-2(a)(3). Furthermore, because transactions between the grantor and the grantor trust are disregarded for federal income tax purposes, any liabilities between the grantor and the grantor trust should be disregarded. See Rev. Rul. 85-13, 1985-1 C.B. 184.9.
  - d. The Treasury Regulations illustrate the tax consequences of turning off grantor trust status in Section 1.1001-2(c), Example (5). In *Madorin*, the grantor trust status was turned off when the underlying assets of the trust had debt in excess of basis, resulting in gain under Section 1001.

9. A power that is often used to cause a trust to be a grantor trust is a nonfiduciary power in the grantor to substitute assets of equivalent value with the trust under Code § 675(4)(c). In Revenue Ruling 2008-22, the IRS provided guidance under section 2036 regarding the tax consequences of a retained power to substitute assets in a trust. This ruling is immensely important to sophisticated estate planning, and it deserves close scrutiny by estate planning practitioners.
- a. Under the facts of the Ruling, a U.S. citizen funded an irrevocable inter vivos trust for the benefit of his descendants and named another person as the trustee. The trust instrument specifically prohibited the grantor from serving as trustee and granted the grantor the power, exercisable at any time, to acquire any property held by the trust - by substituting other property of equivalent value. The substitution power was exercisable by the grantor in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. The trust did, however, require that in order to exercise the substitution power, the grantor must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. Local law, furthermore, imposed upon the trustee a fiduciary obligation to ensure that the properties being exchanged are of equivalent value. Also, local law imposed upon the trustee of a trust that has two or more beneficiaries, a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Without restriction in the trust instrument, the trustee has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law. The grantor died after the trust was created and funded, and the IRS raised the question of whether the trust assets should be includible in the grantor's gross estate under Section 2036(a) or 2038(a), on account of the reserved nonfiduciary power to substitute trust assets.
  - b. The IRS ruled that the substitution power will not, by itself, cause the value of the trust corpus to be includible in the deceased grantor's gross estate, as long as the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. The IRS reviewed the operation of Sections 2036(a) and 2038(a) on property transferred by a decedent during his or her lifetime. Section 2036(a) includes in the value of a decedent's gross estate the value of all property transferred by the decedent at any time (other than by a bona fide sale for full and adequate consideration in money or money's worth), whether by trust or otherwise, if the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or a period that does not in fact end before the decedent's death, if:
    - (1) the decedent retained the possession or enjoyment of the property or the income from the property; or
    - (2) the decedent retained the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the property.
  - c. Section 2038(a)(1) includes in the value of a decedent's gross estate the value of all property transferred by the decedent at any time (other than by a bona fide sale for full and adequate consideration in money or money's worth), whether by trust or otherwise, where the enjoyment of the transferred property was, on the date of the decedent's death, subject to any power held by the decedent (in whatever capacity, alone or in conjunction with any other person) to alter, amend, revoke, or terminate the transfer, or where any such power is relinquished during the three-year period ending on the date of the decedent's death.
  - d. The IRS also reviewed the Tax Court's decision in *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1, in which the Tax Court held that,

because the decedent was bound by fiduciary standards and was accountable in equity to the succeeding income beneficiary and remainder beneficiaries, the decedent could not exercise the reserved substitution power to deplete the trust or to shift trust benefits among the beneficiaries. The court held that the substitution power was not, therefore, a power to alter, amend, or revoke the trust under Section 2038, even though the decedent reserved the power to substitute other securities or property for those held in trust (provided the substituted property was equal in value to the property replaced). In *Jordahl* the IRS argued that the trust assets were includible in the decedent's gross estate under Section 2038, because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The court disagreed, noting that the decedent's fiduciary duty to the beneficiaries stood between him and the ability to treat the property as his own and thus fell outside the scope of Section 2038.

- e. Under the facts in *Jordahl*, the trust instrument in Revenue Ruling 2008-22 stated that the grantor's power to substitute assets of equivalent value was held in a non-fiduciary capacity. Thus, the grantor was not subject to the rigorous standards attendant to a power held in a fiduciary capacity. The trust instrument also expressly prohibited the grantor from serving as trustee. The IRS, however, focused upon the duties imposed upon the actual trustee of the trust. Generally, a trustee has a fiduciary duty to the trust and its beneficiaries and is held to a high standard of conduct with respect to the administration of the trust. A trustee has a duty to the beneficiaries of the trust to administer the trust solely in their interest, which, in turn, requires the trustee to act fairly, justly, honestly, in the utmost good faith, and with sound judgment and prudence. The trustee also has a duty of impartiality that requires the trustee to take into account the interests of *all* the beneficiaries for whom the trustee is acting. Thus, for example, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests is usually voidable by any affected beneficiary. The trustee furthermore must act impartially as to multiple beneficiaries, in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests.
  - f. In situations like that of Revenue Ruling 2008-22, where the grantor of a trust holds a non-fiduciary power to replace trust assets with assets of equivalent value, the grantor is not subject to a fiduciary duty, but the trustee is and the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. A trustee who knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust assets being reacquired, has a fiduciary duty to prevent the exercise of the power. The IRS was thus assured in the facts of the ruling that the trustee's fiduciary duty would preclude the grantor from exercising the power to substitute assets in a manner that would reduce the value of the trust corpus or increase the grantor's net worth, or cause any shifting of benefits between or among the beneficiaries occur. Therefore, it ruled that the grantor's retained power will not cause the value of the trust corpus to be included in his/her gross estate under either Sections 2036 or 2038.
  - g. The exercise of a substitution power where a business interest is replaced with a promissory note has been the subject of recent litigation in state court. See, e.g., *Benson v. Rosenthal*, 2015 U.S. Dist. LEXIS 89238 (E.D. La. 2015); 2016 U.S. Dist. LEXIS 33909 (2016), *Schinazi v. Eden*, A16A0769, A16A0781 (Ga. Court of Appeals, 2016), and *Trust of Condiotti* 4CA0969 (Colo. App. 07-09-2015)
10. In Revenue Ruling 2011-28, IRB 2011-49, addressed whether a grantor's retention of the power, exercisable in a non-fiduciary capacity, to acquire an insurance policy held by a trust by substituting other assets of equivalent value will cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042. The ruling concludes, that a grantor's retention of the power, exercisable in a non-fiduciary capacity, to acquire an insurance policy held

in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042, provided

- a. The trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value;
- b. That the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

B. Caselaw Involving Sales to Grantor Trusts.

1. *Karmazin v. Comm'r*, T.C. Docket No. 2127-03 (pet. filed Feb. 10, 2003, stipulated decision entered Oct. 15, 2003).
  - a. In *Karmazin*, the transferor created a family limited partnership and, on the same day, gave and sold limited partnership interests to two grantor trusts. The taxpayer gave the trusts 10% of the limited partnership interests, and sold the trusts 90% of the limited partnership interests. All or most of the underlying assets of the partnership were marketable securities. The sales were made in exchange for secured promissory notes bearing interest equal to the applicable federal rate, with a balloon payment after twenty years. The sales agreements contained "defined value clauses."
  - b. The IRS contended that the partnership was a sham and that the note did not represent *bona fide* indebtedness, but rather was a reserved interest in the transfers to the trusts. The IRS applied Section 2703 to disregard the partnership, ignored the defined value adjustment clause, treated the transfer as a gift with a retained income interest, rather than a sale, and then applied Section 2702 to ignore the value of the promissory note in determining the amount of the taxable gift. The IRS argued that the note in *Karmazin* did not represent a *bona fide* indebtedness because the only other assets owned by the trust were the limited partnership interests. In addition, the debt was non-recourse, so the trust's other assets were not truly at risk. The Service also argued that no commercial lender would have entered into this transaction without a larger downpayment or personal guarantees, a nine-to-one debt equity ratio was too high, and that the partnership did not produce sufficient income to support the debt.
  - c. *Karmazin* was resolved by a stipulated settlement in which the parties agreed that the sale of partnership units to a grantor trust was a *bona fide* sale and not the gratuitous transfer of partnership units with the reservation of an annuity, as the Service had originally argued. In addition, the interest payments made by the trust were interest and not an annuity. It was agreed that neither Section 2701, nor Section 2702 applied to the transaction. For purposes of determining the sale price, the discount applied in valuing the partnership units was 37% and not 42% as the transaction originally contemplated (based on an appraisal). The defined-value clause ("that number of units equal to a value of \$ X") was invalid for purposes of the settlement.
2. *Estate of Marion Woelbing v. Comm'r*, Tax Court Docket No. 30260-13 (pet. filed 2013; settled March, 2016) and *Estate of Donald Woelbing v. Comm'r*, Tax Court Docket No. 30261-13 (pet. filed 2013; settled March, 2016).
  - a. In 2006, Donald Woelbing sold his nonvoting stock of Wisconsin manufacturer Carma Laboratories, Inc., to a trust for a \$59 million interest-bearing promissory note. Two of

Mr. Woelbing's sons who were beneficiaries of the trust provided personal guarantees for 10 percent of the purchase price of the stock. The purchase price was determined by an independent appraiser and the sales agreement provided for the number of shares sold to be adjusted if the IRS or a court revalued the stock. Mr. Woelbing died in July 2009 and his wife died four years later.

- b. The IRS audited both estates for estate and gift tax issues. The IRS asserted that the promissory note received by Mr. Woelbing was really an interest in the trust, rather than a bona fide debt instrument, and that the note should have a zero value for gift tax purposes under Section 2702. Alternatively, the IRS argued that Section 2702 did not apply, and that Mr. Woelbing made a gift of the difference between the fair market value of the Carma Laboratories, Inc. shares and the fair market value of the promissory note. The IRS also argued that the note should not be included in Mr. Woelbing's gross estate, but that the stock should be included under Sections 2036 and 2038, apparently viewing the promissory note as a retained income interest or beneficial enjoyment in the stock. Again, this would appear to turn on whether the promissory note is a true indebtedness or a retained interest in the transferred shares.
- c. The cases settled before trial. The IRS accepted the validity of the *Wandry*-like formula language in the installment sale agreement, finding that there was no gift in the year of sale but that the value of the stock was higher than reported, so that more shares were not transferred. The IRS conceded that the trust had adequate equity to avoid both the application of Section 2702 and 2036. No penalties were imposed.
- d. The IRS asserted that the Woelbing promissory note was worth less than its face amount because it bore interest at the applicable federal rate, which is lower than the interest rate that an unrelated third party might have charged. Such an argument is contrary to *Frazee v. Comm'r*, 98 T.C. 554, 588 (1992) (Section 7872 applies to sales); *Estate of True v. Comm'r*, T.C. Memo. 2001-167, *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004) (stating that *Frazee* makes it clear that Section 7872 applies to sales); and PLRs 9408018 and 9535026.
- e. The IRS also challenged the valuation adjustment clause used by the Woelbings, though it ultimately conceded its effectiveness.
- f. *See also*, Akers & Hayes, "Estate Planning Issues With Intra-Family Loans and Notes," 38 ACTEC L.J. 51 (Fall/Winter 2012); Deener, "After *Karmazin*," 145 Tr. & Est. 18-26 (Oct. 2006); Keebler & Melcher, "Structuring IDGT Sales to Avoid Sections 2701, 2702, and 2036," 32 Est. Plan. 19 (Oct. 2005); Mulligan, "Fifteen Years of Sales to IDITs—Where Are We Now?" 35 ACTEC J. 227 (Winter 2009).

C. Tax Consequences of Installment Note at Death of Grantor.

1. Revenue Ruling 85-13 (1985-1 CB 184) holds that the grantor of a grantor trust is treated as owning the trust's assets for income tax purposes.
2. Perhaps the most debated aspect of an installment sale to an intentionally defective grantor trust is a three-pronged question about the income tax consequences of the grantor's death on any remaining payment obligation to the grantor and the trust's purchased assets. Commentators have generally aligned themselves along three schools of thought, as follows:

|         |                          |                  |                           |                                   |
|---------|--------------------------|------------------|---------------------------|-----------------------------------|
| Group 1 | Gain recognized at death | Payments are IRD | No basis step-up for note | Basis step-up for trust assets    |
| Group 2 | No tax event at death    | No IRD           | Basis step-up for note    | No basis step-up for trust assets |
| Group 3 | No tax event at death    | No IRD           | Basis step-up for note    | Basis step-up for trust assets    |

Most practitioners advise their clients to adopt the positions in Group 2. Each tax effect of the grantor's death is discussed below.

3. No Gain Realized at Grantor's Death.

- a. Most practitioners take the position that, upon the death of the grantor of a grantor trust, the grantor is deemed to have made a testamentary transfer of the trust's assets to the trust for income tax purposes (given that the grantor was considered the owner of these assets during his lifetime) and that such transfer does not constitute a gain recognition event under Code § 1001.
- b. Code § 1001(b) states that the amount realized from a disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Thus, gain is not recognized on a lifetime gift, as the donor of a gift receives no monetary consideration. Code § 1015 addresses the donee side of the gift transaction, stating that the donee takes the donor's basis, again implying that the gift transaction does not cause the donor to recognize any gain.
- c. With bequests and other testamentary transfers, neither the decedent nor the estate receives consideration, so the same logic applies. The U.S. Supreme Court held that a testamentary transfer of property does not constitute a taxable event in *Crane v. Commissioner*. In *Crane*, a surviving spouse inherited an apartment building at her husband's death. The apartment building was encumbered by nonrecourse indebtedness that was exactly equal to the federal estate tax value of the building. Rather than treating the devise of the building to the surviving spouse as a taxable sale for an amount equal to the liability, the Supreme Court indicated that the surviving spouse's basis should be adjusted to the building's fair market value as of the decedent's date of death, unreduced by the indebtedness, as property acquired from a decedent. Thus, the Supreme Court in *Crane* did not view the disposition of the apartment building to the surviving spouse by reason of the decedent's death as a taxable event.
- d. The Service acquiesced to this logic in Revenue Ruling 73-183, 1973-1 C.B. 364. In this ruling, the transfer of securities from the decedent to his estate at death did not generate a loss on the decedent's final income tax return as the transfer was not a taxable event. In support of this position, the Service stated that "the mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income" within the meaning of Code § 1001(a).
- e. An exception to the no gain recognition on gifts rule has been developed over the years when the gifted property was encumbered by a liability and, as a result of the gift, the donor was relieved of the liability. In this scenario, the debt relief is considered consideration, and so the gift becomes a taxable event for income tax purposes. Such an exception is necessary to prevent abuse. Absent the exception, a taxpayer could borrow against the equity of an asset up to the asset's fair market value, and then transfer the asset subject to the liability (thus, with little to no gift tax consequences) without recognizing gain. In effect, the taxpayer could convert the asset to cash without recognizing gain.
- f. This same concern is not present at death, as the taxpayer would have to die to realize the benefit of the debt relief. Accordingly, the exception for debt-encumbered assets has not been applied to testamentary transfers.
- h. Congress expressed support for this stance when it passed the Economic Growth and Tax Relief Reconciliation Act in 2001. In its explanation of Code § 1022's carryover basis rules (effective in 2010 when there was no estate tax), the Conference Committee explicitly endorsed the "no gain" rule by stating: "The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property."

- i. Finally, the Service seems to have accepted the “no gain on death” rule specifically as it relates to conversions of grantor trusts to non-grantor trusts at the death of the grantor. In Chief Counsel Advice 2009-23024 (Dec. 31, 2008), the Office of the Chief Counsel addressed the tax treatment of a non-grantor trust’s conversion to a grantor trust. The Chief Counsel first reviewed authorities regarding the termination of a grantor trust during the grantor’s lifetime (discussed next), before stating that: “We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event [emphasis added].” While the Service’s statement is dicta, it is further evidence that the Service views the death of the grantor as a non-recognition event.

4. Gain Recognized at Grantor’s Death.

- a. Despite the existing precedents described above, a minority of practitioners take the opposite position that a grantor’s death triggers a taxable event with respect to a grantor trust, under the rationale of *Madorin v. Commissioner*, 84 T.C. 667 (1985).
- b. Under *Madorin* (and Treas. Reg. § 1.1001(c), Example (5)), the termination of grantor trust status during the grantor’s life is treated as a deemed transfer of the assets in the trust from the grantor to a newly-formed non-grantor trust. As a result, if the trust or its assets are encumbered by liabilities in excess of the trust’s basis in its assets and grantor trust status is terminated during the grantor’s life, the deemed transfer will result in taxable gain. Nevertheless, application of the *Madorin* rule to a deemed transfer resulting from the grantor’s death directly conflicts with the long-standing, constitutionally-accepted principles found in *Crane*, confirmed in Congress’s later finding and upheld by the Service’s later rulings, as described above.
- c. For this reason, most practitioners believe the *Madorin* rationale should be limited to a lifetime termination of grantor trust status.

5. No IRD Triggered at Grantor’s Death

- a. “Income in respect of a decedent” (or “IRD”) is income to which the decedent was entitled at death and which is not properly reportable for a period prior to the decedent’s death. Code § 691. When a sale is reported on the installment method outside of the grantor trust structure, gain attributable to any outstanding payment obligation to the decedent would constitute IRD and be taxable to the decedent’s estate (or the beneficiary of the estate).
- b. In order for the IRD rules to apply, however, there must be “income” to which the decedent was entitled. Installment sale payments made during the grantor’s lifetime are not considered income to the grantor because the payments are treated for income tax purposes as payments from the grantor to the grantor. Most practitioners agree that this is the logical and correct result.
- c. Additionally, if, despite existing precedent, the conversion of the grantor trust to a non-grantor trust at the grantor’s death is considered to be a taxable event, Treasury Regulation § 1.691(a)-2(b), Example 4 suggests that this taxable event would not produce IRD so long as it is viewed as occurring after the grantor’s death, and not in the moments before death. In Example 4, the proceeds of a buy-sell agreement that was contractually entered into before the decedent’s death, but that is not consummated until immediately after the decedent’s death, are not IRD. The Tax Court has relied on these Regulations in finding that a sale does not result in IRD where the sale is effective “only upon the decedent’s death”. Because a grantor trust’s conversion to non-grantor trust occurs only at and after the grantor’s death, and not before, the grantor’s death should not trigger recognition of IRD from the continuing payments under the installment sale note.



- d. Lastly, even if the installment sale payments were considered items of IRD, it is unlikely that such payments would be taxable. Code § 691(a)(3) states that the character of the income in the hands of the beneficiary is the same as the character in the hands of the decedent, had he lived. Given that the grantor trust treatment would have continued had the grantor lived, payments from the grantor trust to the grantor would have continued to be non-taxable. Thus, if the grantor's estate or its beneficiary is entitled to the same income tax treatment as the grantor during his lifetime, it follows that the installment sale payments made to the grantor's estate or its beneficiary are also non-taxable for income tax purposes.

6. Trust's Basis in Purchased Assets

- a. Once a trust ceases to be a grantor trust, it is necessary to compute the basis of the assets on either side of the installment sale transaction – both the estate's basis in the installment sale note and the grantor trust's basis in the purchased assets. The estate's basis in the installment sale note is discussed in section c, *infra*. For the assets purchased by the grantor trust, the proper starting point is Code § 1012. Section 1012 states the applicable default rule that a taxpayer's basis in each purchased asset is equal to such asset's cost basis, "except as otherwise provided." Thus, the grantor trust would take a basis in each purchased asset equal to the purchase price it paid for such asset under the installment sale contract (generally considered to be the aggregate of the note payments made to date), unless an exception applies.
- b. There are two possible exceptions to this default rule. The first exception arises under Code § 1014, which provides for a stepped-up basis in the case of property acquired from a decedent. Some commentators believe that, because there is a deemed "transfer" from the grantor to the newly-converted non-grantor trust at the grantor's death, the trust has "acquired the property from a decedent" and, thus, is eligible for a stepped-up basis under Code § 1014.
- c. The weakness in this theory is that only ten forms of property are considered to have been acquired from, or to have passed from, a decedent for purposes of Code § 1014. These forms are listed in Code § 1014(b). Property received by a newly-converted non-grantor trust through a deemed transfer at the grantor's death is not clearly described in Code § 1014(b), thus, Code § 1014 is unlikely to apply to this type of transfer in general (and to the purchased assets in particular).
- d. Assuming Code § 1014 does not apply to determine a trust's basis in purchased assets, the other exception to Code § 1012 is Code § 1015. Code § 1015(a) sets forth the well-known rule that a donee takes the donor's basis in gifted property. However, Code § 1015(a) should not apply to a sale for full and adequate consideration, as subsection (a) is meant to cover gifts only. Code § 1015(b) provides that property acquired "by a transfer in trust (other than ... by a gift, bequest, or devise)" has the same basis as it would in the hands of the donor, increased by any gain (or decreased by any loss) recognized to the grantor upon such a transfer. Since the grantor trust acquired the purchased assets through a transfer in trust and the grantor recognized no gain or loss on the transfer, an Code § 1015(b) analysis would likely dictate that the grantor trust took the grantor's basis in the purchased assets. Moreover, if one takes the position that the grantor's death did not trigger an income tax event to the grantor or his estate with respect to the purchased assets, it is consistent to conclude that his death will not change the grantor trust's pre-existing basis in such assets.

7. For further discussion see, See Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks," (January 14, 2009); Dunn & Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," 95 *Journal of Taxation* (July 2001); Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Management, Estates, Gifts & Trusts Journal* 3 (1999); Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 *Journal of Taxation* 152, 161-64 (2000); Blattmacher, Gans &

Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of Grantor's Death," 97 *Journal of Taxation* 149 (Sept. 2002).

8. Stay tuned, as the IRS Priority Guidance Plan for 2017-2018 lists "Guidance on basis of grantor trust assets at death under §1014" as one of three areas of focus of general guidance.

D. Beneficiary Defective Trusts.

1. A beneficiary defective trust, or "BDT," is similar to a defective grantor trust in that the trust is intentionally designed to violate the grantor trust rules while also removing the contributed assets from the client's estate. The difference with a BDT is that the beneficiary, and not the grantor, is treated as the owner of the trust for income tax purposes. BDTs are an effective tool for clients who would like to maintain some level of control and beneficial enjoyment over the trust assets, yet protect those assets from the claims of creditors, including those of the federal government at the client's death.
2. Code § 678(a) provides that "[a] person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."
3. Grantor trust status with respect to the beneficiary, therefore, can be achieved by giving the beneficiary a present right of withdrawal over contributions to the BDT. Because the beneficiary would have the right to vest the corpus of the BDT in himself, the beneficiary would be treated as the grantor under Code § 678(a).
4. When structuring rights of withdrawal in a BDT, care should be taken to avoid adverse and unintended gift tax consequences.
  - a. Code § 2514(e) provides that a release or lapse of a power of withdrawal will constitute a transfer of property for federal gift tax purposes to the extent that the property subject to such power exceeds the greater of \$5,000 or 5% of the value of the assets out of which the exercise of the power could be satisfied.
  - b. As a result, if a beneficiary permits a power of withdrawal to lapse, he or she could be treated as making a taxable gift to the BDT to the extent that such property over which the beneficiary possessed a power of withdrawal exceeded \$5,000 or 5% of the value of the trust assets. For example, if the client's father contributed \$25,000 to a BDT for the benefit of the client and the client had the power to withdraw the entire contribution, the client would be treated as making a \$20,000 taxable gift to the BDT if she failed to exercise her power of withdrawal.
  - c. To avoid adverse gift tax consequences, the terms of the BDT should limit the beneficiary's annual withdrawal rights to the lesser of \$5,000 or 5% of the value of the trust assets. To the extent that a contribution to the BDT exceeds this amount, the beneficiary may possess a hanging power of withdrawal, which permits the beneficiary to withdraw any excess amounts in subsequent calendar years. With a hanging power of withdrawal, a beneficiary's withdrawal rights gradually lapse, year after year. Once the beneficiary's withdrawal rights fully lapse, all such assets will be excluded from the beneficiary's estate. Given the typical purpose of BDTs, the faster the withdrawal rights lapse, the better.
5. Because the client-beneficiary is treated as the owner of a BDT for federal income tax purposes, the client can receive the same grantor trust benefits available with sales to defective grantor trusts. Namely, (i) the grantor's payment of income taxes is the functional equivalent of a tax-free gift to the BDT, (ii) the BDT's assets accumulate income tax-free during the beneficiary's

lifetime, and (iii) transactions entered into between the beneficiary and the BDT will be disregarded for income tax purposes.

6. In addition to the grantor trust benefits described above, a BDT offers several advantages that a sale to a defective grantor trust does not. First, because the beneficiary is not contributing assets to the BDT, the beneficiary may serve as trustee of the BDT without risking characterization as an incomplete gift for gift tax purposes or inclusion of the assets in the beneficiary's estate. Second, the beneficiary is generally the lifetime beneficiary of the BDT, thereby giving the beneficiary the ability pull assets out of the BDT in the event the beneficiary experiences future cash flow issues.
7. When combined with its creditor protection and transfer tax advantages, BDTs are an attractive option for clients who seek to benefit future generations, yet desire to retain a level of fiduciary control over the trust assets. BDTs are generally excellent vehicles serial entrepreneurs who seek to participate in businesses or other investments with significant appreciation potential. For assets that a client already owns in his or her individual name, the client may consider selling the assets to a BDT for fair market value. This option is particularly attractive if the assets sold generate strong cash flows that may be used to pay off the promissory note made by the BDT in favor of the client.
8. Rev. Proc. 2017-7 Section 4.01(43) provides that BDTs are on the Service's no-ruling list.

*Section 678.—Person Other than Grantor Treated as Substantial Owner.— Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.*

## XIX. PLANNING FOR PERSONAL RESIDENCES

### A. Generally.

1. Most clients, whether they realize it or not, are real estate investors. According the U.S. Census Bureau, the home ownership rate during the second quarter of 2017 was 63.7%.
2. It is common, as part of the estate planning process, to retitle a residence in one spouse's name or in the name of their revocable trust. This may be done to balance assets as among spouses (although this is less of concern today with the advent of estate tax portability) or to avoid probate.

### B. Creditor Considerations and Tenancy By the Entirety.

1. A concern with retitling assets into one spouse's name or into the name of one or both spouse's revocable trust is that the creditor protections offered by tenancy by the entireties (currently 26 states provide such protections) may be lost when the property is retitled.
2. Some states permit the transfer of property, previously titled as tenancy by the entirety, into trust with retention of the creditor protections offered by tenancy by the entirety. *See, e.g.* Virginia Code Section 55-20.2.

### C. Privacy. With the proliferation of online real estate assessor databases and the desire to maintain privacy, many clients are acquiring personal residences in the name of limited liability companies with innocuous names, such as "123 Oak Lane, LLC", that do not contain personal identifying information.

### D. Exclusion of Gain on Sale of Residence.

1. Assuming the use and occupancy requirements are met, the Section 121 exclusion of gain on the first \$250,000 or \$500,000 (in the case of a married couple) on the sale of a principal residence

will generally apply if the property is held in a revocable trust or disregarded entity, such as a single member LLC during the owner's lifetime, since they are treated as the client's alter ego. See, Treas. Reg. Section 1.121-1(c)(3)(i) and (ii).

2. However, after the death of one spouse, if the property is held in a non-grantor trust, such as a credit shelter trust funded at the death of the first spouse, the Code Section 121 exclusion is not available. This may be ameliorated by the basis adjustment to fair market value at death.

E. Insurance and Due on Sale Clauses.

1. If a residence is transferred to a revocable trust or LLC, it is important that the client update the homeowner's insurance coverage insuring such property to reflect the new owner. Depending on the insurance carrier, the trust or LLC may become the name insured or added as an additional insured.
2. Generally, the transfer of mortgage residential property that is used as a primary residence to a revocable trust will not trigger the due on sale clause contained in the mortgage or deed of trust when the property is transferred. This is a result of the Garn-St. Germain Act of 1982 and the specific exclusion and exception found in 12 U.S.C. Section 1701j-3(d)(8).

F. Planning for Use and Occupancy.

1. In some cases, a family member may permit another family member or friend to occupy residential real estate rent free. Arguably, there is a gift equal to the fair market value of the right to use and occupy the residence. This may be particularly acute where a parent purchases an apartment in a urban area for the use and benefit of a child while they are in college or beginning their career. Similarly, prior to the Windsor decision involving same sex marriage, the use and occupancy of a residence by one partner could be considered a gift from the other partner.
2. A solution to this concern might be to transfer a small, say 1% to 10%, tenant in common interest in the underlying real estate to the family member or friend who will occupy the property. Under common law, a tenant in common, irrespective of the size of their interest, has the right to occupy 100% of the property 100% of the time. The parties could enter into a tenancy in common agreement whereby the gifted tenant in common interest is subject to transfer restrictions or repurchase obligations.
3. If a client transfers the residence to a child or an irrevocable trust for the child, but continues to occupy the residence rent free, there is a fairly clear argument that the client has a retained interest that would be included in his or her estate under Code Section 2036.
4. However, assume the client transfers the residence to an irrevocable trust for the benefit of the client's spouse and children. The spouse, as a beneficiary of the trust can use and occupy the residence and can permit the donor spouse to live with him or her. If the beneficiary spouse dies, the donor's spouse can no longer live there rent free. See, Rev. Rul. 70-155 and Estate of Gutches v. Commissioner, 46 T.C. 554 (1966), acq. 1967-1 C.B. 2. holding that where the decedent transfers the residence to his or her spouse, the decedent's continued co-occupancy of the residence with the spouse after the transfer does not raise any inference of an agreement or understanding as to retained possession or enjoyment of the property by the decedent, such that the property would be subject to inclusion under § 2036.
5. For an excellent discussion on planning for residences, see, David A. Handler, "The Techniques and Troubles of Giving Away the Family Home", 46<sup>th</sup> Annual Heckerling Institute on Estate Planning.

G. Qualified Personal Residence Trusts.

1. A Qualified Personal Residence Trust or "QPRT" is an irrevocable trust that holds a personal residence for a term of years. At the end of the trust term, the residence is distributed to the beneficiaries named in the trust – typically children. For example, John creates a QPRT and

transfers his residence to the QPRT for a term of 12 years, with the remainder passing to his children. John has the right to live in the residence and to use the residence for the next 12 years. At the end of the 12-year term, the residence passes to John's children.

2. There are several tax and economic benefits associated with a QPRT. QPRTs are especially well suited at *leveraging* a client's estate and gift tax credit. A transfer of property to a QPRT is currently treated as a taxable gift. The value of the gift is based on the present value of the remainder beneficiary's right to receive the property at the end of the QPRT term. For example, John, age 65, creates a QPRT and transfers his residence to the Trust for a term of 12 years, with the remainder passing to his children at the end of the 12-year term. Assuming the residence is valued at \$1,000,000 and the transfer is made in October 2017, when the Section 7520 rate is 2.2%, based on IRS tables, John is treated as having made a gift to his children valued at \$557,100. This is the first place where there is a significant tax savings. John has effectively transferred an asset worth \$1,000,000 to his children by using only \$557,100 of his \$5,490,000 gift tax exemption equivalent.
3. Another tax and economic benefit is that all of the future appreciation of the residence will be transferred to the children estate and gift tax-free. A QPRT, as a result, is a powerful estate *freezing* tool. Based on the prior example, assuming that the \$1,000,000 residence appreciates at 4% per year for the 12-year term, the residence will be valued at \$1,601,032. All of the appreciation during the 12-year term inures to the benefit of the children. Therefore, by making a gift, valued for estate and gift tax purposes at \$557,100, John will effectively transfer an asset worth \$1,601,032. Assuming John's estate is subject to a 40% estate tax, this produces an estate tax savings of \$417,573.
4. A gift to a QPRT is a gift of a *future* interest and does not qualify for the gift tax annual exclusion. Only gifts of a *present* interest qualify for the gift tax annual exclusion. A gift to a QPRT is subject to an ETIP (estate tax inclusion period) during which GST exemption cannot be allocated. GST exemption can be allocated at the expiration of the QPRT, but the value may be uncertain and the GST exemption may be insufficient to cover the full amount of the transfer. Therefore, QPRTs are not terribly effective for GST type transfer. In drafting the QPRT, it is important to structure the remainder interest so that it passes to non-skip persons only.
5. The term of the QPRT is an important factor in determining the tax consequences of a QPRT. As the QPRT term grows longer, the gift to the remainder beneficiaries grows smaller, and the tax savings is greatly improved. The table below shows the tax results and savings for a \$1,000,000 residence transferred to a QPRT, in October 2017, for varying terms:

| <b>QPRT for Client Age 65, \$1,000,000 Residence, Reversion<br/>October 2017 Transfer, 4% Annual Appreciation, 40% Estate Tax Bracket</b> |                                  |  |   |
|---|----------------------------------|--|---|
| <b>QPRT Term</b>  | <b>Current Value<br/>of Gift</b> | <b>Future Value at End of<br/>Term</b> | <b>Potential Estate<br/>Tax Savings</b> |
| 5 years   | \$815,860                        | \$1,216,653                            | \$160,317                               |
| 10 years  | \$631,630                        | \$1,480,244                            | \$339,446                               |
| 15 years  | \$445,930                        | \$1,800,944                            | \$542,006                               |

6. The value of the retained interest is valued based on the Code § 7520 rate in effect for the month in which the QPRT is created and funded. When interest rates are higher, the value of the retained interest is higher and, thus, the value of the remainder is lower. Therefore, QPRTs are especially effective when interest rates are high.
7. If the client dies during the term of the QPRT, the residence is included in the client's estate at its full fair market value at the time of death. The benefit of the transaction is lost, but the client is no worse off than if the client did not create a QPRT, other than transactional costs in establishing the QPRT. For example, Mary, age 50, creates a QPRT with a 15 year term and transfers her \$1,000,000 house to the QPRT. Mary dies 14 years and 11 months later when the residence is valued at \$1,800,944. The value of the residence is included in Mary's estate at \$1,800,944. However, she does receive a credit for the initial gift to the QPRT.

8. The term is selected by the client/donor. Because of the negative tax consequences of dying before the expiration of the QPRT term, we will typically review the actuarial tables and life expectancy of the client and use approximately 2/3<sup>rd</sup>s of the client's life expectancy. For example, an average individual age 65 has a life expectancy of 17.2 years. As a result, we will use a QPRT term of no greater than 12 years. Obviously, we discuss any known health problems and family history with the client and may make adjustments to the QPRT term, as appropriate, based on those discussions.
9. If the client outlives the term of the QPRT, the residence passes to the remainder beneficiaries. They are the owners of the property. The client can, however, lease the property back from the remainder beneficiaries at a fair market value rent. The obligation to rent the residence back from the client's children can be viewed, by some, as a negative feature; however, many clients view it as an opportunity to transfer additional assets, via rent payments, to their children. IRS Private Letter Rulings have sanctioned QPRTs which included mandatory fair market lease provisions at the end of the QPRT term. See, e.g., PLR 9249014, PLR 9827037, and PLR 199918042.
10. One can minimize the income tax consequences associated with the payment of rent by using a grantor trust. Upon the expiration of the QPRT term, the residence can pass into a trust, structured as a grantor trust for income tax purposes under the grantor trust rules of Code § 671-677, to cause the client/grantor to be treated as the owner of the trust. The effect is that when the client pays rent to the trust, the rent is non-taxable, since the client is paying rent to himself/herself. See Rev. Rul. 85-13.
11. You are allowed to transfer your principal personal residence and one vacation home to a Qualified Personal Residence Trust. You are allowed to have only one *principal* residence, but you can have two *personal* residences (one of which is your principal residence). Yes. If you own two personal residences, you can transfer each residence to a QPRT.
12. In addition, you can transfer fractional interests in your personal residence to multiple QPRTs. This can be used to hedge against the possibility of a premature death. For example, Steve creates four QPRTs with terms of 4, 8, 12, and 16 years. Steve transfers a 25% interest in his residence to each of the QPRTs. If Steve dies after 14 years, only the 25% interest in the last QPRT (with the 16 year term) is included in his estate.
13. It is not uncommon for a husband and wife to own their property jointly or as tenants by the entirety with the right of survivorship. In this case, we will divide the property into two 50% tenant in common interests. Each spouse will create a QPRT and will transfer his or her 50% interest to the QPRT. The Courts have consistently upheld valuation discounts for fractional interests in real estate and it is not uncommon to receive discounts of 20% or more. Under these facts, each of the 50% interests valued at \$500,000 would be discounted to \$400,000 and would produce an even better tax result.
14. Only a personal residence can be transferred to a QPRT. If there is substantial excess acreage that is not related to the residence, the additional land and buildings may not qualify as a QPRT. The IRS has ruled in several Private Letter Rulings that estate-type residences and the attendant outbuildings, guest cottages, and acreage may qualify as a personal residence. The rationale is that a person who purchases an estate type residence normally expects to have the attendant acreage, outbuildings, etc. and, thus, gave these favorable rulings. Each property should be determined on a case by case basis. See, e.g., PLR 9817004, PLR 9818014, PLR 9827037, PLR 200617035, and PLR 200626043.
15. Ordinary and recurring expense associated with the residence, such as real estate taxes, hazard insurance premiums, and minor repairs may be paid by the client/donor. The client can deposit the funds necessary to pay these amounts with the Trustee. The Trustee is permitted in a QPRT to retain sufficient funds to pay these amounts. A QPRT is treated as a grantor trust for income tax purposes and, thus, the client/donor can deduct the real estate taxes paid on his or her personal income tax return. In the event a capital improvement is made to the residence by the client/donor, this will be treated as an additional gift to the QPRT and the amount of the gift will be based on the value of the capital improvements and the remaining term of the Trust.

16. If the residence is sold while held in the QPRT, the proceeds can be reinvested in a new residence. Since a QPRT is a grantor trust, any gain recognized on the sale of a principal residence should qualify for the \$250,000/\$500,000 exclusion of gain from the sale of a principal residence, provided all of the other Code § 121 requirements are met. The exclusion of gain does not apply to the sale of a personal residence that is not a *principal* residence, such as a vacation home. If the proceeds of sale are not reinvested in a personal residence, the QPRT will convert to a Grantor Retained Annuity Trust or “GRAT” and will pay an annuity to the client/donor for the balance of the QPRT term.
17. In 1996, the IRS issued regulations which prohibit the client/donor or their spouse from purchasing the residence from the QPRT. The benefit of this type of transaction is that (i) it avoids the loss of the step up in basis, and (ii) the client is not required to rent the residence from his or her children. Before the issuance of the regulations, a client/donor could purchase the residence back from the QPRT shortly before the expiration of the QPRT term for its then full fair market value. As a result, the remainder beneficiaries would receive cash equal to the purchase price paid and the client/donor would receive the residence back in his or her own name. The QPRT Regulations now require that the trust instrument specifically prohibit a donor or their spouse from re-acquiring the residence.

#### H. Sale-Leaseback of Personal Residence.

1. A QPRT has several limitations that may not be appealing to a client. There is a large initial gift and GST exemption cannot be leveraged. In addition, there is mortality risk and the benefits of the QPRT are lost if the grantor does not outlive the QPRT term. The QPRT regulations prohibit the reacquisition of the residence by the grantor, the grantor’s spouse, or a grantor trust of either of them. In addition, a QPRT uses the Code § 7520 which is 20% higher than the mid-term AFR.
2. An alternative to the QPRT that addresses each of these concerns is the sale of a personal residence to a “defective” grantor trust in exchange for a promissory note, followed by a leaseback of the residence for fair market value rent.
3. Assume the following example. Joe owns a beach house that is valued at \$2 million. It is in an area where there is a robust rental market for houses like his. A qualified appraiser advises you that the residence would rent for \$10,000 per week during the 15 summer weeks (for a total of \$150,000), for \$20,000 per month for the months of April, May, September, and October (for a total of \$80,000), and for \$5,000 per month for the months of November through March (for a total of \$25,000). The gross rent that could be potentially be received is \$255,000, but the appraiser considers that there will be vacancies and time allotted for maintenance and repairs. In addition, the appraiser considers that the lease will be a triple-net lease with Joe paying real estate taxes, insurance, and repairs with respect to the residence. The appraiser concludes that the fair market annual rental of the residence is \$180,000.
4. Joe creates a defective grantor trust funded with \$200,000 in cash. This consumes a portion of his \$5.6 million gift exemption and he allocates GST exemption to this gift.
5. Joe sells the residence to the trust in exchange for a \$2 million note bearing interest at the long-term AFR (November 2017 rate is 2.6%) with interest only and a balloon payment in 15 years. The note permits Joe to prepay principal without penalty.
6. The trust receives annual rent of \$180,000 from Joe. Since it is a grantor trust, there is no income recognized on Joe’s payment of rent to the trust. The trust repays interest of \$52,000 (2.6% times \$2 million note) to Joe annually and the Trustee uses some portion of the additional \$128,000 of rental income not used to pay interest to curtail the debt on the note.
7. In *Tehan v. Commissioner*, T.C. Memo 2005-128, the decedent gifted fractional interests in his residence to his children over a period of years. The decedent and his children executed a written agreement that stated that decedent could occupy the residence, rentfree, for as long as his desired. The decedent occupied the property until his death, and he paid all taxes and expenses for the

property. The Tax Court held that Code section 2036 caused estate tax inclusion of the entire property, because of the express agreement that granted decedent the rent-free use of the property for a period that did not end until his death.

8. In *Estate of Barlow v. Commissioner*, 55 T.C. 666 (1971), husband and wife transferred farm property, by gift, to their children and immediately leased the property back from the children for rent that was customarily paid by tenant farmers in the region. During the first two years of the lease, husband and wife created trust accounts for each child (naming husband as trustee) and deposited funds into those individual trusts accounts for the rent due to such child. Husband and wife deducted the amounts of these payments as farm rental, and one or more of the children reported the funds deposited as taxable income. In year three, rental payments were withheld due to various family difficulties, with the understanding that the back rent would be repaid when circumstances improved. Four years elapsed without payment of additional rent, and husband died before any back rent was paid. Following husband's death, the children filed claims against his estate for back due rent. The Tax Court held that Code section 2036(a) did not cause inclusion of the property in husband's estate. It reasoned that while the unanticipated financial difficulties of the family prevented the terms of the lease from being followed to perfection, the intent of the transaction was not to grant husband a retained interest for less than full and adequate consideration.
9. In *Estate of Riese v. Commissioner*, T.C. Memo 2011-60, decedent contributed a residence to a three year QPRT. The trust agreement provided that at the end of the QPRT term, the property would be divided in equal shares among trusts for the taxpayer's children. During the planning process, decedent's counsel advised decedent that she would need to pay fair market rental upon termination of the QPRT if she wanted to continue living there. Shortly before termination of the QPRT, decedent's lawyer advised decedent's daughter that the rental amount could be determined and paid at the end of the calendar year in which the QPRT terminated. For six months after termination of the QPRT, decedent continued to live in the residence and paid all taxes, insurance, upkeep and maintenance on the property. However, she died before the first year's rent was determined or a lease agreement executed. Following the decedent's death (six months after expiration of QPRT term), her executors determined the appropriate back-rent due and paid it to the trusts for the children. The Tax Court held that Code section 2036 did not cause estate tax inclusion, because the evidence showed that the parties (decedent and remainder beneficiaries) had always agreed that she would pay fair rental value to occupy the residence following termination of the QPRT term, and that unfortunate circumstances led to the failure to execute the necessary lease agreement and determine the appropriate rent before decedent's death.
10. It may be possible to structure a sale-leaseback by husband and wife with sales to their respective grantor trusts to take advantage of fractional interest discounts.
11. In addition to the Code § 2036 risk, the Service could argue the step-transaction doctrine might apply to such a transaction and argue that this is a transfer with a retained interest because there is no taxable gain recognized on the sale, no interest or rental income recognized on the payment of interest or rent, and the transferor has retained the use and occupancy of the residence.

#### **PART IV – REDUCING AND PAYING THE ESTATE TAX**

#### **XX. STATUTORY ESTATE TAX RELIEF.**

##### **A. Alternate Valuation.**

1. General Provisions. Code § 2031 provides that the value of a decedent's gross estate is the fair market value of all of the decedent's property as of the date of his or her death, unless the "alternate valuation method" under Code 2032 is elected. Code § 2032 provides that "the value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate. . . . as of the date 6 months after the decedent's death."
2. Exceptions. There are two exceptions to this rule:



- a. If the decedent's property that is distributed, sold, exchanged or otherwise disposed of within six months after date of death, such property is valued as of the date of such distribution, sale, exchange or other disposition, and
  - b. If any interest in the decedent's estate which is affected "by mere lapse of time," such interest is valued as of the decedent's date of death with adjustments for any valuation differences not due to mere lapse of time as of the appropriate alternate valuation date.
3. Distributed, Sold, Exchanged. The phrase "distributed, sold, exchanged, or otherwise disposed of" includes all possible ways by which property ceases to be part of a decedent's gross estate, but does not include transactions which are mere changes in form.
  4. Mere Lapse of Time. Property interests that may be affected by a mere lapse of time include "patents, estates for the life of a person other than the decedent, remainders, reversions, and other like properties, interests or estates." Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time. Life estates, remainders and other similar interests are valued for alternate valuation purposes using (1) the age of the person whose life may affect the value of the interest as of the decedent's date of death, and (2) the value of the property *as of the alternate valuation date*, so that the mere lapse of time does not affect the value of the interest.
  5. Deductions. If alternate valuation is elected, deductions will not be allowed with respect to an asset to the extent that such deductions are already taken into account in determining the alternate value of that asset. Additionally, charitable and/or marital deduction(s) are valued as of the decedent's date of death and are adjusted for any differences in value (other than changes due to mere lapse of time) as of the earlier of the date of disposition or six months after date of death.
  6. Reduction of Gross Estate and Estate Tax. The election is available only when both the values of the gross estate and the estate tax (after allowable credits) are reduced. Code § 2032(c). This provision was added to discourage the executor's election of an alternate valuation date merely to reduce a beneficiary's income tax liability upon a later sale of the property. In such instances, the election was an abuse of the underlying purposes of Code § 2032 - to reduce the overall estate tax liability when assets had declined in value after the decedent's death.
  7. Must File Return. The election is not available if a federal estate tax return is not required to be filed. If no federal estate tax return is required, determine whether an alternate valuation election is allowable under local law. The election is not available if the "optimum" marital deduction formula clause is used, since there would be no tax to be reduced.
  8. Making the Election. The election may be made on an estate tax return filed any time within one year after the time prescribed by law (including extensions) for filing such returns. Code § 2032(d)(2). Thus, the election can be made up to 27 months after death. The election is irrevocable. § 2032(d)(1). The election is made by checking "Yes" to the box on line 1, page 2 of the Form 706 under the "Elections by the Executor."

**B. Special Use Valuation.**

1. Code § 2032A provides an alternative method of valuing real estate used in a farming business or other closely-held business if such property constitutes a substantial part of the estate's total assets. See Code § 2032A. If this "special use" valuation method is elected, the value of the real property included in the estate under this method may be up to \$750,000 less than the property's fair market value. See Code § 2032A(a)(2). The \$750,000 amount is indexed for inflation and in 2018, the limit is \$1,140,000.
2. The real estate in question must pass from the decedent to a "qualified heir." This heir can either inherit it or buy it from the estate. Qualified heirs include the decedent's ancestors (parents, grandparents), spouse, and lineal descendants (children, grandchildren). They also include the lineal descendants of the decedent's spouse or parents, and the spouses of the lineal descendants.

3. For five of the eight years leading up to the decedent's death, the realty must have been used in a farm or family business on or in which the decedent or a family member worked ("materially participated").
4. The real and personal property in the business or farm included in the decedent's estate has to comprise at least 50% of the gross estate, and the real property in the business or farm included in the decedent's estate has to comprise at least 25% of the gross estate. (For these purposes, the realty is valued at its "high" value, e.g., \$1 million in the example given in the first paragraph above.) In meeting these tests, two or more qualifying businesses can be combined as long as they all have real estate included in the decedent's estate.
5. The qualified heir must consent (with IRS) to be liable for all of the estate taxes saved if, within ten years, the property is transferred to anyone other than a qualified heir (of the first qualified heir) or if the property stops being used for the qualified purpose (for example, if it's sold to an outsider or is developed by the family as a shopping mall).

C. Planning for Liquidity to Pay Estate Taxes.

1. If an estate lacks sufficient liquid assets to pay estate taxes or other expenses, it may need to obtain a loan to cover the costs of administration. Among the options available to the estate are the following:
  - a. Relief Under Code § 6161
  - b. Installment Payment of Estate Tax Under Code § 6166
  - c. Borrowing from a Third-party Commercial Lender
  - d. Borrowing from a Related Party, such as a trust, family member, or business entity, including a life insurance trust.
2. Often, taxpayers will structure loans from commercial lenders or related parties as so-called "*Graegin* loans" to take advantage of an immediate estate tax deduction attributable to the interest payable over the term of the loan. Estate of Graegin, T.C. Memo. 1988-477. A typical *Graegin* loan prohibits the pre-payment of the principal of the loan, thereby making the amount of interest payable ascertainable with reasonable certainty. Interestingly, this produces an immediate estate tax deduction of the full amount of interest payable without any reduction for the future interest payments.
3. Code § 2053(a)(2) states that the value of the taxable estate is determined by deducting administrative expenses from the value of the gross estate.
4. Treas. Reg. § 20.2053-3(a) limits deductible administrative expenses to those expenses "actually and necessarily incurred in the administration of the decedent's estate."
5. Treas. Reg. § 20.2053-1(d)(4)(i) permits administrators to deduct expenses even if the exact amount of the expense is unknown, provided that such amount is ascertainable with reasonable certainty and is certain to be paid.
6. Courts have applied the standard set forth in Code § 2053(a)(2) and the Regulations thereunder to allow deductions for interest paid on *Graegin* loans when the following factors are present:
  - a. The loan is a necessary expense of the estate due to the nature of the asset contained in the estate or the illiquidity of the estate;
  - b. The loan term is not unreasonably long;
  - c. The amount of interest claimed as a deduction is within the parameters of a loan that is commercially available to the estate considering the date, term, and security offered; and
  - d. The loan is a bona fide arm's-length arrangement that will have an economic impact on the lender and the estate.

7. Courts have allowed related party loans, but typically require the estate to bear a greater burden in proving the necessity of the loan. The structure of the loan can be either annual payments of principal and interest for a fixed term or contain a balloon payment, as long as the amount of the interest claimed as a deduction is readily ascertainable. The term of the loan should reflect a business reason for the selection of the length of the term, such as when the executor reasonably expects to have funds to pay the loan due to expected cash flow, life expectancy, or the timing of a business transaction concerning an asset of the estate. The Regulations now provide a list of factors indicative of a bona fide loan between related parties.

XXI. CODE § 6166.

- A. To ease some of the financial hardship created when a closely-held business constitutes the majority of the decedent's estate, an executor may elect under Code § 6166 to pay the estate tax owed over a 14-year period, if certain requirements are met. Under Code § 6166(a)(3), the executor of the estate may elect to completely defer the estate tax for a period of up to five years and subsequently pay the tax in up to ten annual installments.
- B. For decedents dying after December 31, 1997, the estate must pay interest at the rate of 2% per year on the portion of the deferred tax attributable to the first \$1 million (as adjusted for inflation) of closely-held business property. For tax year 2018, the inflation adjusted amount is \$1,520,000.
- C. The interest paid on the deferred estate tax is not deductible as an expense of the estate. The interest rate imposed on the amount of the deferred estate tax attributable to the taxable value of closely-held business property in excess of limitation amount is 45% of the rate generally applicable to underpayments of tax, and this amount is also not deductible.
- D. In order to be eligible for the tax deferral election under Code § 6166, the value of the interest in the closely-held business must comprise at least 35% of the value of the gross estate reduced by the expenses, indebtedness and losses of the estate. If the estate owns at least a 20% interest in more than one business, these interests may be aggregated for the purpose of satisfying the 35% test.
- E. The tax deferral allowed by Code § 6166 applies only to interests in closely-held businesses as defined by the section. A decedent owns an interest in a closely-held business under this section if the decedent is one of the following:
  1. A sole proprietor; or
  2. A partner in a partnership with no more than 45 partners, or where 20% or more of the total capital interest in such partnership is owned by the decedent; or
  3. A shareholder who owns 20% or more in value of the voting stock of a corporation, or such corporation has 45 or fewer shareholders.
- F. When determining whether there are 45 or fewer shareholders or partners in a corporation or partnership respectively, all stock or partnership interests owned by the decedent's siblings, spouse, lineal descendants, and ancestors are deemed to be owned by the decedent. Likewise, in determining whether the 20% value test is met, the decedent not only owns his or her own stock or partnership interest but is also deemed to own the interests held by his or her siblings, spouse, lineal descendants and ancestors.
- G. In addition, the decedent must have been actively engaged in the trade or business; (not a passive investment activity). The management of investment type assets does not qualify as a trade or business. The tax deferral election to pay the estate tax in ten installments must be made within the time allowed for filing the estate tax return, which is, nine months from the decedent's death, including any extension of time granted for the filing of the return.
- H. Service Must Exercise Discretion in Requiring Bond or Special Lien.

1. In *Estate of Edward P. Roski Sr. et al. v. Commissioner*, 128 T.C. No. 10 (Apr. 12, 2007), the Tax Court held 1) that it has jurisdiction to review an IRS determination denying an estate's election under Code § 6166 to pay its taxes in installments, and 2) that the IRS abused its discretion in making that determination, because the IRS does not have authority to require a bond or special lien in every case under Code § 6166.
  2. The executor of the Roski estate (the "Estate") filed a timely estate tax return and attached a notice of election under Code § 6166 to defer payment of the tax owed. The IRS notified the Estate that because of the election, it would be required to either post a bond or provide a special lien under Code § 6324A. The Estate responded by requesting that the IRS exercise its discretion and not require the Estate to post a bond or provide a special lien. In support of this request, the Estate cited the following facts:
    - a. the Estate was unable to find a company to post the bond;
    - b. the well-established business that was part of the Estate provided assurance that adequate funds would be available to pay the Estate tax liability, thereby mitigating any default risks;
    - c. the executor was a highly respected businessman who at all times had fulfilled his tax obligations;
    - d. the government already had security under the Code § 6324 lien; and
    - e. the imposition of a special lien would have negative effects on the Estate's business.
  3. Nonetheless, the IRS issued a notice of determination denying the election, because the Estate failed to provide the bond or special lien. The Estate filed a petition with the Tax Court for a re-determination and judgment that it was entitled to the election. The IRS filed a motion for summary judgment, arguing that Code § 7479 does not give the Tax Court jurisdiction to review the IRS' denial of the election. The Estate objected to this motion and filed a cross-motion for summary judgment, arguing 1) the IRS' refusal to exercise its discretion by requiring a bond in every case was an abuse of discretion and 2) the undisputed facts established that if the IRS had properly exercised its discretion, no bond or special lien would have been required.
  4. The Tax Court denied the IRS' motion for summary judgment. In support of its decision, the Court pointed to the "strong presumption that the actions of an administrative agency are subject to judicial review." The Tax Court also rejected the IRS' argument that Code § 7479 only provides for review of the eligibility requirements for a Code § 6166 election, and not the actual bond requirement of Code § 6165, finding that Code § 6165 is included by reference in Code § 6166.
  5. The Tax Court then determined that the IRS had abused its discretion in applying a bright-line rule that an estate must provide a bond or special lien. In support of this conclusion, the Tax Court noted the following:
    - a. the IRS has changed its position four times in the last 15 years regarding the bond requirement under Code § 6166; and
    - b. neither the plain language nor the legislative history of Code §§ 6166 and 6165 indicate that a bond is mandatory.
  6. The Court, however, refused to grant the Estate's motion for summary judgment, holding that the facts on the record were insufficient to allow it to make such a determination.
- I. Notice 2007-90. In response to the *Roski* case, the IRS issued Notice 2007-90 which sets forth the factors the IRS will consider when determining whether deferred estate tax installment payments under Code § 6166 pose a sufficient credit risk to justify the requirement of a bond or special lien:

1. Duration and stability of the business. This factor considers the nature of both the closely-held business on which the estate tax is deferred and the assets of that business, as well as the relevant market factors that will affect the business's future success, its recent financial history, and the experience of its management, in an effort to predict the likelihood of its success and survival through the deferred payment period.
2. Ability to pay the installments of tax and interest in a timely manner. This factor considers how the estate expects to be able to make the annual payments of tax and interest when due, and the objective likelihood of realizing that expectation. Facts relevant to this factor may include the nature of the business's significant assets and liabilities, and the business's cash flow (both historical and anticipated).
3. Compliance history. This factor addresses the business's history regarding compliance with all federal tax payment and tax filing requirements, in an effort to determine whether the business and its management respect and comply with all tax requirements on a regular basis. This factor also addresses the estate's compliance history with respect to federal tax payment and filing requirements.

The above list is non-exclusive. IRS will consider all relevant facts and circumstances, in addition to the factors identified on the list, in determining whether the requirement of a bond or special lien is justified. No single factor is determinative, and not all factors may be relevant to every estate.

## XXII. CODE § 6161.

- A. Generally. Under Code § 6161, the Secretary of the Treasury is authorized to grant extensions for payment of federal tax under a variety of circumstances.

1. Code § 6161(a)(1) permits an extension for payment of federal estate tax of up to twelve months from the date the tax is due. That subsection specifies no grounds for an extension.
2. Code § 6161(a)(2) authorizes the Secretary to extend for reasonable cause the time for payment of federal estate tax for periods of up to ten years from the date prescribed for payment of tax, or, in the case of installment payments due under Code § 6166, twelve months after the due date for the last installment.
3. Further, Code § 6161(b)(2) permits an extension for payment of deficiencies in federal estate tax for a period not to exceed four years from the date otherwise fixed for payment of the deficiency, again for reasonable cause.
4. Code § 6161(a)(2) also applies to payment of generation-skipping transfer tax (GSTT).
5. Trustees of qualified domestic trusts may request an extension of time for payment of tax on property remaining in the trust at the death of the surviving spouse.

- B. Reasonable Cause.

1. Treasury Regulation Section 20.6161-1(a)(1) gives four examples of reasonable cause.
2. Example 1 involves a situation where the estate has sufficient liquid assets to pay the tax when due, but these assets are located in several jurisdictions and the executor is having difficulty marshaling them to be available for the payment of tax. There is a basis for a reasonable cause extension in this example, although it would be a relatively short extension.
3. Example 2 involves a situation where the estate contains assets that are the right to receive payments in the future, such as annuities, royalties, receivables, and contingent fees. The executor cannot readily borrow against these assets except under terms that would inflict severe losses on the estate. There is a reasonable cause for extension.

4. Example 3 involves a claim of the estate that has substantial value but that cannot be collected without litigation. The example assumes that the size of the gross estate is really unascertainable, since the nature and amount of collection here could not be determined. A reasonable cause for extension would be present.
5. Example 4 involves a situation where the estate does not have sufficient funds to pay taxes, family allowances, and claims without borrowing at a rate of interest higher than that generally available. The estate includes assets that the executor has attempted unsuccessfully to convert into cash. There is reasonable cause for extension.

### XXIII. GRAEGIN LOANS.

- A. Even before the *Graegin* case, courts and the IRS recognized that obtaining loans to pay estate taxes may be “necessary” if the loan prevents the forced sale of estate assets at deflated prices.
  1. In *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971), the Tax Court permitted an executor to deduct interest paid on a loan obtained to pay estate taxes. The estate borrowed funds from the Todd Cattle Co. on July 21, 1967 that were due and payable on or before April 15, 1968 with an annual interest rate of 6.25%. On March 31, 1969, the estate repaid the loan by transferring interests held in Todd Cattle Co. The Tax Court found that the loan was a necessary administrative expense because the estate lacked sufficient liquid assets to pay estate taxes and if the estate sold its non-liquid assets, the sales would take place at deflated prices.
  2. Similarly, in Revenue Ruling 84-75, 194-21 I.R.B. 5, the IRS stated that “because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering D’s estate.” The IRS disallowed a current deduction, however, because the executor had the option to prepay the loan at any time without penalty and, therefore, the loan payments were only a future expense.
  3. In *Estate of Sturgis*, T.C. Memo. 1987-415, the estate’s primary asset was timberland. Because it did not have other liquid assets to pay the estate tax, the estate obtained a \$2.6 million third-party loan. Three years passed and although the estate had nearly \$1 million in liquid assets, it had only paid \$11,000 on the loan’s principal. The executor argued that he retained the liquid assets in case ongoing litigation in the Tax Court increased the estate’s tax liability. The Tax Court held that even though the estate could have paid more towards the loan, the interest expenses on the larger principal amount were a necessary and therefore deductible administrative expense due to the uncertain nature of the estate’s tax liability.
- B. *Estate of Graegin*, T.C. Memo. 1988-477, confirmed that loans to pay estate taxes are deductible as administrative expenses, but only to the extent the loan was necessary and certain to be paid.
  1. In *Graegin*, the estate obtained a loan taken from a wholly owned subsidiary of the closely-held company in which the decedent held stock.
  2. Significantly, a third-party shareholder owned a small interest in the parent corporation and held an option to acquire additional shares of stock. The decedent’s son was president of both companies.
  3. The term of the loan ran for 15 years at 15% simple interest (which was the prime rate on the day the loan was taken out), and the loan provisions contained a provision against early repayment. A 15-year loan term was selected because 15 years was the actuarial value of the life expectancy of the widow, whose estate would have contained enough assets to repay the loan in full.
  4. The Tax Court held that the interest on the loan was deductible as an administrative expense when the debt was incurred. The deductions for interest amounts paid on the loan were limited to amounts that were certain to be paid.

5. The Court focused on the credibility of the Paul Graegin and his intent to repay. In addition, the Court focused on the existence of a non-family member shareholder of the corporation who could ensure that the loan payments were made. Finally, the Court focused on the lack of liquidity in the estate and necessity of the loan.
- C. *Graegin* loans determined to be deductible have consistently exhibited the following features:
1. The loan was *necessary* due to the illiquidity of the estate;
  2. The interest expense was subject to *reasonable estimation*, i.e. ascertainable with reasonable certainty;
  3. The loan was *bona fide* in the sense that it had an economic impact;
  4. The lender was *accruing interest* so that both parties were treating it consistently; and
  5. The ability to borrow the funds was *authorized under local law*.
- D. *Graegin* loans determined not to be deductible, or determined to be deductible only after heightened scrutiny, have consistently exhibited the following features:
1. A relationship between the estate and the lender;
  2. Use of the funds, or a portion thereof, for a purpose other than payment of estate tax or state tax liability; or
  3. Failure to show the loan was necessary to preserve an asset of value of the estate.
- E. The factors listed above are not always determinative, but their presence or absence will undoubtedly affect whether interest paid on a *Graegin* loan are deductible. The IRS and the courts have offered the guidance set forth below on specific *Graegin* loans.
- F. In *McKee, et al. v. Commissioner*, T.C. Memo. 1996-362, the Tax Court determined the estate could deduct the interest on loans it obtained from the decedent's closely-held corporation to pay estate taxes as an administrative expense. The executors of the estate were also the directors of the closely-held company. The executor in this case borrowed an amount from the closely-held corporation in exchange for an unsecured demand note bearing an interest rate of 11% for a term of 85 days. These proceeds were applied with assets that were disclaimed by the surviving spouse toward the payment of the estate tax due. The intention was for the executors to repay the loan as soon as the buy-sell agreement could be amended to enable the pledge of the company shares in connection with a loan having a longer term obtained from a third-party. A complicated series of transactions occurred that involved a third-party loan, a redemption of the company stock, and two more subsequent loans from the company. The Tax Court determined that all interest expenses on the four loans were deductible as administrative expenses because the executors were faced with a liquidity problem and would otherwise have been forced to sell a large block of stock to pay the estate tax. While the court decided the case in favor of the estate-taxpayer, the facts presented by this case demonstrate the burden an executor must prove if the loan used to pay the estate tax is from a closely-held company or between related parties.
- G. In *Estate of Thompson v. Commissioner*, T.C. Memo. 1998-325, the Executor borrowed \$2 million from an irrevocable insurance trust created by the decedent during his lifetime to pay the operating expenses of a Cane Mill, which constituted a significant portion of the decedent's estate. The initial loan bore an annual interest rate of 5% with a 1-year term. The executor and the trust entered into additional loans with various interest rates each year thereafter. The Tax Court allowed the estate to deduct interest on the borrowed funds because the interest was deductible under Georgia state law and necessary given the illiquidity of the estate. Notably, the Tax Court stated that "section 2053 does not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary."
- H. The decedent in *Estate of Lasarzig v. Commissioner*, T.C. Memo. 1999-307, died owning interests in a family trust and a QTIP trust. The family trust paid its portion of estate taxes, but the QTIP trust lacked

sufficient liquid assets to satisfy its share of the estate tax burden. The QTIP's remaining assets consisted of one environmentally contaminated piece of real property and two parcels that were being leased to a shopping center developer. Due to a down real estate market, the QTIP trust distributed the shopping center parcels to the QTIP beneficiaries, who subsequently transferred them into their individual family trusts. After the estate exhausted its assets, the QTIP beneficiaries' family trusts obtained a third-party loan to pay the estate taxes due. The Tax Court held that the loan was not deductible as an administrative expense. Because the estate had no probate assets at the time of the loan, the loan was not obtained during the administration of the estate and therefore could not possibly be a necessary administrative expense under Code § 2053.

- I. A California state court case, *Klein v. Hughes*, 2004 WL 838198 (Cal. App. 1st Dist. 2004) involved an estate with an estimated tax liability of \$212,460,485. The executors of the estate negotiated with the Service a proposal that would have allowed the estate to obtain a loan in the amount of \$49 million that would carry an interest rate of 8.75%, with all unpaid principal and interest due on December 31, 2027 (a 25-year term). No interest payments would be required for the loan aside from a \$10 million payment due in September 2005, and prepayment of the amounts would be prohibited. It was determined the trust would incur a total of \$309 million in deductible interest expenses by the due date, which would reduce the estate's liability for estate tax by \$166.5 million. The assets in the gross estate were limited liability companies from which the estate had no power to compel cash distributions and which were subject to stringent restrictions on transfer. The Service approved the structure of the loan informally in a Closing Agreement, with the stipulation that the lender was not a related entity or an entity controlled or owned by the estate. Be cautious relying on this case, however, as the opinion did not discuss whether the proposed structure was permissible under applicable tax law. Rather, the opinion only considered a petition for permission to engage in the transaction over the objection of the parent of a minor beneficiary of the estate. Notably, the appellate court reversed the probate court on this limited issue, and decided that future income taxes incurred on behalf of a remainder beneficiary should not be equitably prorated among all beneficiaries. See *Estate of Hughes*, 133 Cal. App. 4th 121 (2005). Based on the foregoing, the loan structure in *Hughes* is not an example of a fact pattern that can be modeled without obtaining prior approval from the Service.
- J. The Service challenged a loan taken out by an estate when the interest payment was larger than necessary due to the amount borrowed and a term that was deemed to be unreasonably long. In *Estate of Gilman, et al. v. Commissioner*, T.C. Memo. 2004-286, the estate's primary asset was stock in a holding company that controlled the decedent's business and other assets. After a failed loan between the holding company and a limited liability company managed by the executors, the executors, on the advice of tax counsel, elected to pay the estate tax in full, rather than make a Code § 6166 election. To pay the estate tax owed, the executors obtained a private loan with a term of 10 years, a fixed interest rate, and no ability to prepay. The Tax Court determined that only a short-term loan was necessary and disallowed deductions taken for the loan amounts used to compensate the executors in their capacity as directors and officers of the decedent's closely-held companies. The decedent's will expressly prohibited compensation for the executors. The court agreed that the amount borrowed to pay the estate tax was necessary due to the reduction in cash flow of the businesses during the course of the administration of the estate and the illiquidity of the estate, but the funds borrowed to pay the compensation of business consultants, the officers of the company, or other administration expenses were not necessary as estate administration expenses and therefore not eligible to be deducted. Interest relating only to the portion of the loan related to payment of the estate tax were permitted as a deduction.
- K. In *Estate of Black v. Commissioner*, 133 T.C. 15 (2009), the Tax Court denied an interest deduction for a *Graegin*-style loan. The court found that the loan was not necessary. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate. The court stated:

The loan structure, in effect, constituted an indirect use of Erie stock to pay the debts of Mrs. Black's estate and accomplished nothing more than a direct use of that stock for the same purpose would have accomplished, except for the substantial estate tax savings. Those circumstances distinguish these cases from the cases on which petitioner relies in which loans from a related, family-owned corporation to the estate were found to be



necessary to avoid a forced sale of illiquid assets, see *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971); *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, or to enable the estate to retain the lender's stock for future appreciation, *McKee v. Commissioner*, T.C. Memo. 1988-362. . . . Moreover, as respondent points out, the principal beneficiary of the estate, [the son], was also the majority partner in Black LP. Thus, he was on both sides of the transaction, in effect paying interest to himself. As a result, those payments effected no change in his net worth, except for the net tax savings.

- L. In *Estate of Murphy v. United States*, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009), a federal district court held that the value of a decedent's interests in a family limited partnership and in the limited liability company that was its general partner were valued, for estate tax purposes, with significant discounts for lack of control and lack of marketability. The court rejected IRS attempts to include the value of the underlying assets in the estate, finding that the partnership was created for substantial, bona fide non-tax reasons. The court also held that the interest paid by the estate on loans from the partnership (a *Graegin* loan) and certain trusts (a non-*Graegin* loan) was deductible, though the non-*Graegin* loan interest was deductible only to the extent it had actually been paid.
- M. In *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255 (Oct. 31, 2011), the Tax Court (Judge Kroupa) upheld the estate tax deduction for the full amount of interest that would ultimately be paid on a loan obtained by the estate from a trust created by the decedent's father, even though the beneficiaries and fiduciaries of the estate were the same as those of the trust. The loan prohibited prepayment, thus permitting advance payment of the interest under *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477.
- N. In *Keller v. United States*, 697 F.3d 238 (5th Cir. 2012), aff'g 2009 WL 2601611 (S.D. Tex., 2009) and 2010 WL 3700841 (S.D. Tex., 2010), the Fifth Circuit affirmed two district court decisions. The court permitted a decedent's estate to claim a valuation discount for interests in a family limited partnership that was not funded until after the decedent's death, finding that applicable state law (Texas) treated the partnership as the owner of the property from the moment that the decedent signed the partnership agreement with an intent to transfer certain bonds to the partnership. The court also permitted the estate to deduct over \$50 million in interest on a loan from the partnership, the proceeds of which were used to pay estate taxes and expenses, because the debt was "actually and necessarily incurred" to avoid liquidation of estate assets, and because the loan did not permit prepayment of interest.
- O. In *Estate of Koons v. Commissioner*, \_\_\_ Fed. Appx. \_\_\_, 2017 WL 1501062 (11th Cir. April 27, 2017), aff'g TC Memo. 2013-94, a decedent's estate held a 70.4-percent interest in an LLC that held cash and marketable securities. A year after the decedent's death, the LLC lent \$10.75 million to the decedent's revocable trust to provide cash for paying estate and gift tax liabilities. The terms of the loan required annual repayments of \$5.9 million in principal and interest from 2024 to 2031, and did not permit prepayment. The Eleventh Circuit, affirming the Tax Court, held that the appropriate valuation discount for the LLC interests was 7.5 percent, rather than the 31.7 percent claimed by the estate, because of the size of the decedent's controlling interest and the liquidity of the LLC assets. The court also denied the deduction for the loan interest, because the estate could have compelled the LLC to distribute assets to the trust, rather than borrowing them, and thus did not need the loan to pay its taxes and expenses.
- P. Structured properly, *Graegin* loans can be an extremely powerful tool for estate administrators. They prevent the forced sale of estate assets at depressed values, thereby preserving capital for use in closely-held businesses or for other expenditures. And perhaps more importantly, the interest paid on a properly structured *Graegin* loan can be deducted against estate taxes pursuant to Code § 2053(a)(2) and the regulations thereunder. As was the case in *Hughes*, discussed above, this can potentially save an estate millions of dollars.
- Q. In Litigation Memo. TL-65 (March 14, 1989, released March 17, 1998), the IRS discussed their position on *Graegin*-style loans, which is reflected in the arguments presented by the Service before the Tax Court in the *Gilman* and *McKee* cases as discussed below. The memorandum concedes the position taken by the court in *Graegin*, but directs agents to examine the substance

of a loan between related parties and the lender's treatment of the interest. The taxpayer must show that the interest is certain to be paid and that the lender is accruing the interest. The memorandum provides:

Where such interest is uncertain in amount due to fluctuations in rate or the possibility of accelerated repayment, however, it may not be deducted until accrued or paid. If, in a balloon payment loan, the rate is fixed and the length of the loan is not subject to acceleration, the interest amount may be accrued and deducted on the estate tax return even though it will not be paid for a number of years. This was the situation in Estate of Graegin.

Additionally, the taxpayer must show facts that indicate the loan is necessary and the terms of the loan are reached at arm's length. As the Service explains:

Closely related to the issue of bona fide debt is the question of necessity. Arguments that a debt was unnecessarily incurred will contribute to arguments that the transaction lacks substance, particularly where the agreement is reached at less than arms' length. Unusual financing techniques, e.g., unsecured loans, high rates of interest, long terms, require close scrutiny, especially if less expensive lending alternatives were available from third-party sources. While the Service does not have unlimited ability to second guess the actions of estate administrators, it may disallow deductions for administrative expenses for expenses incurred solely for the benefit of the heirs.

- R. In *Priv. Ltr. Rul. 199903038*, the Executor took out a fixed-interest rate loan for a term of 7 years with no prepayment ability and the estate was allowed a deduction for interest subject to prior approval of the loan by the state court as required by local law.
- S. In *Priv. Ltr. Rul. 199903039*, the estate obtained from a commercial bank a 10-year loan with a fixed rate of interest payable annually. The loan provided for a balloon payment at the end of the term and prohibited prepayment. Over two-thirds of the decedent's estate consisted of stock in a closely-held company. The Service granted a deduction for the loan expenses, assuming that the loan was a necessary expense and authorized under local law. The Service did not rule on either of these assumptions.
- T. *Priv. Ltr. Rul. 199952039* allowed a deduction where the Executor took out a 10-year fixed interest loan from a commercial lender, the terms of the loan did not allow for prepayment, and there was a balloon payment feature.
- U. *Priv. Ltr. Rul. 200020011* examined whether a *Graegin*-style loan was necessary for purposes of Code § 2053. The facts showed that the decedent's estate could not obtain operational lines of credit because of the tax lien under Code § 6166, and therefore determined it was in the best interest of the decedent's closely-held company to take out a loan. The loan was secured, and taxes paid, and the Service allowed the estate and lender to amend the loan documents to provide the loan could not be prepaid. Additionally, the Service noted that the loan, while benefiting a beneficiary of the estate, was necessary to preserve a significant asset of the estate.
- V. In *Priv. Ltr. Rul. 200449031*, the Executor took out a commercial loan with terms that provided prepayment as an option feature (which the Executor could and did opt out of). The IRS allowed the estate to deduct the interest payments.
- W. In *Tech. Adv. Mem. 200513028*, the estate was not allowed to deduct the interest of a *Graegin* loan as an administrative expense because the Service did not think the loan payments would ever be paid to the lender, thereby causing no economic impact. The facts presented had the estate executing a promissory note that would allow the estate a line of credit up to a designated amount, with a fixed interest rate (which was at least 1% above the then existing prime rate) and a term of 10 years, with no prepayment allowed. The lender, however, was a family limited partnership in which the estate was a 97% partner and the decedent's child was the remaining partner and co-executor of the estate. The Service determined that this arrangement did not have an economic impact on the parties and was not necessary to preserve an estate asset because the family limited partnership was not engaged in any active business that would necessitate the retention of liquid assets available to use to pay the estate tax.

- X. In 2009, Treasury issued final regulations governing the deduction of an estate's contingent or unpaid claims or expenses. The Regulations are effective for estates of decedents dying on or after October 20, 2009. Treas. Reg. § 20.2053-1(f). Treas. Reg. § 20.2053-1(d)(4) is applicable to *Graegin* loans. Consistent with the case law outlined above, Treas. Reg. § 20.2053-1(d)(4)(i) permits a deduction for loans obtained to pay estate taxes even though the loan amounts have not yet been paid so long as "the amount to be paid is ascertainable with reasonable certainty and will be paid." No deduction, therefore, may be taken for vague and uncertain estimates, such as claims or expenses that are contested or contingent, because those expenses cannot be ascertained with reasonable certainty. *Id.* The Regulations also include provisions regulating loans between related parties.
1. Treas. Reg. § 20.2053-1(b)(2)(i) imposes the core requirement that interest paid on loans between related parties will only be deductible if the loan represents a *bona fide* obligation. Treas. Reg. §§ 20.2053-1(b)(2)(ii)(A) to (E) lists five factors indicative (but not necessarily determinative) of a bona fide obligation between related parties:
    - a. The transaction occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent;
    - b. The nature of the loan is not related to an expectation or claim of inheritance;
    - c. The loan expense originates pursuant to an agreement between the decedent and related party that is substantiated with contemporaneous evidence;
    - d. Performance by the borrower is pursuant to the terms of an agreement that can be substantiated; and
    - e. All amounts paid on the loan are properly reported by each party for federal income and employment tax purposes.
  2. Treas. Reg. § 20.2053-1(b)(2)(iii) defines related parties to include:
    - a. Family members, including (i) the decedent's spouse, grandparents, parents, or siblings; (ii) the lineal descendants of the decedent or the decedent's spouse, and (ii) the spouse and lineal descendants of any such grandparent, parent, or sibling;
    - b. Related entities in which the decedent had a direct or indirect beneficial ownership interest at death or three years prior to death. Related entities include any entity in which the decedent had a managing interest at death, such as if the decedent was a general partner in a general partnership or a manager in a limited liability company. Related entities do not include publicly-traded entities or closely-held companies in which the decedent and his or her family members owned less than 30% at the time the loan was made; and
    - c. Beneficiaries of a decedent's estate, including beneficiaries of a trust of the decedent.
- Y. The Regulations contain provisions for the filing of a protective claim for refund. Under Treas. Reg. § 20.2053-1(d)(5)(i), executors may file a protective claim for refund any time before the expiration of the applicable statute of limitations. The protective claim preserves the estate's right to claim a refund for expenses that will not be paid or would not otherwise meet the deductibility requirements of Code § 2053 until after the running of the limitations period. The protective claim only needs to identify each expense that is potentially deductible and the reasons why the payment of such expense has been delayed. The IRS plans to issue guidance regarding the filing of protective claims and to revise the estate tax return form to include a protective claim for refund. Protective claims are particularly useful for expenses payable from shares qualifying for the charitable or marital deduction. The protective claim prevents the reduction of these otherwise deductible shares until the expense is actually paid or becomes ascertainable with reasonable certainty. See Treas. Reg. § 20.2053-1(d)(5)(ii).

#### XXIV. LIFE INSURANCE.

- A. Many clients are unwilling to undertake the uncertainty or complexity associated with the tax benefits associated with Code §§ 303, 2032A, or 6166. As a result, they will plan to ensure estate liquidity through the purchase of life insurance.
- B. In many cases, the insurance policy will be purchased through an irrevocable life insurance trust. The trust will be designed to avoid the business owner-insured's retention of any incidents of ownership over the insurance policy. If properly drafted and structured, the trust will receive the insurance death benefits estate tax free.
- C. Typically, the business owner will gift premiums to the trust. The beneficiaries of the trust will have *Crummey* withdrawal powers, designed to qualify for the gift tax annual exclusion. Assuming the *Crummey* withdrawal powers are not exercised, the Trustee of the trust will use the gifted funds to pay the premiums on the life insurance policies.
- D. In drafting the trust agreement, it is important not to obligate the trustee to use funds in the trust to pay any of the costs of administration or federal estate taxes or state death taxes owed by the estate of the insured (or the estate of the survivor of the husband and wife in the case of a second-to-die policy). However, the trustee can and should be given the right either to lend money to or to purchase assets from the estate of the insured and the estate of the insured's spouse. The agreement should provide that any loan to the estate of the insured or the insured's spouse be properly secured and adequate interest be paid and that the purchase of assets be made for full and adequate consideration in money or money's worth.
- E. The purchase of assets by the irrevocable trust from the estate should result in little or no taxable income to the estate, since the estate will receive a step-up in basis for income tax purposes for assets included in the decedent's gross estate.
- F. Life insurance could be purchased by a funded defective grantor trust holding income producing assets. This would permit the trust to forego the use of *Crummey* withdrawal powers as a source of premium funding, as the income from the business interest could be used to pay premiums. This can be particularly useful when the premiums to be paid are large, the client's family is small, or both. The could also be beneficial from a GST tax perspective, since the GST exemption allocated to the defective grantor trust can be further leveraged.

#### PART V – PRACTICAL AND NON-TAX PLANNING CONSIDERATIONS

#### XXV. CONSENT TO TRANSFER AN INTEREST AND “BAD BOY” CLAUSES.

- A. Consent of Co-Owners.
  - 1. Prior to transferring an interest in an entity holding real estate, it is important to review the applicable governing documents, such as operating agreements or partnership agreements to determine whether there are any restrictions on transfer (there almost always is), and whether there is a mechanism to obtain consent or any carve-outs for certain permitted transfers.
  - 2. The mechanisms relating to consent to transfer of an interest are often reflective of the attorney who prepared the agreement. An operating agreement prepared by a real estate or corporate attorney will often contain a blanket prohibition without the consent of the manager or general partner, or a requisite percentage of the members. An operating agreement drafted by an estate planning attorney will contain similar provisions, but often include a carveout related to estate planning related transfers.
- B. Lender Consent.
  - 1. Very often loan documents encumbering real estate held in an entity contain provisions that limit the ability of the owner to transfer an interest without the consent of the lender.

2. The lender, understandably, wants to ensure that a transfer of ownership interests in the underlying entity does not circumvent a due on sale clause. Similarly, the lender wants to ensure, from an underwriting perspective, that the transferee can honor the original obligations contained in the loan documents. In addition, the lender will want to ensure that the management team and the controlling parties do not change in a way that impairs the credit quality of the asset.
3. Clients are often reluctant to revisit this point with their lenders, as the level of review, time, delay, and cost can be significant. In some cases, the client will defer making an estate planning related transfer until they plan to revisit the lending arrangement, perhaps through a loan modification or refinance, and include a request for consent to the estate planning related transfer at that time.

C. “Bad Boy” Clauses.

1. It is common for a lender to require that the borrower and/or its principals to execute a “bad boy guaranty” (a/k/a recourse carve out guaranty), which provides for personal liability against the borrower and principals of borrower upon the occurrence of certain enumerated bad acts committed by the borrower or its principals. The types of acts typically found in “bad boy” clauses include waste, fraud, misappropriation, bankruptcy, violation of special purpose entity covenants, incurring subordinate debt without lender’s consent, and transfers of an ownership interest.
2. If triggered by enumerated bad acts, bad boy guarantees require the borrower and/or guarantor to be personally liable for damages to the lender, or alternatively, converts an otherwise non-recourse loan into a full-recourse loan as against the borrower or guarantor. In either result, lenders will have the right to seek significant personal liability against the borrower and/or guarantors, so it is essential that borrowers and/or guarantors have complete control over the potential triggering acts.
3. Given the significant risk associated with triggering a bad boy clause, it is important for the attorney advising a real estate owner to carefully review the loan documents to determine whether such a trigger exists. To the extent possible, the client should negotiate carveouts for estate planning related transfers, especially such as where there is a transfer of a non-controlling interest, such as a limited partnership interest.

## XXVI. SECURITIES LAW CONSIDERATIONS.

A. Generally.

1. Private investment funds generally are funds which are exempt from registration under the Securities Act of 1933 and the Investment Company Act of 1940. To fall within applicable exemptions, as a general matter, such private investment funds permit only those investors who are “accredited investors” (as defined in the 1933 Act) and “qualified purchasers” (as defined in the 1940 Act).
2. For an excellent article on this topic, see, Sanft, “Trusts as Hedge Fund Investors? — Accredited Investor and Qualified Purchaser Rules for Trusts and Other Estate Planning Vehicles”, *BNA Securities Law & Regulation*, April 12, 2010.

B. Securities Act of 1933.

1. Non-public offerings are exempt from the registration requirements. The term “non-public offering” is not defined in the statute; however, Regulation D under the 1933 Act provides safe harbor rules for determining which offerings qualify as non-public. Under Rule 506 of Regulation D, a sale of securities to an unlimited number of “accredited investors” and no more than thirty-five nonaccredited investors will be deemed a non-public offering. This exception to the registration requirements reflects Congress’ assumption that accredited investors are sophisticated and able to protect their own financial interests without regulatory assistance.

2. The term “accredited investor” is defined in Rule 501(a) of Regulation D. There are eight categories of accredited investors:
  - a. a bank, savings and loan association or similar institution as defined in Section 3(a)(5)(A) of the 1933 Act, acting in its individual or fiduciary capacity;
  - b. private business development companies;
  - c. any organization described in Internal Revenue Code Section 501(c)(3), corporation, partnership, or Massachusetts or similar business trust with total assets in excess of \$5 million, which was not formed for the specific purpose of acquiring the securities offered;
  - d. directors, executive officers or general partners of the issuer of the securities or any director, executive officer, or general partner of a general partner of that issuer;
  - e. any natural person whose net worth (either alone or jointly with his or her spouse) at the time of purchase exceeds \$1 million;
  - f. a natural person who has an income in excess of \$200,000 in each of the last two years or joint income with that person’s spouse in excess of \$300,000 in each of those years and reasonably expects to reach the same income level in the current year;
  - g. any trust with total assets in excess of \$5 million, which was not formed for the specific purpose of acquiring the securities offered, and whose purchase is directed by a sophisticated person; and
  - h. entities in which all the equity owners are accredited investors under the foregoing categories.
3. Many trusts acquire fund interests via gifts and intra-family sales to which the accredited investor rules may not apply. Registration under the 1933 Act is required for a sale or other disposition of a security for value. The term “sale” is to be defined broadly and is intended to capture any method employed to obtain money from members of the public. Gifts of securities will not trigger registration under the 1933 Act since gratuitous transfers do not fall within the definition of a sale under the Act. Intra-family sales also should be exempt from registration under Section 4(1) of the 1933 Act, which provides an exemption for transactions by any person other than an issuer, underwriter or dealer. Whether a particular resale of securities issued in a non-public offering falls within the exemption under Section 4(1) is a question of fact. Rule 144 of the 1933 Act offers a safe harbor under Section 4(1) for sales that meet certain criteria. One requirement under Rule 144 is that the security be held for a minimum of one year prior to the sale. Therefore, estate planning transfers that occur within one year of the original acquisition may not fall within the safe harbor.

C. Investment Company Act of 1940.

1. The Investment Company Act of 1940 was enacted to protect investors by providing information to the public regarding the investments of the issuing company. Under the 1940 Act, certain entities, defined as “investment companies,” must register with the SEC and disclose information regarding their investment policies.<sup>51</sup> In addition to registration and annual reporting requirements, the 1940 Act imposes significant restrictions on the activities of registered investment companies and affiliated persons and provides for sanctions for violations of the Act.
2. The term qualified purchaser is defined in Section 2(a)(51) of the 1940 Act and includes: (a) any natural person (and his or her spouse if they invest jointly) owning not less than \$5 million in investments; (b) certain family-owned companies (including trusts) owning not less than \$5 million in investments; (c) a trust not described in the preceding clause (b) that is created by one or more qualified purchasers and for which investment decisions are made by qualified purchasers, so long as the trust is not established specifically for the purpose of acquiring the securities offered; and (d) a person, acting for his own account or for the accounts of other qualified

purchasers, who in the aggregate owns and invests on a discretionary basis at least \$25 million in investments.

3. A trust will be a qualified purchaser if it meets one of the following four requirements (or if the trust qualifies as a donee as discussed in paragraph 5 below): (i) the trust has at least \$5 million in investments and is for the benefit of certain family members; (ii) the trust's grantor and trustee are qualified purchasers; (iii) the trust owns or manages, for its own account or the accounts of other qualified purchasers, in the aggregate, at least \$25 million in investments; or (iv) the trust's grantor and trustee are knowledgeable employees.

## XXVII. VALUATION AND BALANCE SHEET CONSIDERATIONS

### A. Valuation Considerations.

1. Unlike the owner of a closely held operating business, clients with interests in real estate often have relatively current appraisals for real estate that they own.
2. The appraisal was likely obtained in connection with a real estate related financing, ordered by the bank lender, and prepared for that purpose. The client's interest in this situation is to have a value as high as possible, as it permits the client to borrow as much as possible on the most favorable terms. This may not produce the best result from a wealth transfer planning perspective. The existence of a series of appraisals for the same parcel of real estate creates a body of evidence of value that is hard to refute.
3. The appraisal may be several years old and the client will want to use the stale appraisal, as opposed to obtaining a new appraisal. The attorney will need to explain the need for a current appraisal of the underlying real estate and then, a second appraisal, of the entity ownership interest. Clients are rarely pleased with this conversation.

### B. Balance Sheet Considerations.

1. Clients often like to present strong balance sheets to their lenders, as this is an important underwriting consideration.
2. Clients are often dismayed to learn that assets that they have or will transfer out of their estate for wealth transfer tax planning purposes should not be included on the balance sheet. It is not an asset that they own and it should not be used to satisfy claims of creditors.
3. One possible solution that could be considered is the use of a spousal lifetime access trust or "SLAT", where one spouse creates a trust where the other spouse is a beneficiary with rights to income and principal distributions. Arguably the beneficiary-spouse could show the income and other distributions from the trust as a source of income; however, this is risky and could cause potential estate inclusion.