AN ESTATE PLANNER'S PERSPECTIVE ON RECENT TAX DEVELOPMENTS – THE YEAR IN REVIEW

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INTRODUCTION

The past twelve months have witnessed substantial changes in the estate, gift and generation-skipping transfer taxes and in the income tax laws relating to estate planning.

This outline summarizes the legislation, regulations, revenue rulings and procedures, regular decisions of the Tax Court, the Claims Court and the courts of appeals, as well as selected district court and Tax Court memorandum decisions, private rulings, notices, announcements and other Service and Treasury documents from the past year.[1] Because of publication deadlines, this outline includes only those developments reported publicly from December 1, 2010 through December 22, 2011.

The tax developments in this outline are divided into 5 categories:

(I) Estate taxes,
(II) Gift taxes,
(III) Generation-Skipping Transfer Taxes

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[1] Private letter rulings (PLRs) and technical advice memoranda (TAMs) are not legal precedents. Code § 6110(k)(3). They may, however, show how the Service might address a similar case, and they have been cited and discussed by several courts. See, *e.g.*, *Wolpaw v. Comm'r*, 747 F.3d 787 (6th Cir. 1995), *rev'g* T.C. Memo. 1993-322 (taxpayers can rely on 20-year old PLR, absent definitive regulations); *Estate of Blackford v. Comm'r*, 77 T.C. 1246 (1982) (noting that the Service litigation position was contrary to a prior PLR); *Xerox Corp. v. U.S.*, 656 F.2d 659 (Ct. Cl. 1981) (stating that PLRs are useful in ascertaining the scope of the doctrine adopted by the Service and demonstrating its continued and consistent application by the Service); *Fanning v. U.S.*, 568 F.Supp. 823 (E.D. Wash. 1983) (noting that a distinction between the facts of the instant case and those of prior cases had been cited in a TAM, and that TAMs are often relied upon by the courts).

All references to "Code" are to the Internal Revenue Code of 1986, as amended to date, unless otherwise specifically indicated.

(IV) Special Valuation Rules, and
(V) Income Taxes.

Each category is divided by Internal Revenue Code section, except that special consolidated discussions examine the various developments relating to the taxation of family partnerships and LLCs and charitable remainder trusts.

There is also an additional section, "Selected Attachments," that includes sample forms illustrating some of the planning techniques discussed in this outline, and other items of relevance to the subject, such as relevant portions of the IRS "no-rulings" list and the Treasury/IRS Priority Guidance.

I. ESTATE TAXES

A. Code § 2001. Estate Tax Reform

1. The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 Raises Exemptions, Lowers Rates, and Much More. Pub. L. 111-312, 111th Cong., 2nd Sess. (Dec. 17, 2010), 124 Stat. 3296

The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "TRUIRJCA") makes the following major changes in the estate, gift and GST tax rules:

- The TRUIRJCA reinstates the estate tax, together with its estate tax value basis rules, effective January 1, 2010. The estate tax is retroactively reinstated with a full $5 million applicable exclusion amount and a 35% top tax rate (which, because it applies to all estates above $500,000, creates a flat 35% estate tax rates above the applicable exclusion amount).

- The TRUIRJCA allows the executor of a 2010 decedent's estate to elect out of the estate tax regime (with a $5 million exemption and a 35% rate and basis equal to estate tax value) and into the carryover basis regime (no estate or GST tax and modified carryover basis). The election, once made, is revocable only with the consent of the Secretary.

  Note. See discussion of Notice 2011-66 and Rev. Proc. 2011-41, below.

  The decision whether or not a particular estate should be subject to the estate tax and estate tax value basis regime, with a $5 million exemption and 35% top rate, or the no-estate

tax and carryover basis regime, will sometimes be obvious, but often it will not be easy. It is quite easy to calculate the estate taxes that would be due, but projecting the effect of modified carryover basis will be more difficult.

Projecting the tax effects of the modified carryover basis rules requires calculation of the net appreciation in each asset, the character of the gain on the sale of each asset, the tax rate applicable to the gain on the sale of each asset, when each asset is likely to be sold, and whether there are tax benefits that might reduce the tax on such sales (such as the $250,000 exclusion for gain on the sale of a principal residence). These calculations themselves depend upon the identity of the beneficiaries receiving the assets.

Assets passing to charity can, of course, be sold without current tax, unless the gain would be unrelated business taxable income. Assets passing to a beneficiary who is a dealer in such assets, however, may generate ordinary income on their sale. A residence passing to a beneficiary may be sold with favorable tax treatment if the beneficiary makes it his or her primary residence.

The executor must also determine how the allocation of the available $1.3 million aggregate basis increase and $3 million spousal property basis increases, in order to determine the cost of modified carryover basis.

In addition, many wills and trusts drafted since 2001 have included alternate dispositions if there is no estate tax applicable with respect to the decedent's estate. This election, therefore, may determine both the amount of tax due from the estate, but also who receives the estate itself. Such an election can be difficult for a family member to make without creating at least the appearance of self-dealing. Family members who are named as executors of the estate of a 2010 decedent should seriously consider resigning in favor of an independent, professional fiduciary.

In any event, even an independent professional fiduciary is likely to want court approval of any such election (a beneficiary who is also a fiduciary would be virtually begging for a lawsuit if he or she did not obtain court approval). The fiduciary should obtain detailed calculations of the tax consequences to the estate, and the consequences to each beneficiary, and propose to the court that the election be made or not be made. Other interested parties should be provided notice and opportunity to dispute the proposal. The fiduciary should then act in accordance with the court order.

- The TRUIRJCA reinstates the GST tax for transactions in 2010, with a $5 million GST exemption. Section 2664, which previously stated that the GST tax rules did not apply to transfers in 2010, is repealed retroactively. Transferors can allocate GST exemption to transfers made in 2010, including the payment of premiums on life insurance policies held by an irrevocable trust.

- The TRUIRJCA states that 2010 generation-skipping transfers shall have an applicable rate of zero. This means that a 2010 direct skip transfer, taxable distribution or taxable termination would not produce a current GST tax obligation, and that the generation step-down rule of Section 2653(a) will protect generation-skipping transfers in trust from imposition of GST tax on subsequent distributions to skip-persons occupying the second generation below that of the transferor.

  For example, a 2010 direct skip transfer in trust for a grandchild of the transferor would not be subject to GST tax in 2010, and the transferor would be assigned to the first generation above that of the grandchild for purposes of determining the tax on subsequent distributions and terminations of interests. This would protect the trust from GST tax on subsequent distributions to the grandchild or his or her siblings, but not subsequent distributions to the grandchild's descendants or those of the grandchild's siblings, because the generation move-down rule does not change the inclusion ratio of the trust.

- The TRUIRJCA states that the executor's election not to apply the estate tax to the estate of a 2010 decedent does not prevent the decedent from being treated as the transferor of the trust for GST tax purposes. The election not to apply the estate tax is ignored for this purpose and the 2010 decedent is deemed to have made a transfer subject to estate tax for purposes of determining who the transferor is for GST tax purposes. A generation-skipping trust created in 2010 by testamentary disposition would thus be exempt from the GST tax only to the extent that GST exemption is allocated to create an inclusion ratio of 0.

- The TRUIRJCA extends the time for filing an estate tax return with respect to the estate of a decedent dying after December 31, 2009, and before the date of enactment, including any elections required to be made on such returns and any

disclaimers of interests in such estates, until at least 9 months after the date of enactment (September 19, 2011).

- The TRUIRJCA increases the estate and gift tax applicable exclusion amount to $5 million, indexed for inflation after 2011. It also reduces the top estate tax rate to 35%, creating a flat 35% estate tax on estates above the applicable exclusion amount. These rules are applicable with respect to estates of decedents dying after December 31, 2009, and before January 1, 2013.

  Note, the $5 million figure is increased to $5,120,000 for 2012. Rev. Proc. 2011-52 § 3.29, 2011-45 I.R.B. 701 (Nov. 7, 2011).

- The TRUIRJCA increases to $5 million the GST exemption, which is determined with reference to the former. Code § 2631(c).

- The TRUIRJCA reunifies the estate and gift tax exemptions after 2010, so that for gifts made in 2011 or 2012, the exemption is $5 million. The exemption for gifts made in 2010 is still $1 million.

- The TRUIRJCA adjusts the estate tax credit for gift taxes paid on lifetime transfers, to reflect the fact that the gift taxes paid in some years were at higher or lower rates than those applicable in the year of death. New Code § 2001(g) calculates the estate tax credit for gift taxes paid as if all of the gifts were taxed at the rates applicable on the date of death.

- The TRUIRJCA allows the executor of a decedent's estate to elect to allow the decedent's surviving spouse (but no other beneficiary) to take advantage of the decedent's unused applicable exclusion amount, for the spouse's estate and gift tax purposes. This rule applies with respect to estates of decedents dying after 2010 and before January 1, 2013.

  Note. This election must be made on a timely estate tax return that computes the amount of the unused applicable exclusion amount and that affirmatively elects for the surviving spouse to receive this increased exemption. The election, once made, is irrevocable. Code § 2010(c)(5)(A). The Service can examine a deceased first spouse's estate tax return to adjust the amount of applicable exclusion amount carried over

by the surviving spouse, without any limitations period on the examination. Code § 2010(c)(5)(B).

The increased applicable exclusion amount applies for the surviving spouse's gift taxes and estate taxes, but not for GST taxes. The increased applicable exclusion amount does not, however, change the base amount on which the obligation to file an estate tax return is set.

The first spouse's applicable exclusion amount received by the surviving spouse is not indexed for inflation. Thus, only the surviving spouse's basic applicable exclusion amount (not the increased amount) would thereafter affected by indexing. Code § 2010(c)(3)(B).

The surviving spouse cannot take advantage of a carryover of unused applicable exclusion amounts from more than one predeceasing spouse. Only the applicable exclusion amount of the last spouse of the decedent can be utilized. Code § 2010(c)(4)(B)(i).

- The TRUIRJCA reinstates the EGTRRA sunset rule for the changes made by the Act. Absent further legislative changes, on January 1, 2013, the estate tax applicable exclusion amount and gift tax exemption will return to $1 million, the GST exemption will return to $1 million indexed for inflation after 1997 (over $1,340,000), the top estate tax rate will return to 55% (with a five percent surtax on certain very large estates), the top gift tax rate will return to 55%, and the GST tax rate will return to 55%.

- The TRUIRJCA preserves the other EGTRRA changes in the estate tax law through 2012. These include:

(1) Repealing of the state death tax credit;

(2) Expanding the rules for the estate tax deduction of conservation easements;

(3) Allowing automatic allocation of a donor's GST exemption to lifetime transfers that are not direct skips;

(4) Allowing a transferor to make a retroactive allocation of GST exemption to a transfer in trust, if a beneficiary of the trust is a non-skip person and a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, assigned to a generation younger

than the transferor's generation, and if that beneficiary dies before the transferor;

(5) Allowing the qualified severance of a trust into multiple trusts for GST tax purposes;

(6) Providing that the value of property for purposes of determining the GST inclusion ratio in connection with timely and automatic allocations of GST exemption, would be its value as finally determined for gift or estate tax purposes;

(7) Directing the Secretary to grant extensions of time to allocate GST exemption and to grant exceptions to the time requirement, considering all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant;

(8) Providing that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption establishes that GST tax exemption were allocated to a particular transfer or a particular trust;

(9) Expanding the rules governing deferred payment of estate taxes attributable to closely-held business interests under Section 6166, by:

(a) allowing Section 6166 deferral for interests in qualifying lending and financing businesses, but limiting such deferral to five years;

(b) raising from 15 to 45 the number of partners of a partnership or shareholders of a corporation that will be eligible for deferral under Section 6166.

2. Administration Proposes Making 2009 Estate and GST Tax Laws Permanent – With a Few Changes. Dept. of Treasury "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" pp. 123-130 (Feb. 14, 2011)

The President's 2012 budget proposals presume the following major changes in the estate, gift and GST taxes.

- Restoring the 2009 estate, gift and GST tax rules on January 1, 2013. These would include a top estate, gift and GST tax rate of 45%, a $1 million gift tax exclusion, and a $3.5 million estate and GST basic exclusion amount. This proposal was also part of the 2011 budget proposal;

- Making portability of the deceased spousal unused exclusion amount permanent;

- Require consistency in valuation for income and estate tax purposes, so that beneficiaries were required to use estate tax values to determine the adjusted basis of property received from a decedent. This proposal was also included in the 2011 budget proposals;

- Permit the Treasury to issue regulations that expand Section 2704(b), to ignore in valuing partnerships, LLCs, and other entities, a new category of "disregarded restrictions," so as to reduce the use of valuation discounts for such entities. This proposal was also included in the 2011 budget proposals;

- Require a minimum ten year term for GRATs, require a positive value to the remainder interest in a GRAT, and prevent the use of decreasing payments in a GRAT. This proposal was also included in the 2011 budget proposals;

- Provide that the allocation of GST exemption to a transfer protects that transfer from GST tax for no more than 90 years.

3. **Despite 2010 Estate Tax Reform, Some Republicans Outright Repeal of Estate Tax and Other Reform Measures Continue to Attract Interest. H.R. 6522, 111th Cong., 2nd Sess. (Dec. 15, 2010); H.R. 6538, 111th Cong., 2nd Sess. (Dec. 16, 2010); H.R. 25, 112th Cong., 1st Sess. (Jan. 5, 2011); H.R. 86, 112th Cong., 1st Sess. (Jan. 5, 2011); H.R. 99, 112th Cong., 1st Sess. (Jan. 5, 2011); H.R. 123, 112th Cong., 1st Sess. (Jan. 5, 2011); H.R. 143, 112th Cong., 1st Sess. (Jan. 5, 2011); H.R. 177, 112th Cong., 1st Sess. (Jan. 5, 2011); H.R. 206, 112th Cong., 1st Sess. (Jan. 6, 2011); H.R. 696, 112th Cong., 1st Sess. (Feb. 14, 2011); H.R. 1259, 112th Cong., 1st Sess. (March 30, 2011); H.R. 1757, 112th Cong., 1st Sess. (May 5, 2011); H.R. 3467, 112th Cong., 1st Sess. (Nov. 17, 2011); S. 13, 112th Cong., 1st Sess. (Jan. 25, 2011); S. 336, 112th Cong., 1st Sess. (Feb. 14, 2011); S. 820, 112th Cong., 1st Sess. (April 14, 2011)**

The movement to kill or otherwise modify the estate (and GST, and maybe gift) tax will not fade quietly away.

- **Repeal Proposals.** Two bills to repeal the estate tax were introduced in the House of Representatives by Republican Members of Congress even as Congress was passing Public Law 111-132, which reformed the wealth transfer taxes for 2010 - 2012. More bills have been introduced in the 112th Congress further urging outright repeal of the estate tax. H.R. 6522 (2010) and H.R. 86, both introduced by Rep. Michele Bachmann (R-Minn.), and H.R. 6538 (2010), introduced by Rep. Connie Mack (R-Fla.) would make the Bush income tax cuts permanent, and permanently repeal the estate, gift and GST taxes, retaining the basis step-up (and step-down) rules of Section 1014. H.R. 123, introduced by Rep. Phil Gingrey (R-Ga.), H.R. 206, introduced by Rep. Randy Neugebauer (R-Texas), H.R. 696, introduced by Rep. Mike Pence (R-Ind.), and S.336, introduced by Sen. Jim DeMint (R-S.C.), all would make the Bush tax cuts permanent, and restore the estate, gift and GST taxes to their 2010 status (before the 2010 Tax Relief Act), thereby repealing the estate tax and the GST tax, but reinstating carryover basis and a gift tax with a $1 million exclusion amount. H.R. 99, introduced by Rep. David Dreier (R-Ca.), would make several other income tax changes, as well as repealing the estate, gift and GST taxes, and retaining the Section 1014 basis rules. H.R.143, introduced by Rep. Robert E. Latta (R-Ohio), and H.R.177, introduced by Rep. Mac Thornberry (R-Tex.), would simply repeal the estate, gift and GST taxes and retain the basis rules of Section 1014. H.R. 1259, introduced by Rep. Kevin Brady (R-Tx.) would repeal the

estate and GST taxes, retain the gift tax with a $5 million exemption and 35% top rate, and reinstate Section 2511(c). H.R. 25, introduced by Rep. Rob Woodall (R-Ga.), and S. 13, introduced by Sen. Saxby Chamblis (R-Ga.) would repeal the income tax, payroll tax, and estate, gift and GST taxes, enact a national sales tax primarily administered by states, and eliminate the Service. S. 820, introduced by Sen. Richard Shelby (R-Ala.) would repeal the income, estate, gift and GST taxes, and replace the income tax with a flat tax.

- **Preserve 2010 Changes.** H.R. 1757, introduced by Rep. Shelley Berkley (D-Nev.) would make the 2010 Tax Relief Act changes permanent.

- **Back to the Future?** On November 17, 2011, Democratic Ways and Means Committee member Jim McDermott (D-Wash.) and Rep. Charles Rangel (D-N.Y.) have introduced H.R. 3467, "the Sensible Estate Tax Act of 2011," which would: (a) raise the top estate and gift tax rate (and the sole GST tax rate) to 55 percent; (b) lower the applicable exclusion amount to $1 million, indexed for inflation after 2012 (but using inflation adjustments starting from 2000); (c) restore the state death tax credit; (d) restrict the use of valuation discounts for nonactive businesses; (e) require grantor retained annuity trusts to have a minimum ten-year term; (f) require consistent basis reporting between estate and person acquiring property from decedent; (g) eliminate the effect of the allocation of GST exemption after 90-years; (h) clarify that the limitation on the use of a deceased spousal unused exemption amount is the lesser of the basic exclusion amount or the last deceased spouse's applicable exclusion amount; and (i) limit a decedent's gift taxes payable, for purposes of calculating estate tax obligation, to those that would have been payable using the reduced applicable exclusion amount, thereby eliminating any "clawback" for those who have used the increased gift tax exemption in 2011.

Note. The 2010 election of a Republican majority in the House of Representatives and a stronger Republican minority in the Senate is likely to keep this issue alive. Practitioners should seriously consider retaining in their clients' documents provisions directing how their clients' estates will be disposed of if there is no applicable estate tax on the date of the client's death. Practitioners may even justify recommending that new instruments include alternate dispositions in case the estate tax does not apply with respect to a decedent's estate. Of course, such provisions are less easily drafted than they were in

2010, because there is no guidance regarding what changes in the tax law, such as carryover basis or capital gains at death, might accompany repeal of the estate and GST taxes.

4. Service Extends Some Filing Dates. Notice 2011-76, 2011-40 I.R.B. 479 (Oct. 3, 2011)

The Service announced that estates of 2010 decedents will have more time to file the various required returns and pay any estate taxes due. Specifically, the Service stated that:

- Executors who wish to elect out of the estate tax by filing Form 8939 will now have until Tuesday, January 17, 2012, to file that form. No penalty will be imposed under Section 6716 for an executor who files Form 8939 after November 15, 2011, and before January 18, 2012. This is a change in the due date and not an extension, so the extension is automatic and need not be requested or justified.

- No penalty under Section 6716 will be imposed to the executor of a 2010 estate solely because a statement required to be furnished to beneficiaries is provided after December 15, 2011, as long as it is provided before February 18, 2012.

- An executor who files Form 8939 before January 18, 2012, and allocates the decedent's available GST exemption (or makes an election under the GST tax) on an attached Schedule R or R-1, will be deemed to have timely allocated or elected, and such allocation or election will be effective as of the decedent's date of death under Section 2632.

- The automatic allocation rules under Section 2632 will apply if the executor timely files the Form 8939 without attaching a Schedule R or R-1.

- If the executor does not make or timely revokes the Section 1022 Election, then the automatic allocation rules apply, unless the executor timely files Form 706 or Form 706-NA with the Schedule R or R-1 attached.

- The estate of a 2010 decedent that files a timely Form 4768 to extend the date for filing the estate tax return, will have until Monday, March 19, 2012 to file its estate tax returns (Form 706 or 706-NA) and pay any estate tax due. This does not change the filing date, but it makes the automatic grant of a six-month

filing extension apply also to the payment of estate tax. Good cause is, in essence, conclusively presumed.

- For estates of those dying after December 16, 2010 and before January 1, 2011, the estate tax return will be due 15 months after the date of death.

- The Service will not impose late filing and late payment penalties (Section 6651(a)(1) or 6651(a)(2)) on estates of 2010 decedents who died before December 17, 2010, if the estate timely files Form 4768 and then files its estate tax return and pays the estate tax by March 19, 2012.

- The Service also will not impose late filing or late payment penalties (Sections 6651(a)(1) or 6651(a)(2)) on estates of decedents who died after December 16, 2010, and before January 1, 2011, if the estate timely files Form 4768 and then files its estate tax return and pays its estate tax within 15 months after the date of death.

5. Service Provides Guidance on Election Out of the Estate Tax for 2010 Decedents. Notice 2011-66, 2011-35 I.R.B. 184 (Aug. 29, 2011); Rev. Proc. 2011-41, 2011-35 I.R.B. 188 (Aug. 29, 2011)

- **Rev. Proc. 2011-41.** This procedure provides details respecting the modified carryover basis that apply if a Section 1022 Election is made. Executors contemplating a Section 1022 Election must determine both the date-of-death fair market value and the decedent's adjusted basis in all assets passing on account of his or her death, and then determine how to allocate the various basis increases allowed under Section 1022.

  Property Acquired From the Decedent. Revenue Procedure 2011-41 states that the modified carryover basis rules determine a recipient's basis in all property acquired from that decedent, regardless of the year in which the property is sold or distributed. Rev. Proc. 2011-41 § 4.01(1). This appears to be true even if the property is sold before the Section 1022 Election is actually made. This generally favors allocating basis to those assets which have been sold before the Section 1022 Election is made, in order to obtain the earliest advantage of the basis increase.

The modified carryover basis rules apply only to property "acquired from the decedent." Property acquired from the decedent includes:

(1) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in Section 645(b)(1), regardless of whether the Section 645 election is made;

(3) property transferred by the decedent during his or her lifetime to a trust that is not a qualified revocable trust, but with respect to which the decedent reserved the right to make any change in the enjoyment of the trust through the exercise of a power to alter, amend, or terminate the trust (including a retained reversionary interest in the trust on death or a retained power of appointment); and

(4) any other property that passes without consideration from the decedent by reason of his or her death, such as any property transferred at the decedent's subject to the exercise or lapse of a general power of appointment not created by the decedent, property held by the decedent and another person as joint tenants with right of survivorship or as tenants by the entirety, and a surviving spouse's one-half interest in community property. Rev. Proc. 2011-41 § 4.01(4).

Property acquired from the decedent does not, however, include:

(1) Items of IRD. Code § 1022(f). For this purpose, annuities subject to income tax under Section 72 are considered an item of IRD. Rev. Rul. 2005-30, 2005-1 C.B. 1015. Rev. Proc. 2011-41 § 4.01(2);

(2) a decedent's interest in a qualified terminable interest property (QTIP) trust or similar arrangement funded for the benefit of the decedent by the decedent's predeceased spouse. Rev. Proc. 2011-41 § 4.01(4). Therefore, the income tax treatment of loss assets (those with an adjusted basis higher than their fair market value on the date of decedent's death) that are held by a

QTIP trust created by the decedent's predeceasing spouse, is more favorable under the modified carryover basis rules than under the estate tax value basis rules. Under the modified carryover basis rules, the built-in loss is not forfeited because the assets are not property acquired from a decedent; under the estate tax value basis rules, the basis is decreased to the fair market value of the assets. This favors making the Section 1022 Election where a QTIP trust for the decedent's benefit holds substantial loss assets.

Property to Which Basis Increase May be Allocated. The aggregate basis increase and the spousal property basis increase (together, the Basis Increase) can be allocated only to property that was also "owned by the decedent at death." Code § 1022(d)(1)(A). Property that was acquired from the decedent but not owned by the decedent at death, therefore, takes a modified carryover basis, with no possible allocation of Basis Increase.

Property owned by the decedent at death includes:

(1) property legally titled in the name of the decedent at death (and not held by the decedent solely in a legal or representative capacity);

(2) property owned jointly, whether as tenants in common or with rights of survivorship (see Code § 1022(d)(1)(B)(i));

(3) property transferred by the decedent during life to a qualified revocable trust as defined in Section 645(b)(1), regardless of whether the Section 645 election is made; and

(4) certain community property (see Section 1022(d)(1)(B)(iv)). Rev. Proc. 2011-41 § 4.01(4);

(5) property of a trust that would not otherwise be deemed to be owned by the decedent, which trust requires that the trust property revert back to the decedent upon death, such as property in a GRAT or QPRT that reverts to the grantor or the grantor's estate upon his or her death. Rev. Proc. 2011-41 § 4.01(4), Ex. 2.

Property owned by the decedent at death does not include:

(1) property over which the decedent holds any power of appointment;

(2) property transferred to a trust by the decedent during life, over which the decedent retained a power to alter, amend, or terminate the trust, but not a power to revoke the trust. Such trusts are not be qualified revocable trusts under Section 645, because the decedent has no power to revest the assets in himself or herself, as defined in Section 676. See Reg. § 1.676-1;

(3) property transferred to a trust by the decedent during life over which the decedent retained an income interest;

(4) property transferred to a foreign trust by a United States grantor, even if the grantor owns the trust for income tax purposes under Section 679;

(5) an interest in a QTIP trust or similar arrangement created for the decedent's benefit by a predeceased spouse. Rev. Proc. 2011-41 § 4.01(4).

Basis Increase may not be allocated to property that is acquired by the decedent a lifetime transfer for less than adequate and full consideration in money or money's worth during the three- year period ending on the date of the decedent's death, even though that property is both owned by and acquired from the decedent. Code § 1022(d)(1)(C). This prohibition does not apply to property acquired by the decedent from his or her spouse, if the property was not transferred to the spouse during such three-year period in whole or in part by inter vivos transfer for less than adequate and full consideration in money or money's worth. Rev. Proc. 2011-41 § 4.01(5).

Basis Increase also may not be allocated to the stock or securities of a foreign personal holding company, a DISC or former DISC, a foreign investment company, or a passive foreign investment company, unless such company is a qualified electing fund as defined in Section 1295 with respect to the decedent, despite the fact that such property is owned by and acquired from the decedent. Code § 1022(d)(1)(D). Rev. Proc. 2011-41 § 4.01(5).

Determining the Basis Increase. The Basis Increase consists of the sum of the General Basis Increase ($1.3 million

Aggregate Basis Increase plus the Carryovers/Unrealized Losses Increase) and the $3 million Spousal Property Basis Increase. Code §§ 1022(b), 1022(c).

Revenue Procedure 2011-41 provides substantial guidance on the calculation and use of the Carryovers/Unrealized Losses Increase. This increase consists of the sum of:

(1) the amount of any capital loss carryovers under Section 1212(b) that would (but for the decedent's death) have been carried forward from the decedent's last taxable year to a later taxable year;

(2) the amount of any net operating loss carryovers under Section 172 that would (but for the decedent's death) have been carried forward from the decedent's last taxable year to a later taxable year; and

(3) the amount of unrealized losses that would have been allowable under section 165, had the property acquired from the decedent been sold at fair market value immediately before the decedent's death. Code § 1022(b)(2)(C). Section 165(c)(3) losses (casualty and theft losses on nonbusiness and noninvestment property) would not arise on a hypothetical sale of the property, and so must be claimed on the decedent's final income tax return, rather than being included in the Carryovers/Unrealized Losses Increase. Rev. Proc. 2011-41 § 4.02(2)(b).

The capital loss deduction limitations, such as the $3,000 annual limitation for the deduction against ordinary income of net long-term capital losses of an individual, are ignored in computing unrealized losses for purposes of the Carryovers/Unrealized Losses Increase. Code § 1022(b)(2)(C)(ii). Rev. Proc. 2011-41 § 4.02(2)(b), Ex. 3.

Existing income tax rules determine the decedent's share of loss carryovers and unrealized losses under Sections 172 and 1212(b), if the decedent's final Form 1040 is filed jointly with the decedent's surviving spouse. Thus for example, a calendar year decedent and surviving spouse who file a joint tax return for 2010 determine these amounts based on their relative tax liability in the decedent's final taxable year ending on the date of the decedent's death, and the surviving spouse's taxable year ending on December 31, 2010. Rev. Proc. 2011-41 § 4.02(2)(b).

The $3 million Spousal Property Basis Increase may be allocated to "qualified spousal property" owned by and acquired from the decedent. Qualified spousal property is property that either is transferred outright to the decedent's surviving spouse or is QTIP, as defined for Federal estate tax purposes, whether or not held in trust.

The executor may allocate Spousal Property Basis Increase to qualified spousal property that has already been distributed or that is sold before its distribution, whether the allocation is made before or after the sale. Rev. Proc. 2011-41 § 4.02(3). Spousal Property Basis Increase may be allocated to property that the estate sells even if the allocation would produce a net loss on the sale, as long as the allocation does not increase the adjusted basis above the fair market value of the asset on the date of death. Rev. Proc. 2011-41 § 4.02(3), Ex. 4.

The Spousal Property Basis Increase may be allocated only if the executor:

(1) certifies on the Form 8939 that the net proceeds from the sale of that property will be distributed to or for the benefit of the decedent's surviving spouse in a manner that would qualify property as qualified spousal property; and

(2) attaches to Form 8939 (discussed below) each document providing a bequest or devise to the surviving spouse.

The executor cannot allocate the Spousal Property Basis Increase to any portion of the assets or the proceeds of the disposition of the assets that are themselves not distributed to the surviving spouse. Thus, the Spousal Property Basis Increase cannot be allocated to assets that are left to the surviving spouse, if the executor sells them and applies the proceeds to pay administrative expenses or taxes. Rev. Proc. 2011-41 § 4.02(3), Exs. 5 and 6.

The Spousal Property Basis Increase may be allocated to property held by a qualified testamentary charitable remainder trust, if the surviving spouse is the sole non-charitable beneficiary and the trust would have qualified for the estate tax marital deduction had no Section 1022 Election been made. Code § 2056(b)(8); Rev. Proc. 2011-41 § 4.02(3).

Nonresident Alien Basis Increase. The U.S. assets owned by a nonresident alien decedent may receive a $60,000 Aggregate Basis Increase, with no Carryovers/Unrealized

Losses Increase. Code § 1022(b)(3). The executor of the U.S. estate of a nonresident alien decedent may also allocate the $3 million Spousal Property Basis Increase to qualified spousal property owned by and acquired from the decedent. Rev. Proc. 2011-41 § 4.02(4).

Allocating Basis Increase. The executor has very broad authority in the manner in which the Basis Increase is allocated among the property owned by and acquired from the decedent. The Basis Increase must be allocated on a property-by-property basis, but it may be allocated to one or more shares of stock or to a particular block of stock, rather than to the decedent's entire holding of that stock. Basis Increase may be allocated to property even after the executor has disposed of or distributed the property. Of course, an executor may not allocate more Basis Increase to an asset than will be needed to raise its adjusted basis to its fair market value on the date of death. Code § 1022(d)(2). Rev. Proc. 2011-41 § 4.03.

The executor may allocate Basis Increase to an interest in property owned by the decedent, such as a life estate or remainder interest. If the decedent's death results in the division of the decedent's property into different interests, however, other than undivided portions or fractional interests of each and every interest or right in the property that was owned by the decedent, Basis Increase may not be allocated separately to the various interests in that property created by reason of the decedent's death. Thus, if the decedent leaves property that he or she owns outright to different persons as a life estate and remainder, Basis Increase may be allocated to the property owned by the decedent at death, but not to the life estate and/or the remainder interest. Rev. Proc. 2011-41 § 4.03.

The authority for allocating Basis Increase to undivided portions or fractional interests of each and every interest or right in the property means that a decedent who leaves property in various shares, whether or not they are easily severable, can allocate Basis Increase to one share disproportionately. For example, if decedent leaves Blackacre equally to Spouse and Child, the executor could allocate the General Basis Increase entirely to the share passing to Child.

Determining Fair Market Value. The fair market value of property for modified carryover basis purposes is determined in the same fashion as it would have been for estate tax

purposes. The executor must attach any appraisals required under the estate tax rules to the Form 8939. Rev. Proc. 2011-41 § 4.04(1).

The Basis Increase allocated to property acquired from the decedent by a recipient cannot increase the recipient's basis above the fair market value of that property or interest on the date of death. The fair market value of an undivided portion of the decedent's property that is acquired from the decedent at death is deemed to be a fractional share of the total fair market value of the decedent's property at death, without any discounts or premiums that were not applicable in determining the value of the decedent's own interest. Rev. Proc. 2011-41 § 4.04(2). Thus, if the decedent leaves Blackacre, worth $1 million at his or her death, equally to Spouse and Child as tenants-in-common, the value of their interests, as a cap on the Basis Increase allocation, is $500,000, without regard to the fact that tenancy-in-common interests are usually significantly less marketable than interests held in one's sole name. This is a very generous rule, because it increases the value of the various shares of the property for purposes of Basis Increase allocation.

Special Rules for Community Property. Both the decedent's interest and the spouse's interest in community property owned by them on the date of the decedent's death are treated as property owned by and acquired from the decedent. Code § 1022(d)(1)(B)(iv); Rev. Proc. 2011-41 § 4.05. Therefore, the surviving spouse's basis in his or her one-half interest in community property will be adjusted on the decedent's death to the lesser of the surviving spouse's own adjusted basis or the fair market value of that interest on the decedent's date of death. Basis Increase may be allocated to the surviving spouse's one-half interest in community property. Rev. Proc. 2011-41 § 4.05, Ex. 7.

All of the unrealized losses that would have been allowable to both the decedent and the surviving spouse had the property been sold at fair market value immediately before the decedent's death, are included in the General Basis Increase. Only the decedent's own net operating loss carryovers and capital loss carryovers, however, are included in the General Basis Increase. The decedent's net operating loss carryovers and capital loss carryovers that are deductible on the final jointly filed Form 1040 are not added to the General Basis Increase. Rev. Proc. 2011-41 § 4.05.

Holding Period. The holding period of a recipient's property the basis of which is determined under the modified carryover basis rules, includes the decedent's holding period, even if the executor allocates sufficient Basis Increase to the property to give it a basis equal to its fair market value on the date of death. The applicable percentage determination for purposes of the depreciation recapture rules of Section 1250, which adjusts the amount of potential recapture based on the length of the taxpayer's holding period, is calculated under the recapture rules applicable to acquisitions by gift. The recipient's holding period in property the basis of which is determined under the modified carryover basis rules, therefore, includes the decedent's holding period, regardless of whether the executor allocates Basis Increase to that property. Rev. Proc. 2011-41 §4.06(1).

Tax Character of Property. The tax character of property acquired from the decedent by a recipient (such as whether it is an investment asset or inventory) is determined in the same way as its holding period. Thus, to the extent a recipient's basis in property is determined under the modified carryover basis rules, the tax character of the property is the same as it would have been in the hands of the decedent. For example, depreciable tangible personal property of a decedent that passes to a beneficiary who holds it for nonbusiness purposes remains subject to the ordinary income recapture rules of Section 1245. Rev. Proc. 2011-41 § 4.06(2), Ex. 9.

Depreciation of Property Acquired from the Decedent. Property acquired from a decedent to which the modified carryover basis rules apply may be depreciable in the hands of the recipient, even if it was not depreciable in the hands of the decedent, if the recipient changes its tax character. The recipient, however, remains bound by the decedent's depreciation method, recovery period, and conventions with respect to that portion of the recipient's basis in the property that equals the decedent's adjusted basis in the property. If the property is depreciable property in the hands of both the decedent and the recipient during 2010, the allowable depreciation deduction for 2010 is allocated between them on a monthly basis. See Reg. § 1.168(d)-1(b)(7)(ii). The portion of the recipient's basis in the property that exceeds the decedent's adjusted basis in the property on the date of death, including any Basis Increase allocated to the property, is treated for depreciation purposes

as a separate asset placed in service on the date of the decedent's death. Rev. Proc. 2011-41 § 4.06(3).

Passive Activity Losses. An interest in a passive activity that is transferred at the death of a 2010 decedent whose executor makes a valid Section 1022 Election is determined under the rules for transfers of interests by gift. The basis of such interest immediately before the transfer, therefore, is increased by the amount of any passive activity losses allocable to such interest that have not been allowed as deductions as a result of Section 469(a). These losses cannot be deducted for any taxable year. The basis adjustment under Section 469(j)(6) is deemed to occur immediately before the decedent's death, and is applied to determine the decedent's adjusted basis in the property at death for purposes of the modified carryover basis rules. Any loss that would have been sustained under Sections 165(c)(1) or (c)(2) on a hypothetical sale of the property immediately before the decedent's death may be included as Section 165 losses in the General Basis Increase. Because the reduction in the hypothetical loss under section 165 by reason of the Section 469 basis adjustment equals the amount of passive activity loss added to the decedent's basis, the Service concluded that there is no duplication of a benefit under these two sections. Rev. Proc. 2011-41 § 4.06(4), Ex. 10.

All of the suspended passive activity losses allocable to both spouse's interest in community property are used to determine the decedent's and the spouse's adjusted basis in the community property under the modified carryover basis rules, and to determine the amount of unrealized Section 165 losses included in the General Basis Increase. Passive losses that are used to increase basis and/or to increase the General Basis Increase, may not thereafter be deducted by the surviving spouse. Losses attributable to the surviving spouse's interest in community property that are not so used by the decedent's executor remain the surviving spouse's own suspended passive activity losses. Rev. Proc. 2011-41 § 4.06(4), Ex. 11.

Satisfaction of Pecuniary Bequest with Appreciated Property. Section 1040 states that an estate the executor of which distributes appreciated carryover basis property to satisfy a pecuniary bequest, must recognize gain only to the extent the post mortem increase in the value of the asset. The same rule is applied to distributions of appreciated trust

property made in satisfaction of trust provisions that are the equivalent of a pecuniary bequest, but only to the extent so provided in regulations. The Revenue Procedure creates a safe harbor for distributions from a qualified revocable trust, as defined in Section 645(b)(1), or from trusts that would have been included in the decedent's gross estate for federal estate tax purposes under Sections 2036, 2037, or 2038, had the decedent's executor not made the Section 1022 Election. Section 1040 does not apply to the distribution of property that constitutes an item of IRD. Rev. Proc. 2011-41 § 4.06(5).

Transfers to Foreign Estates and Nongrantor Trusts. Section 684 states that any transfer of appreciated property by a U.S. person to a foreign estate or nongrantor trust is treated as a sale or exchange on which the transferor recognizes gain. This provision also applies to transfers of property occurring on the 2010 death of a decedent whose executor makes the Section 1022 Election. The regulations make an exception for transfers of property by reason of the death of a U.S. person, if the basis of the property in the hands of the recipient is determined under the estate-tax-value basis rules of Section 1014(a). Reg. § 1.684-3(c). Revenue Procedure 2011-41 states that if property is owned by and acquired from a U.S. decedent dying in 2010, the executor's allocation of Basis Increase will be deemed to occur before the application of Section 684, reducing or eliminating recognition of gain under Section 684.

Testamentary Charitable Remainder Trusts. The Service stated that a testamentary charitable remainder trust that is otherwise qualified, but that fails to meet the requirement that a deduction is allowable under Section 2055, solely because the decedent's executor makes a Section 1022 Election, will still be a qualified charitable remainder trust. Rev. Proc. 2011-41 § 4.07.

Effective Date. This revenue procedure is effective August 29, 2011, the date this revenue procedure was published in the Internal Revenue Bulletin. Taxpayers may apply the safe harbor rule in the revenue procedure for prior periods, however.

- **Notice 2011-66.** This notice provides detailed guidance regarding how and when to make the Section 1022 Election, and how to make other GST tax elections and allocations that

may be needed by an executor who is not filing an estate tax return for a 2010 decedent.

How to Make the Election. The executor of the estate of a 2010 decedent can elect out of the estate tax by filing a Form 8939, "Allocation of Increase in Basis for Property Acquired From a Decedent." This form has not yet been released, by the press release accompanying the issuance of Notice 2011-66 and Revenue Procedure 2011-41 states that it will be published in "early this fall". Inf. Rel. 2011-83 (Aug. 5, 2011). Notice 2011-66 § I.A.

The notice states that the Form 8939 must be filed on or before November 15, 2011 (but see Notice 2011-76, above, which extends the filing date to January 17, 2012). Once made, the Section 1022 Election is irrevocable, except as provided later in the notice. Any prior filing that purported to be a Section 1022 Election must be replaced by a Form 8939. Notice 2011-66 § I.A.

An executor cannot validly file both an estate tax return and a Form 8939 for a 2010 decedent. The executor must select one or the other. The Service will, if it receives both a Form 8939 and an estate tax return (either Form 706 or Form 706-NA) for the same decedent, issue a letter to each person who filed such a form, notifying them of the conflicting forms and the name and address of each other person who filed a form, and explaining that each person must collectively sign and file either a restated estate tax return or a restated Form 8939 within 90 days from the date the Service mails the letters. If no restated form is filed within that period, the Service will determine whether the executor has made a Section 1022 Election or the estate remains subject to the estate tax, considering all relevant facts and circumstances disclosed to the Service, including (but not limited to) the relative total fair market values of the decedent's property in the executors' possession and the nature and significance of the economic impact of the Section 1022 Election (or its loss) on the beneficial owners of the property held by each executor. The Service notes that some factors may be more relevant, and may be accorded more weight, than others for any particular estate. Notice 2011-66 § I.A. The Service does not explain how it will weigh various factors or whether it will seek to maximize revenue by its actions. Practitioners should remember that the Service's job is not to minimize the tax obligation for an estate and its beneficiaries, and there is no assurance that they will do so if the parties fail to make a correct Section 1022 Election.

Allocating the Basis Increase. The executor must allocate the Basis Increase on a timely filed Form 8939. Section 2203 determines who is the "executor" for this purpose, so if someone is appointed, qualified, and acting for a decedent's U.S. estate, the Service generally will only accept Section 1022 Elections filed by that person. If no person has been so appointed, anyone in actual or constructive possession of property acquired from the decedent may file a Form 8939 and allocate Basis Increase for the property he or she actually or constructively possesses. The Service will, if it receives multiple Forms 8939 that collectively purport to allocate more Basis Increase than is legally available, issue a letter to each person who filed such a form, informing them of the name and address of each other person who filed a Form 8939 for that decedent, and explaining that each of them must collectively sign and file a single, restated Form 8939 allocating available Basis Increase in order to make a Section 1022 Election. The restated Form 8939 must be filed within 90 days from the date the Service mails such letters. If no timely, signed and restated Form 8939, is filed, the Service will allocate the available Basis Increase as it, in its discretion, may determine, considering all relevant facts and circumstances disclosed to the Service. That allocation might, the Service states, be made on a pro-rata basis, based on the amount of unrecognized appreciation in the property owned by the decedent at death that was reported on the timely filed Forms 8939, or in any other manner deemed appropriate for the particular decedent's estate by the Service in the exercise of its discretion. Notice 2011-66 § I.B. Practitioners should be cautious about allowing the Service to make such an allocation, since the Service is unlikely to make the maximum effort to minimize ultimate income tax liabilities.

The Service cautions that the recipient's basis in a particular property (including the amount of Basis Increase allocated to that property) is subject to adjustment upon the examination by the Service of any tax return reporting a value dependent upon the property's basis (for example, the property's depreciation, sale, or other disposition that triggers gain or loss on the property, or otherwise). Notice 2011-66 § I.B.

Reporting Requirements. An executor making a Section 1022 Election must report and value on the Form 8939 all property (excluding cash and property that constitutes the right to receive an item of income in respect of a decedent) acquired from the decedent. Code § 6018(b)(1). In addition,

the executor also must report all appreciated property acquired from the decedent, valued as of the decedent's date of death, that was required to be included on a donor's Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, where the property was acquired by the decedent by inter vivos transfer for less than adequate and full consideration in money or money's worth during the three-year period ending on the date of the decedent's death. Code § 6018(b)(2). This does not include property transferred to the decedent by the decedent's spouse, unless the spouse acquired the property in whole or in part by inter vivos transfer for less than adequate and full consideration in money or money's worth during that same three-year period. Notice 2011-66 § I.C.

The executor of the U.S. estate of a deceased nonresident alien need only report tangible property situated in the United States that is acquired from the decedent and any other property acquired from the decedent by a U.S. person. Notice 2011-66 § I.C.

The executor must, within 30 days after filing a timely Form 8939, provide a statement to each recipient acquiring property reported on Form 8939. If there are multiple executors, each must file this statement. This statement must set forth the information required under Section 6018(c), whether or not Basis Increase is allocated to such property. Notice 2011-66 § I.C.

The executor must also provide updated statements to each recipient of property reported on Form 8939, if an adjustment is made to the basis. This updated statement must be filed within 30 days after making the adjustment or receiving notice of the adjustment from the Service, whichever is applicable. Notice 2011-66 § I.C.

When to File Form 8939. In general, Form 8939 is due November 15, 2011 (but see Notice 2011-76, above, which extends the filing date to January 17, 2012). A Form 8939 filed before that date may be amended or revoked on another Form 8939 filed on or before the filing date. No Form 8939 filed by one executor will have any effect on any Form 8939 filed by a different executor. Notice 2011-66 § I.D.1.

The Service will not grant extensions of time to file a Form 8939 and will not accept a Form 8939 or an amended Form 8939 filed after the filing date, except in the event of conflicting filings or in certain relief situations described below. Thus, a taxpayer cannot file both an estate tax return and a Form 8939 that would be effective only if an estate tax audit

results in an increase in the gross estate above the applicable exclusion amount. Notice 2011-66 § I.D.2.

Persons qualifying under Section 7508 (persons serving the military in a combat zone or contingency operation) or Section 7508A (cases involving Presidentially-declared disaster or terroristic or military actions), are eligible to file a Form 8939 after the normal filing date, as provided in those sections. Any executor filing a Form 8939 after the normal filing date, pursuant to Sections 7508 or 7508A should write “Filed Pursuant to Section 7508” or "Filed Pursuant to Section 7508A", as applicable, on the top of the form. The extension applies even if one does not write these notations at the top of the form, however. Furthermore, for decedents qualifying for relief under section 692 (members of Armed Forces, astronauts, and victims of certain terrorist attacks on death), an executor must file a Form 8939 to make the Section 1022 Election. Notice 2011-66 § I.D.1.

Four types of relief from the filing requirements for Form 8939 are available. First, an amended Form 8939 may be filed after the normal filing date, solely to allocate Spousal Property Basis Increase among the property eligible to receive an allocation of that basis. This late return is permitted if: (1) the Form 8939 was timely filed and was otherwise complete when filed; and (2) the amended Form 8939 is filed no more than 90 days after the date of the distribution of the qualified spousal property to which Spousal Property Basis Increase is allocated on that amended Form 8939. Notice 2011-66 § I.D.2.

Second, an executor who timely files a Form 8939 may file an amended Form 8939 on or before May 15, 2012, if Section 9100 relief is obtained under Regulations Section 301.9100-2(b). This amendment may not be filed to revoke a Section 1022 Election, and the executor must write “Filed Pursuant to Section 301.9100-2” on the top of the amended Form 8939. Notice 2011-66 § I.D.2.

Third, an executor may also ask for Section 9100 relief to supplement a timely filed Form 8939, in order to extend the time to allocate any Basis Increase that has not previously been validly allocated. This relief, if appropriate, will be granted only if: (1) after filing the Form 8939, the executor discovers additional property to which remaining Basis Increase could be allocated; and/or (2) the fair market value of property reported on the Form 8939 is adjusted as the result of an Service examination or inquiry. Relief will not be granted to reduce an allocation of Basis Increase made on a timely filed Form 8939. Notice 2011-66 § I.D.2. This relief does not

appear to be available to change an allocation other than because of after-discovered assets or adjustments in value due to an Service examination or inquiry.

Fourth, an executor may apply for Section 9100 relief to extend the time to file Form 8939, to make the Section 1022 Election and allocate Basis Increase. In this context, however, the Service states that the amount of time that has elapsed since the decedent's death may constitute a lack of reasonableness and good faith and/or prejudice to the interests of the government (for example, the use of hindsight to achieve a more favorable tax result and/or the lack of records available to establish what property was or was not owned by the decedent at death), which would prevent the grant of the requested relief. Notice 2011-66 § I.D.2.

GST Tax in 2010. The GST tax was retroactively reinstated and applies to the estates of all decedents who died in 2010, even if a Section 1022 Election is made. The applicable rate for GST transfers in 2010 is zero, which the Service interprets to mean that the maximum federal estate tax rate for purposes of computing the GST tax on such a transfer is deemed to be zero. Therefore, the only way to achieve a zero inclusion ratio for a 2010 transfer is to allocate GST exemption to the transfer. Notice 2011-66 § II.A.

An executor who makes the Section 1022 Election may allocate the decedent's available GST exemption by attaching the Schedule R of Form 8939 to the Form 8939 for that estate. If the Form 8939 is timely filed, the GST allocation will be considered timely made. Notice 2011-66 § II.A.

A donor of a 2010 inter vivos direct skip who wishes to pay GST tax at the applicable rate of zero percent should also want to avoid automatic allocation of GST exemption to the transfer, since such exemption would be wasted. Such a donor may elect out of the automatic allocation of GST exemption to an outright inter vivos direct skip by filing a timely gift tax return (Form 709), describing both the transfer and the extent to which the automatic allocation is not to apply. The Service will interpret the reporting of an inter vivos direct skip not in trust occurring in 2010 on a timely filed gift tax return as constituting the payment of tax (at the rate of zero percent), which itself constitutes a valid election out of the automatic allocation of GST exemption to that direct skip. This interpretation also applies to a direct skip not in trust occurring at the close of an estate tax inclusion period (ETIP) in 2010, other than by reason of the donor's death. This interpretation does

not extend to direct skips in trust, however, because a donor may reasonably not want to allocate GST exemption to a 2010 direct skip made to a trust. This interpretation will also not apply to either a direct skip or the closure of an ETIP occasioned by the donor's death in 2010. Reg. § 26.2632-1(c)(4). The rules regarding the automatic allocation of GST exemption will apply to transfers described in the preceding sentence unless the transferor affirmatively elects to have those rules not apply. Notice 2011-66 § II.B.

A return reporting a direct skip, a taxable distribution, or a taxable termination (including any election required to be made on such return) that occurred after December 31, 2009 and before December 17, 2010 must be filed by September 19, 2011, including extensions. A Schedule R attached to a Form 8939, however, is still due on or before the normal filing date. Notice 2011-66 § II.C.

The due date of a return or portion of a return relating to an indirect skip, or to a post-December 16, 2010 direct skip is not extended. The due date for filing a gift tax return reporting a transfer after December 17, 2010 and before January 1, 2011, reporting no GST transfer was April 18, 2011, including extensions. Similarly, the due date for filing a gift tax return to elect to treat a trust as a GST trust or to allocate GST exemption to a taxable termination or taxable distribution in 2010, was April 18, 2011, including extensions. Notice 2011-66 § II.C.

A donor who timely filed a gift tax return for the taxable year ending December 31, 2010, but failed to allocate GST exemption to a transfer occurring in that year, however, may be eligible for Section 9100 relief. Notice 2011-66 § II.C.

Transfer Certificates. A transfer agent who holds property registered in the name of a nonresident alien decedent can usually avoid application of the ten-year estate tax lien under Section 6324(a)(1), by obtaining a transfer certificate from the Service certifying that the estate has no estate tax liability. Reg. § 20.6325-1(a). The notice states that no transfer certificate is required, and the Service will not issue transfer certificates, with respect to the property of a nonresident decedent who is not a citizen of the United States, who died in 2010, and whose executor makes the Section 1022 Election. Notice 2011-66 § III.

Section 645 Elections. The Section 645 election to treat a qualified revocable trust as part of a decedent's estate, rather than as a separate entity, applies from the date of death

until the "applicable date," which is defined as the date two years after the date of death, if no estate tax return is required to be filed. The Service explained that an estate as to which a Section 1022 Election is filed will also have an applicable date that is two years after the date of the decedent's death. Notice 2011-66 § IV.

B. Code § 2010. Unified Credit

1. Basic Exclusion Amount Adjusted for Inflation. Rev. Proc. 2011-52 § 3.29, 2011-45 I.R.B. 701 (Nov. 7, 2011)

The IRS has adjusted the basic exclusion amount to $5,120,000 for 2012.

2. Service Provides Initial Guidance on Electing Portability of Deceased Spousal Unused Exclusion Amount (DSUEA). Notice 2011-82, 2011-42 I.R.B. 516 (Oct. 17, 2011)

The Service, in both a Notice and the instructions to the federal estate tax return (Form 706) for the estates of 2011 decedents, has provided the first guidance regarding how to elect and establish a right to the portability of the first spouse's unused applicable exclusion amount (the "deceased spousal unused exclusion amount" or DSUEA). This guidance is both helpful and slightly disappointing, because it requires executors of relatively modest estates to file a full federal estate tax return in order to make this election.

- **Making the Portability Election**. Notice 2011-82 states that the portability election can be made only by filing a timely "properly- prepared and complete" federal estate tax return with respect to the decedent's estate. There is no express election on the return – no box to check or declaration to make – merely filing the return is deemed a portability election.

  The Service, as dictated by the Code, noted that an estate tax return is required in order to elect portability, even if the return is not otherwise required, such as where the gross estate is under the decedent's unused applicable exclusion amount. There is no "small estate" exception and no short-form return on which to make an election.

  A portability election, once made, is irrevocable. No portability election may be made on a return filed after the due date (including extensions).

The Service stated that the requirement of a computation of the first spouse's DSUEA will be satisfied by the mere filing of the return. Notice 2011-82 suggests that the Service plans to revise the estate tax return form to add an express computation of the DSUEA, but until it does so, such a computation will be deemed contained in a timely- filed and complete return that is prepared in accordance with the instructions.

- **Not Electing Portability.** An executor who does not wish to elect portability must either not file an estate tax return, or file a return that declares that the portability election is not being made. The Instructions to the 2011 Form 706 state this declaration may take either of two forms: (1) an attached statement indicating that the decedent's estate is not making the portability election; or (2) writing "No Election under Section 2010(c)(5)" across the top of the first page of the return.

- **Only 2011 or 2012 Decedents Need Apply.** Portability can be elected only on estate tax returns for decedents dying after December 31, 2010 and before January 1, 2013, absent further legislation. The unused exclusion amount of a deceased spouse who died before January 1, 2011, cannot be used by the surviving spouse, regardless of the date of the surviving spouse's death

- **Surviving Spouse's Use of DSUEA.** The instructions to the Form 706 for the estates of 2011 decedents notes that, if this is the return of a surviving spouse, and the first spouse also died in 2011, and the executor of the first spouse's estate elected portability, the surviving spouse's return must include a copy of the first spouse's estate tax return.

- **Regulations.** Notice 2011-82 states also that the Treasury intends to issue regulations under Section 2010(c)(6), addressing various issues arising with respect to implementation of the portability rules. The Treasury invites comments on:

  1. The determination in various circumstances of the deceased spousal unused exclusion amount and the applicable exclusion amount;
  2. The order in which exclusions are deemed to be used;
  3. The effect of the last predeceasing spouse limitation described in section 2010(c)(4)(B)(i);

4. The scope of the Service's right to examine a return of the first spouse to die without regard to any period of limitation in Section 6501; and
5. Any additional issues that should be considered for inclusion in the proposed regulations.

C. Code § 2013. Credit for Tax on Prior Transfers

2011 Award for Dumb Cause of Action. No Credit for Tax on Prior Transfers Allowed an Estate That Owes No Tax. *Miglio v. Treasury Department*, 2011 WL 3348069, 108 A.F.T.R.2d 2011-5537 (N.D. Ill. Aug. 2, 2011) (slip copy)

Jennie Miglio was one of seven sisters. Each sister left her estate to the surviving sisters, with Jennie as the last to die. Two of the sisters, Antoinette and Frances, died within ten years of Jennie. Both Antoinette's and Frances' estates paid federal estate taxes. Jennie's estate paid no federal estate tax, partly because of charitable bequests. The executor of all three estates sought a refund of the estate taxes paid by Antoinette's and Frances' estates, based on the application of the credit for tax on prior transfers under Section 2013.

The District Court (Judge Aspen) granted the Service a motion to dismiss, finding that Jennie's estate was not eligible for a refund based on the credit for tax on prior transfers, because the estate owed no estate tax and the credit is not a refundable credit. The court also held that a claim for refund on behalf of Frances' estate based on its failure to have earlier applied the credit for the tax on prior transfers with respect to the assets received from Antoinette's estate, was barred by the statute of limitations, because it was not filed within three years from the time that the estate tax return was filed or two years from the time that the estate tax was paid. Code § 6511(a). The executor argued that it was Jennie's estate that was claiming the refund with respect to Frances' estate, but the court held that any other party claiming on behalf of Frances' estate was subject to the same limitations rules.

D. Code §§ 2031, 2032, 2032A and 7520. Valuation

1. Fifth Circuit Upholds Jury Verdict Valuing Real Property Based on Subsequent Contract, Rezoning and Sale. *Estate of Levy v. United States*, 402 Fed.Appx. 979 (5th Cir. Dec. 1, 2010) (slip copy), *aff'g* 2008 WL 5504695 (W.D.Tex. 2008) (slip copy), *cert. denied, 2011 WL 1481312, 131 S.Ct. 2914, 79 USLW 3610 (May 23, 2011)*

The decedent's estate sought a $3.2 million estate tax refund claiming that certain real property was overvalued by the Service on audit. A jury found that the property was worth $25 million – the price that the Service had proposed. The jury primarily appeared to be impressed by the fact that the estate listed the property, and eventually sold the property, for $25 million, and that it was immediately resold for $26.5 million. Also, the estate's expert testified that the market in the locality (Plano, Texas) remained relatively flat during the period between the decedent's death and the sale of the property. The estate appealed.

The Fifth Circuit, in a per curiam opinion, held for the government. The estate argued that the trial court should not have admitted evidence of ongoing negotiations over the sale of the property, because offers to buy and sell are not probative of fair market value. The Fifth Circuit noted that offers from unidentified third parties are hearsay, but that offers from "identified, sophisticated developers who could be reasonably expected to have investigated the value of the land before making a proposal" are relevant and admissible, and the "developers could have been called to testify had the Estate desired to test their knowledge under cross-examination." Moreover, the court stated, offers to buy are admissible to establish fair market value when they are part of ongoing negotiations resulting in a contract with substantially the same terms. The estate also argued that evidence of the final sales price was inadmissible, because the sale was both too remote in time and contingent on rezoning. The Fifth Circuit disagreed, noting that the sale was under a contract signed two years after death, and that this was within a reasonable period of time. The court stated that a contract to sell the actual property is relevant and admissible, even when a contract to sell comparable property might not be. The estate also argued that the final sales price should be inadmissible because the sale was contingent on rezoning, and the chances of obtaining approval for rezoning was remote on the date of death. The court noted that the decedent had failed in his prior attempt to have the property rezoned, but that his attempted rezoning was both aggressive and unrealistic, whereas the locality's comprehensive plan actually called for the property to be rezoned. The district court also used a valuation expert, Jack P. Friedman, in establishing

the value of the property. The estate argued that this expert's testimony used an "unrecognized appraisal method" and because his assumption the property would be rezoned improperly relied on hindsight. The court held that "the admissibility of offers under the circumstances of this case" made acceptable the appraiser's references to such offers with appropriate contingencies.

2. **Tax Court Values Limited Partnership Interest in Timberland Partnership, With Focus on Relative Use of Net Asset and Discounted Cash Flow Values. *Estate of Giustina v. Comm'r*, T.C. Memo. 2011-141 (June 22, 2011)**

The decedent, Natale Giustina, owned timberland in Oregon through Giustina Bros. Lumber & Plywood. Giustina Land & Timber Co. Limited Partnership (the "LP"), which held a 51.875% interest in three other entities that owned a substantial amount of Oregon timberland. The decedent died owning a 41.128% limited partnership interest in the LP. The LP's agreement gives the general partners full control over the business of LP, including the power to sell the partnership's assets and to make pro rata distributions. The partnership agreement allows a limited partner interest to be transferred to another limited partner, a trust for the benefit of a limited partner, or any other person approved by the general partners. A limited partner may not withdraw from the partnership unless all of the limited partner's interests have been transferred. A buy-sell agreement bars a limited partner from transferring a partnership interest other than a transfer to a member of the transferring partner's family group, or after offering the other limited partners a right of first refusal. The decedent's executor valued the estate's interest in the LP at $12,678,117. The Service issued a deficiency, valuing the interest at $35,710,000.

The Tax Court (Judge Morrison), valued the decedent's partnership interest at approximately $24 million. The court stated that the partnership interest should be valued under the cashflow method (how much cash the partnership would be expected to earn if it continued its forestry operations, including growing trees, cutting them down, and selling the logs), and the net asset method (the value of the partnership's assets if they were sold). The Service expert estimated that the partnership's annual cashflow would be $9,979,969 in the first year after the decedent's death, and that the total future cashflow, discounted to present value, would be $65,760,000. The estate's expert estimated the first year cash flow at $4,560,000 and the discounted total future cashflow to be $33,800,000. The court found that the Service expert's cashflow estimates "not persuasive," because of an internal inconsistency between that expert's cashflow estimates and his calculation of the effect of lack of control on the

value of the decedent's LP interest, because he "unrealistically assumed" that the partnership's operating expenses would remain fixed, even though he projected that its revenues would increase by three percent per year, and because the Service expert based his calculations on the cashflow results of the most recent year, whereas the estate's expert based his cashflow results on a five-year period, which reduces the effect of a temporary variation in cashflow. On the other hand, the court stated that the estate's expert incorrectly reduced each year's predicted cashflow by 25% to account for the income taxes that would be owed, but used a discount rate used for pretax returns. See *Gross v. Comm'r*, T.C. Memo. 1999-254, *aff'd* 272 F.3d 333 (6th Cir. 2001). Thus, the court rejected the income tax discount. The court also held that the estate's expert used a discount rate of 18%, which was too high, and reduced it to 16.25%, because that appraisal applied a 3.5 percent partnership specific risk premium to reflect the fact that all of the timberland was in Oregon. The court stated that the lack of geographic diversity can be offset if the purchaser holds other assets reflecting other geographic focus. The court also disagreed with the estate's appraiser respecting a proposed 35% discount for lack of marketability of the 41.128% limited partnership interest. The court allowed only a 25% discount for lack of marketability, finding that the discounts from restricted stock studies were more applicable to this partnership than the discounts from the pre-IPO studies. The court concluded that the cashflow method valuation should be weighted 75% and the net asset method 25% in valuing the partnership interests, because the value of the timberland was so much greater than the discounted value of the cashflow. The holder of a minority interest cannot compel liquidation, but the court stated that there were various ways in which a voting block of limited partners with a two-thirds interest in the partnership could cause the sale of the underlying assets, (such as by replacing a majority of the general partners), and the substantial disparity between the net asset value and the discounted cashflow value suggest that there was a 25-percent probability that a buyer would persuade other limited partners to compel liquidation The court rejected an additional lack-of-control discount, finding that it was already reflected in the 75/25%age weighting of the cashflow valuation. The court also rejected a separate lack-of-marketability discount, because it was already included in the stipulated net asset value for the land.

3. **Tax Court Values Interest in Media Business Using Discounted Cash Flow with Appropriate Discounts.** ***Estate of Gallagher v. Comm'r*, T.C. Memo. 2011-148 (June 28, 2011)**

The decedent, Louise Paxton Gallagher, owned 15% of Paxton Media Group LLC (PMG), which was founded in Paducah, Ky. in 1896 and owned 28 daily newspapers, 13 paid weekly publications, and some specialty publications on the date of the decedent's death. The decedent's interest was the largest single interest in the company. PMG had $169 million in revenue and $48.1 million in net income in the year of death. The decedent's estate valued the decedent's interest at $34.9 million, based on an appraisal by the group's president and chief executive officer. The Service valued the units at $49.5 million. The estate appealed and then obtained an independent appraisal valuing the estate's units at $26.6 million.

The Tax Court (Judge Halpern) valued the LLC interests at $32.6 million – less than the amount reported on the estate tax return, but more than the value asserted in litigation. The court used the discounted cash flow method of valuation, which is often used for active businesses. The court rejected use of the guideline company method, which compares a company to similar public companies, agreeing with the estate that there were no publicly-held corporations sufficiently similar to PMG to use the guideline company method. The court rejected the taxpayer's attempt to tax affect the value of the LLC interests (the entity was taxed as an S corporation) for income taxes that would be due on the cash flow. The court noted that "the principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an S corporation." *Gross v. Comm'r*, T.C. Memo. 1999-254. The court allowed a 23% minority discount and a 31% lack of marketability discount.

4. **Value of Marital Trust Assets Denied Offset for Value of Breach of Fiduciary Duty Claim Against Decedent.** ***Estate of Foster v. Comm'r*, T.C. Memo. 2011-95 (April 28, 2011)**

The estate of the decedent, Ellen Foster, was involved in complex litigation stemming from a buy-sell agreement entered into by her late husband and his company, Foster & Gallagher, Inc. (F&G), a successful mail-order horticulture business that relied heavily on a sweepstakes program as part of its direct mail advertising. The agreement required F&G to buy the stock of the Foster family group upon the death of the decedent and her husband, and to maintain a $50 million life insurance policy to fund the purchase. The agreement prevented the company from borrowing against or otherwise encum-

bering the policy. In 1995, Mr. Foster sold most of his shares to the company's ESOP. The company borrowed $70 million (the ESOP loans) from four institutional lenders (the ESOP transaction lenders) and lent these funds to the ESOP. The ESOP used the $70 million to buy F&G shares from Mr. Foster. Mr. Foster died in 1996, leaving his estate to three marital trusts, of which the decedent was the sole income beneficiary. The decedent could withdraw the principal of one trust (Marital Trust # 3) at any time. Northern Trust Company and decedent were the co-trustees of the Marital Trusts and together could invade principal for decedent's benefit. In 1998, F&G began experiencing financial trouble on account of negative publicity surrounding sweepstakes advertising strategies such as the one F&G employed. F&G's revenues and earnings steadily declined, causing it to be in violation of the financial covenants of the ESOP loans. The ESOP transaction lenders (which included Northern Trust) asked to restructure the loans to gain a security interest in F&G's assets, and Northern Trust, as co-trustee of the Marital Trusts, waived the buy-sell agreement's restrictions, allowing F&G to borrow against the cash surrender value of the life insurance, and later allowing F&G to assign the policy as collateral for the ESOP loans. Pursuant to a demand from F&G, the decedent borrowed $6.8 million from Northern Trust and lent it to F&G (the Founder's Loan). The decedent's loan from Northern Trust was secured by over $12 million worth of assets that she withdrew from Marital Trust #3. The loans caused the life insurance not to be self-funding. The company filed for bankruptcy in 2001 and the insurance policy lapsed for nonpayment of premiums. Before the company's bankruptcy filing, the ESOP beneficiaries sued the ESOP trustee and Mr. Foster's estate (and the decedent, as executrix of her husband's estate) (the ESOP lawsuit), alleging breaches of fiduciary duty in connection with the ESOP transaction. The court held for the decedent as executrix of her husband's estate, because that estate was closed, and for both the decedent and the ESOP trustee, finding that there was no breach of fiduciary duty. The decedent died during the appeal of that holding. The decedent's executors deducted the value of the claim against the marital trusts ($14,676,915), based on an appraisal. The decedent's executors also sued the decedent's former attorneys for the decedent for legal malpractice and breach of fiduciary duty, and sued Northern Trust for breach of fiduciary duty and self-dealing. The executors notified the Service that there was an additional asset – the value of their claims against the former attorney and Northern Trust. Thereafter, the case against the former attorney was settled for $850,000 and the case against Northern Trust was settled for $17 million. The Service then assessed a deficiency based on the inclusion in the gross estate of the value of the claims against

the former attorney and Northern Trust, and denial of the deduction for the value of the claims against the decedent.

The Tax Court (Judge Cohen), held that in valuing the marital trusts for estate tax purposes, no deduction was allowed for the value of the claims against the trusts in connection with the suit by the ESOP beneficiaries. The court noted that the property in the marital trusts is valued under the traditional rules of Section 2031, and that the litigation could not have affected a buyer's rights in the marital trust assets, partially because the district court had already ruled in favor of the decedent before her death. The estate could, therefore, have transferred the marital trust assets to a buyer free of the claim, because the ESOP beneficiaries had not filed a stay of judgment pending appeal. The court also valued the claim by the decedent's estate against the former attorney and Northern Trust at $930,000, rejecting both the Service claimed $5.1 million valuation and the estate's claimed $33,000 valuation. The court held that the estate could deduct its actual litigation expenses under Section 2053.

5. Tax Court Allows Discount for 95% Interest in Ranch and Values Other Estate Assets. *Estate of Mitchell v. Comm'r*, T.C. Memo. 2011-94 (April 28, 2011)

James Mitchell, the decedent, was the son of a co-founder of American Airlines and an heiress to a successful Chicago meat-packing family. The decedent inherited real estate, including a ranch and beachfront property, and several valuable paintings by John Gamble, Frederic Remington, and Charles Marion Russell. Six days before his death, the decedent gave a five percent interest in the beachfront property and the ranch to a trust for his sons. The decedent's estate included the remaining 95% interests. The beach-front property was subject to a lease with options that extended for 20 years. The ranch was an unencumbered fee simple interest.

The Tax Court (Judge Kroupa) valued the real property and the artwork, considering the relative merits of the appraisers and appraisals presented by the parties. The Service agreed to stipulate that a 19% discount should be allowed for the 95% interest in the beachfront interest and a 32% discount for the five percent interest, and that a 35% discount should be allowed for the 95% interest in the ranch and a 40% discount for the five percent interest.

Note. These discounts are quite significant, and practitioners should consider seriously the use of tenancy-in-common arrange-ments for real estate, particularly where the client has not the finances or disposition to maintain a family limited partnership or limited liability company. The right to partition and other management issues can be

addressed in a tenancy-in-common agreement, to facilitate the co-ownership by the parties.

The Service made the argument, which the court rejected, that with a large tenancy-in-common interest, the discount should reflect only the cost of buying out the other five percent interest at a premium. The court found this an inappropriate valuation methodology. Service appraisers have stated at a valuation symposium that this approach may be applied in the typical 1%/99% family limited partnership, arguing that the discount for the 99% limited partnership interest should not exceed the cost of buying out the one percent general partner. This analysis is arguably flawed, however, because with certain situations, the general partner will simply not want to sell, or will insist that they will sell only for an extraordinary premium.

6. Treasury Reproposes Regulations Limiting What Events Can Change Value of Estate Assets For Alternate Valuation Date Purposes. REG-112196-07, 76 Fed. Reg. 71491 (Nov. 18, 2011)

The alternate valuation date permits an executor to elect to value all of the assets of a decedent's estate on the date six months after the date of the decedent's death or, if earlier, the date the estate disposes of the asset, rather than on the date of death. Int. Rev. Code § 2032(a). Treasury has withdrawn an earlier proposal and issued new proposed regulations, which seek to prevent the use of the alternate valuation date to reduce the value of a decedent's assets based on certain events that occur after the date of death.

- **Deemed Distributions, Sales, Etc.** The new proposed regulations are less dramatic than their predecessors, in that they create no new broad general rule, but instead they specifically ignore, for alternate valuation date purposes, changes during the alternate valuation period, in the percentage of ownership or control in an entity includible in the gross estate, and the extent of participation by the estate (or other holder of property includible in the gross estate) in relevant post-death events. An estate (or other holder) must, for alternate valuation date purposes, value any property that is subject to such a transaction at its value immediately before the transaction. Prop. Reg. § 20.2032-1(c)(1)(i).

  An estate may value an asset on the date six months after the date of death, notwithstanding a change in ownership percentage, in two limited situations. First, the estate may use the regular alternate valuation date without regard to transactions in which an interest in a corporation, partnership, or other entity includible in the decedent's gross estate is exchanged for

one or more different interests in the same entity or in an acquiring or resulting entity during the alternate valuation period. Prop. Reg. § 20.2032-1(c)(1)(ii) Such transactions may include, for example, reorganizations, recapitalizations, mergers, or similar transactions. This rule applies where the fair market value of the interest received in the exchange is equal to that of the property for which it was exchanged. For this purpose, the fair market values of the surrendered property and received interest are deemed to be equal if the difference between the fair market values of the surrendered property and the received interest does not exceed five percent of the fair market value of the surrendered property as of the transaction date. Prop. Reg. § 20.2032-1(c)(1)(ii).

In addition, the new proposed regulations state that, if, during the alternate valuation period, an estate (or other holder) receives a distribution from a business entity, bank account, or retirement trust (entity) and an interest in that entity is includible in the decedent's gross estate, the estate may use the 6-month date to value the property held in the estate. This rule applies, however, only if the fair market value of the interest in the entity includible in the gross estate immediately before the distribution is equal to the sum of the fair market value of the distributed property on the date of the distribution and the fair market value of the interest in the entity includible in the gross estate immediately after the distribution. Otherwise, the estate must use the fair market value as of the distribution date and immediately prior to the distribution of the entire interest in the entity includible in the gross estate. Prop. Reg. § 20.2032-1(c)(1)(iii)(A).

- **Implementing Rules.** The new proposed regulations also include several additional rules to be used in implementing these new approaches. First, it would adopt an aggregation rule to use in calculating the fair market value of each portion of property that is, or is deemed to be distributed, sold, exchanged, or otherwise disposed of during the alternate valuation period, and that remains in the gross estate on the 6-month date. Prop. Reg. § 20.2032-1(c)(1)(iv).

  Second, it would adopt a rule to use in determining the portion of a trust includible, by reason of a retained interest, in the decedent's gross estate under section 2036 as of the alternate valuation date. Prop. Reg. § 20.2032-1(c)(iii)(B).

  Third, section 20.2032-1(c)(2) of the regulations would be amended to clarify when property, the title to which passes by contract or by operation of law, is deemed to be distributed,

sold, exchanged, or otherwise disposed of for alternate valuation date purposes.

Fourth, a new rule would provide that, any post-death event that Congress, by statute, deems to have occurred on the date of death, will not result in a distribution, sale, exchange, or other disposition of the property for alternate valuation date purposes. Prop. Reg. § 20.2032-1(c)(4) . To date, the preamble notes, the only post-death event that satisfies this exception is the grant, during the alternate valuation period, of a conservation easement in accordance with Section 2031(c).

- **Effective Date.** Generally, these regulations would apply to estates of decedents dying on or after the date on which the final regulations are published in the Federal Register.

Note. The reproposed regulations represent a continued government attempt to address a division between two courts over the impact of certain *post mortem* events on the value of an asset for alternate valuation date purposes. In *Flanders v. United States*, 347 F. Supp. 95 (N.D. Cal. 1972), a district court held that a reduction in value of property as a result of a voluntary act by the trustee in entering into a Land Conservation Agreement under the California Land Conservation Act of 1965, restricting the property to agricultural uses for 10 years, could not be taken into consideration in valuing the property under the alternate valuation method. The court stated:

> It seems clear that Congress intended that the character of the property be established for valuation purposes at the date of death. The option to select the alternative valuation date is merely to allow an estate to pay a lesser tax if unfavorable market conditions (as distinguished from voluntary acts changing the character of the property) result in a lessening of its fair market value.

347 F.Supp. at 99.

In *Kohler v. Comm'r*, T.C. Memo. 2006-152, nonacq. AOD 2008-1 (March 3, 2008), the Tax Court held that valuation discounts attributable to restrictions imposed on closely-held corporate stock pursuant to a post-death reorganization should be taken into consideration in valuing stock on the alternate valuation date. The Tax Court reached its conclusion that the stock to be valued on the alternate valuation date was the stock received in the reorganization, rather than the stock transferred to the corporation, based on the provision

in the regulations that states that stock exchanged for stock of the same corporation in a tax-free reorganization is not treated as distributed, exchanged, sold, or otherwise disposed of under Section 2032(a). Reg. § 20.2032-1(c)(1). Accordingly, the court stated, the stock was not treated as disposed of on the date of the reorganization and was not valued as of the date of death or the date of the reorganization, but rather on the alternate valuation date.

The Preamble to the 2008 regulations reviewed the history of the alternate valuation date rules, which were added in 1935 in light of the estate tax hardship caused by the stock market crash of 1929, particularly on estates of decedents who died a few months before the crash. See 79 Cong. Rec. 14632 (1935) (statement of Mr. Samuel B. Hill); H.R. Rep. No. 74-1681, 74th Cong., 2nd Sess. p. 9 (1935); S. Rep. No. 74-1240, part 1, 74th Cong., 2nd Sess. pp. 9-10 (1935); and S. Rep. No. 74-1240, part 2, 74th Cong., 2nd Sess. pp. 8-9 (1935). The legislative history, the IRS stated, shows that the purpose of this section was to address changes in value attributable to changes in market conditions, rather than changes attributable to voluntary acts.

The 2008 proposed regulations would have adopted a broad rule that allowed the alternate valuation method to the extent that the reduction in value was due to market conditions, and denied it where reduction in value was due to other post-death events occurring during the alternate valuation period. The proposed regulations would have defined "market conditions" as events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property includible in the decedent's gross estate. Changes in value due to mere lapse of time or to other post-death events would have been ignored in determining the value of the decedent's gross estate under the alternate valuation method. REG-112196-07, 73 Fed. Reg. 22300 (April 25, 2008).

7. Treasury Finalizes Actuarial Valuation Regulations Reflecting 2000 Actuarial Data. T.D. 9540, 76 Fed. Reg. 49570 (Aug. 10, 2011)

The Treasury, as required by Code § 7520(c)(3), has finalized the temporary regulations updating its actuarial tables to reflect the new mortality data produced by the 2000 U.S. census.

- **Increased Longevity.** Not surprisingly, the new data reflects an increased life expectancy for all persons under age 95. For example, the following reflects how many persons out of a group of 10,000 births, would be alive at various ages:

Age	1990 CM Table	2000 CM Table
30	97,070	97,750
40	95,373	96,419
50	92,370	93,591
60	85,537	87,595
70	71,357	74,794
80	47,084	50,819
90	17,046	18,472
100	1,424	1,477

Oddly, longevity has declined for persons aged 102 or over.

- **General Effects.** The increased longevity under Table 2000 CM increases the value of lifetime interests and decreases the value of remainders or reversions following lifetime interests. This is mixed news for estate planners, making charitable remainder trusts (CRTs) and qualified personal residence trusts (QPRTs) slightly less desirable, and making lifetime charitable lead trusts (CLTs), private annuities and self-cancelling installment notes (SCINs) slightly more desirable.

- **Charitable Remainder Trust.** The value of a charitable remainder interest following a lifetime annuity or unitrust interest will be smaller under the new tables, because the increased longevity under Table 2000 CM gives the noncharitable beneficiary more years of annuity or unitrust payments. This reduces the value of the deductible charitable remainder interest.

- **Qualified Personal Residence Trust.** The value of the grantor's reserved interest in a QPRT includes both the value of the right to use the residence for a fixed term-of-years and the value of the contingent reversionary interest if the grantor dies during the fixed term-of-years. The increased longevity under Table 2000 CM reduces slightly the value of the reversionary interest, because it is less likely that the grantor will die during the term-of-years. This, in turn, decreases the value fo the grantor's retained interests, and increases the amount of the taxable gift of the remainder interest.

- **Lifetime Charitable Lead Trust.** A lifetime CLT trust pays an annuity or unitrust amount to named charities for the lifetime of a designated individual (often the grantor or the grantor's spouse), with a remainder interest for designated individuals or trusts for their benefit. The increased longevity under Table

2000 CM increases the value of the charity's annuity or unitrust interest and decreases the value of the noncharitable remainder interest. Thus, the income and either gift or estate tax deductions for a gift to a lifetime grantor CLT and the gift or estate tax deductions for a gift to a lifetime nongrantor CLT will be increased under the new rules.

- **Private Annuity.** A private annuity is an intrafamily sale of property for an unsecured promise to pay the seller a fixed dollar amount at least annually, for the lifetime of a named measuring life (usually the seller). The increased longevity under Table 2000 CM increases the value of the reserved annuity, and reduces the amount that must be distributed annually in order to produce a total value equal to that of the assets sold. This makes it easier to finance a private annuity from the income and gains generated by the annuity property itself, and makes these devices more useful.

- **Self-Cancelling Installment Note.** A SCIN involves a sale of property for an installment obligation that terminates on the earlier of the complete repayment of the debt or the seller's death. The purchase price for a SCIN must include a premium that reflects the additional benefit that inures to the buyer if the seller dies before the note is completely repaid. The increased longevity under Table 2000 CM reduces the likelihood that the grantor will die before each note payment is made, and reduces the SCIN premium. This makes the SCIN more affordable to the buyer, and enhances its estate planning utility.

- **Grantor Retained Annuity Trust.** A GRAT is not usually affected by the new actuarial tables. A GRAT is required to pay an annuity to the grantor for a term of years. In some cases, the trust principal reverts to the grantor if he or she dies during the term of years. The increased longevity under Table 2000 CM reduces the likelihood that the grantor will die during the term of years, but the value of that reversionary is not itself a qualified interest, and is ignored for gift tax purposes.

  The increased longevity under Table 2000 CM would, however, be relevant for a GRAT the remainder of which passes to someone who is not a family member of the grantor, because the value of the reversionary interest would now be taken into account in determining the amount of the gift. Code §§ 2702(a)(1), 2702(a)(2)(B). For this purpose, a member of the grantor's family includes the grantor's spouse, a lineal descendant of the grantor or the grantor's spouse, and the

spouse of any such descendant. Code §§ 2702(e), 2701(e)(1). In such cases, the value of the reversionary interest would be taken into account in measuring the gift to the remainder beneficiary, and the reduced value of the reversionary interest, like that in a QPRT, would diminish the value of this technique.

- **Effective Dates.** Generally, the new tables apply to transfers for which the valuation date is on or after May 1, 2009. As a transition rule for gift and estate tax purposes, if the date of a gift or the date of death is on or after May 1, 2009, but before July 1, 2009, the transferor may choose to determine the value of the transfer (and/or any applicable charitable deduction) under tables based on either Life Table 90CM or Table 2000CM.

  In cases involving a charitable deduction with a valuation date on or after May 1, 2009 and before July 1, 2009, if the executor or donor elects to use the Section 7520 interest rate for March or April 2009, then the mortality experience contained in 90CM must be used. If the executor or donor uses the Section 7520 interest rate for May or June 2009, Service said, then the tables based on either Table 90CM or Table 2000CM may be used. If the valuation date occurs after June 30, 2009, the executor or donor must use the new mortality experience contained in Table 2000CM even if the use of a prior month's interest rate is elected.

  The estate of a mentally incompetent decedent may elect to value the property interest included in the gross estate under either the mortality table and interest rate in effect at the time the decedent became mentally incompetent, or the table and interest rate in effect on the decedent's date of death, if the decedent was under a mental incapacity that existed on May 1, 2009, and continued uninterrupted until the decedent's death, or the decedent died within 90 days after regaining competency on or after May 1, 2009.

Note. See also IRS Publications 1457 (Actuarial Valuations, Version 3A: Remainder, Income, and Annuity Examples – For One Life, Two Lives, and Terms Certain), 1458 (Actuarial Valuations, Version 3B: Unitrust Remainder Examples – For One Life, Two Lives, and Terms Certain), and 1459 (Actuarial Valuations, Version 3C: Examples for Computing Depreciation Adjustment Factors).

8. Service Releases Interest Rate Adjustments for Section 2032A. Rev. Rul. 2011-17, 2011-33 I.R.B. 160 (Aug. 15, 2011)

The Service released the 2010 and 2011 interest rates to be used in computing the special use value of farm real property for which an election is made under Section 2032A.

9. Section 2032A Limitation Adjusted for Inflation. Rev. Proc. 2011-52 § 3.30, 2011-45 I.R.B. 701 (Nov. 7, 2011)

An estate can reduce the estate tax value of qualifying real property used in a farm or business and valued under Section 2032A, by up to $1,040,000 for estates of decedents dying in 2012.

10. Transfer and Lease of Farmland to Qualified Heir Does Not Result in Recapture Tax Under Section 2032A. PLR 201129016, 201129018, 201129019, 201129020 (July 22, 2011)

D died owning farmland. D actively and materially participated in the farming activities at death. D's will left the residue of his estate outright to his four children in equal shares. The share for any predeceased child was left in trust for D's grandchildren through that deceased child, until the grandchild reached age 25. Three of the children who survived D disclaimed part of his interest in the farm, and the disclaimed shares went to trusts for the relevant grandchildren or outright to grandchildren who had already reached 25 years of age. The various beneficiaries propose to form four LLCs to which they will transfer their undivided interests in exchange for proportionate interests in the LLCs. Each LLC proposes to enter into a leasing agreement with a partnership, in exchange for a sum certain per annum or a certain percentage share of the crops grown per annum, as the partnership shall decide.

The Service ruled that neither the transfers to the LLC nor the leasing resulted in additional estate tax under Section 2032A(c)(1)(A). The Service noted that Reg. § 20.2032A-3(b)(1) states that a decedent can own farm property either directly or through an interest in a corporation, partnership, or trust. Where the ownership is indirect, the decedent's interest in the business, must qualify under the tests of Section 6166(b)(1) as an interest in a closely-held business on the date of the decedent's death and for sufficient other time. The Service acknowledged that no regulations have ever been issued applying this rule to qualified heirs, but quoted from the legislative history to show that Congress intended this rule to apply to qualified heirs as well. H.R. Rep. No. 94-1380, n.3 at 25, 94th Cong., 2d Sess. (1976). Therefore, the grandchildren were "qualified heirs" and they

may own their interests indirectly through trusts or through an LLC, without ceasing to be deemed to hold them for purposes of Section 2032A. The Service also noted that there is no cessation of farming use when there is a lease in which the lessor receives a share of crops or income based on the farm production. S. Rep. No. 97-144, at 133, 97th Cong., 1st Sess. (1981). Income from a leasing arrangement in which the lessee has the option to pay the lessor rent either in the form of a sum certain or a certain percentage of the crop share is substantially dependent upon production. *Estate of Gavin v. United States,* 113 F.3d 802 (8th Cir. 1997); *Schuneman v. United States*, 783 F.2d 694 (7th Cir. 1986). Therefore, the leases to the partnership do not disturb the special use valuation for the estate.

11. Service Allows Late Alternate Valuation Date Election, If Made Within One Year of the Return Due Date. PLRs 201122009 (June 3, 2011) and 201109014 (March 4, 2011)

- **PLR 201122009.** Executor of Decedent's estate filed a timely estate tax return prepared by CPA 1. CPA 1 did not make the alternate valuation election. The executor later met with CPA 2 who suggested that executor elect to use alternate valuation. After obtaining appraisals, CPA 2 prepared a supplemental Form 706. The alternate valuation date election was made on supplemental information filed within one year of the due date of the return, including extensions.

  The Service permitted a late election of alternate valuation date, pursuant to Reg. §§ 301.9100-1 and 301.9100-3. The Service noted that an extension is not permitted unless the estate tax return is filed no later than 1 year after the due date of the return, including extensions. The Service also explained that relying on a competent expert to prepare the return and make the election demonstrates that the taxpayer has acted reasonably and in good faith. Reg. § 301.9100-3(b)(1)(v). Based on the facts submitted and the representations made, the Service concluded that the extension should be permitted.

- **PLR 201109014.** The personal representatives of D's estate hired CPA to prepare the estate tax return, and they signed and filed a timely return prepared by CPA, valuing the assets on the date of the decedent's death. Over 18 months after the due date (including extensions) of the return, the personal representatives realized that the estate could have benefitted from an alternate valuation date election. They asked the

Service to grant additional time to make the alternate valuation date election under Section 2032.

In a 2010 ruling, the Service denied the request, noting that the Code requires that the alternate valuation date election be made on the estate tax return and that it be made not later than one year after the time prescribed by law (including extensions) for filing such return. Code § 2032(d)(2). Although the taxpayer acted reasonably and in good faith, and that granting relief would not prejudice the interests of the government, the Service stated that it still cannot allow an alternate valuation date election more than one year after the return filing date.

In a 2011 ruling, the Service reversed its position. It stated that, "after reconsideration, we conclude that Decedent's estate meets the requirements for relief. . . ."

Note. The Service will grant discretionary extensions of the time for making the alternate valuation date election in appropriate cases, but it will not do so when the one-year limitation has passed. The 2010 ruling was wrong, because the return was filed on time, but without the election. The preamble to the regulations stated:

> In view of the 1-year limitation imposed under section 2032(d)(2), the proposed regulations provided that no request for an extension of time to make the alternate valuation election under the provisions of §§ 301.9100-1 and 301.9100-3 will be granted if the request is submitted to the IRS more than 1 year after the due date of the return of tax imposed by section 2001 (including extensions of time actually granted). One commentator argued that the 1-year limitation in section 2032(d)(2) applies only to late-filed returns, and therefore should not limit the availability of relief under §§ 301.9100-1 and 301.9100-3 to make a late alternate valuation election if the taxpayer timely filed its return, but failed to make the election on the return. After considering the language and intent of section 2032 and §§ 301.9100-1 and 301.9100-3, the IRS and Treasury Department have determined that taxpayers may request relief under §§ 301.9100-1 and 301.9100-3, even after the expiration of the 1-year period, and that such relief may be granted (subject to the require-

ments of §§ 301.9100-1 and 301.9100-3) provided that the return of tax is filed no later than 1 year after the due date of the return (including extensions of time actually granted.) 70 Fed. Reg. 295 (Jan. 4, 2005).

E. Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs) (Code §§ 2031, 2036-2038, 2511, 2512, 2704 *et alia*)

1. Treasury Would Expand Scope of Section 2704(b) and Ignore More Restrictions, Reducing Valuation Discounts. Dept. of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" p. 127 (Feb. 14, 2011)

The Treasury includes in the Administration's 2012 budget proposal a potentially significant expansion of the scope of Section 2704(b), which currently ignores in valuing an interest in a closely-held entity, any applicable restrictions on liquidation that would lapse or that could be removed after the transfer.

- **Disregarded Restrictions.** The Treasury proposes that a new category of restrictions called "disregarded restrictions," which would be ignored under Section 2704(b) in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or can be removed by the transferor and/or the transfer's family. The transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations, even if they are no more restrictive than those restrictions imposed by applicable state law. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or member, rather than being merely an assignee.

- **Ignoring Certain Nonfamily Interests.** In order to counter the use of small non-family interests (often charitable) to preclude the transferor's family from being able to remove an applicable or disregarded restriction after the transfer, the Treasury proposes that certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the transferor's family.

- **Marital and Charitable Deductions.** This proposal would make conforming clarifications with regard to the interaction of this proposal with the estate and gift marital and charitable deductions.

- **Effective Date.** These proposals would apply to transfers after the date of enactment, for property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

Note. Time and the law have not been kind to Section 2704(b). Courts have held that Section 2704(b) does not apply to a restriction on the withdrawal of a partner from a partnership, unless that withdrawal would cause the partnership to be liquidated. See, *e.g.*, *Kerr v. Comm'r*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002); *Church v. United States*, 268 F.3d 1063 (5th Cir. 2001), *aff'g per curiam* 85 A.F.T.R. 2d 2000-804, 2000 WL 206374 (W.D. Tex. 2000); *Estate of Jones v. Comm'r*, 116 T.C. 121 (2001); *Knight v. Comm'r*, 115 T.C. 506 (2000); *Estate of Harper v. Comm'r*, T.C. Memo. 2000-202. This has preserved the ability of provisions that limit the withdrawal of a member or partner to preserve or increase valuation discounts. State legislatures have modified their partnership and LLC acts to impose more stringent default rules on: (a) the liquidation of a partnership or LLC; (b) the ability of a partner or member to withdraw from the entity; (c) the admission of a transferee of a partnership or membership interest into full participatory status as a partner or member; and (d) the withdrawal of a partner's or member's share of the entity's assets. These increasingly restrictive state default rules have largely rendered Section 2704(b) insignificant with respect to valuation discount planning, because Section 2704(b) does not apply to restrictions that are no more restrictive than those imposed by state law. The Treasury proposals would undo much of this development and to make Section 2704(b) do more of what it was originally designed to do.

The proposal's reliance on regulations not yet issued, however, makes it hard to know exactly what effect it would have on valuation discounts. Certainly, marketability discounts will be reduced or eliminated for many closely-held entities, particularly those whose assets are largely cash, marketable securities, life insurance policies and other highly-liquid assets. The Treasury could modify the disregarded restrictions to force an appraiser to value a partnership or membership interest as if the transferee partner or member had the unilateral right to withdraw from the entity and compel the distribution of the value of his or her share of the entity's assets. FLPs and LLCs that hold illiquid tangible assets, such as real estate, might still be

entitled to marketability discounts at least equal to those that would be available for a tenancy-in-common interest in the underlying assets. The treatment of active businesses that do not hold substantial tangible assets, however, is unclear.

This proposal would also undercut the need for the more sweeping legislative proposals to limit the use of valuation discounts. See, *e.g.*, H.R. 1577, 109th Cong., 1st Sess. (2005); H.R. 436, 111th Cong., 1st Sess. (Jan. 9, 2009); S. 3533, 111th Cong., 2nd Sess. (June 23, 2010); and H.R. 5764, 111th Cong., 2nd Sess. (July 15, 2010).

See also analysis of the Treasury's proposal in Staff of the Joint Committee on Taxation, 111th Cong., 1st Sess., "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal. Part One: Individual Income Tax and Estate and Gift Tax Provisions," at 137-145 (Committee Print) (Sept. 2009). One point that the Joint Committee on Taxation makes is the Treasury already has enough authority to accomplish this task without further legislation. Section 2704(b)(4) authorizes the Treasury to issue regulations that

> provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

The Tax Court in *Kerr* stated that it was "mindful that the Secretary has been vested with broad regulatory authority under section 2704(b)(4)," but concluded that the current regulations did not support the Service's position in the case. 113 T.C. 449, at 474 (1999). The Joint Committee on Taxation also notes that the Service and Treasury business plan for 2008-2009 describes "a plan to issue guidance under § 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership."

2. **Failure to Follow Partnership Formalities Will Result in Deemed Retention of Beneficial Enjoyment and Inclusion of Undiscounted Value of Underlying Assets in Donor's Gross Estate. *Estate of Jorgensen v. Comm'r*, 431 Fed.Appx. 544, 2011 WL 1666930 (9th Cir. May 4, 2011) (slip copy), *aff'g by unpub'd op.* T.C. Memo. 2009-66; *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209 (Aug. 30, 2011); *Estate of Liljestrand v. Comm'r*, T.C. Memo. 2011-259 (Nov. 2, 2011)**

- ***Jorgensen*.** Col. and Ms. Jorgensen created the Jorgensen Management Association (JMA-1), a Virginia limited partnership, each contributing an equal amount of marketable securities, in exchange for 50% limited partnership interests. They named Col. Jorgensen, their son and their daughter as the general partners, but the children never made contributions to the partnership. Col. and Ms. Jorgensen also gave substantial limited partnership interests to their grandchildren. Col. Jorgensen several years before his wife, and after his death, she created a second partnership (JMA-2), again giving general and limited partnership interests to her children and limited partnership interests to her grandchildren. Low-basis assets were held in JMA-1 and high-basis assets held in JMA-2. The Service contended that the value of the partnership assets were includible in Ms. Jorgensen's gross estate, under Section 2036(a)(1).

  The Tax Court (Judge Haines) held that the value of the underlying partnership assets contributed by Ms. Jorgensen to the two partnerships should be included in her gross estate under Section 2036(a). The court held that the transfer to the partnerships was not a bona fide sale for adequate and full consideration; because there was no "legitimate and significant nontax reason for creating the family limited partnership." The court noted that the partnerships were not designed: (i) to help Ms. Jorgensen manage her assets, because her revocable trust and power of attorney already served that function; (ii) to provide a financial education to the two children, noting that Col. Jorgensen had never attempted to teach his children about investments and their management activities were few; (iii) to encourage family unity, noting that the different relationship each child had with money made placing them together as general partners "as likely to cause family disunity as unity"; (iv) to perpetuate the Jorgensens' buy-and-hold investment philosophy, because "[t]here are no special skills to be taught when adhering to a 'buy and hold' strategy, especially when one pays an investment adviser to recommend what to buy

and when to sell"; (v) pool assets, because the assets had been managed together before the partnerships were created and the children and grandchildren did not contribute to the partnerships; (vi) to protect assets against the claims of the creditors of the children and grandchildren, because the son, who was admittedly a spendthrift, was designated as a general partner and because there was no evidence of actual creditor issues. The court also cited the failure of the parties to follow partnership formalities (neither partnership maintained books and records other than a checkbook that went unreconciled and monthly brokerage statements; there were no formal meetings between or among the partners; no minutes were ever kept; and Ms. Jorgensen used partnership assets to pay personal expenses and paid partnership expenses with her personal assets.) Ms. Jorgensen was not financially dependent on distributions from the partnerships for her day-to-day expenses, but she was dependent on the partnerships to satisfy her gift-giving program. Furthermore, the court noted, JMA-II lent $125,000 to the son, on which loan he did not regularly pay interest or principal. The court also noted that Col. Jorgensen formed the partnerships without input from his wife and children. The court also held that Ms. Jorgensen retained the beneficial enjoyment of the partnership assets, noting that (i) Ms. Jorgensen retained sufficient assets outside the partnership for her day-to-day expenses, but not enough to make the gifts she wished to make; and (ii) partnership distributions were used to pay transfer taxes, legal fees, and other obligations of the decedent's estate.

The Ninth Circuit (Judges Reinhardt, Hawkins and Gould) affirmed. On appeal, the estate conceded that the decedent retained some benefits in the transferred property, because of her having written checks on partnership accounts to pay some personal expenses and having made some family gifts of partnership assets, but it argued that these were *de minimis* or that the application of Section 2036(a) should be limited to the actual amount accessed by decedent. The court held that writing over $90,000 in checks on the partnership accounts and using partnership assets to pay over $200,000 of personal estate taxes was not *de minimis*. Citing *Strangi v. Comm'r*, 417 F.3d 468, 477 (5th Cir. 2005) (post-death payment of funeral expenses and debts from partnership funds indicative of implicit agreement that transferor would retain enjoyment of property); *Bigelow v. Comm'r*, 503 F.3d 955, 966 (9th Cir. 2007) (noting payment of funeral expenses by partnership as supporting reasonable inference decedent had implied

agreement she could access funds as needed). The court also held that the Tax Court did not err by concluding there was an implied agreement decedent could have accessed any amount of the purportedly transferred assets to the extent she desired them. The actual amount of checks written for decedent's benefit does not undermine the court's finding that she could have accessed more, it was only used to buttress the court's conclusion that decedent had such access to the funds if needed. Furthermore, the court agreed that the tax court did not clearly err by concluding decedent's transfer was not a *bona fide* sale for adequate and full consideration, because transfers to family partnerships are subject to heightened scrutiny, and, to be *bona fide*, must objectively demonstrate a legitimate and significant nontax reason for the transfers. In this case, the assets transferred were marketable securities which did not require significant or active management, there was some disregard of partnership formalities, and the nontax justifications were either weak or refuted by the record (including formation of a second family partnership to hold higher-basis assets for gift-giving purposes, purportedly for the same nontax justifications that the original partnership could have already served).

- ***Estate of Turner.*** Clyde W. Turner, Sr. and his wife, Jewell, each transferred $4,333,671 in cash, certificates of deposit, and publicly-traded securities, to Turner & Co., a family limited partnership they had created. Each donor received a 0.5-percent general partnership interests and a 49.5 percent limited partnership interest. The donors retained adequate assets outside of the partnership to support themselves comfortably. Over a two-day period less than five weeks before Clyde, Sr.'s death, Clyde, Sr. and Jewell gave limited partnership interests to their children, a trust for one of their children, and their grandchildren by a deceased child. Clyde, Sr. died and the Service argued that the undiscounted value of 50 percent of the partnership assets should be included in his gross estate.

  The Tax Court (Judge Marvel) held for the government, under both Sections 2036(a)(1) and 2036(a)(2). The court noted that Section 2036(a) does not apply if the decedent's transfer was a *bona fide* sale for adequate and full consideration. In the context of a family limited partnership the *bona fide* sale exception is met if there was a legitimate and significant nontax reason for creating the partnership and if the transferors received partnership interests proportionate to the

value of the property transferred. *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). The court held that the partnership was not created for a significant nontax reason. The court stated that the partnership was not formed to consolidate assets for management purposes and allow someone other than the donors or their children to maintain and manage the family's assets for future growth pursuant to more active and formal investment management strategy. The court stated that consolidated asset management may be a legitimate and significant nontax purpose, but it is not generally a significant nontax purpose only where the assets require active management. *Estate of Schutt v. Comm'r*, T.C. Memo. 2005-126; *Estate of Black v. Comm'r*, 133 T.C. 340, 371 (2009); *Estate of Erickson v. Comm'r*, T.C. Memo. 2007-107; *Estate of Harper v. Comm'r*, T.C. Memo. 2002-121. There were no active business assets in this partnership, and Clyde Sr. had no unique or distinct investment philosophy that he hoped to perpetuate. (Clyde, Sr. actually testified that his lack of a coherent investment plan was one of the primary reasons for forming the partnership.) The court also held that the partnership was not formed to facilitate resolution of family disputes through equal sharing of information, which may be a legitimate and significant nontax reason for creating a family partnership. *Estate of Mirowski v. Comm'r*, T.C. Memo. 2008-74; *Estate of Stone v. Comm'r*, T.C. Memo. 2003-309. Here, the ill will among the Turner children was not about money, *per se*, and there was no evidence that the children ever expressed a particular interest in managing their parents' assets. The bad feelings among the children stemmed from the fact that Clyde, Jr. had a domineering personality and an unpleasant attitude toward his sisters and their husbands. The court nextr held that the partnership was not formed to protect the family assets and Jewell from one of her grandsons, Rory, who had a serious drug problem and had been arrested several times, and to protect Rory from himself, though asset protection may be a legitimate and significant nontax reason for forming a family partnership. See, *e.g., Schurtz v. Comm'r*, T.C. Memo. 2010-21. Here, the court found the estate's argument not to be credible, because Jewell had a close relationship with Rory, and she gave him money from time to time, and there was no proof that she wanted or needed protection from Rory. Also, the partnership did not actually protect Jewell from Rory, because Clyde, Sr. and Jewell retained significant assets outside the partnership that Jewell could still give to Rory. The court also noted that the partner-

ship did not protect Rory from himself, because Rory had no assets before the gifts of partnership interests, and the trust created to hold Rory's partnership interests provided adequate protection. The court also stated that several additional factors indicated that the transfers to the partnership were not *bona fide* sales, including (a) the fact that Clyde Sr. stood on both sides of the transaction, creating the partnership with no meaningful bargaining or negotiation with Jewell or with any of the other anticipated limited partners; (b) Clyde Sr. used partnership funds to make personal gifts, to pay premiums on life insurance policies, and to pay legal fees relating to his and Jewell's estate planning; and (c) Clyde Sr. and Jewell did not complete the transfer of assets to the partnership for at least 8 months after formation of the partnership.

The court then held that Clyde, Sr. had an implied agreement to retain possession or enjoyment of the transferred assets, based on the continued use of the partnership assets for personal purposes. See *Estate of Gore v. Comm'r*, T.C. Memo. 2007-169; *Estate of Erickson v. Comm'r*, T.C. Memo. 2007-107. The court also noted that the partnership agreement expressly provided for paying the general partner a "reasonable" management fee, and Clyde Sr. and/or Jewell chose to receive a $2,000 per month without any apparent regard for the nature and scope of their actual management duties. The record did not show that this was a reasonable fee, or even what the general partners did for the fee. Jewell did not manage the partnership and it was unclear whether Clyde, Sr. managed it. This made the partnership resemble an investment account from which withdrawals could be made at will, rather than a true investment medium. The court stated that this "impression is reenforced by a provision in the partnership agreement that gave Clyde Sr. the right, as general partner, to amend the partnership agreement at any time without the consent of the limited partners." The court also noted that (i) Clyde Sr. transferred most of his assets to the partnership; (ii) although the general partners retained sufficient assets outside of the partnership to meet their living expenses, they opted to receive management fees for few or no management services and took distributions from the partnership at will; (iii) the transferors used the partnership assets to make personal gifts, pay life insurance premiums, and pay legal fees related to their estate planning. Clyde, Sr. also commingled personal and partnership funds when he personally paid the partnership's debt to a bank, bought certain property on behalf of the partnership, and reimbursed the

partnership for its purchase of certain notes. Clyde Sr. also received disproportionate distributions from the partnership. Most importantly, the court stated, the partnership appeared to be created for primarily testamentary purposes. Clyde, Sr. stated that the entity was created because he and his wife were not "getting any younger," it was part of their estate planning, and it was designed to provide income for future generations. The court also noted Clyde Sr.'s personal and sentimental attachment to certain bank stock, and the fact that he had made it very clear that it was never to be sold, which the court interpreted as an implied agreement to retain beneficial enjoyment of the stock.

The court also held that the assets were properly includible in the decedent's gross estate under Section 2036(a)(2), because he had the right to control the beneficial enjoyment of the partnership assets. The court recognized that a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under section 2036(a)(2). *United States v. Byrum*, 408 U.S. 125 (1972); *Estate of Schutt v. Comm'r*, T.C. Memo. 2005-126. Clyde Sr. was, for all intents and purposes, the sole general partner and the partnership agreement gave him broad authority not only to manage partnership property, but also to amend the partnership agreement at any time without the consent of the limited partners. This gave him the sole and absolute discretion to make pro rata distributions of partnership income and to make distributions in kind.

Note. See also discussion of gift tax annual exclusion issue, below.

- ***Estate of Liljestrand*.** Acting on advice of his estate planning attorney, Paul, the decedent, formed a limited partnership ("PLP"). Sometime after forming the partnership, the decedent transferred to it nearly $6 million in real estate, including a mini-warehouse in Oregon, eight condominiums in California, three buildings in a California shopping center, a medical building in Arizona, and a strip mall in Florida. The decedent, through his revocable trust, held a 99.98-percent interest in PLP. consisting of all of the general partnership units and class A limited partnership units, and all but one of the class B limited partnership units. One son, Robert, who managed the decedent's real estate and was co-trustee of his revocable trust, received one class B limited partnership unit. The decedent later limited partnership interests gave to irrevocable trusts he established for his children.

The Tax Court (Judge Haines) held that the decedent had retained the beneficial enjoyment of the assets transferred to the partnership, and included the undiscounted value of the partnership assets in his gross estate under Section 2036(a)(1). The court stated that the assets were not transferred in a *bona fide* sale for an adequate and full consideration in money or money's worth. First, the court held that there was no legitimate and significant nontax reason for creating the partnership. In this regard, the court noted that: (1) forming PLP did not ensure that the real estate would be centrally managed by Robert, which was already assured by Robert's employment agreement with the trust which he entered into before the partnership was formed; (2) forming PLP did not assure Robert's long-term employment as manager of the real estate, because his conflict of interest as co-trustee of the revocable trust continued with respect to the partnership interests held by the trust in the same manner as they had existed with respect to the real estate held by the trust; (3) the partnership appeared not to have been formed to ensure that the real estate would not be subject to partition or division under Hawaiian law, because most of the real estate was outside of the state and not subject to Hawaiian law, the decedent's attorney did not even bother to research the law of the states in which the property was located (suggesting that this was not a true motivating issue), the children could not have partitioned the property because they would not have owned interests in it (it would have been held entirely by the trustees), and there was no evidence that any of the children wanted to partition the property; and (4) there was no evidence that the decedent or the other partners were particularly concerned with creditor claims, and the estate could not name a single creditor or even establish an activity or pattern of activity by the partners that might open them up to potential liability. Second, the court rejected the argument that the formation of the partnership was a *bona fide* sale, noting that the partnership failed to follow even the most basic partnership formalities, and that it commingled assets during the first two years of its existence, held only one partnership meeting in over 12 years, had no other formal meetings between the partners, kept no minutes of meetings, used partnership assets to pay the decedent's personal expenses (including his housekeepers and personal secretary, his equity line of credit on his home, his mortgage on an Hawaiian condominium, his grandchildren's tuition, and pay the taxes and the expense of accounting services for his children), failed to make the

proportionate distributions required under the partnership agreement, and made numerous loans to partners without receiving promissory notes or repayment. Furthermore, the court noted, the decedent was financially dependent upon partnership distributions to maintain his lifestyle and pay his everyday expenses. The court also noted that the *bona fide* nature of the transaction is called into question where, as here, the decedent stands on both sides of a transaction. Citing *Estate of Jorgensen v. Comm'r*, T.C. Memo. 2009-66; *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145; *Estate of Harper v. Comm'r*, T.C. Memo. 2002-121. The decedent, in this case, received all but .02 of one percent of the partnership interests, and the one son who received that interest got it as a gift from the decedent, and never had his own lawyer. Also, the decedent never consulted with his other children regarding formation of the partnership. Third, the court held that the transfer was not made for adequate and full consideration. The court noted that there was no evidence that Robert contributed the $362 required for his partnership interest, and noted its particular concern about the fact that PLP had no bank account for its first two years, into which a contribution could even be made. Furthermore, PLP did not begin keeping track of partnership capital accounts until one and one-half years after its formation, making it questionable whether the capital accounts were correctly maintained. Fourth, the court concluded that the decedent impliedly retained the right to the income from the transferred assets, as demonstrated by: (a) he retained insufficient assets outside the partnership to maintain his lifestyle and satisfy his obligations; (b) PLP used its assets to satisfy the decedent's personal expenses and liabilities; (c) PLP commingled personal and partnership assets, particularly during the first two years of its existence; and (d) the preferred partnership interests guaranteed the decedent a return of virtually all of the partnership income, suggesting an agreement to retain an interest in the contributed assets. Finally, the court noted the testamentary characteristics of the partnership arrangement, finding that the motivation for PLP's formation was "admittedly postmortem," with no significant change in the decedent's relationship with the assets before his death.

3. Ninth Circuit Rejects Step Transaction Aspects of Gift on Formation of a Family Limited Liability, But Agrees with Fact-Based Analysis. *Linton v. United States*, 630 F.3d 1211 (9th Cir. Jan. 21, 2011), *aff'g in part, rev'g in part* 638 F.Supp.2d 1277 (W.D. Wash. 2009)

In November, 2002, William and Stacy, a married couple, formed WLFB Investments, a Washington state LLC, and issued all of the membership interests to William. On January 22, 2003, William gave one-half of the membership interests to Stacy, and also executed (a) quit claim deed conveying a parcel of his separate property real estate to the LLC, effective on the date of the deed; (b) an assignment of assets signed by William as assignor and William and Stacey as assignees on behalf of the LLC; and (c) letters signed by William authorizing the transfer of securities and cash to the LLC. One brokerage apparently received William's letter on January 24 and made the transfers between January 24 and 31, 2003, and another appears to have made the transfers between January 24 and 29, 2003. At the same meeting in the office of William and Stacy's attorney, the couple signed but left undated documents (i) creating an irrevocable trust for each of their four children, and (ii) assigning an 11.25% LLC interests to each trust. Several months later, the couple's attorney filled in the dates of the transfer documents as January 22, 2003, though he, William, and the couple's accountant all stated that the date that was supposed to have been inserted was January 31, 2003. William's and Stacy's 2003 federal gift tax returns, prepared by their attorney, stated that gifts of LLC interests were made on January 31, 2003. The LLC's "Membership Interest Ledger, prepared by the attorney's staff, showed the initial ownership of 100% of the partnership by William, a transfer of 50% to Stacy, and subsequent gifts to the four trusts. The dates on those ledger entries, however, were left blank. The appraisal prepared by the couple's accountant stated that percentage interests in the LLC were given to the trusts on January 31, 2003. The partnership tax return showed that the capital contributions were credited first to William's capital account, then one-half was moved to Stacy's capital account, and thereafter interests were moved to the trusts' capital accounts. William stated that he decided how much he would transfer to the LLC based on the amount of available gift tax exemptions, taking into account valuation discounts. The LLC agreement restricted the transfer of membership interests to nonfamily members and reserved management functions to the Managers (the taxpayers). The taxpayers claimed a 47% valuation discount based on the theory that the limitations on alienability and non-controlling status rendered the percentage interests in the LLC unmarketable. The Service denied

any discount. The taxpayers paid the gift tax deficiency and sued for a refund.

The U.S. District Court for the Western District of Washington (Judge Zilly) granted summary judgment for the Service. The district court relied on language in the trust agreements and gift documents to determine that the children's trusts were created and the gifts of the LLC interests were made to those trusts contemporaneously, on January 22, 2003. The court also determined the contributions of cash, securities and real property were made to the LLC either at the same time as or soon after the gifts of the LLC interests to the children's trusts. Thus, the court held that the transfers of LLC interests constituted indirect gifts of the undiscounted value of the underlying assets. The district court also held, in the alternative, that even if the taxpayers established that the cash, securities and real property were contributed to the LLC before the gifts of LLC interests to the trusts, they were indirect gifts of the underlying assets under the step transaction doctrine.

The Court of Appeals for the Ninth Circuit, in a per curiam opinion, affirmed in part and reversed in part. The court focused much of its attention on the facts of the case, stating that the sequencing of the transfer of assets to the LLC and the gifts of LLC interests was critical. *Senda v. Comm'r,* 433 F.3d 1044, 1046 (8th Cir. 2006). If the LLC is funded first, followed by some lapse of time, and then LLC interests are given away, the gifts are ordinarily characterized as gifts of discountable LLC interests. If the contributions to the LLC occur after the transfer of LLC interests to the children's trusts, however, the gifts are ordinarily characterized as undiscountable indirect gifts of the particular contributed assets. The court focused on when the LLC interests were transferred under applicable state law (Washington), noting that under state law, a gift is not completed until there have occurred a subject matter capable of delivery, delivery and acceptance, and a donative intent. *In re Marriage of Zier,* 147 P.3d 624, 628 (Wash. Ct. App. 2006). The LLC interests were in existence from November, 2002, when the LLC was created. Delivery of the LLC interests requires the execution of documents, rather than physical delivery. On January 22, 2003, the taxpayers signed both the trust instruments and a gift document giving the trusts certain percentage LLC interests. These documents were signed in the presence of the trustee to whom delivery to the trust would need to be made. Delivery occurred, therefore, on January 22, 2003. Acceptance of the gift is presumed, and so the court deemed the gifts accepted on January 22, 2003. This left as the key element the intent to make a gift. The taxpayers stated that they did not intend to give away LLC interests until January 31, 2003, but state law does not apply a subjective-intent standard in the interpretation of legal

instruments. *Hearst Commc'ns, Inc. v. Seattle Times Co.,* 115 P.3d 262, 267 (Wash. 2005); *In re Estate of Curry,* 988 P.2d 505, 508 (Wash. Ct. App. 1999). Rather, it applies an objective standard, particularly where there is a writing. *See*, however, *Restatement of Property (3d): Wills and Other Donative Transfers* § 10.1 (2003) (adopting a subjective standard). The objective indicia of intent in this case, unfortunately, are ambiguous. The gift documents stated that the Lintons "hereby gift" the LLC interests, suggesting that the intent to make a gift occurred on the date of signing. The lack of dating on those documents rendered this statement ambiguous, however. A writing is also effective to complete a gift "when the donor puts the document beyond retrieval" by delivering the document to the donee, so the mere execution of the gift documents on January 22 did not make the gifts effective on that date. The signed documents were retained by the donors' attorney, which suggests no intent yet to complete the gift. The attorney stated that he later came to believe that the clients wanted the documents dated January 31, 2003, suggesting that at the time the documents were signed, there was no intent to complete the gift. On the date of signing, however, the taxpayers did not give their attorney instructions as to when to make the gifts effective. The attorney divined the taxpayers' intent months later, based on documents provided him by their accountant. The court stated that, because the taxpayers never instructed their lawyer to make the gifts effective on January 31, "they cannot plausibly claim that they left the documents with [the attorney] with instructions to make the gifts effective on January 31." More importantly, even if the taxpayers had given their attorney such instructions, he appears to have taken no action on January 31 that might have made the gifts effective on that date. In light of this ambiguity on a key issue, the court reversed and remanded the case for the district court to determine when the taxpayers intended to complete the gifts.

The taxpayers contended that they were entitled to summary judgment because, even were the Service correct about the timing of the transfer of assets to the LLC and the transfer of LLC interests, no gift to the trusts could have occurred at all, because the LLC agreement states that "A Member's Capital Account shall be increased by the Member's capital contributions to the Company...." The taxpayers argued that, if they gave assets to the company after they gave membership interests to the trusts, then the transfers would be properly credited to their own capital accounts, rather than those of the trusts. Therefore, there would be no gift. The court characterized the taxpayers' "failed-gift" argument as "too clever." The LLC membership ledger showed that the capital accounts of the children's trusts were, in fact, increased, as did the LLC's informational return that its accountants prepared and filed with the Service in March,

2004. The taxpayers suggested that these documents were erroneous and should be ignored. The court suggested, however, that the membership ledger and the LLC's informational return together reflect the substantive reality of the situation: all parties involved regarded the trusts' capital accounts as having been enhanced by the gifts.

The court then rejected the district court's alternate reliance on the step transaction doctrine. The court stated that the step transaction doctrine treats multiple transactions as a single integrated transaction for tax purposes if all of the elements of at least one of three tests are satisfied: (1) the end result test, (2) the interdependence test, or (3) the binding commitment test. *True v. United States,* 190 F.3d 1165, 1174-75 (10th Cir. 1999). The court noted that the Tax Court has described the step transaction doctrine as combining "a series of individually meaningless steps into a single transaction." *Esmark, Inc. & Affiliated Cos. v. Comm'r,* 90 T.C. 171, 195 (1988). In this case, the Service pointed to no meaningless or unnecessary step that should be ignored and, examining the step transaction doctrine in light of the three applicable tests, the Ninth Circuit concluded that its application does not entitle the government to summary judgment. The end result test asks whether a series of steps was undertaken to reach a particular result, and, if so, treats the steps as one. Under this test, a taxpayer's subjective intent is, the court noted, "especially relevant," and the result sought by the taxpayers is consistent with the tax treatment that they seek: they wanted to convey LLC interests to their children, without giving them management control over the LLC or ownership of the underlying assets, and if the transactions could somehow be merged, the taxpayers would prevail, because the end result would be that their gifts of LLC interests would be taxed as they contend. The interdependence test asks "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Associated Wholesale Grocers, Inc. v. United States,* 927 F.2d 1517, 1523 (10th Cir. 1991). Placing assets into an LLC is an ordinary and objectively reasonable business activity that makes sense with or without any subsequent gift. The taxpayers' creation and funding of the LLC enabled them to specify the terms of the LLC and contribute the desired amount and type of capital to it-reasonable and ordinary business activities. Thus, the interdependence test would not succeed for the Service in this case. The binding commitment test asks whether, at the time the first step of a transaction was entered, there was a binding commitment to take the later steps. *Comm'r v. Gordon,* 391 U.S. 83, 96 (1968). The test only applies to transactions spanning several years, and so is irrelevant in this case.

The Ninth Circuit, however, mitigated its statements in footnote 9, in which it stated that it really did not like being restricted to analyzing this case under the three traditional step transaction tests, but that the parties had both argued under those three tests. The court reviewed *Holman* and *Gross* in the footnote, and then stated:

> To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interests to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That risk would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long period to make the transactions distinct, notwithstanding that some of the value transferred to the LLC was cash.

The court added that, in addition to the three traditional tests, courts often look at the timing of the transaction. Therefore, if the Service establishes that there was very little time between the steps in this transaction, there would be no need to apply the three traditional step transaction doctrine tests.

The Ninth Circuit added insult to injury for the Service, assessing costs of the appeal against the government.

Note. See also Gerzog, "*Linton* Reversed: Indirect Gift and Step Transaction," 130 Tax Notes No. 13 (2011).

F. Code §§ 2036 - 2038. Retained Powers and Interests

1. Treasury Issues Final Regs on Increasing GRATs and Certain Other Retained Interests. T.D. 9555, 76 Fed. Reg. 69126 (Nov. 8, 2011)

Treasury has issued final regulations regarding the portion of certain retained interest trusts, including grantor retained annuity trusts (GRATs) with increasing payments, that should be included in a grantor's gross estate if the grantor dies during the term of the trust. The final regulations make several changes in the regulations that were earlier proposed. Reg-119532-08, 74 Fed. Reg. 19913 (April 30, 2009).

- **Decedent Survived by Other Recipient.** The gross estate of a decedent whose reserved income, annuity or similar payment from transferred property commences after the death of another person who is alive on the date of death, must be reduced by the value of the outstanding interest of the other person. If the other person predeceased the decedent, the reservation by the decedent may be considered to be either for life, or for a period that does not in fact end before death. Reg. § 20.2036-1(b)(1)(ii). The amount includible in the decedent's gross estate is calculated as follows: (a) determine the fair market value of the whole trust fund; (b) determine the corpus required to provide the decedent's income, annuity, or other distribution (using the Section 7520 rate applicable on the date of death); (c) determine the trust corpus required to provide the annuity or other interest that the decedent would have received had he or she survived the other recipient (again, using the Section 7520 rate applicable on the date of death); (d) determine the present value of the interest to be received by the surviving recipient (again using the Section 7520 rate applicable on the date of death); (e) subtract amount (c) from amount (d), but not less than amount (b); (f) the lesser of amount (a) and amount (e) is includible in the decedent's gross estate. Reg. §§ 20.2036-1(c)(1)(ii), Ex. 1; 20.2036-1(c)(2)(iv), Ex. 8.

- ***Walton* GRATs and Similar Arrangements.** The estate of a decedent includes the value of payments that the decedent was receiving during life and that will continue to be made to the decedent's estate for a specified period, only as part of the value of the interest the decedent was receiving under Section 2036(a). The value of the payments that must be made to the decedent's estate are not included under Section 2033, because to do so would double-count the same assets. Payments that become payable to the decedent prior to the decedent's date of death, but that are not paid until after the decedent's date of death, are includible in the decedent's gross estate under section 2033. Reg. § 20.2036-1(c)(1)(i). See discussion of the rationale for this change at 76 Fed. Reg. at 69127. A grantor's right to an annuity or similar payment that has already accrued to the grantor, but which has not been distributed on the date of death, however, is separately included in the grantor's gross estate under Section 2033. Reg. § 20.2036-1(c)(1)(i) This amount is a liability of the trust, so the value of the trust corpus should be reduced by the amount of the liability, which could reduce the amount includible in the gross estate, if the trust corpus is less than the

amount required to pay the grantor's annuity or similar interest from trust income.

- **Retained Annuity Following Current Annuity Interest of Another.** The gross estate of a decedent who retained the right to receive an annuity, unitrust or other payment (rather than income) after the death of the current recipient of that same payment, includes under Section 2036(a) the amount of trust corpus required to produce sufficient income to satisfy the entire annuity that the decedent would have been entitled to receive had he or she survived the current recipient, reduced by the present value of the current recipient's interest. If greater, however, the decedent's estate includes the amount includible shall not be less than the amount of corpus required to produce sufficient income to satisfy the annuity or other payment the decedent was entitled, at the time of the decedent's death, to receive for each year. Of course, the amount includible cannot exceed the value of the trust corpus on the date of death. The amount includible under these rules is determined as follows: (a) determine the fair market value of the trust corpus on the decedent's date of death; (b) determine the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment, using the Section 7520 rates on the date of death; (c) determine the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment that the decedent would have been entitled to receive for each trust year if the decedent had survived the current recipient; (d) determine the present value of the current recipient's annuity, unitrust, or other payment (without applying the exhaustion test); (e) subtract the amount in (d) from the amount in (c), but not below zero; (f) the amount includible in the decedent's gross estate is the amount in (a) or, if less, the amount in (e). Reg. § 20.2036-1(c)(2)(ii).

- **Graduated Retained Interests.** The regulations explain the estate tax treatment of an interest in a graduated GRAT, GRUT or other arrangement in which a payment is made at least annually, that increases (but does not decrease) over a period of time, not more often than annually. Reg. § 20.2036-1(c)(2)(iii)(A). The regulations basically treat the grantor as having retained two different interests – the right to receive the annuity or other amount in effect on the date of death, and the right to receive an incremental payment in future years. The grantor's gross estate includes the sum of the value of these two components (the "base amount" and the "corpus amount").

Reg. § 20.2036-1(c)(2)(iii)(C). The "base amount" is the amount of corpus required to generate the annuity, unitrust, or other payment payable for the trust year in which the decedent's death occurs, determined without regard to the subsequent additions. Reg. § 20.2036-1(c)(2)(iii)(B)(1). A "periodic addition" to a graduated retained interest for each year after the year of the decedent's death is any increase in the amount of the annuity, unitrust, or other payment that would have been payable for that year, had the decedent survived, over the amount payable in the immediately preceding year. Reg. § 20.2036-1(c)(2)(iii)(B)(2). The "corpus amount" for each trust year in which a periodic addition occurs (an "increase year"), is the amount of trust corpus which, starting from the decedent's date of death, is necessary to generate an amount of income sufficient to pay the periodic addition, beginning in the increase year and continuing in perpetuity, without reducing or invading principal. The corpus amount required as of the decedent's date of death for each increase year is the product of: (a) the result of dividing the periodic addition (adjusted for frequency of payments and for payments due at the beginning of a period) by the section 7520 rate; and (b) 1, divided by the sum of 1 and the Section 7520 rate raised to the T power (1 / (1 + rate)^T). The second factor applies a present value discount to reflect the period beginning with the date of death and ending on the last day of the trust year immediately before the year for which the periodic addition is first payable. The sum of these amounts represents the amount of trust principal that would be necessary to generate the annual payments that would have been paid to the decedent if the decedent had survived and had continued to receive the graduated retained interest. The amount of trust corpus includible in a decedent's gross estate under this section, however, still cannot exceed the fair market value of the trust corpus on the decedent's date of death.

- **Effective Date.** Generally, the regulations are effective on November 8, 2011.

2. Continued Use of Residence After Termination of QPRT Does Not Result in Estate Taxation, Even Though No Rent Paid. *Estate of Riese v. Comm'r*, T.C. Memo. 2011-60 (March 15, 2011)

Sylvia created a three-year QPRT that terminated six months before her death. One of her daughters took care of her financial affairs, and consulted with her estate planning attorney regarding the decedent's

continued occupancy of the residence. The attorney had repeatedly told the daughter and the decedent that the continued use of the residence would require payment of a fair market rent. After the QPRT terminated on April 19, 2003, the decedent's attorney advised the daughter to contact several real estate brokers to determine the correct rent, and to execute a written lease before the end of the year. The decedent died before the daughter had completed that process. The decedent's executor excluded the residence from the gross estate and deducted the unpaid rent for the period after the termination of the QPRT and before the date of death.

The Tax Court (Judge Vasquez) held that the residence was excludible from the decedent's gross estate, because no rent-free use had been retained by the decedent. The court noted that, while the decedent's daughter had never directly discussed rent with the decedent after the QPRT terminated, she had discussed it with the decedent's attorney, and was acting at his direction to arrange a lease, when the decedent suffered a stroke and died unexpectedly. The court reviewed several key precedents, including *Estate of Barlow v. Comm'r*, 55 T.C. 666 (1971), in which there was a written lease and market rents paid for two years, after which rent payments started because of unforseen circumstances, and the court held that there was no retained life estate in the property. In *Guynn v. United States*, 437 F.2d 1148 (4th Cir. 1971), the decedent bought a residence and moved into it, and thereafter conveyed title to her daughter and continued to live there without paying rent and without an express agreement entitling her to do so, and the court held that the value of the property was included in the gross estate on the basis of an implied agreement for a retained life estate. In *Estate of Tehan v. Comm'r*, T.C. Memo. 2005-128, the decedent conveyed his interest in his home to his eight children and, pursuant to an express agreement, continued to exercise "the sole and exclusive right to the use and occupancy of the Property for such period of time as he desires'" and paid no rent, and the court held that there was a retained life estate. The court noted that in *Guynn* and *Tehan*, there was never an understanding that the decedent would pay rent, whereas in *Barlow* and this case, the decedent always intended to pay a market rent. The court stated that the existence of an implied agreement was negated by the express agreement among the parties for the payment of rent.

Note. The court also held that the estate could deduct under Section 2053(a)(3) the rent that her estate was legally obligated to pay her daughters for the decedent's occupation of the residence after the termination of the QPRT and before her death. The court denied a deduction for rent for the short period after the decedent's death, noting that there was no formal lease and the decedent's ten-

ancy-at-will ceased upon her death. “The estate did not require a roof over its head and was not obligated to pay rent. . . .” The court also denied a $125,000 deduction for a payment made to the decedent’s son-in-law for services provided. The estate argued that the son-in-law had extensive knowledge of decedent’s assets because of his previous service to her, but the court noted that the estate failed to prove the nature of the services provided to the estate.

3. How Not to Produce a Fractional-Interest Discount for a Tenancy-in-Common Interest in Real Estate. *Estate of Adler v. Comm’r*, T.C. Memo. 2011-28 (Jan. 31, 2011)

The decedent, Axel Adler, had owned 1,100 acres of land in Carmel, California. In 1965, Axel deeded an undivided one-fifth interest in the property to each of his five children as tenants in common. The deed reserved to Axel “the full use, control, income and possession of . . . [the property] . . . for and during . . . [his] natural life”. Axel continued to use the property. None of his children resided there or attempted to interfere with his use, possession, or enjoyment of the property. Axel paid all expenses associated with the property and was not asked to and did not pay rent to the children. Axel never sought the children's permission to alter or improve the property. On the date of death, the property was worth $6,3909,000. The estate, however, claimed that the estate actually included five separate tenancy-in-common interests, and applied a 32% marketability discount and a 16% minority-interest discount.

The Tax Court (Judge Morrison), held for the Service that no discounts were appropriate. The court noted that the three conditions for the application of Section 2036(a)(1) were met: (1) Axel transferred an interest in the property during life, (2) the transfer was not a sale, and (3) Axel retained possession or enjoyment of the property for life. Reg. § 20.2036-1(a); *Estate of Bongard v. Comm’r*, 124 T.C. 95, 112 (2005). The general purpose of Section 2036, the court explained, is to include the value of property in the value of the gross estate where Axel transfers the property during life and the transfer is essentially testamentary in nature. Transfers included under Section 2036(a)(1) are essentially testamentary in nature because the transferor controls the disposition of the property at death but possesses and enjoys the property during life. The court agreed that, when a person dies holding a fractional interest in property, it is often appropriate to discount the value of the interest because the lack of control and the lack of liquidity decrease the property's value. Whether property should be valued as a whole or as separate fractional interests, however, depends on when the interests are separated. If ownership is split during Axel's lifetime, the interest Axel retained is valued sepa-

rately. If the split occurs only at death, the property is valued as a whole – with no discount for split ownership. *Ahmanson Found. v. United States*, 674 F.2d 761, 768 (9th Cir. 1981). In this case, therefore, the court held that the ownership of the property should be considered to have been split up at Axel's death. The retention of a lifetime use of the property, the court stated, rendered the division testamentary in character, and negated any marketability or control discounts.

4. Actually Living in the House is a Tough Fact to Get Past. *Estate of Van v. Comm'r*, T.C. Memo. 2011-22 (Jan. 27, 2011)

The decedent, Adelina Cheng Van, was a Chinese immigrant who became quite knowledgeable about the real estate market in and around San Francisco, California. In 1988, one of the decedent's daughters and son-in-law (the Hus) asked her to see if the decedent's long-time boyfriend would sell to them a house in which the decedent lived. The boyfriend became worried that the decedent might bring a palimony suit, and so had her sign a "Mutual Agreement and Release," that required him to sell her the house. The Hus gave the decedent the $170,000 for a downpayment, and gave her the money to make payments on the $80,000 promissory note she signed. Within hours of recording the deed to the house, the decedent recorded a grant deed conveying title to the house to herself and two of her grandchildren (the children of the Hus), as joint tenants. Several years later, the decedent had the two grandchildren reconvey title to her solely. The decedent then created a revocable trust and deeded the house to herself as trustee. Two years later, she transferred title to the house from herself as trustee to her daughter and three granddaughters. The decedent died and her son became the personal representative of her estate. The son filed an estate tax return disclosing the existence of the house, but excluding it from the gross estate on the grounds that it belonged to the Hus. The Service disagreed, and assessed a deficiency.

The Tax Court (Judge Holmes) held for the Service. The estate argued that the Hus really owned the house, because they gave the decedent the money to buy it, under what they claimed was an agency agreement. They stated that they allowed the decedent to take title in her own name to placate her boyfriend and insure that the sale would take place. They noted that the decedent had previously served as the Hus' agent for real-estate purchases. The court focused first on state law (California), to decide what interests the decedent held at death. The court noted that, unlike the agency situations in which the decedent had previously acted for the Hus, in this situation, the decedent took legal title to the house in her own

name and actually lived there. State law, furthermore, presumes legal ownership by the person in whose name title is held, and requires clear and convincing evidence to overcome that presumption. The court found that the evidence adduced by the Hus, including arguments that they were worried about the son-in-law's possible creditors, did not meet this burden. The Tax Court also rejected the argument that a resulting trust existed, based on the provision of the purchase price by the Hus. The court noted that, under state law, a resulting trust arises where there is a showing that the transferee was not intended to take the beneficial interest, but in this case, the decedent not only "intended to take the beneficial interest" in the house, she actually did take a beneficial interest and then lived there for years. Furthermore, state law makes an exception to the resulting trust doctrine for transactions between parent and child, which are deemed presumptively gifts. Therefore, the court refused to impose a resulting trust on the property. The court concluded that the decedent wanted to transfer the property to her daughter's children, but she also wanted to retain its lifetime use. She never paid rent on the property, and the court concluded that the fair market value of the house should be included in the decedent's gross estate.

5. Bankruptcy Court Permits Creditor Invasion of Alaska Self-Settled Spendthrift Trust – Extreme Facts or a Flaw in the Entire Technique? *Mortensen v. Battley*, 2011 WL 5025288 (Bank. D. Alas. Jan. 14, 2011) (summ. judg. denied) (slip copy); *Mortensen v. Battley*, 2011 WL 5025249 (Bank. D. Alas. May 26, 2011) (memorandum order) (slip copy); *Mortensen v. Battley*, 2011 WL 5025252 (Bank. D. Alas. July 8, 2011) (reconsideration denied) (slip copy)

Thomas Mortensen created an Alaska self-settled spendthrift trust in February, 2005, naming himself and his descendants as beneficiaries. At that time, the grantor had three children and no grandchildren. the grantor transferred to the trust real property he owned in Seldovia, Alaska, which was then worth approximately $60,000. The grantor had heard about Alaska's asset protection trust rules in casual conversation, researched the topic and then created the trust using a template he had found. The trust instrument called the trust "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)." The grantor named his brother and a personal friend as trustees and his mother as trust protector. The grantor then had the trust document reviewed by an attorney, who appears to have suggested only minor changes. The trust instrument stated that its purpose "to maximize the protection of the trust estate or estates from creditors' claims of the grantor or any beneficiary and to minimize all wealth transfer

taxes." When the grantor funded the trust, he had approximately $29,881 in his bank accounts, $9,339 in business accounts receivable, two modest vehicles. The grantor' mother sent him $100,000 after he established the trust, bringing to $153,000 his total assets outside of the trust. At that time, he owed $49,711 in credit card debt and he had no other debts. There was, at that time, no litigation against the grantor pending or threatened. The grantor transferred to the trust about $80,000 of the money from his mother. Thereafter, the grantor' credit card debt increased significantly, and when in August, 2009, he filed a petition for bankruptcy, he had over $250,000 in credit card debt and $8,140 in medical debt. The bankruptcy trustee initiated an adversary proceeding to set aside the trust as a fraudulent conveyance.

After first denying cross-motions for summary judgment, the Bankruptcy Court (Judge MacDonald) held for the trustee in bankruptcy, finding that the trust assets were available to satisfy the claims of the grantor's creditors for ten years, under Federal bankruptcy law. 11 U.S.C. § 548(e). This provision of the bankruptcy law permits a trustee in bankruptcy to avoid transfers made on or within 10 years of the date of the filing of a bankruptcy petition, if:

> (A) such transfer was made to a self-settled trust or similar device;
>
> (B) such transfer was by the debtor;
>
> (C) the debtor is a beneficiary of such trust or similar device; and
>
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

The grantor' trust clearly satisfied the first three requirements, and the court focused on whether there was an "actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted." The grantor claimed that his intent was "to preserve the property for his children," but the court noted that the instrument itself stated that its purpose was to frustrate the claims of future creditors. The court also noted that the grantor created the trust after several years of below-average income, high credit card debt, and "financial carnage" from his divorce. Furthermore, the court noted, the grantor did not use the $100,000 he

received from his mother to pay off his debts, but rather to speculate in the stock market on behalf of the trust. The court also used this stock speculation on behalf of the trust as evidence that the trust was not created merely to preserve the Seldovia property for the grantor's children.

Note. This provision of the bankruptcy act was added by the Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109–8, § 1042, 109th Cong., 1st Sess. (2005), 119 Stat 23, purportedly to "close. . . the self-settled trusts loophole" and to "provide the estate representative with an extended reachback period for certain types of transfers." 5 *Collier on Bankruptcy* ¶ 548.10[1], [3][a] n. 6 (N. Alan Resnick & Henry J. Sommer eds., 16th ed.).

The court also rejected the argument that the trust failed under Alaska's own rules, because the grantor was insolvent when he formed it. The court found that he was, in fact, solvent when he created the trust, and noted that the real estate that he transferred to the trust could have been exempt from creditor claims under Alaska's homestead rules, had the grantor retained it outside the trust.

Self-settled spendthrift trusts are includible in a grantor's gross estate under Section 2036 and 2038, if the grantor's creditors can compel the trustee to satisfy the grantor's debts from the trust fund. This opinion does not really negate the utility of all self-settled spendthrift trusts in Alaska, Nevada, or any of the other states that permit them. The court focused on the fact-sensitive issue of intent to hinder or defraud current or future creditors. It is incumbent upon the practitioner advising a client who creates a self-settled spendthrift trust to establish clear evidence of a dominant estate planning purpose for establishing the trust. Including a statement that the trust is designed "to maximize the protection of the trust estate or estates from creditors' claims of the grantor" is a definite mistake. Instead, one needs to focus on the current use of the grantor's applicable exclusion amount, the preservation of trust assets for future generations, the use of professional asset management, and other similar estate planning goals, to justify the creation of a self-settled spendthrift trust. Section 538(e) of the Bankruptcy Code severely limits the utility of self-settled spendthrift trusts, but it does not render them useless.

G. Code § 2041. Powers of Appointment

1. Right to Withdraw Principal For "Welfare" Is Not a General Power of Appointment. *Estate of Chancellor v. Comm'r,* T.C. Memo. 2011-172 (July 14, 2011)

Ann Chancellors husband died, leaving a will that created a credit shelter trust and named the decedent co-trustee, together with a bank. The co-trustees were given the power to distribute principal to and among the beneficiaries "for the necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures"of the beneficiaries, "taking into consideration the standard of living to which they are accustomed and any income available to them from other sources." The will also stated that the credit shelter trust was created "to convey . . . the maximum portion of my estate which, at the time of my death, shall be exempt from the federal transfer tax." The decedent never requested or received any trust corpus. The Service, at the decedent's death, contended that the $1,205,034 assets of the trust should be includible in her gross estate for federal estate tax purposes, because her power over the trust fund constituted a general power of appointment.

The Tax Court (Judge Thornton) disagreed, and held for the estate, finding that the decedent held a power over the trust subject to an ascertainable standard relating to her health, education, support, or maintenance. Code § 2041(b)(1)(A); Reg. § 20.2041- 1(c)(2). There was no question that the standard was ascertainable, but the Service and the court focused on whether it was related solely to the decedent's health, education, support, or maintenance. *Estate of Little v. Comm'r*, 87 T.C. 599, 601 (1986); *Estate of Strauss v. Comm'r*, T.C. Memo. 1995-248. The court agreed with the Service that, in some contexts, the right to withdraw for "welfare" does not relate solely to health, education, support, or maintenance. *Lehman v. United States*, 448 F.2d 1318, 1319 (5th Cir. 1971) (the right to consume corpus whenever, in the decedent's own discretion, she deemed the trust income "insufficient for her support, maintenance, comfort, and welfare"); *Estate of Jones v. Comm'r*, 56 T.C. 35, 37-41 (1971), *aff'd*, 474 F.2d 1338 (3d Cir. 1973) (power to consume trust corpus "in situations affecting * * * [the decedent's] care, maintenance, health, welfare and well- being"). The court distinguished these cases from the present trust, where the decedent could consume for "necessary * * * welfare or other appropriate expenditures". The court noted that the Mississippi Supreme Court has endorsed the view that the word "comfort" in a trust document is intended to maintain the beneficiary's standard of living as existed at the trust's creation. *Gulf Natl. Bank v. Sturtevant*, 511 So. 2d 936, 938 (Miss. 1987). That

court had not construed the term “welfare,” but in *Gulf Natl. Bank*, it favorably cited *Blodget v. Delaney*, 201 F.2d 589, 593 (1st Cir. 1953), which did so, finding that “comfort and welfare”, unlike “happiness,” “desire,” or “use and benefit,” was similar to maintenance or support, and that it did not cover whim or caprice, or even an invasion of principal by the trustee to satisfy the life beneficiary’s wish to make a gift. See also *In re Buell’s Estate*, 66 N.Y.S.2d 180 (1946) (interpreting “welfare” under New York law as providing for ‘“physical comfort and well-being’ in accordance with the beneficiary’s accustomed standard of living”). The court also noted that the word “welfare” had to be considered together with the qualifiers “necessary” and “needed,” further demonstrating the relationship between “welfare” and the beneficiaries’ maintenance and support according to their accustomed standards of living. The court also held that the phrase “other appropriate expenditures needed” by the beneficiaries created a non-general power of appointment, particularly when preceded by a list of “necessary” support-related purposes. The Mississippi Supreme Court would, the Tax Court stated, “most likely apply the rule of ejusdem generis” to construe the words “other appropriate expenditures needed” as referring to expenditures that are similar to those previously enumerated.

Note. The trustees were also authorized to apportion trust income among decedent, her husband’s children, and her husband’s grandchildren “in accordance with their respective needs.” The Service declined to raise questions about whether this power was a general power of appointment.

2. Service Accepts State Court Reformation to Correct an Inadvertent General Power of Appointment. PLR 201132017 (Aug. 12, 2011)

D and S created a joint revocable trust providing that, on the death of the first settlor to die, the trust would be divided into a Marital Trust, a By-Pass Trust, and a Survivor’s Trust. The instrument also stated that, on the death of the surviving spouse, the trustee shall pay from the trust estate the surviving spouse's debts, expenses, and death taxes due by reason of the his or her death, and charge those payments against property in the By-Pass Trust (except that a any Non-Qualified Marital Trust will bear any estate, gift, generation-skipping or other transfer taxes imposed on it. The trustee is prohibited from using any “insurance proceeds, qualified retirement plan distributions, or other assets otherwise excludable from federal estate tax to pay debts, expenses, death taxes, or any other obligations enforceable against the Surviving Trustor's estate” to pay debts, expenses, and estate taxes. The instrument also gives the surviving

spouse a general testamentary power to appoint the balance of the Survivor's Trust to anyone, including his or her estate, his or her creditors, or the creditors of his or her estate. D died survived by the S and three children. S became executor of D's estate and trustee of the Survivor's Trust, the By-Pass Trust, and the Marital Trust. D and S hired an attorney to provide them with estate planning advice. The attorney drafted the trust. After D's death, another attorney was consulted, and upon review of the trust provisions, the new attorney confirmed that the trust language incorrectly provided that expenses, debts and taxes would be charged against the By-Pass Trust. S and the drafting attorney represented that it was D's and S's intent to minimize estate taxes, including maximizing the use of the unified credit, and that the By-Pass Trust should have been drafted to ensure that the assets in the By-Pass trust would not be included in the surviving spouse's gross estate. S contended that the present language resulted from a scrivener's error, and the drafting attorney agreed. S, as trustee, brought an action in state court to have the language of the trust reformed so as to charge debts, taxes and expenses against the Survivor's Trust, rather than against the By-Pass Trust. S and the drafting attorney agreed that the language that charged the By-Pass with debts, taxes and expenses was not only contrary to the intent of the settlors in creating the trust, but that it contradicted the language that directed that the trustee not use "any insurance proceeds, qualified retirement plan distributions, or other assets otherwise excludable from federal estate tax to pay debts, expenses, death taxes, or any other obligations enforceable against the Surviving Trustor's estate." S noted that the phrase "other assets otherwise excludible" would necessarily include assets in the By-Pass Trust. Finally, S noted that the trust stated that "[t]o whatever extent the then remaining balance of the Survivor's Trust has not been effectively appointed by the Surviving Spouse pursuant to the above general power of appointment and not consumed for the payment of debts, expenses, and taxes, the Trustee shall distribute the Survivor's Trust, including any distributions made to the trust by reason of such death, such as from the Surviving Spouse's Will or life insurance policies on the Surviving Spouse's life, as set forth in Section 4.04 hereinbelow." This language, S noted, suggested that the Survivor's Trust should bear the debts, expenses and taxes incurred due to the death of the surviving spouse.

The local court granted the petition for modification, retroactively reforming the trust to charge debts, taxes and expenses against the Survivor's Trust, rather than against the By-Pass Trust. The trustee asked the Service to rule that the By-Pass Trust, as modified, did not give S a general power of appointment, that modification of the trust pursuant to the court's order was not an exercise or release of a

general power of appointment for gift tax purposes, and that S was not deemed to have made a gift of an interest in the trust as a result of the court order. The Service granted the requested relief, explaining that a power of appointment exercisable to meet the estate tax, or any other taxes, debts, or charges which are enforceable against the estate is a general power of appointment. The question, however, was the true terms of the trust instrument. The Service also discussed *Comm'r v. Estate of Bosch*, 387 U.S. 456, (1967), in which the Supreme Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Supreme Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute, and that the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by the highest court of a state, however, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. Under State law, the Service explained, a trust has standing to seek reformation and a probate court has equitable power to modify a trust if the provisions of the trust are ambiguous or if adherence to the terms of the trust would defeat the primary purpose of the trust. The Service quoted a state case to the effect that "equitable power of a trial court to modify or reform a trust extends to situations where the trust instrument contains some expression of the trustor's intention, but a drafting error renders that expression ambiguous." A mistake by the scrivener or draftsman in reducing the intent of the parties to writing is ground for reformation. Therefore, a retroactive amendment is permitted in order to correct errors, but the power to make such amendments may be used only when necessary to correct a clear mistake and prevent injustice. In this case, the Service stated:

> documentation submitted by Surviving Spouse strongly indicates that Decedent and Surviving Spouse did not intend to have any control over the assets held in the By-Pass Trust, and that the provision in Section 4.01 of Trust to charge Surviving Spouse's debts, expenses and death taxes from the By-Pass Trust was the result of a scrivener's error. In reforming the By-Pass Trust, Court found that the modification of Trust was an equitable reformation of Trust under common law and State Statute 1.
>
> Consequently, we conclude that the Court's Order on Date 4, modifying the trust instrument *nunc*

> *pro tunc* based on a scrivener's error is consistent with applicable State law that would be applied by the highest court of that state. Section 4.01 of Trust, as modified pursuant to the Court's Order, does not provide Surviving Spouse with a general power of appointment under § 2041(b) over the assets of the By-Pass Trust. Therefore, based on the facts submitted and the representations made, we conclude that the value of the assets in the By-Pass Trust will not be included in Surviving Spouse's gross estate under § 2041(a)(2) upon his death.

The Service stated that the trust, as modified, did not give S a general power of appointment, so that the modification cannot constitute the release or exercise of such a power. Furthermore, it cannot constitute a deemed taxable gift under general gift tax concepts.

H. Code § 2042. Life Insurance Proceeds

1. Right to Designate Beneficiaries is an Incident of Ownership Resulting in Estate Taxation of Life Insurance Proceeds. *Estate of Coaxum v. Comm'r*, T.C. Memo. 2011-135 (June 16, 2011)

The decedent, Edward Thomas Coaxum, was the insured in six policies that provided death benefits, and he possessed at his death the power to change the beneficiaries on all six relevant policies. The estate tax value of the policies was $1,283,184.

The Tax Court (Judge Morrison) held that the decedent's gross estate included the value of the life insurance policies, under Section 2042(2), because the decedent had the power to change the beneficiaries, and the right to change the beneficiaries was an incident of ownership. Reg. § 20.2042-1(c)(2).

Note. The decedent also died owning annuities with a value of $472,956. The Tax Court also held that the value of the annuities was includible in the decedent's gross estate under Section 2039(a). The executor argued that the deduction allowed for the estate tax on these annuities under Section 691(c) should negate the estate tax, but the court pointed out that this deduction is an income tax deduction, rather than an estate tax deduction.

2. **Insured Grantor's Right to Reacquire Insurance Policy Creates Grantor Trust Without Incidents of Ownership under Section 2042. Rev. Rul., 2011-28, 2011-49 I.R.B. 830 (Dec. 5, 2011)**

The grantor established and funded an irrevocable trust for the benefit of the grantor's descendants. The grantor contributed cash to the trustee, who then bought a life insurance policy on the grantor's life. The terms of the trust prohibit the grantor from serving as a trustee. The grantor makes annual gifts to the trustee to pay premiums on the insurance policy. The policy proceeds are payable to the trust. The governing instrument states that the grantor may, at any time, acquire any property held in the trust by substituting other property of equivalent value, and that this power of substitution is exercisable in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. The grantor can exercise this power by certifying in writing that the substituted property and the Trust property for which it is substituted are of equivalent value. Local law: (a) imposes on the trustee a fiduciary obligation to ensure that the property that the grantor seeks to substitute is equivalent in value to the property distributed to the grantor; (b) requires the trustee to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries; and (c) grants the trustee 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 Service ruled that the grantor's right of substitution did not give the grantor an incident of ownership over the policy. The Service discussed Rev. Rul. 84-179, 1984-2 C.B. 195, which had stated that Congress intended that the incidents of ownership rule of Section 2042 would parallel the statutory scheme governing those powers that would cause other types of property to be included in a decedent's estate under Sections 2036 and 2038. In Rev. Rul. 84-179, the decedent transferred the policy to his wife and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. That ruling stated that the decedent was not considered to possess incidents of ownership in the policy, if he could not exercise the powers for his personal benefit, he did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the trust powers to the decedent was not part of a prearranged plan involving his participation. The ruling stated, however, that the decedent wouldl be deemed to have incidents of ownership over an insurance policy on the decedent's life where his powers were held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and

maintaining the policy to the trust. Therefore, the IRS explained, if the decedent reacquired powers over insurance policies in an individual capacity, the powers would constitute incidents of ownership even though the decedent was a transferee. See *Estate of Fruehauf v. Comm'r*, 427 F.2d 80 (6th Cir. 1970); *Estate of Skifter v. Comm'r*, 468 F. 2d 699 (2d Cir. 1972).

The Service also discussed *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1, where the Tax Court held that a reserved power to substitute other assets for securities held in trust, when held in a fiduciary capacity, was not a power to alter, amend, revoke or terminate the trust under Section 2038. The Service argued in *Jordahl* that the proceeds from insurance policies held by the trust should also be included under Section 2042(2), but 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 beneficiary, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries. Accordingly, the Tax Court held that the substitution power was not a power to alter, amend, or revoke the trust under Section 2038. The court also held that the decedent's power to substitute an insurance policy was merely a power to exchange at arm's length, comparable to a right to buy the policy, and that such a right could not be considered an incident of ownership.

Of course, the Service also discussed Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (April 17, 2008), where it stated that a the grantor's nonfiduciary right to substitute assets for property of equivalent value was not a retained power under Sections 2036 or 2038, if the trustee (a) had 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; and (b) the substitution power could not be exercised in a manner that would cause the shifting of benefits among the trust beneficiaries.

In the case of a nonfiduciary right to substitute other assets of equivalent value for a life insurance policy held by the trust would not be an incident of ownership, if: (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, and (b) the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries, which exists if: (i) 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 (ii) 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.)

Note. It is surprising that the Service did not discuss in this ruling its prior treatment of the right to buy a life insurance policy as an incident of ownership. In Rev. Rul. 79-46, 1979-1 C.B. 303, the Service considered an insurance policy maintained by an employer on the insured's life. The insured's employment contract gave the insured the right to buy the policy at any time, for an amount equal to its cash surrender value. The Service stated that the right to buy the policy amounted to a power to veto the policy's cancellation, and that it was an incident of ownership possessed by the insured. The IRS lost on this argument in *Estate of Smith v. Comm'r,* 73 T.C. 307 (1979), *acq'd in result*, 1981-1 C.B. 2. The Service acquiesced in *Estate of Smith*, but only in the result; they continued to disagree with the Tax Court's method of determining what constitutes an incident of ownership. The Service has not, furthermore, withdrawn Rev. Rul. 79-46.

Rev. Rul. 2011-28 is important, because there are many reasons why one would want an irrevocable life insurance trust to be a wholly-owned grantor trust for income tax purposes. The grantor might, for example, wish to transfer S corporation shares to the trust, and grantor trusts are eligible S corporation shareholders. The grantor may also wish to transfer an encumbered insurance policy to the trust, and grantor trust status avoids any possible treatment of such an event as a transfer for value for income tax purposes. See Rev. Rul. 2007-13, 2007-1 C.B. 684.

Section 677(a)(3) renders the grantor the deemed owner, under the grantor trust rules, of "any portion of a trust . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be . . . applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse . . . ." This rule, however, is unclear about what portion of the trust the grantor is deemed to own, merely because the trust owns an insurance policy on the grantor's life. A nonfiduciary power retained by the grantor to substitute all of the assets of a trust in exchange for assets of equivalent value clearly creates a wholly-owned grantor trust under Section 675(4)(C).

Rev. Rul. 2011-28 now makes it quite easy to assure that a trust that holds insurance on the grantor's life is a wholly-owned grantor trust. Practical estate planners should frequently consider including in an irrevocable life insurance trust a nonfiduciary power in the grantor to substitute trust assets for other assets of equivalent value.

I. Code § 2053. Expenses, Indebtedness and Taxes

1. Estate Can Deduct Interest on *Graegin* Loan Secured to Pay Debts and Estate Taxes. *Estate of Duncan v. Comm'r*, T.C. Memo. 2011-255 (Oct. 31, 2011)

Walter Duncan left his successful oil-and-gas business to his three children in trust. The trust for the one of the children (the "Walter Trust"), was held for Vincent, his wife and his descendants. Vincent, who had significant assets of his own apart from those in the Walter Trust, also created a revocable trust to pay his estate's obligations and taxes after his death (the "2001 Trust"). Upon Vincent's death, the Walter Trust and the 2001 Trust were each divided into six trusts – one for each of Vincent's six children. Vincent's estate lacked adequate liquid assets with which to pay his debts and taxes, and so the executors determined to borrow money from the 2001 Trust to settle these obligations. The Walter Trust lent the 2001 Trust $6,475,515.97, with interest at 6.7 percent per annum, compounded annually, and repayable after 15 years. The note expressly prohibited the prepayment of interest and principal. When the loan was made, the long-term applicable Federal rate was 5.02 percent and the prime rate of interest was 8.25 percent. The record did not say how the proceeds of the loan were transferred to the estate. The estate paid $11 million as estimated federal estate taxes with its request for an extension of the time to file the return. On its estate tax return, the estate deducted $10.6 million for the interest owed to the Walter Trust on loans taken to pay the estate taxes. The estate also deducted $750,000 for estate settlement services. The estate reported a Federal estate tax liability of $8,283,410, which was $2,792,105 less than the amount it had paid with its extension request. The Service refunded that difference to the estate, but on examination, it disallowed the deductions and assessed a $4,900,760 deficiency.

The Tax Court (Judge Kroupa) held that the loan was a *bona fide* debt, based on the factors enumerated in *Estate of Rosen v. Comm'r*, T.C. Memo. 2006-115, but the court noted that *Rosen* involved whether an arrangement was debt or equity, and the two trusts in this case are not so related that one can be treated as the owner of the other, and thus, the loan therefore cannot be equity even if it is not *bona fide*. The Service also noted the factors for determining the bona fide nature of a loan in *Estate of Graegin v. Comm'r*, T.C. Memo. 1988-477, but the court noted that these factors are not exclusive and that the ultimate questions are whether there was a genuine intention to create a debt with a reasonable expectation of repayment and whether that intention fits the economic reality of

creating a debtor-creditor relationship. *Litton Bus. Sys., Inc. v. Comm'r*, 61 T.C. 367, 377 (1973). The Service argued that the loan was not bona fide because the borrower and lender trusts have the same trustees and beneficiaries. The court disagreed, noting that it was required that the 2001 Trust be directed to repay the Walter Trust, because applicable state law (Illinois) requires a trustee of two different trusts to maintain their individuality. *Harris Trust & Sav. Bank v. Wanner*, 61 N.E.2d 860, 865 (Ill. App. Ct. 1945) (quoting *Moore v. McKenzie*, 92 A. 296, 298 (Me. 1914) (emphasis added)). Thus, the trustees could not simply ignore the 2001 Trust's debt. Also, there is no basis in tax law for treating the two trusts as a single entity, particular as they had different grantors. See Code § 643(f); Reg. § 1.641(a)-0(c). The Service then argued that the loan was not reasonably necessary for the estate administration. The estate claimed that it had to borrow money because it could not have otherwise met its obligations without selling illiquid assets at reduced prices. The Service argued that the 2001 Trust could have sold illiquid assets to the Walter Trust at full fair market value, and analogized to Estate of Black v. COmm'r, 133 T.C. 340 (2009), where the beneficiary of an estate is also the majority partner of a partnership owned by the estate, and the court held that a loan from the estate to the partnership was unnecessary because the estate could have redeemed its illiquid partnership interest in exchange for marketable securities held by the partnership. The court noted that in that case, it had not held that the loan was unnecessary because the estate could have sold stock, but rather it was unnecessary because the estate would have had to sell the stock under any circumstance. The sale of the stock was inevitable, and the estate therefore could not have entered into the loan for the purpose of avoiding that sale. In this situation, the estate avoided having to sell its partnership interests by obtaining the loans in question. Also, the 2001 Trust could not have compelled the Walter Trust to buy its illiquid assets, because to do so would improperly shift the value of the discount from the Walter Trust to the 2001 Trust. The Service also argued that the loan should have carried a shorter term and a lower interest rate. The court believed that the trustees were not reasonably certain that the 2001 Trust would have enough money to pay all of the taxes and expenses within three years (the period to which the Service proposed limiting the estate's interest expense deduction). The court stated that, even if the estate actually generated enough cash to repay the loan after three years, the court would not "use hindsight second guess the" fiduciaries' judgments when they were acting in the best interest of the estate. The Service argued that the interest rate on the loan was too high, that the co-trustees should have used the long- term applicable Federal rate instead, and that their selection of a higher interest rate

had no economic consequence because the Walter Trust's interest income offsets the 2001 Trust's interest expense. The court held that the long-term applicable Federal rate is inappropriate, because it is based on the yield on Government obligations, which reflects the Government's cost of borrowing, which is low because Government obligations are low-risk investments. Using the long-term applicable Federal rate consequently would have been unfair to the Walter Trust. The Service also argued that the amount of the interest expense was uncertain, because the 2001 Trust could choose to make an early repayment of the loan, even though the note prohibited prepayment. The Service argued that, because the trustees and beneficiaries were identical for both trusts, they could always agree to cancel the prepayment prohibition. The court disagreed, because the trustees were obligated to administer the two trusts separately. If interest rates rose to the point where the Walter Trust would benefit from early repayment, the trustees could not direct it because this would harm the 2001 Trust, which would be better off reinvesting the money used to prepay the loan. If interest rates did not rise.

The court also denied deductions for: (a) the cost of storing and maintaining certain tangible personal property, because the estate had not shown that retention of the assets was necessary for estate administration; (b) a $38,583.90 payment to Medicare and a $60 payment to a diagnostics lab for services provided, because the estate had not proved that they were payments for debts that existed on the date of death; (c) the monthly trust management fees, because they were trust administration expenses, rather than estate settlement expenses; and (d) a $989.24 payment for excess liability coverage, a $1,656.54 payment for auto insurance, and $14,064 in storage expenses, because the estate provided no proof that any of these were needed for estate administration. The court allowed deductions for (a) additional attorney's fees, because the Service had not in their brief given any claim that this was unreasonable and was, therefore, deemed to have conceded the issue; and (b) a $300 bank fee for opening the decedent's safety deposit box, again because the Service had offered no reason for denying the deduction.

Note. The Service frequently challenges the advanced deduction for interest on *Graegin* loans, most often on the basis that the loan is not necessary for the estate administration. See, e.g., *Estate of Black v. Comm'r*; *Estate of Stick v. Comm'r*, T.C. Memo. 2010-192; *Keller v. United States*, 2010 WL 3700841, 106 A.F.T.R.2d 2010-6309 (S.D. Tex., 2010) (slip copy). Practitioners using Graegin loans to accelerate the estate tax deduction for interest payments should be careful to document meticulously the reason for the loan, the basis for the determination that the funds are required, and the basis on which the interest rate is established.

2. **Palimony Claim Might Be Deductible for Estate Tax Purposes. *Shapiro v. United States*, 634 F.3d 1055 (9th Cir. Feb. 22, 2011)**

Bernard and Cora Jane lived together for 22 years but never married. Cora Jean cooked, cleaned, and managed the household employees, including a gardener, housekeeper, and pool man. Bernard paid for Cora Jean's living expenses and provided her with a weekly allowance. The separated after Cora Jean found out that Bernard was involved with another woman. After they separated, Cora Jane filed suit against Bernard, seeking damages for breach of an express and implied contract, breach of fiduciary duty, and quantum merit, under applicable state law (Nevada). Cora Jean claimed she and Bernard had agreed to pool their resources and to share equally in each others' assets. Bernard died while the suit was pending. Ultimately, a jury found for the estate, and while the case was on appeal, the suit was settled for $1 million. After settling the case, the estate deducted $8 million under Section 2053(a)(3), for the value of the claim. The Service assessed a deficiency. The estate paid and sued for a $2 million refund. The estate's expert thereafter valued the claim at just over $5 million as of the date of death, and the estate amended its claim to request a refund for the decrease in property value due to notices of lis pendens recorded by Cora Jean on Bernard's properties during her lawsuit.

The U.S. District Court for Nevada granted the Service summary judgment, finding that Cora Jean's housekeeping services were not sufficient consideration for the support she received from Bernard, and that there was no valid contract between them. The court, therefore, held that no deduction was allowable for the value of the claim made by Cora Jean against Bernard's estate.

The Ninth Circuit (Judge Silverman) reversed, finding that district court was wrong when it concluded that Cora Jean lacked a valid contract claim. The court discussed *Hay v. Hay*, 678 P.2d 672 (Nev. 1984), in which the Nevada Supreme Court adopted the California rule that "courts should enforce express or implied contracts between nonmarital partners except when such a contract is inseparably based upon the provision of sexual services." The court disagreed with the trial judge that, as a matter of law, Cora Jean had not provided sufficient consideration to support a contract under Nevada law. This was, the court stated, a factual question that precludes summary judgment. The court remanded the case to the trial judge both to redetermine the issue of the sufficiency of the consideration and the value of the claim. The appeals court also affirmed the district court's grant of summary judgment to the Service on the estate's claim for a deduction because of the reduction in property value caused by the notices of lis pendens filed by Cora Jean on a number

of Bernard's properties. The court stated that the estate had abandoned this claim by failing to raise it in opposition to the United States' motion for complete summary judgment.

In a separate opinion, Judge Tashima disagreed with the majority's disposition of the issue of the valuation of the claim for federal estate tax purposes. The dissent argued that the case should turn on federal tax law, rather than state contract law, and that the estate had to show that the claim was supported by full consideration in money's worth. This, the dissent noted, is not met merely because a claim is "legally binding and enforceable against [an] estate" under state law. *Taft v. Comm'r*, 304 U.S. 351, 355 (1938); *United States v. Stapf*, 375 U.S. 118, 131 (1963). Cora Jean, as Bernard's long-term romantic partner, was a natural object of his bounty, so the claim had to be supported by adequate and full consideration that is "a non-zero sum which augmented the decedent's estate." Thus, the estate had not, the dissent stated, raised a genuine issue of material fact to support its contention that the claim, even assuming that it was contracted bona fide, was supported by full consideration in money's worth for the purpose of federal tax law.

3. Tax Court Denies Advance Deduction of Pending Malpractice Claim Against Decedent's Estate. *Estate of Saunders v. Comm'r*, 136 T.C. 406 (April 28, 2011)

Gertrude Saunders' husband, William, had represented Harry Stonehill in some extensive tax litigation. After 10 years of litigation, Stonehill's litigation counsel obtained documents that suggested that William had informed the Service that Stonehill maintained a secret Swiss bank account, and that this disclosure had led to tax fraud charges against Stonehill. Suit was then filed against William and, later, his estate, for legal malpractice, breach of confidence, breach of duty of loyalty, and fraudulent concealment. The suits asked for over $90 million in compensatory damages, plus additional punitive damages. The attorneys for William's estate found no relevant or material evidence that would help the defense, because of the significant passage of time from the date of the alleged misconduct and the date the claims were made. In 2007, a jury held that William had breached his fiduciary duty and his duty of confidentiality and undivided loyalty, but that these had not caused damage to Stonehill or his estate. The Stonehill estate appealed, but ultimately the litigation was settled with a payment of $250,000 and waiver of the award to Saunders of $289,000 in costs. The decedent's executors deducted $30 million for the value of the claim outstanding on the date of her death in 2004, based on an independent professional appraisal.

The Tax Court (Judge Cohen) held that the estate could deduct only the amounts it actually paid. The decedent had died before the final regulations under Section 2053 were issued, but the court held that the claim was still too uncertain to be deducted based on estimates as of the date of death. Reg. § 20.2053-1(b)(3), before the 2009 amendments, stated that the value of a claim against a decedent's estate may be deducted "though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid." In this case, the court held that there was no clear value to the claim and that it was unclear whether it would ever be paid. The court held that a claim is not reasonably certain and deductible merely because an appraiser can attempt to value it, and that appraisals submitted by the Service and the taxpayer both suggested a lack of reasonable certainty.

4. Estate Denied Deduction for Son's Care Giver Compensation, but May Deduct Administrator's Commission and Some Legal Fees. *Estate of Olivo v. Comm'r*, T.C. Memo. 2011-163 (July 11, 2011)

Anthony Olivo, the administrator of the estate of his late mother, took care of her for nearly a decade, while she suffered from severe medical conditions. He had to provide regular insulin tests and injections, and substantial other round-the-clock care. Providing for her resulted in the disbanding of his sole practice as a tax attorney. Anthony kept good records of his care for his mother. Anthony filed an estate tax return claiming a $44,200 deduction for the statutory amount to which he would be entitled as a commission for his services as administrator of the estate, a $50,000 deduction for the estimated attorney's fees, a $5,000 deduction for estimated accountant's fees, and a $1,240,000 deduction for an alleged debt owed to him by the estate for the care he provided to the decedent during her lifetime, pursuant to an alleged agreement he had with her to compensate him for his services. None of these amounts had been paid when the estate tax return was filed. The Service disallowed all of the deductions.

The Tax Court (Judge Wells) agreed with the Service that no deduction was allowable for the $1,240,000 claimed compensation for Anthony's care of his mother, but it sustained the deduction for his administrator commission and the attorney fees he incurred in contesting the deficiency. The court noted that the alleged agreement between Anthony and the decedent was supported only by the testimony of Anthony. The court stated that it "not accept testimony that is improbable, self-serving, and uncorroborated by other evidence." See, *e.g., Baird v. Comm'r*, 438 F.2d 490, 493 (3d Cir. 1970), *vacating* T.C. Memo. 1969-67; *Shea v. Comm'r*, 112 T.C. 183, 189

(1999); *Tokarski v. Comm'r*, 87 T.C. 74, 77 (1986). The court rejected Anthony's testimony as "highly questionable," finding that if there were such an agreement, he would have reduced it to writing, especially in light of his legal training and experience, the contentious nature of the probate of the estate of his father, who predeceased his mother, the apparent animosity between Anthony and his sister, Emilia, and Anthony's obvious interest in ensuring that he would receive compensation from the decedent. The court also rejected the argument that Anthony was entitled to some recovery under *quantum meruit*, because applicable state law presumes that services rendered to a family member living in the same household are rendered gratuitously. *Waker v. Bergen*, 132 A. 669, 669-670 (N.J. 1926); *Disbrow v. Durand*, 24 A. 545, 546 (N.J. 1892). Anthony's testimony did not overcome this presumption by a preponderance of the evidence. The court did allow deduction for the administrator's commission that had been or would be paid to Anthony, finding that the estate was entitled to a deduction under the then-applicable regulations if: (1) the district director was reasonably satisfied that the commissions claimed will be paid; (2) the amount claimed as a deduction is within the amount allowable by the laws of the jurisdiction in which the estate is being administered; and (3) it is in accordance with the usually accepted practice in the jurisdiction to allow such an amount in estates of similar size and character. Reg. § 20.2053-3(b)(1). The court noted that the estate only claimed a deduction for $44,200, but that the statutory fee schedule entitled Anthony to $52,223.28, and stated that the estate can deduct the full $52,223.28 commission, if it actually paid it. The court denied the deduction of $55,400 for legal fees incurred by the estate, noting that it found evidence that Anthony performed some legal services for the estate, in addition to his services as administrator, but that he kept no records of the time he spent performing legal services for the estate – he merely estimated the number of hours and used a billing rate of $150 per hour.

5. IRS Provides Guidance on Filing and Resolution of a Protective Refund Claim for an Estate With Contingent Claims Against the Decedent. Rev. Proc. 2011-48, 2011-42 I.R.B. 527 (Oct. 17, 2011)

The final regulations under Section 2053 state that, with certain exceptions, the amount deductible as a claim or expense is limited to the amount actually paid. The regulations permit the executor to file a protective refund claim where amounts are not yet paid or deductible when the estate tax return (Form 706) is filed. Reg. § 20.2053-1(d)(5)(i). Rev. Proc. 2011-48 provides the procedures for filing and dealing with a Section 2053 protective refund claim. A taxpayer that files a protective claim for refund and provides notification for

consideration to the Service in accordance with the procedures set forth in this procedure will satisfy the generally applicable procedural requirements for claiming a refund as well as the procedural requirements specific to section 2053 for claiming a refund. A taxpayer that chooses not to follow or fails to comply with the revenue procedure is subject to all of the generally applicable provisions governing claims for refund as well as to the specific Section 2053 provisions relating to claims for refund, and will not have the benefit of the limited review described in Notice 2009-84, 2009-44 I.R.B. 592 (Nov. 2, 2009).

- **Timeliness.** A protective refund claim must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever is later. If no return was filed, it must be filed within two years of the time the tax was paid. Rev. Proc. 2011-48 § 4.01.

- **Content of the Claim.** The protective refund claim must be made in a written declaration executed under penalties of perjury, and it must identify and describe in detail the claim or expense for which a Section 2053 deduction may be claimed. Rev. Proc. 2011-48 § 4.02. The claim must be accompanied by documentary evidence of the authority of the fiduciary or other person to file and pursue the claim on behalf of the estate. See Reg. § 301.6402-2(e). A fiduciary or other person filing the protective refund claim who is the same as the person who filed the decedent's estate tax return, need only include a statement affirming that he, she, or it also filed the estate tax return and continues to act in as representative of the estate. Rev. Proc. 2011-48 § 4.03.

- **Method of Filing.** Estates of decedents dying on or after January 1, 2012 can file this protective refund claim by either (a) attaching one or more completed schedules PC to the estate tax return, which schedule is expected to be first available as part of the 2012 Form 706; or (b) filing Form 843 (Claim for Refund and Request for Abatement), with the notation "Protective Claim for Refund under Section 2053" entered across the top of page 1 of the form. Estates of decedents dying after October 19, 2009, and before January 1, 2012, must file the annotated Form 843. A taxpayer who filed a protective refund claim before the date of the revenue procedure may replace the initial filing with a timely filing in accordance with the procedure. Rev. Proc. 2011-48 § 4.04(1). A separate protective refund claim must be filed for each claim or expense for which a Section 2053 deduction may be claimed

in the future. An estate tax return may, therefore, include more than one Schedule PC. The protective refund claim cannot include any claim for refund not based on a Section 2053 deduction, and each claim should indicate whether other protective claims for refund are being filed or were previously filed and the approximate date on which each was filed. Rev. Proc. 2011-48 § 4.04(2).

- **Identifying the Claim or Expense.** The outstanding claim or expense forming the basis of a claimed Section 2053 deduction must be identified with clarity sufficient to give the Service notice of each claim or expense for which a deduction is being claimed. This identification must include an explanation of the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense. Generally, claims or expenses related to but separate from a particular Section 2053 claim or expense must be separately identified. The use of "vague or broad language that does not describe a specific claim or expense" does not satisfy this requirement. Rev. Proc. 2011-48 § 4.05(1). Any claim or expense that has been adequately identified in a protective refund claim is deemed to include, without any further identification, any related and ancillary expenses relating to resolving, defending, or satisfying the identified claim or expense as well as expenses relating to pursuing the claim for refund for the identified claim or expense. Such ancillary expenses include attorneys' fees, court costs, appraisal fees, and accounting fees. Of course, this does not mean that those items are fully deductible under Section 2053 – only that the claim covers them. Rev. Proc. 2011-48 § 4.05(2).

- **Claims Involving Contested Matters.** Each protective refund claim involving a contested claim against the estate must notify the Service of the contested matter and the estate's potential liability. The following facts will generally suffice: (a) the name or names of the claimant(s); (b) the basis of the claim or other description of the subject matter of the contested matter; (c) the extent or amount of the liability claimed; and (d) a brief statement reporting the status of the contested matter at the time the protective claim for refund is filed with the Service. Notice regarding a contested matter that is being litigated may be provided by a copy of the relevant pleadings and a general reference to them on the protective refund claim. Rev. Proc. 2011-48 § 4.05(3).

- **Claims or Expenses Related to Those That Are Ascertainable in Amount, Counterclaims, and Claims Under $500,000.** The estate can deduct on the initial estate tax return certain claims that are ascertainable in amount (Reg. § 20.2053-1(d)(4)), certain counterclaims (Reg. § 20.2053-4(b)), and certain claims that, in the aggregate, do not exceed $500,000 (Reg. § 20.2053-4(c)). An estate can preserve its right to claim a refund based on an increase in any of these claims by filing a protective refund claim that meets the requirements of the revenue procedure, and that discloses the amount already claimed on the estate tax return for such a claim or expense. Rev. Proc. 2011-48 § 4.05(4).

- **Administration of a Protective Refund Claim.** The Service will not generally review a protective refund claim substantively until the amount of the claim or expense has been established, it may reject a protective refund claim if it does not meet any of the preliminary procedural requirements, such as not being filed in a timely matter, being filed by an unauthorized person, not being filed under penalty of perjury, or not adequately describing the claimed deduction or expense. The Service will acknowledge receipt in writing, but this does not mean that all of the procedural requirements have been met. The IRS may question the procedural issues when it reviews the substance of the claim after the amount has been established. Rev. Proc. 2011-48 § 4.06(1). One who does not receive acknowledgment of receipt within 180 days after filing the protective refund claim by Schedule PC or within 60 days after filing Form 843, should contact the Service by telephone ((866) 699-4083). A certified mail receipt or other evidence of delivery to the Service is not sufficient to ensure and confirm the Service's receipt and processing of the protective claim for purposes of the revenue procedure. Rev. Proc. 2011-48 § 4.06(2). One cannot cure late filing of the protective refund claim, but one can cure failure to include a penalty of perjury statement or failure to include adequate identification, but not failure to do either. One can cure the failure to include adequate identification by filing a corrected protective refund claim before the expiration of the limitations period or within 45 days after the Service's notice, if any, of the defect, whichever occurs later. One cannot cure a failure of identification where the Service fails to provide the written acknowledgment of receipt and one does not contact the Service within 30 days after the applicable time period mentioned above. Rev. Proc. 2011-48 § 4.06(3). The IRS will not suspend substantive review of the estate tax

return merely because the same person who filed the estate tax return also filed a protective refund claim. Rev. Proc. 2011-48 § 4.06(4).

- **Notification for Consideration of a Protective Refund Claim.** The Service will refund overpaid estate tax if it determines there is an overpayment of tax in connection with a timely-filed protective refund claim, even though the claim or expense becomes deductible only after the expiration of the limitations period under Section 6511(a). The Service will usually limit its review of the estate tax return with respect to a protective refund claim to the deduction under Section 2053 that was the subject of the claim, if the limitations period has otherwise passed. A taxpayer must notify the Service when the Section 2053 claim or expense reported on the protective refund claim is now ripened into full deductibility. This notification must be executed under penalty of perjury, by the fiduciary or other person authorized to file and pursue the refund claim, and it should generally describe the relevant facts that support, and provide evidence to substantiate, the deduction. It should also claim a refund of the overpayment of tax based on the deduction under Section 2053 and the resulting recomputation of the estate tax liability. Rev. Proc. 2011-48 § 5.01. This notification must be provided within a reasonable period that the reason or contingency delaying the actual payment of the Section 2053 claim or expense has been resolved or the amount deductible has been established. This requirement is satisfied by notifying the Service within 90 days after the date the claim or expense is paid or 90 days after the date on which the amount of the claim or expense becomes certain and is no longer subject to any contingency, whichever occurs later. Notification after this 90-day period should be accompanied by an explanation sufficient to establish that there is reasonable cause for the delay. Otherwise, the notification is late and the deduction will be disallowed. Rev. Proc. 2011-48 § 5.02(1). The 90-day period begins, in the case of multiple or recurring payments, on the date of the last and final, though the appropriate person may notify the Service before the last and final payment, but not more often than annually, of all payments made since the last notification for consideration, and may thereby claim a partial refund attributable to such payment(s). Rev. Proc. 2011-48 § 5.02(2). One notifies the Service for consideration of a Section 2053 claim, by the same methods described for filing the protective refund claim – a supplemental Form 706 with an updated Schedule PC, or an updated Form

843). Rev. Proc. 2011-48 § 5.02(3). One filing a supplemental estate tax return with an updated Schedule PC, must include a notation on the top of page 1, “Supplemental Information – Notification for Consideration of Section 2053 Protective Claim(s) for Refund filed on [DATE OF PROTECTIVE CLAIM]”, and must include a copy of the originally-filed protective refund claim that identifies the claims or expenses that now are deductible must be attached to the Form 706. One filing an updated Form 843 must include a notation on the top of page 1, “Notification for Consideration of Section 2053 Protective Claim for Refund filed on [DATE OF PROTECTIVE CLAIM]”, and must include a copy of the originally-filed protective refund claim. Rev. Proc. 2011-48 § 5.03(1). A separate notification for consideration must be filed for each Section 2053 claim or expense for which a protective refund claim was filed. Rev. Proc. 2011-48 § 5.03(2).

- **Authority of Transferee or Other Person to Represent Estate.** If a fiduciary is no longer acting on behalf of the estate when the amount subject to a protective refund claim is ready for IRS consideration, one or more persons that are transferees of the probate or nonprobate estate may establish under applicable local law that person’s legal authority to pursue the claim for refund on behalf of the estate. Such person must attach to the notification for Service consideration documentary evidence substantiating the assertion of authority to pursue the claim. Such evidence may be a certified copy of the final accounting showing the source of the initial tax payment, relevant testamentary instruments, an affidavit executed under penalties of perjury by the executor or other appropriate party conferring the authority or the right to pursue the refund to one or more transferees or other persons, or such other evidence as may be requested by the Service. Rev. Proc. 2011-48 § 5.04.

- **Effects on the Marital and Charitable Deductions.** Neither the charitable nor the marital deduction is reduced by a claim or expense that may be the subject of a protective refund claim, until that claim or expense has met the requirements for a deduction. Reg. § 20.2053-1(d)(5)(ii). The computation of the amount to be refunded under Section 2053 should identify any necessary adjustment to the marital and charitable deductions claimed by the estate, as well as any other arithmetic adjustments that result from the allowance of the deduction.

- **Effective Date.** The revenue procedure applies to protective refund claims filed on behalf of estates of decedents dying on or after October 20, 2009, the date final regulations but only to the extent that the relevant Code sections apply to the decedent's estate.

J. Code §§ 2055, 2522. Charitable Deduction

1. Estate Can Deduct Amount Paid to Charitable Trust in Settlement of Dispute Over Will With No Residuary Clause. *Estate of Palumbo v. United States*, 2011 WL 860418 (W.D. Pa. March 11, 2011)

Antonion Palumbo's last will, which was amended by three codicils, failed to include a residuary clause, because of a scrivener's error by the decedent's lawyer. The decedent's son claimed that he was the ultimate beneficiary of the residue, because he was the sole intestate heir. The trustee of the charitable trust claimed that it was the actual residuary legatee. After bona fide and arm's length negotiations, which included the son, the charity, and the state attorney general, the parties reached a settlement agreement, approved by a trial court, under which the charitable trust received $11.7 million of the residuary estate, and the decedent's son received $5.6 million and certain real property. The Service denied the estate tax deduction for the $11.7 million passing to the charitable trust.

The U.S. District Court for the Western District of Pennsylvania (Judge Schwab) granted summary judgment to the decedent's estate. The court stated that Section 2055 was intended to encourage charitable giving, and that it should be broadly construed to accomplish that result. The Service argued that the charitable trust had no legally enforceable right to the residuary estate, so that there could be no *bona fide* dispute, and so no deduction should be allowed. *Bach v. McGinnes*, 333 F.2d 979 (3d Cir. 1964). The court disagreed, noting that the law of will construction, while normally limiting reference to the four corners of the document, also seeks to find the testator's intent and does not favor an intestacy. The court held that a state court could reasonably hold that the charity, which had been the residuary beneficiary under all prior instruments and which was omitted as residuary beneficiary only by an admitted scrivener's error, was entitled to the estate. As the dispute was bona fide, the court allowed the charitable deduction. Citing *Estate of Dumont v. Comm'r*, 150 F.2d 691 (3d Cir. 1945).

Note. Generally, the charitable deduction is allowed for an outright distribution to charity made in settlement of a bona fide will

contest, even if distribution under the actual terms of the will would not qualify for the charitable deduction. The Service will challenge the deduction under settlements of will contests when they think that the contest is not bona fide, that the charity has no real interest in the estate, or that the settlement is the result of collusive action. Rev. Rul. 89-31, 1989-1 CB 277; also *Flanagan v. United States*, 810 F.2d 930 (10th Cir. 1987); *Estate of Strock v. United States*, 655 F. Supp. 1334 (W.D. Pa. 1987); *Northern Trust Co. v. United States*, 1977 WL 1340, 41 AFTR2d 78-1523 (N.D. Ill. 1977). The validity of the holding in *Palombo* turns on whether the district court correctly interpreted state law. If the highest court of the state would likely agree that the evidence of the drafting attorney was admissible and believable, then the district court was correct and the $11.7 million was deductible. Otherwise, it was wrong and no estate tax deduction should be allowed for that gift. It would be arguable, however, that if no estate tax deduction is allowed because the charitable gift is deemed to have passed from the son, rather than the decedent, that an income tax deduction might be allowed the son. See also Crawford, "Palumbo and the Estate Tax Charitable Deduction," 131 Tax Notes 423 (Apr. 25, 2011).

Also note that, in a summary opinion filed April 22, 2011, the court denied attorney's fees to the taxpayer, finding the Service position substantially justified. *Estate of Palumbo v. United States*, No. 2:10-cv-00760, 2011 TNT 79-9 (W.D. Pa. April 21, 2011).

See also Crawford, "Palumbo and the Estate Tax Charitable Deduction," 131 Tax Notes 423 (2011).

2. Service Permits *Post Mortem* Reformation to Change Nondeductible Interests into Qualified Deductible Charitable Split-Interests. PLR 201125007 (June 24, 2011); PLR 201115003 (April 15, 2011)

- **PLR 201125007.** At D's death, D's revocable trust became irrevocable and provided that the assets, after the payment of Decedent's debts and expenses and the distribution of certain tangible personal property to Niece, would be held in trust for Family Member and Foundation (a qualified charity). Family Member is an elderly relative of D. The terms of the trust require the trustee to pay for the health costs of Family Member for the rest of her life, and to pay the burial expenses of Family Member at her death. The trust recognized that Family Member then resided in an assisted living facility with monthly expenses of $A, that those expenses could increase, and that the trustee should provide from principal any necessary funds to meet these costs. The executor of D's estate hired a valuation expert to value Family Member's interest in

the trust, taking into account the foreseeable and ascertainable costs to fulfill the distribution standard. D then obtained an order from a local court that the trust language created an ascertainable distribution standard requiring distributions for Family Member's lifetime health, support, and maintenance, and reforming the trust by adding and modifying its terms to provide payout to Family Member for her lifetime equal to B percent of the initial value of the trust fund on D's death, and to Foundation equal to C percent of the initial value (which together totaled five percent), and containing the other provisions set forth in Rev. Proc. 2003-57, 2003-1 C.B. 257.

The executor sought a private ruling approving the reformation. The Service determined that the valuation expert had not used the correct methodology to value Family Member's interest in the trust, and the executor sought a revised valuation that considered the reasonable and foreseeable costs of health, maintenance, and support using actual records of expenses, cost estimates provided by the local funeral home, publicly available interest rates, AARP studies of nursing home rate increases, and bank trustee representations of administrative costs. Based on the revised valuation of the noncharitable interest, the executor obtained a modification of the original order adjusting the percentage of the annuity amount payable to Family Member and the percentage payable to Foundation.

The Service stated that the revised order properly reformed the trust under Section 2055(e)(3), and that an estate tax deduction would be allowed for the present value of Foundation's remainder interest in the CRAT. The Service noted that: (1) the charitable remainder interest in the trust, before reformation, was a "reformable interest," because it created a charitable remainder interest that was presently ascertainable and severable from the noncharitable interest and that would have been deductible for estate tax purposes, but for the special rules on split-interest trusts. Reg. § 20.2055 -2(a); (2) the actuarial value of the charitable remainder interest in the proposed Family Member CRAT will not differ by more than five percent from the actuarial value of those interests provided for prior to reformation; (3) the terms of Family Member CRAT provide for termination of Family Member's interest at the same time both before and after the reformation; (4) the reformation will be effective as of the date of D's death; and (5) the reformation proceeding was started not later than 90 days after the last date (including extensions) for filing an estate tax return, if an estate tax return is required to be filed.

- **201115003.** D’s will left the residue of his estate in trust to pay income to individuals A and B for their concurrent and consecutive lives, to pay $2X a year to each of Charity 1 and Charity 2. Individuals A and B survived decedent, but they are not closely-enough related to D to be used as the measuring lives for a deductible gift of a charitable annuity. See Reg. § 20.2055 -2(e)(2)(vi)(a). When the trust ends (at the death of the later to die of A and B), $25X is to be distributed to Charity 3, $25X to Charity 4, $10X to individual C, and $7.5X each to individuals D, E, F and G. The remaining trust corpus is then to be distributed one-third to individual H, one-third to Charity 1 Foundation and one-third to Charity 2. The executor of D’s estate sought to reform the trust in state court to create two trusts, a charitable lead annuity trust (CLAT) and a charitable remainder unitrust (CRUT). The CLAT will pay $2X annually each to Charities 1 and 2 for a period of 22 years (the actuarial life expectancy of A and B), and then terminate with distributions of $10X to C; $7.5X each to D, E, F and G; and the rest to H. The trust will comply with the terms of Rev. Proc. 2007-46, 2007-1 C.B. 102, which contains trust provisions that meet the requirements for a testamentary charitable lead annuity trust providing for annuity payments payable to one or more charitable beneficiaries for the annuity period followed by the distribution of trust assets to one or more noncharitable remainder beneficiaries. The CRUT will pay a unitrust amount to A and B or the survivor, and when both have died, pay $25X each to Charities 3 and 4, and divide the remainder equally between Charity 1 Foundation and Charity 2. This trust will comply with the terms of Rev. Proc. 2005-59, 2005-2 C.B. 412, which contains trust provisions that meet the requirements for a testamentary charitable remainder unitrust with concurrent and consecutive interests for two measuring lives followed by the distribution of trust assets to a charitable remainderman.

  The Service stated that these were both qualified reformations under Section 2055(e). The Service noted that: (1) the charitable interests are reformable interests because as originally drafted, the trust provides for charitable interests that are presently ascertainable and, hence, severable from the noncharitable interests; (2) although payments to A and B were not expressed in specified dollar amounts or a fixed percentage of the fair market value of the property, a judicial proceeding was begun before the 90th day after the last date (including extensions) for filing D's estate tax return; (3) the difference between the actuarial value (determined as of the date of the D's death) of the qualified interest and the actuarial value of the

reformable interest does not exceed five percent of the actuarial value (as so determined) of the reformable interest; (4) both before and after the reformation, in the case of the CRUT, the non-remainder interest terminates at the same time, and in the case of the CLAT, the reformable interest and the qualified interest are for the same period; and (5) the reformation is effective as of the date of D's death.

K. Code §§ 2056, 2044, 2519, 2523, 2207A. Marital Deduction

1. Marital Deduction Reduced Because Decedent's Statement of "Desire" Treated as a Specific Bequest. TAM 201126030 (July 1, 2011)

Decedent's estate owed substantial debt obligations. The will included a "statement of intent" concerning certain assets, and stating that, if Decedent died owning certain investment assets, "it is my desire that such equity interests be retained and that each of them be distributed so that all such equity interests are ultimately owned in equal shares by [Children]." Decedent's will made specific bequests to Spouse, as well as other specific bequests of life estates. Decedent's will also created a Family Trust for the benefit of Decedent's children. The IRS National Office was asked whether the language "it is my desire", used with respect to the gifts of equity investment assets, was mandatory or precatory. If it is mandatory, then those interests are specific bequests to Decedent's Children. If it is precatory, those items are added to the residue of Decedent's estate, which will be used to satisfy Decedent's debts and, therefore, leave the specific bequest to Spouse undiminished by debts. Therefore, if the language is precatory, the marital deduction will be increased.

The Service deemed the language to be mandatory. Under applicable state law, Decedent's intent must be ascertained from the language used within the four corners of the instrument, looking at the clear meaning of the words actually used, rather than any extrinsic evidence of intent. Furthermore, a court is required to give effect to every part of the instrument if the language is reasonably susceptible to a harmonious construction. The Service noted that some words that, in their ordinary meaning are precatory, are often construed as mandatory when used in a will, or when the context of the entire document shows that they are an expression of an intent to make a disposition. Distinctions have been drawn between expressions of desire directed to beneficiaries, to executors, and to trustees. A wish directed to a beneficiary is generally regarded as precatory, unless the words clearly express the testator's intention to the contrary; but

where the words are addressed to an executor, they are more often regarded as mandatory, or at least prima facie mandatory. The clause in question was an instruction to the executor, and the use of the word "desire" when addressed to an executor is often construed as a mandatory direction. In this will, the Service noted, Decedent often gave the executor clear language when discretion was intended, such as allowing the exercise of "sole and absolute discretion". In one instance, Decedent expressed a preference to a beneficiary, but granted the beneficiary discretion, with the statements "I request, but do not require", "I further request, but not require", and "I suggest". Thus, the Service concluded that the disposition of the equity interests was a specific bequest.

2. **Service Voids Unnecessary QTIP Elections. PLRs 201131011 (Aug. 5, 2011) and 201112001 (March 25, 2011)**

- **PLR 201131011.** Decedent's pour-over will left the residue of his estate to his revocable trust, which directed that the trust be divided into a Marital Trust and a Family Trust. The Marital Trust is to be funded an amount necessary to reduce both the Federal and state estate taxes to zero. The trustee funded Marital Trust with assets equal to the amount required to reduce the State death tax to zero, which was less than the federal applicable exclusion amount for Decedent's year of death. The executor elected to deduct the Marital Trust as a QTIP. The combination of the Marital Trust and the Family Trust did not exceed Decedent's applicable exclusion amount.

  The Service stated that, under Rev. Proc. 2001-38, 2001-1 C.B. 1335, it would ignore the QTIP election, because it was not needed to reduce the federal estate tax to zero.

  Note. One has to wonder how the Service's determination would affect the state estate tax QTIP election. Some states require that the elections be made consistently, while others do not. Practitioners using a state-only QTIP should determine whether a request for the Service to ignore the QTIP election might frustrate the state death tax planning.

- **PLR 201112001.** Decedent's revocable trust created a Marital Share and a Family Share upon Decedent's death, based on a formula that provided a credit-shelter Family Share and residue equal to the Marital Share. The Marital Share was held in a trust that directed payment to the surviving spouse, Spouse, all of the trust income and as much of the principal as Spouse requested "for any reason." Spouse also had a general testamentary power of appointment over the Marital

Trust. The Family Share was held in a Family Trust, all of the net income being payable to Spouse at least monthly, together with as much principal as Spouse might require for her "health, education, maintenance and support." The Decedent's executor filed a timely estate tax return and made a QTIP election for both the Marital Trust and the Family Trust. With the aid of new counsel, Spouse discovered that the QTIP election for the Family Trust was not necessary to reduce the estate tax liability to zero, and requested a ruling under Rev. Proc. 2001-38, 2001-1 C.B. 1335, that the QTIP election made with respect to the Family Trust was void for purposes of estate, gift and GST tax purposes, because it was not necessary to reduce the estate tax liability to zero.

The Service granted the request to void the election to deduct the Family Trust. It also noted that the Marital Trust was a general power of appointment trust under Section 2056(b)(5), and thus also voided the election to deduct that trust, as unnecessary to obtain the Federal estate tax marital deduction.

Note. This estate tax return seems to have been prepared by someone with very little experience in estate taxes and estate tax planning. Estate tax returns are not entry-level projects, and should generally be left to or, at least, supervised by persons with significant experience in estate taxes and estate tax planning. In this case, apart from the cost of obtaining the private letter ruling, no damage was done, other than to the reputation of the person who prepared the decedent's estate tax return.

3. Service Rescinds Ruling that Allowed Late *Inter Vivos* QTIP Election. PLR 201109012 (March 4, 2011), rescinding PLR 201025021 (June 25, 2010)

Grantor created an irrevocable inter vivos trust for the benefit of Spouse, directing the trustees to pay Spouse all of the net income at least quarterly, along with as much of the principal as the trustees consider advisable for Spouse's health, education, support, or maintenance. The trust instrument stated that Grantor intends, "to the extent that QTIP elections are made on the gift tax returns with respect to Trust," to be entitled to the maximum federal gift tax marital deduction. Grantor hired Law Firm to prepare and file the gift tax returns but return did not include a QTIP election under Section 2523(f)(2).

The Service, in a 2010 ruling, granted Grantor additional time within which to make the QTIP election. Section 2523(f)(4)(A) states

that the inter vivos QTIP election "shall be made on or before the date prescribed by § 6075(b) for filing a gift tax return with respect to the transfer (determined without regard to § 6019(2)). . . ." The Service stated that relief would be granted under Reg. § 301.9100-1(c) upon evidence that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. The Service also noted that Reg. § 301.9100-3(b)(1)(v) deems a taxpayer to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election. In this case, the taxpayer was allowed until 60 days after the date of the ruling to make the QTIP election.

The Service, in its 2011 ruling, retroactively withdrew PLR 201025021, stating that Reg. § 301.9100-3 applies only to requests for extensions of time fixed by administrative pronouncement, and the time for making a QTIP election is fixed by statute.

Note. PLR 201025021 was the only time that the Service had permitted a late *inter vivos* QTIP election. The position taken in PLR 201109012 is consistent with several prior private rulings. See PLRs 200314012 (Dec. 17, 2002), 9641023 (July 10, 1996), 9437032 (June 20, 1994).

Inter vivos QTIPs are a very popular estate planning technique for several reasons. They can enable one spouse to assure that the donee spouse has adequate assets includible in his or her gross estate to take full advantage of the donee spouse's own applicable exclusion amount and GST exemption. A donor spouse can even use an *inter vivos* QTIP to create a nonmarital trust, that if the donor spouse survives the donee spouse, will be taxed to the donor spouse as a grantor trust for income tax purposes. See Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust[sm]," 21 Prob. & Prop. 52 (July/August, 2007).

Practitioners must be very careful, however, to assure that the donor spouse makes the election to deduct gifts made to an *inter vivos* QTIP. Section 2523(f)(4)(A) states that the QTIP election must be made by the donor on or before the date for filing a timely gift tax return. Practitioners creating an *inter vivos* QTIP for a client may want to assume responsibility themselves for filing the gift tax return, better to assure that the return is filed and that the election is made.

L. Estate Tax Procedures

1. Only One Bite of the Apple – Estate Tax Refund Suit is Untimely Because Executor Not Entitled to Second Estate Tax Filing Extension. *Dickow v. United States*, 654 F.3d 144 (1st Cir. Aug. 19, 2011)

Charles Dickow was executor of the estate of Margaret Dickow. Charles filed a timely request for an extension of the time to file and pay, enclosing a $945,000 check for the estimated tax. The Service granted the automatic six-month extension of time to file the estate tax return and, just over five months later, Charles filed a second request for an extension of the time to file, stating that "despite due diligence on his part, he has not received an appraisal of a real estate asset which constitutes a large portion of the Estate." The Service denied the second request for an extension to file, but granted the additional extension of time to pay. Charles claimed that he never received the rejection of the request for additional time to file, and that he had relied to his detriment on the Service' silence as evidence that the second request had been granted. Charles filed the estate tax return within the time of the second extension (the one that had not been granted), requesting a refund, which the Service granted. Almost three years later, Charles sent in an amended estate tax return claiming a refund of $237,813.48. The Service denied the claim.

The U.S. District Court for Massachusetts (Judge Woodlock) granted the Service summary judgment, finding that the claim for refund was invalid because Charles claim was untimely under Sections 6511(a) and 6511(b)(2)(A). The court determined that the Code (Section 6081(a)) was ambiguous as to whether the Service could grant more than one six-month extension, but that the regulations were clear that the Service could grant only one six-month extension. The district court gave deference to the regulations. *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Since Charles could not have received a second extension, and his claim was filed three years and six months after the tax payment, it was untimely. The court also held that Charles' claim for equitable estoppel could not provide jurisdiction over this action, and that, even if it could, he had not proven the required element of affirmative misconduct by the Service.

The First Circuit (Chief Judge Lynch) affirmed on both issues. The court noted a taxpayer seeking an estate tax refund must file the claim within the later of three years after filing the tax return or two years after paying the tax. A taxpayer who claims a refund within three years of filing the return can receive a refund of only the portion of the tax paid within the three years immediately preceding the refund

claim, plus any extensions of time for filing the return. Code § 6511(b)(2)(A). The claim for refund was ineffective, therefore, because the payments had all been made more than three years before the date of the claim. The court stated that the second extension had not been granted and could not be counted towards the look-back limitation. The First Circuit also rejected Charles' claim that the government should be equitably estopped to assert the statute of limitations, because it had "misrepresented" to him that the second extension had been granted by not telling him explicitly that the request had been denied. The court agreed with the District Court that equitable exceptions do not apply to the statute of limitations under Section 6511. *United States v. Brockamp*, 519 U.S. 347 (1997). Furthermore, the court noted, Charles did not establish the elements of equitable estoppel, because he showed no " definite misrepresentation of fact"

2. Fifth Circuit Agrees that Tax Court Lacked Jurisdiction Over Revocable Trust, Despite Claim of Equitable Recoupment. *Estate of Anderson v. Comm'r*, 434 Fed.Appx. 381, 2011 WL 3241949 (5th Cir. July 27, 2011)

Deane Anderson established a revocable trust with Randall K. and Dennis L. Whited as beneficiaries and, after Deane's death, trustees. Deane's estate tax return and tax payment were due on December 30, 2011, and on September 30, 2002, his estate paid the Service $20,000 and asked for an extension of time to file the estate tax return. The Service granted a six-month extension, giving the estate until to March 30, 2003 to file its return. The estate claimed that the Service later granted it a second extension to file its return but that it then revoked that extension. The Service claimed that the estate asked for a second extension, but that it was granted only an extension of the time to pay taxes. The estate later filed its tax return and submitted another payment of $1,000. The estate asked the Service to calculate the tax, and the Service determined that the estate owed $5,673.02, and issued a $15,411.62 refund. On audit, the Service rejected a $90,000 deduction for a "net loss during administration" from a commodities trade and assessed a $52,946 deficiency. The estate and trust petitioned the Tax Court for a redetermination of the deficiency and late-filing penalty, never arguing that the deductions were allowable, but contending that the Notice of Deficience was improper and that the Service was estopped from pursuing the deficiency.

The Tax Court granted the Service' motion to dismiss the cases with respect to the trust, because the court "ha[d] no jurisdiction over

th[e] Trust, or those individuals, [the Whiteds,] in their individual capacities in this case." After discovery, the Service moved for summary judgment and the estate filed a cross-motion for summary judgment. The Tax Court granted the Service' motion, denied the estate's cross- motion, and sustained the deficiency, and a $9,655 late-filing penalty.

The Fifth Circuit, in a per curiam opinion, affirmed the decisions of the Tax Court. The court held that the Tax Court had no jurisdiction over the trust or the Whiteds in their individual capacities because no notice of tax deficiency or liability had been issued to them. The estate conceded that it had no equitable recoupment claim with respect to the $90,000 commodities loss, but argued that because it cannot claim equitable recoupment as a defense against its own deficiency, the Tax Court must have jurisdiction over the trust's claim for an equitable recoupment defense against its tax liability. The court disagreed, noting that the Tax Court's jurisdiction is limited to cases where a deficiency has been assessed, and that the doctrine of equitable recoupment cannot be raised without jurisdiction.

3. Estate Tax Refund Suit Dismissed as Untimely. *Green v. United States*, 428 Fed.Appx. 863, 2011 WL 2621003 (10th Cir., July 5, 2011), *aff'g by unpub'd order* 2010 WL 3258566, 106 A.F.T.R.2d 2010-5906 (N.D. Okla., 2010)

Robert C. Green died in 1980 and his wife, Gladys, was sole beneficiary. In 1982, the estate filed a tax return reporting it owed $75,798 in taxes. In 1985, Service assessed additional taxes of $83,422. The estate failed to pay the taxes and the Service filed a collection action in 1998. The administrator of Mr. Green's estate confessed judgment for the taxes and, in 1989, the district court entered judgment for the Service in the amount of $480,588. The Service filed its judgment in the probate court. In 1996, the probate court ordered that assets remaining after paying administration expenses and attorney's fees, $713,292, be paid to the government. The decedent's widow, as successor administrator, received notices of the filings and actions taken by the court during the probate proceedings. In 2002, the successor administrator filed suit against the government in a Freedom of Information Act action, for documents concerning the Service collection efforts respecting the estate. The Service produced more than 2,300 pages of documents. Mrs. Green sued in federal court for wrongful levy (Section 7426), unauthorized disclosure (Section 7431), failure to release a lien (Section 7432), and unauthorized collection activity (Section 7433). The complaint also alleged that the Service had seized her property in violation of the Fourth Amendment. The District Court dismissed the complaint. In the fall of 2005,

Ms. Green filed a new suit against the Service, asserting wrongful levy and constitutional violations. The District Court held that the statute of limitations barred the wrongful levy claim and entered judgment in favor of the United States. In 2007, Ms. Green filed a suit for an estate tax refund. The District Court rejected this claim, as well. Ms. Green argued that she had sent a protest letter to the Service on April 17, 1996, but that she had received no response. Ms. Green was unable to produce a copy of the letter to show that it constituted a claim, and the court dismissed the complaint without prejudice. In February 2010, Ms. Green, again through her guardian, filed this suit in which she sought a refund under § 7422 of the taxes, interest, and penalties collected from the estate in 1996. She provided three documents that were not part of her pleadings in her earlier refund suit: (1) an April 8, 1996 letter from her to then United States Senator Don Nickles in which she asked for his help in stopping the proposed sale of estate assets; (2) an April 28, 1996 letter from Janice D. Green to a regional commissioner of the Service in which she outlined her belief that a piece of proposed Congressional legislation "could help my mother and other taxpayers in similar situations," asked him to stop the proposed sale of estate assets, and explained that an oil industry bust in Oklahoma at the time of her father's death caused the estate to be overvalued; and (3) a July 18, 2002 letter from Janice D. Green to the district director of the Service, which said it was an "administrative claim," under Sections 7433 (unauthorized collection activity), 7432 (failure to release lien), and 7431 (unauthorized disclosure).

The U.S. District Court for the Northern District of Oklahoma held that Ms. Green lacked standing, because the tax was paid by the estate.

The Tenth Circuit (Baldock) affirmed the dismissal of the estate tax refund suit, but on the grounds that the estate failed to submit a timely refund claim to the Service. The court noted that the filing of a timely refund claim is an absolute requirement for a valid suit for a refund. *United States v. Dalm*, 494 U.S. 596, 602 (1990). Furthermore, the claim must be filed within the later of two years after the tax was paid or three years after the return was filed. The court stated that it did not need to decide whether the April, 1996 letters constituted an informal claim, since they were even then too late.

4. Late Payment Penalties Assessed Against Estate Because of Deficient Request for Extension. ***Baccei v. United States*****, 632 F.3d 1140 (9th Cir. Feb. 16, 2011),** ***aff'g*** **2008 WL 2561876, 101 A.F.T.R.2d 2008-2717 (N.D. Cal. 2008),** ***further order*** **2008 WL 4345113, 102 A.F.T.R.2d 2008-5801 (N.D. Cal. 2008)**

Ronald Baccei was the executor of an estate. He hired a CPA to prepare and file a federal estate tax return. The CPA filed a timely request for extension, but omitted to complete Part III of the application – the request for an extension of the time in which to pay the tax. The accountant did, however, enclose a supplemental letter explaining the reason for the request for time both to pay and to file. The estate tax return was filed on time, as extended, with a $1.6 million payment. The Service assessed a $58,954.28 late-payment penalty and $69,801 of interest. The executor paid the tax and sued for a refund, based on the extension of the time to file and pay.

The U.S. District Court for the Northern District of California (Judge Hamilton) granted the Service summary judgment, finding that the executor did not properly request an extension of time to pay the taxes and did not establish reasonable cause for the estate's failure to pay. The district court rejected the estate's argument that the request substantially complied with the regulations, because the regulations requirement was substantive, rather than procedural, and the substantial compliance doctrine applies only to procedural regulations. The district court also held that reliance upon a "well-qualified and knowledgeable CPA" does not constitute reasonable cause.

The Ninth Circuit (Judge Burgess) affirmed, finding that the estate had the burden of proving that the failure to pay was due to reasonable cause, and it had failed to do so. The court refused to hear the estate's argument that its financial need to liquidate real property assets constituted reasonable cause, because it had not been raised in the trial court. The court rejected the application of the doctrine of substantial compliance, finding that the requirement that the application state the period of the extension requested is "neither unclear nor unimportant; rather it is essential to the Service's tax collection efforts because it allows the Service to assess the reasonableness of the taxpayer's request." The court rejected the application of the doctrine of equitable estoppel, finding that the Service had no duty to inform the estate that its payment extension request was deficient or provide an opportunity to amend the extension application, and equitable estoppel applies only if the Service engaged in affirmative misconduct. Finally, the court rejected the claim that reliance on a CPA was reasonable cause, citing *United States v.*

Boyle, 469 U.S. 241 (1985) ("the taxpayer's reliance on an agent. . . is not 'reasonable cause' for a late filing").1)

5. **Fourth Circuit Affirms Delay Penalty Against Attorney Who Made Misrepresentations to Both Tax Court and State Court. *Estate of Allison v. Comm'r*, 403 Fed.Appx. 866 (4th Cir. Dec. 4, 2010), *aff'g per curiam without opinion*, T.C. Memo 2008-149**

Daniel was both the personal representative of and attorney for the estate of his mother. The estate was simultaneously involved in both two disputes before the Tax Court and a dispute involving the probate of the estate in state court. The probate case was opened in 1995, and involved a dispute over certain administration expenses. The Tax Court cases opened in 2000, less than two months after the probate court had ordered Daniel to close the estate. The Tax Court cases involved questions relating to certain taxable gifts made by the decedent. The Service and the estate resolved all of the tax issues, except for a question of the fees and commissions claimed on the Federal Estate Tax Return, which were the subject of the probate litigation. The attorney obtained six continuances of the Tax Court cases based on his representation that resolution of the tax cases required only the final resolution of the probate case. He obtained several continuances of the probate case, and avoided a contempt citation, by representing to the probate court that resolution of the probate case awaited only resolution of the tax cases.

The Tax Court concluded that the attorney had made false representations before the court in order to delay proceedings, and it imposed upon the attorney a delay penalty under Section 6673(a)(2) equal to the costs incurred by the Service in the matter (which costs the Service was directed to calculate for the court). The court declined to impose the penalty of up to $25,000 on the estate under Section 6673(a)(1)(A), finding that it would harm persons other than the attorney, who was the real party at fault. The court noted that the attorney's "education and legal experience, not to mention his admission to the Tax Court bar, underscore the egregiousness of his conduct." The court also noted that, because the attorney was currently admitted to practice before the Tax Court, "other sanctions may be appropriate."

The Fourth Circuit affirmed *per curiam*, without a written opinion.

6. **Statutory "Executor" Is Proper Person to Whom to Send Notice of Deficiency. *Estate of Gudie v. Comm'r*; 137 T.C. ___ (No. 13) (Nov. 30, 2011)**

The decedent named her nieces Mary and Patricia as the beneficiaries of a living trust, which held part of her estate. Mary was also named co-trustee, and both Mary and Patricia were named successor co-trustees upon the decedent's death. Neither Mary nor Patricia were named as executor. Mary signed the decedent's estate tax return as executor, but she refused to be formally appointed to that role under state law. Each of the nieces received more than $3.4 million on the decedent's death, but the estate tax return reported no taxes due. On examination, the determined that (1) the decedent had made nearly $3 million of unreported adjusted taxable gifts; (2) the decedent had made $279,000 of gifts that were invalid for estate and gift tax purposes; and (3) the estate was not entitled to deduct $8.64 million as an outstanding debt. The IRS assessed a deficiency and sent a deficiency notice to Mary, as executor. Mary petitioned the Tax Court for review, after which the IRS increased the deficiency and accuracy-related penalty.

The Tax Court (Judge Wherry) rejected Mary's argument that the court lacked jurisdiction because Mary had never been appointed executrix by a state probate court and, Mary argued, the notice of deficiency had, therefore, been sent to the wrong person. The court agreed with the IRS that, because Mary was had actual or constructive possession of the decedent's property, she was a statutory executor under Section 2203, and was, therefore, the correct person to whom the notice of deficiency should be sent. The court dismissed Mary's differentiation between property that passes directly to beneficiaries and property that passes through probate. Mary's actual or constructive possession of the decedent's property made her a statutory executor under Section 2203 with responsibility to file the estate tax return, and filing the return notified the IRS that Mary held a fiduciary role and was a person to whom the notice could be sent.

7. **Equitable Tolling of Statute of Limitations Does Not Apply to Estate Tax Refund Suit. *Davis v. United States*, 2011 WL 6294467 (N.D. Miss. Dec. 15, 2011) (slip copy)**

The decedent's estate filed its estate tax return on February 3, 2003, and paid its tax liability on April 17, 2003. On November 3, 2003, a state court held that the decedent owned only a vested remainder in certain property, rather than a fee simple interest. The holding was affirmed by an appeals court on January 20, 2005, and the state supreme court denied certiorari on March 2, 2006. The estate filed a

claim for refund on November 4, 2008, based on the decedent's lessened interest in the real property. The IRS denied the claim for refund as untimely.

The U.S. District Court (Judge Mills) held for the Service, finding that the limitations period on a claim for refund is fixed absolutely by Section 6511, and that equitable tolling of the statute of limitations does not apply. The estate argued that, because the Service requires that a taxpayer have sufficient legal and factual grounds to file a claim for refund, the estate could not file its claim until after the litigation had been completed. The court explained that the government consents to be sued only under specific circumstances, including the filing of a refund action within three years from the time the return was filed or two years from the time the tax was paid, whichever is later. The court noted that the Supreme Court has concluded that Congress did not intend for equitable tolling to apply to Section 6511's time limitations. *United States v. Brockamp*, 519 U.S. 347, 354 (1997). This Court noted that the estate should have been aware of the refund claim as early as November 3, 2003 when the chancery court determined that the decedent had a vested remainder interest in the farm property. It could have filed its claim for refund at that time. Furthermore, within three years from that date, both the chancery court and Mississippi Court of Appeals ruled on the decedent's ownership interest in the farm property. Had the estate filed an administrative claim at that point, it would have been timely.

8. Claims Court Lost Jurisdiction In Refund Suit After Tax Court Petition Was Filed. *Curtin v. United States*, 2011 WL 6013072 (Dec. 1, 2011)

The decedent's estate had three personal representatives, Curtin, Johnson, and De Bekessy. De Bekessy, the decedent's son, resided in France; the other resided in the United States. The estate paid $17.5 million in estate taxes, together with Curtin's request for an extension of the time for filing the return. Within the extended time, De Bekessy filed an estate tax return and reported a $10,383,013 overpayment and, eight days later, Curtin and Johnson filed an estate tax return, reporting a $5,129,772 overpayment. The IRS sent a $10,383.013 refund check to De Bekessy in Paris, who promptly negotiated the check. Curtin and Johnson sued the Government demanding that a replacement check be issued to them. Thereafter, the IRS sent a notice of deficiency to Curtin and DeBekessy stating that the estate owed an additional $33,146,275 in taxes. Curtin and De Bekessy filed petitions in the Tax Court for redetermination.

Initially, the Court of Federal Claims (Senior Judge Margolis) granted partial summary judgment to the Government, holding that

there is no statutory basis for a suit for a replacement check. *Curtin v. United States*, 91 Fed. Cl. 683 (Ct. Fed. Cl. Feb. 26, 2010). After the filing of the petition for redetermination of the assessed deficiency, the court issued another order dismissing the balance of the complaint, which asked for a refund of some of the estate taxes. The court explained that Section 7422(e) states that, if the Secretary files a notice of deficiency while suit is pending in the district court or Court of Federal Claims, and the taxpayer files a petition in the Tax Court, the district court or Court of Federal Claims "shall lose jurisdiction of taxpayer's suit to whatever extent jurisdiction is acquired by the Tax Court of the subject matter of taxpayer's suit for refund. . . ." The court explained that Section 7422(e) requires dismissal of all claims that the Tax Court acquires jurisdiction over, not just those the taxpayer asserts in Tax Court. *Russell v. United States*, 592 F.2d 1069, 1071-1072 (9th Cir. 1979); *Finley v. United States*, 612 F.2d 166, 170 (5th Cir. 1980); *Peters v. United States*, 222 Ct. Cl. 534, 535 (1979). The district court or Court of Federal Claims can decline to dismiss a case only where there is a "substantial issue" as to whether the Tax Court has acquired jurisdiction over the taxpayer's suit. *Dorsey v. United States*, 211 Ct. Cl. 339, 341 (1976). In this case, the Tax Court has jurisdiction to determine both the amount of the deficiency and the amount of any overpayment. Code §§ 6214(a), 6512(b)(1); *Naftel v. Comm'r*, 85 T.C. 527, 531 (1985). Therefore, the court could not entertain a claim for refund of an overpayment. *Fairchild Industries, Inc. v. United States*, 218 Ct. Cl. 680 (1978).

9. Estate Tax Examiner Could Not Bind the Service to Discharge Estate Tax Lien. *Adamowicz v. United States*, ___ Fed. Cl. ___, 2011 WL 5843694 (Ct. Fed. Cl. Nov. 21, 2011)

The executors of the estate of Mary Adamowicz filed an estate tax return and elected to defer estate taxes on her business interests under Section 6166. Thereafter, they sought to sell some of the property and asked the estate tax examiner to issue a certificate of discharge under Section 6325(c), releasing the estate taxes lien under Section 6324(a) with respect to a specific asset. Allegedly, the estate tax examiner agreed to do so in exchange for the payment of a proportionate share of the taxes, but after that payment, the Service refused to issue the certificate of discharge. The executors sued for breach of contract.

The Court of Federal Claims (Senior Judge Margolis) granted summary judgment for the Service, finding that the agent lacked the authority to bind the Service to release of the estate tax lien. The court explained that, while the District Courts have exclusive jurisdiction over suits for damages for refusal to release a lien, a suit over

failure to issue a certificate of discharge is different and may be brought in either the District Court or the Court of Federal Claims. Releasing a federal tax lien under Section 6325(a) terminates the underlying tax obligation, but issuing a certificate of discharge merely permits the taxpayer to transfer specific property; the underlying tax obligation remains in place and undischarged. Reg. §§ 301.6325–1(a), 301.6325–1(c); *Behr v. United States,* 2010 WL 1131383, at *17 n. 23 (D. Minn., 2010), *adopted by* 2010 WL 1131285 (D. Minn., 2010), *aff'd,* 399 Fed. Appx. 125 (8th Cir.2010); *Bloom v. United States,* 220 F.Supp.2d 382, 388 (M.D. Pa. 1999). The court then explained that a government employee can bind the United States in contract only if he or she has actual authority to do so. *Jumah v. United States,* 90 Fed. Cl. 603, 612 (2009), *aff'd* 385 Fed. Appx. 987 (Fed. Cir .2010). Here, there was no express actual authority, because Sections 7121 and 7122 preclude the alleged agreement and because no other statute or regulation creates authority in any employee of the Service to commit to discharge property under Section 6325(c). *Botany Worsted Mills v. United States,* 278 U.S. 282, 288–289 (1929); *Klein v. Comm'r,* 899 F.2d 1149, 1152 (11th Cir.1990). A final and conclusive agreement with the Service requires a closing agreement under Section 7121 or a compromise under Section 7122, neither of which was undertaken in this case. The executors argued that, by a letter, they had agreed to pay the proportionate part of the estate taxes deferred in return for the Service's agreement to discharge the lien, but because the letter did not suggest that the parties could later renegotiate the amount of tax due, it requires a conclusive settlement that must be entered into under Sections 7121 and 7122. The court also held that the estate tax examiner lacked implied actual authority, because such authority must be "an integral part" of that employee's duties, such that he or she could not perform his or her duties without it. *Leonardo v. United States,* 63 Fed. Cl. 552, 557 (2005), *aff'd,* 163 Fed. Appx. 880 (Fed. Cir.2006). This criterion is not met where the statute or regulations expressly preclude the authority, or where the agency has reasonable alternatives to creating the implied actual authority in the employee. Here, Sections 7121 and 7122 and their regulations expressly preclude an employee's authority to enter into the alleged agreement, the authority to agree to a discharge is not "necessary" or "essential" to any IRS employee's duties, and there were reasonable alternatives.

10. Suit for Refund of Late Filing and Payment Penalties Must Go To Trial, Because Estate Could Potentially Prove Reasonable Reliance on Advice of Counsel. *Estate of Liftin v. United States*, ___ Fed. Cl. ___, 2011 WL 5395546, 108 A.F.T.R.2d 2011-7108 (Ct. Fed. Cl. Nov. 8, 2011)

Morton Liftin's will named his son as executor. The will left bequests to the decedent's widow, who was not a U.S. citizen at the time of the decedent's death. The executor paid an estimated estate tax in a timely manner, but because the widow indicated that she would apply for U.S. citizenship in order to allow the estate to take advantage of the marital deduction, the executor consulted an estate planning attorney regarding whether the estate could properly wait to file its tax return. The attorney advised the executor that the estate could file its return after the extended due date and preserve the full marital deduction, and that doing so "would not trigger a penalty" as long as the return was filed within a "reasonable time" after the widow became a naturalized U.S. citizen and after completion of related litigation against the estate. The executor filed a late estate tax return, after the widow became a naturalized U.S. citizen and the estate litigation was settled. The return showed a nearly-$200,000 overpayment, but the IRS assessed a 25% late filing and payment penalty on the tax due. The estate paid the penalties and sued for a refund. The IRS filed a motion for judgment on the pleadings.

The Court of Federal Claims (Judge Miller) denied the motion, finding that the estate had made a sufficient showing that it may be able to prove that its failure to file in a timely manner was due to reasonable cause, because it relied in good faith on expert advice concerning a substantive question of tax law, and that its failure to timely file was not the result of willful neglect. A taxpayer can avoid penalties by showing that he or she "exercised ' ordinary business care and prudence' but nevertheless was 'unable to file the return within the prescribed time.'" *United States v. Boyle,* 469 U.S. 241, 246 (1985). Reasonable cause may exist when a taxpayer files a return late because the taxpayer relied on an expert's erroneous advice. *Estate of La Meres v. Comm'r*, 98 T.C. 294, 318 (1992). Here, the court noted, the taxpayer alleged that the attorney had, on multiple occasions, advised that late filing in order to give the widow time to become a naturalized U.S. citizen and for other ancillary matters to be completed not only was permissible, but that would not result in a penalty. Thus, the court concluded, the estate might be able to prove facts demonstrating that it made a full disclosure to the attorney, relied in good faith on his advice regarding whether filing after the widow became a citizen would trigger a penalty, and that the estate did not otherwise know its return was due. The court rejected the IRS

argument that the estate was obligated to challenge its attorney or seek a second opinion, finding that to hold otherwise "would nullify the very purpose of seeking the advice of a presumed expert in the first place." *United States v. Boyle,* 469 U.S. at 251. The court also noted that whether the executor should have known that filing late would expose the estate to penalties and thus constitute willful neglect, was a question of fact that cannot be decided on a motion for judgment on the pleadings.

11. Distinguishing Estate Tax Payment from Estate Tax Deposit Can Determine Whether Statute of Limitations Bars Refund Claim. *Boensel v. United States*, 99 Fed. Cl. 607, 2011 WL 3438401 (Fed. Cl. Aug. 5, 2011)

Donald Boensel was the executor of his father's estate. When his father died, Donald was dealing with personal issues and a failing business, so he hired an accounting firm and a law firm to handle the estate. Donald's attorneys recommended that, as the date for filing the estate tax return neared and they had not yet fixed the values of the estate assets, he should estimate the estate tax liabilities and remit $435,000, which was ten percent more than the accountants believed the estate would owe. Donald assumed that he had no further obligation to pay estate taxes, but in 2005, the Service notified him that he still had to file an estate tax return. He filed the return in 2006, stating that the estate tax liability was $323,140, and that, therefore, he was due a $111,850 refund.

The Service disallowed the refund claim as being untimely, because it was claimed more than three years after the overpayment. Code § 6511(b)(2). Boensel filed a complaint with the Court of Federal Claims, arguing that the three-year look-back period for refund claims should not apply because the $435,000 remittance was actually a deposit, rather than a payment of estimated taxes.

The Court (Judge Firestone) held for the Service, finding that the estate had made an estimated tax payment, rather than a deposit. The court noted that when the remittance was made in 1999, the Service did not actually authorize taxpayers to make deposits to meet potential tax liabilities. Section 6603, which permits such deposits, was not enacted until 2004. The court discussed the decision of the Supreme Court in *Rosenman v. United States*, 323 U.S. 658 (1945), where the court held that an estate tax remittance was a deposit rather than a payment, because there was no outstanding assessment against the estate at the time of the remittance. The court held that the case law since *Rosenman* now required consideration of all relevant facts and circumstances to determine whether a remittance is a deposit or a payment. In this case, the court focused on the fact

that the executor failed to contest the estate's liability when it submitted the remittance, tending to show that the remittance was a payment.

12. Government Can Decide After Initial Trial to Contest $12 Million Estate Tax Deduction for Executor's and Attorneys' Fees. *Keller v. United States*, 2011 WL 1642189, 107 A.F.T.R.2d 2011-2025 (S.D. Tex. April 29, 2011) (slip copy)

In August 2009, the district court held that the estate of the decedent, Maude Williams, was entitled to a deduction for executor's fees and administrative expenses, but left it up to the parties to determine the amount of the deduction. The executors argued stated that the fees were deductible in full, because the government conceded in an interrogatory submitted before trial, that there was no issue as to the deductibility of the fees. The government argued that, at the time of the interrogatory, the only claim for such fees was the estimate included on the estate tax return, which had not been finalized. Also, the government had stated in the interrogatory that it did not challenge these amounts "at this time." After trial, the government determined to challenge the deductions.

The District Court (Judge Rainey) held that, because the payment of executors' and trustees' fees was not even begun until after the Government's interrogatory response, the Government could not have raised its objection to the necessity of the fees in that response. Also, the qualifying language "at this time" in the response preserved the issue for later raising.

13. Service Issues Interim Guidance on Referrals for Certain Art Appraisal Services. SBSE Memo 04-0111-008 (Jan. 27, 2011)

The Service has provided interim guidance to agents, requiring that an agent who is valuing a work of art with a claimed value of $50,000 or more, must refer the matter to the IRS Art Appraisal Services. This is an increase from the previous threshold of $20,000.

14. Two Percent Interest Rate on Deferred Estate Taxes on Closely-Held Business Adjusted for Inflation. Rev. Proc. 2011-52 § 3.38, 2011-45 I.R.B. 701 (Nov. 7, 2011)

The value of a closely-held business interest, the deferred estate taxes on which bear interest at a two percent rate, is increased to $1,390,000 for estates of decedents dying in 2012.

II. GIFT TAXES

A. Code § 2501. Taxable Gifts

Service Adds Gift Tax Consequences of Decanting to No-Ruling List and Requests Comments. Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (Jan. 3, 2011); Notice 2011-101, 2011-2 I.R.B. ___ (Dec. 27, 2011)

- **Rev. Proc. 2011-3.** The Service added to its no-rulings list the question of whether decanting that results in a change in beneficial interests is a gift under Section 2501. This issue is designated one that is currently under study.

  Note. See also no-ruling position regarding the income tax and GST tax consequences of decanting, discussed below.

- **Notice 2011-101.** The Service has asked for comments from practitioners and other interested parties regarding the proper income, estate, gift, and GST tax treatment of decanting. It has asked for these comments by April 25, 2012. The specific questions regarding which it has asked for comments include:

Note. The Service is evidently preparing a formal ruling or regulations on the tax consequences of decanting. In light of the growing popularity of decanting as a means of modifying the terms of an irrevocable trust, this is important news. Whether it is good news or bad news depends upon the content of that guidance that the IRS provides.

B. Code § 2503. Gift Tax Annual Exclusion

1. Indirect Gift to Crummey Insurance Trust by Paying Life Insurance Premiums Qualifies for Annual Exclusion. *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209 (Aug. 30, 2011)

Clyde W. Turner, Sr. established an irrevocable life insurance trust to own life insurance policies for the benefit of his children and grandchildren. Two of Clyde, Sr.'s children were named co-trustees. The trust had 12 beneficiaries, consisting of Clyde, Sr.'s then-living children and grandchildren. In 1992 and 1997, the trust bought life insurance policies. The trust provided that Clyde, Sr. and others could make contributions to the trust. Clyde, Sr. paid the premiums on the policies directly by checks to the insurer. The trust gave each beneficiary a *Crummey* power to withdraw:

> the lesser of (1) $20,000 ($10,000 if the beneficiary was not married at the time of the withdrawal), minus the total amounts previously withdrawn by that beneficiary during the same calendar year, or (2) the amount of the transfer, divided by the number of beneficiaries.

Notice was not always given to the *Crummey* powerholders, and no beneficiary ever exercised the *Crummey* power. When Clyde, Sr. died, the Service denied the annual exclusion for the direct payment of the insurance premiums.

The Tax Court (Judge Marvel) held for the estate. The court explained that availability of the annual exclusion depends upon the existence of a present interest, which turns on the beneficiary's legal ability to exercise their right to withdraw trust corpus, and the trustee's right legally to resist a beneficiary's demand for payment. Clyde, Sr. had made indirect gifts to the trust by paying life insurance premiums, and these gave the beneficiaries a right to withdraw a share of the trust assets equal to the value of the contribution. That sufficed to create a present interest. Furthermore, the court stated, the fact that "some or even all of the beneficiaries may not have known they had the right to demand withdrawals" did not prevent there being created a present interest, noting that in *Crummey*, notice had not been given. *Crummey v. Comm'r*, 397 F.2d 82, at 86-87 (9th Cir. 1968), *aff'g in part and rev'g in part* T.C. Memo. 1966-144; *Estate of Cristofani v. Comm'r*, 97 T.C. 74, at 80 (1991).

Note. See also discussion of family limited partnership issues, above.

2. Annual Exclusion for Most Gifts Not Adjusted for Inflation in 2011 or 2012; Exclusion for Gifts to Non-Citizen Spouse Increased. Rev. Proc. 2011-52 § 3.31, 2011-45 I.R.B. 701 (Nov. 7, 2011)

The gift tax annual exclusion remains $13,000 per donee for transfers made in 2012. The annual exclusion for gifts to a non-U.S. citizen spouse is raised to $139,000 for transfers made in 2012.

C. Code § 2512. Valuation of Gifts

Defined Valuation Formula Clauses Sustained by Tax Court Again. *Estate of Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. Aug. 4, 2011), *aff'g* T.C. Memo. 2009-280; *Hendrix v. Comm'r*, T.C. Memo. 2011-133 (June 15, 2011)

- ***Petter***. Anne Petter was the niece of one of the first investors in what became United Parcel Service (UPS). When her uncle died in 1982, he left Anne his stock. Anne worked with attorneys to create arrangements that would both take care of her heirs and also fund public charities. Anne did a part-gift/part sale of her interests in an LLC she created to some intentional grantor trusts. The document of sale and gift provided that the transferred units would be divided between the charities and the trusts as follows:

> Transferor * * *
>
> 1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and 1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.
>
> 1.2: The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.

Both trusts repaid their promissory notes to Anne. The charities were effectively represented by independent counsel. The transfers were appraised by a qualified appraiser and were fully disclosed with all of the documentation on Anne's federal gift tax return.

On audit, the Service raised the gift tax value of the LLC units. It also claimed that the defined value gift clause was unenforceable and violated public policy, and that no additional income tax deduction

would be allowed for the additional units of LLC interest allocated to the charities on account of the revaluation.

In the Tax Court (Judge Holmes) held for the taxpayer. The court reviewed the history of defined value gifts and sales and similar transactions, from *Comm'r v. Proctor*, 142 F.2d 824 (4th Cir. 1944), *cert. denied* 323 U.S. 756 (1944), through *Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009). The court stated succinctly that "savings clauses are void, but formula clauses are fine." The court analyzed Anne's transaction documents and concluded that what she had done was to make "gifts of an ascertainable dollar value of stock; she did not give a specific number of shares or a specific percentage interest in the [LLC]." The court rejected the Service public policy arguments, noting that:

> the facts in this case show charities sticking up for their interests, and not just passively helping a putative donor reduce her tax bill. The foundations here conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests. Perhaps the most important of these was their successful insistence on becoming substituted members in the PFLLC with the same voting rights as all the other members. By ensuring that they became substituted members, rather than mere assignees, the charities made sure that the PFLLC managers owed them fiduciary duties.

Judge Holmes also noted that there are other situations in the Code and regulations where the law expressly approves of formula clauses, such as charitable remainder trusts and the marital deduction. The court also held that the charitable deduction for the additional allocation of shares to charities was properly taken on the date of the original transfer, even though there were subsequent revaluations and reallocations.

On appeal, the Ninth Circuit (Judge Bybee) affirmed. The Service argued that the additional amounts transferred to the charities because of the revaluation were not deductible for gift tax purposes, because they were "dependent upon the performance of some act or of the happening of a precedent event in order that [the transfer] might become effective." Reg. § 25.2522(c)–3(b)(1). The Service argued that additional gifts were dependent on the revaluation of the LLC units by the Service. The Ninth Circuit disagreed, stating that a "condition precedent" is one that must occur before a transfer to a charity becomes effective. Reg. § 25.2522(c)–3(b)(1). The court stated that a defined value formula clauses does not contain a

condition precedent, because additional transfers of LLC units to the foundations were not dependent upon the occurrence of an Service audit. The additional transfers became effective immediately upon the execution of the transfer documents and delivery of the units of LLC interest. The only open question was the value of the units transferred, not the transfers themselves. The court stated that the reallocation clauses merely enforced the charities' rights to receive a pre-defined number of units: the difference between a specified number of units and the number of units worth a specified dollar amount. The court noted that either of the trusts or either of the charities could have challenged the valuation of the LLC units in the donor's appraisal, although it was unlikely that they would have done so. The court stated that the regulations deny the gift tax charitable deduction only where a transfer is itself dependent upon an event. Reg. § 25.2522(c)–3(b)(1). The Service also argued that the documents in question did not actually give the foundations the right to additional units of LLC interest, and that Section 2001(f)(2) renders the value of the LLC units reported on the decedent's gift tax return as the binding value for gift tax purposes. The court disagreed, noting that (1) the gift tax return value must be based on gift tax valuation purposes, which requires that the value of an asset "as finally determined for federal gift tax purposes" be its fair market value. Citing Reg. § 25.2512–1; (2) Section 2001(f)(2) applies only for determining the valuation of gifts as to which the statute of limitations has expired, and is irrelevant where, as here, the statute of limitations is still open; and (3) Section 2001(f)(2) states that the value is finally determined if it is determined by a court, which would mean that the foundations could redetermine the value by a state court suit to contest the accuracy of the donor's appraisal.

The court also noted that its decision was consistent with that of the Eighth Circuit in *Christiansen*, where the Service made a similar argument under the analogous estate tax charitable deduction rules. See Reg. § 20.2055–2(b)(1). The Eighth Circuit had held that a charity's right to receive 25 percent of the transferred assets above $6.35 million was certain on the date of the transfer, and that the Service had failed "to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death." *Id.* The court rejected the Service attempt to distinguish *Christiansen,* finding that: (1) although *Christiansen* involved a qualified disclaimer and Section 2518(a) expressly provides that a qualified disclaimer relates back to the time of death, the Eighth Circuit's analysis had focused on the word "transfer" in the regulations, rather than the relation back features of Section 2518(a); (2) although the Eighth Circuit relied on

the express language of Reg. § 20.2055– 2(e)(2)(vi)(a), an estate tax regulation that has no parallel in the gift tax regulations, the actual outcome of the case was based on Reg. § 20.2055–2(b)(1), which is virtually identical to that of the gift tax regulations under consideration in Petter; and (3) *Christiansen* was not wrongly decided.

The court also rejected the Service argument that a holding in favor of the taxpayer conflicts with a longstanding Supreme Court precedent that a charitable deduction is allowable only with respect to amounts that charities are assured of receiving. The court stated that, as *Christiansen* had also recognized, the Supreme Court cases on which the Service relied do not state that deductions are to be disallowed if valuations involve lengthy or disputed appraisal efforts or if the Service's actions challenging the value result in an adjustment. Citing *Humes v. United States,* 276 U.S. 487 (1928) (disallowing a deduction for a gift a charity would have received if the decedent's niece died childless before the age of 40); *Comm'r v. Estate of Sternberger,* 348 U.S. 187 (1955) (disallowing a deduction where a bequest to charity was dependent upon the testator's daughter dying without descendants). In this case, the taxpayer's gifts were not contingent upon any future event.

Finally, the court rejected the Service argument that public policy supported its interpretation of Reg. § 25.2522(c)–3(b)(1). The court explained that the regulation's text clearly did not preclude the charitable deduction at issue, and concluded that public policy cannot do so. In a footnote (footnote 7), the court noted that the Service had made its public policy argument strongly before the Tax Court, relying on *Proctor*, but that "the Service has now abandoned it because the Service explicitly disclaims pursuing this argument on appeal." Accordingly, the court did not address whether the dollar formula clauses and reallocation clauses are void as against public policy.

The court concluded:

> Contrary to the IRS's argument, the additional transfer of LLC units to the foundations was not subject to a condition precedent within the meaning of Treasury Regulation § 25.2522(c)–3(b)(1). Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula. This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant, which means that both before and after the IRS audit, the foundations were entitled to receive the same number of units. Absent the audit, the foundations

> may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive. Accordingly, we hold that Treasury Regulation § 25.2522(c)–3(b)(1) does not bar a charitable deduction equal to the value of the additional units the foundations will receive. "[W]e expressly invite [ ] the Treasury Department to 'amend its regulations' if troubled by the consequences of our resolution of th[is] case."

- ***Hendrix***. The taxpayers, John and Karolyn Hendrix, wanted to make gifts to trusts for their daughters and more remote descendants of nonvoting shares of the stock of his closely-held S corporation, John H. Hendrix Corp. The taxpayers also wanted to make certain charitable gifts and on advice of estate planning counsel, they established a donor-advised fund at the Greater Houston Community Foundation, a large public charity. The taxpayers and their attorney negotiated with the Foundation's counsel for three months to determine the precise terms of the fund and the taxpayer's gifts to the fund. The taxpayers then transferred $20,000 to establish the donor-advised fund. The taxpayers' counsel sent to the Foundation a draft of an assignment agreement and a dispute resolution and buy-sell agreement executed by the corporation and its shareholders. The draft indicated that the taxpayers would give shares of the nonvoting stock to the Foundation and would transfer (part as a gift and part as a sale) other shares of the same stock to trusts for the taxpayers' daughters. The draft indicated that a formula clause would set by a dollar amount the portion of the stock that would be transferred to the trusts, and that the remaining stock would be added to the donor-advised fund within the Foundation. After two months, the Foundation's attorney agreed to the terms. The taxpayers retained an independent professional appraiser to value the nonvoting stock, which it did, based in part on the values it had used the previous year in a corporate redemption and the company's updated accounts and tax records. The taxpayers then transferred 287,619 shares (each) of the nonvoting stock pursuant to a formula under which: (1) a portion of the assigned shares having a fair market value as of the effective date equal to $10,519,136 was assigned to trustees to be held in equal shares for the benefit of the daughters, and (2) any remaining portion of the assigned shares was assigned to the Foundation for the benefit of the donor-advised fund. The assignment agreements defined fair market value as the price at which those shares would change hands as of the effective date between a hypothetical willing buyer and a hypothet-

ical willing seller, neither under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The assignment agreements required that the trusts pay proportionally any gift taxes imposed as a result of the transfer. The assignment agreements required that the trustees sign promissory notes obligating the trustees to pay $9,090,000 to each petitioner. On the same day, a second set of assignment agreements was executed containing the same terms as the first set of assignment agreements, with each taxpayer transferring 115,622 nonvoting shares to trusts for the daughters and to the Foundation, the fair market value of the trust's portion of the stock at $4,213,710, and directing the trustees to deliver to each taxpayer a note in the amount of $3,641,233. Under both sets of assignment agreements, the taxpayers had no involvement in allocating the shares among the transferees – that was left to the transferees. The assignment agreements stated that the dispute resolution and buy-sell agreement governed any dispute among the parties and any transfer of the nonvoting stock. The dispute resolution and buy-sell agreement required that any dispute related to the fair market value between or among the corporation, the shareholders, assignees, or any party be resolved by arbitration, if it could not be resolved by agreement. On the same date as the transfers of the stock, the trustees delivered the demand promissory notes to the taxpayers, and the taxpayers executed agreements stating that the trusts and the Foundation as tenants-in-common would collectively own all of the assigned shares. The notes were secured by the trustees' shares of the nonvoting stock. The taxpayers filed gift tax returns claiming a $50,000 charitable contribution and a $1,414,581 taxable gift. The trusts were represented by the taxpayers' estate planning attorney, in negotiating the proposed confirmation agreements after the transfers of the stock. The attorney advised the trusts to seek another appraisal of the stock, rather than relying on the appraisal that the taxpayers had used. The trustees retained the same appraiser as had been used by the taxpayers, and they valued the stock at $36.66 per share on the date of the gifts and sales. The attorney sent a copy of the appraisal to the Foundation and its counsel. The Foundation's counsel advised that they obtain an independent appraisal, pursuant to their internal procedures for gifts of hard-to-value assets. They did so, and their appraiser concluded that the appraisal obtained by the trustees was reasonable and fair. The confirmation agreement was then entered into by the Foundation and the trustees based on a fair market value of $36.66-per share.

The Service agreed to a stipulation, for purposes of trial, that if the defined value formula clauses contained in the Assignment Agreements did not control the valuation of the shares of nonvoting common stock transferred by the taxpayers, then the fair market value

of the shares should be based on a per share value of $48.60 times the number of shares agreed to by each transferee in the Confirmation Agreements.

The Tax Court (Judge Paris) upheld the use of the defined value formula clauses to fix the transferred amount of the hard-to-value stock, because it found that the parties conducted themselves at arm's length. The government argued that the defined valuation clauses were invalid as contrary to public policy. The Tax Court noted that this case would be appealable to the Court of Appeals for the Fifth Circuit, and that it would, therefore, be guided by that court's holding in *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), r*ev'g* 120 T.C. 358 (2003), which had sustained the use of defined value clauses generally. That decision, however, did not preclude the court's need to consider whether the formula clauses in this case were the result of an arm's-length transaction, and whether they were contrary to public policy. The court held that the transaction in this case was an arm's length transaction. The court agreed that a court may disregard the form of a transaction in favor of its substance, if there is collusion, an understanding, a side deal, or another indicium that the transaction was not at arm's length. This requires, however, more than "mere suspicion and speculation arising from the fact that a taxpayer engaged in estate planning." *Strangi v. Comm'r*, 293 F.3d 279, 282 (5th Cir. 2002), *aff'g in part and rev'g in part* T.C. Memo. 2003-145; *Hall v. Comm'r*, 92 T.C. 312, 335 (1989). The court stated that there was, in this case, no credible evidence that the parties colluded or had side deals or that the form of the transactions otherwise differed from the substance. The government argued that the formula clauses were not an arm's length transaction because the parties (the taxpayers and their daughters and trusts) were close and lacked adverse interests. The court stated that the mere facts that taxpayers and their daughters were "close" and that the taxpayers' estate plan benefitted the daughters did not necessarily negate the existence of an arm's length transaction. *Kimbell v. United States*, 371 F.3d 257, 263 (5th Cir. 2004); *Huber v. Comm'r*, T.C. Memo. 2006-96; *Estate of Stone v. Comm'r*, T.C. Memo. 2003-309. The court found nothing to show that the clauses were not subject to negotiation or that the taxpayers and the daughters' trusts lacked adverse interests, and that the economic and business risk assumed by the daughters' trusts as buyers of the stock necessarily placed them at odds with the taxpayers and the Foundation. The court also refused to find collusion between the taxpayers and the Foundation. The taxpayers' creation of a donor-advised fund at the Foundation was consistent with their general pattern of charitable activity, because they could still request the Foundation to provide a grant to any of their usual donees. The Foundation, in turn, accepted various potential risks incident to its

receipt of petitioners' gift of the nonvoting stock, including a loss of the Foundation's tax-exempt status if it failed to exercise due diligence as to the gift. The Foundation, a manager of nearly $270 million in assets, exercised its bargaining power when its counsel insisted that petitioners pay local taxes and penalties as well as Federal and State taxes and penalties if the corporation failed to distribute sufficient income to pay those taxes. The Foundation also was represented by independent counsel and it conducted an independent appraisal through its own appraiser. Furthermore, the Foundation had a fiduciary obligation to ensure that it received the number of shares it was entitled to receive under the formula clauses. The court also rejected the contention that the formula clauses were void as contrary to public policy. The government relied on *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944), and the cases and rulings that followed it, but the court distinguished those precedents. In *Proctor*, a taxpayer assigned his interest in two trusts subject to the life estate of his mother. The trust was to make certain payments to the taxpayer. The trust agreement contained a saving clause under which, if it were ultimately determined that any part of the transfer in trust was subject to gift tax, the property subject to the tax would remain the property of the taxpayer. The Court of Appeals for the Fourth Circuit held that this saving clause was void as contrary to public policy, because the provision discouraged the collection of the tax because any attempt to collect the tax would defeat the gift, it had the effect of obstructing the administration of justice by requiring a court to pass upon a moot case, and it would reduce a Federal court's final judgment to a declaratory judgment. *Proctor* has been followed by the Tax Court in *Ward v. Comm'r*, 87 T.C. 78 (1986) (invalidating saving clause that provided for a retroactive adjustment of stock to escape any imposition of gift tax). The Tax Court stated that the present case was distinguishable from the *Procter* line of cases because the defined value formula clauses in this case imposed no condition subsequent that would defeat the transfer, and because the formula clauses further the fundamental public policy of encouraging gifts to charity. See *Estate of Christiansen v. Comm'r*, 130 T.C. 1, 16-18 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009).

Note. The *Hendrix* discussion of substance over form seems oddly inappropriate in a gift context. The court focused on the independent interests and negotiations of the parties, but in a donative transaction, there are rarely any negotiations. Also, the discussion of the need for economic and business risks seems inappropriate in a gratuitous transfer. Possibly these issues arose because the transaction was a part-sale. Nonetheless, the transaction and the defined value gift clause were both sustained.

These cases are clear judicial approval of the use of defined value gifts. *McCord, Christiansen*, *Petter*, and *Hendrix* should make practitioners quite comfortable using these clauses for blended charitable and noncharitable gifts, unless and until the Service does change its regulations, as invited in *Petter*.

Donors who are not charitable inclined may considering having the excess gifts transferred to a zero-gift GRAT. It is understood that the Service has conceded several cases in which zero-gift GRATs were used in conjunction with a defined value gift clause. This seems odd, however, because the net effect of a zero-gift GRAT is for the excess gift to return to the donor, which should fall well within the *Proctor* line of cases.

A donor who does not use a charitable donee loses the benefit of the strong policy encouraging charitable gifts. This policy was cited by the Tax Court in both *Petter* and *Hendrix*. See also Duffey & Duffey, "Valuation Formula Clauses for the Noncharitably Inclined," 38 Est. Plan. 30 (June, 2011).

Another point of interest: the taxpayers in all four of the taxpayer victories (*McCord, Christiansen*, *Petter*, and *Hendrix*) were represented by John Porter, Esquire, Baker Botts, LLP, Houston, Texas.

D. Code § 2518. Disclaimers

1. Disclaimer of Share of Residue is Qualified Because of Anti-Lapse Statute and Testator's Intent. *Estate of Tatum, Jr. v. United States,* 436 Fed.Appx. 320, 2011 WL 3444095 (5th Cir. Aug. 8, 2011), *rev'g and rem'g per curiam* 2010 WL 3942738, 106 A.F.T.R.2d 2010-6556 (S.D. Miss., 2010)

Franklin M. Tatum, Jr. (Junior) was the only surviving child of Frank M. Tatum, Sr. (Senior), and he was one of his father's executors. Senior's will left 60% of his residuary estate to Junior, and 20% to each of Junior's two children. It also stated that the share for any of these descendants who did not survive Senior would pass to the descendant's own descendants, *per stirpes*. Junior disclaimed any interest in certain stock passing under the residuary clause. The three executors submitted an order to the local probate court, which adopted it, stating that the disclaimed stock would pass to the children of Junior as if he had predeceased his father. The Service claimed that the disclaimer was not qualified under Section 2518, and assessed over $1.6 million in gift taxes, plus statutory interest.

The District Court (Judge Starrett) held that the disclaimer was not qualified, because the disclaimed property passed back to the disclaimant, rather than to his children. The court noted that applicable state law (Mississippi) determines the succession to disclaimed

property based on the decedent's intent, as shown from the wording of the will. The court noted that the Mississippi Supreme Court had stated that a widow's renunciation of a life estate was equivalent to its termination by her death, unless a contrary intent was evidenced by the will. *Rose v. Rose*, 126 Miss. 114, 88 So. 513 (Miss. 1921); *Greely v. Houston*, 148 Miss. 799, 114 So. 740 (Miss. 1927). That court had also held, however, that a lapsed residuary bequest passes by intestate succession. *Byrd v. Byrd*, 181 So. 727, 731 (Miss. 1938); *Moffett v. Howard*, 392 So.2d 509, 511 (Miss. 1981). Under state intestacy law , the disclaimed assets were transferred to Junior as the only surviving descendant.

The Fifth Circuit, in a *per curiam opinion*, reversed and remanded. The court noted that the treatment of a lapsed portion of a residual bequest as intestate property is qualified by the state's anti-lapse statute, which prevents lapse of a bequest to a predeceasing child of the testator – the bequest passes as if the legatee had survived the testator and then died intestate. Miss. Code § 91–5–7; *In re Estate of Mason*, 616 So.2d 322, 330 (Miss.1993); *Moffett v. Howard,* 392 So.2d 509, 512 (Miss.1981). Therefore, to the extent that Junior's disclaimer effectively resulted in a lapsed bequest, his disclaimed interest "passe[d] without any direction on [his] part ... to a person other than [himself]." The Fifth Circuit also noted that, even if state law did not cover the situation, the will manifested the testator's intent that disclaimed property go to the disclaimant's children.

Note. In planning a disclaimer of a share of the residuary estate, the disclaimant may avoid these problems by at the same time disclaiming also any interest passing to him or her by intestacy. Similarly, one disclaiming a specific or general gift may also want to disclaim any interest in that property that would pass under the residuary clause of the will.

2. Sweeping of Required Minimum Distribution into Disclaimant's Bank Account Does Not Preclude Qualified Disclaimer of Part of Retirement Plan Benefits. PLR 201125009 (June 24, 2011)

Decedent died survived by Spouse and three children, leaving, among other assets, an individual retirement account (IRA), and three Section 403(b) retirement accounts. All of the beneficiary designation forms named Spouse as the primary beneficiary, and stated that, if Spouse survived Decedent and disclaimed her interests in the retirement accounts, the disclaimed interests would be held by a trustee of a disclaimer trust under Decedent's will. The disclaimer trust pays all income to Spouse for life, together with discretionary distributions of principal. Spouse also has the right to withdraw five percent of the trust principal each year. Decedent was receiving required minimum

distributions (RMDs) from the retirement accounts at his death. The RMDs from all of the accounts were distributed quarterly by automatic deposit into Bank Account 1, which was held jointly in the names of Decedent and Spouse with rights of survivorship. Spouse died. Thereafter, the brokerage firms automatically deposited RMDs into Bank Account 1. Thereafter, a court appointed Daughter as Administratrix of Spouse's estate. Daughter then closed Bank Account 1 and opened Bank Account 2 for Spouse's estate, transferring the entire balance of Bank Account 1 into Bank Account 2. On a later date, the local court granted Daughter, as Administratrix, authority to disclaim Spouse's entire interest in the IRA and two of the Section 403(b) accounts, and to disclaim one of the investments in another Section 403(b) account. Daughter executed the disclaimer in proper form.

The Service stated that Daughter's disclaimer was qualified under Section 2518, despite the fact that the RMDs from the disclaimed accounts and assets had already been transferred by automatic deposit to the bank account that was owned by Spouse. The Service stated that these transfers did not constitute an acceptance of any portion of Decedent's retirement accounts, within the meaning of Reg. §§ 2518(b)(3) and 25.2518-2(d).The Service relied largely on Rev. Rul. 2005-36, 2005-1 C.B. 1368, which states that a beneficiary's receipt of RMDs from an IRA constitutes acceptance of that portion of the corpus of such account, plus the income attributable to that amount, but that it does not preclude the beneficiary from making a qualified disclaimer with respect to all or a portion of the balance of the IRA. The amount of income attributable to the RMDs for each account that is deemed accepted by Spouse and not disclaimable is calculated with respect to each account by:

$$\frac{\text{the total amount of RMDs Received from an account}}{\text{The total value of that account on the date of death}} \times \text{Total income earned on that account between the date of death and the date of disclaimer}$$

Spouse may make a qualified disclaimer of the balance of the retirement accounts if the requirements of Section 2518 have been otherwise been met.

E. Gift Tax Procedures

Federal Court Refuses to Order Release of California Property Tax Records to Catch Gift Tax Non-Filers. *In re Tax Liabilities of Does*, 2011 WL 2119091, 107 A.F.T.R.2d 2011-2318 (E.D. Cal. May 23, 2011) (slip copy); In re John Does, No. 2:10-mc-00130-MCE-EFB, 244 DTR K-3 (E.D. Cal. Dec. 15, 2011)

The Service requested a summons to order the California Board of Equalization to turn over its computer database in order to discover donors who have not reported taxable intrafamily gifts of real property between 2005 and 2010. The Board of Equalization maintains information about transfers under California Propositions 58 and 193, which exclude from reassessment property transfers between parents and children and grandparents and grandchildren. An Service representative stated that “based on information received from examinations across the country and information voluntarily disclosed by other states, the Service has determined that taxpayers who transfer real property to a related party for little or no consideration frequently fail to file Form 709 and report this transfer, despite the fact that they are required to do so by the internal revenue laws.” This, the Service asserts, provides a reasonable basis to believe that a significant portion of the California taxpayers who have transferred property to their children or grandchildren for little or no consideration have failed to report these transfers as taxable gifts.

The U.S. District Court rejected the request, stating that the government had not shown that the information was not available through other sources. The court stated that, if the government renewed its petition, it should be prepared to show that a John Doe summons can be issued on a sovereign state.

The court allowed the government to represent, and the second time the court granted the requested John Doe summons requiring California's Board of Equalization to provide information on property transfers in which the parties may not have paid the federal gift tax. The court noted that, this time, the government was able to show that the information it sought via the summons was not readily available through other sources. In its revised petition, the government pointed out that California's Board of Equalization not only is obligated to collect the needed documents, it is the only agency that will guarantee to have each and every property transaction for the time period sought, and in the format needed, ensuring accuracy and efficiency for the Service’s investigation. The court also noted that, while Section 7602(a)(2) allows IRS to summon any “person” having possession of information relating to a person who is liable for tax, it does not define “person” for this purpose. The court held that a state or agency could be a person for this purpose.

III. GENERATION-SKIPPING TRANSFER TAXES

A. Code § 2601. Effective Date Protection

1. General Power of Appointment Eliminates Effective Date Protection for Generation-Skipping Trust. *Estate of Timken v. United States*, 601 F.3d 431 (6th Cir. April 2, 2010), *aff'g* 630 F.Supp.2d 823 (N.D. Ohio, 2009), *cert. denied*, 131 S.Ct. 905, 2011 WL 55405, 79 USLW 3149, 79 USLW 3394, 79 USLW 3399 (Jan. 10, 2011)

Henry H. Timken, Jr. left a marital trust at his death in 1968, directing that the income be paid to the decedent, his widow, Louise Blyth Timken, and giving her a testamentary general power of appointment over the trust assets. In default of the exercise of the power of appointment, the trust assets would be used to pay the estate tax portion due to the inclusion of the trust in the decedent's estate, and the remaining trust assets would be divided and placed in separate trusts for the grantor's nieces and nephews and for the children of any deceased niece or nephew. Louise died in 1998 without exercising her power of appointment. Some of the nieces and nephews disclaimed their shares, and these shares were divided equally among the grantor's grandnieces and grandnephews.

The Service, relying on a 1998 version of the regulations, treated the lapse of the decedent's general power of appointment as a constructive addition to the trust, rendering the 1968 trust subject to the GST taxes. Reg. § 26.2601-1(b)(1)(v)(A) (1998). The Service assessed a $4 million GST tax deficiency. The estate paid the tax and sued for a refund.

The U.S. District Court for the Northern District of Ohio (Judge Adams) held that the 1998 effective date regulations were a valid construction of an ambiguous statute, and that the lapse of the decedent's general power of appointment was a constructive addition to the 1968 trust, so that the distributions to grandnieces and grandnephews were subject to the GST tax. The district court relied principally on *Estate of Gerson v. Comm'r*, 127 T.C. 139 (2006), *aff'd*, 507 F.3d 435 (6th Cir. 2007), *cert. denied sub nom. Kleinman v. Comm'r*, 533 U.S. 1076 (2008), where the Sixth Circuit held that the effective date provision was ambiguous when applied to a transfer resulting from the exercise of a general power of appointment under a pre-1985 irrevocable trust. The Sixth Circuit in *Gerson* held that the regulations that had been amended in 1999 were a reasonable interpretation of the statute and entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The district court agreed that the 1999 amendment to the

regulations on which the Sixth Circuit had opined in *Gerson* did not apply to the Timkin trust, but held that *Gerson* established the ambiguity of the statute and that under the 1998 regulations reached the same conclusion in a reasonable interpretation of the statute. The court also rejected an attempt to distinguish between the lapse and the exercise of a general power of appointment, finding that the *Gerson* court had held that the lapse, exercise or release of a general power of appointment should all be treated identically for GST tax purposes.

The Sixth Circuit (Judge Rogers) affirmed, holding that the statute was still ambiguous and that the 1998 regulations construed it reasonably. The court noted that Section 2601 is ambiguous because it does not state whether a transfer under a general power of appointment created as part of a trust that was irrevocable on September 25, 1985, is itself a transfer under that trust or a transfer under the power of appointment. The 1998 regulations stated, in applicable part, that:

> [W]here any portion of a trust remains in the trust after the post- September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise or lapse.

Reg. § 26.2601-1(b)(1)(v)(A) (1998). These regulations, the court stated, treat a general power of appointment the same as outright ownership, consistent with treatment of general powers of appointment in other tax code provisions. Under *Chevron*, therefore, the regulations were entitled to deference. The court rejected the decisions of the Eighth and Ninth Circuits in *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002), *rev'g* 126 F.Supp.2d 1279 (N.D. Ca. 2000), and *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999), which held that Section 2601 was unambiguous with respect to exercises of general powers of appointment. Rather, as it had done in *Gerson*, the court sided with the Second Circuit's decision in *Peterson Marital Trust v. Comm'r*, 102 T.C. 790 (1994), *aff'd* 78 F.3d 795 (2nd Cir. 1996), 78 F.3d 795 (2d Cir. 1996), which stated that the reference to "corpus added to the trust" was inherently ambiguous in the context of the lapse of a general power of appointment.

Note. The Sixth Circuit is the only court to review the regulations after their 1999 amendment, but it appears not to believe that the 1999 changes materially enhanced the regulations. The deference due to regulations under *Chevron* makes it extraordinarily difficult to overturn them, and practitioners faced with a pre-September 25, 1985 irrevocable trust that creates a general power of appointment should advise the holder of the power to consider not appointing the assets to a skip-person. Rather, the tax can be deferred by appointing the assets to a trust in which both skip-persons and nonskip-persons have beneficial interests, so that no GST tax is currently imposed.

2. Service Adds GST Tax Consequences of Decanting to No-Ruling List and Requests Comments. Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (Jan. 3, 2011); Notice 2011-101, 2011-2 I.R.B. ___ (Dec. 27, 2011)

- **Rev. Proc. 2011-3.** The Service has added to its no-ruling list the question of whether decanting that results in a change in beneficial interests causes a loss of GST-exempt status or constitutes a taxable termination or taxable distribution under Section 2612. This issue is designated one that is currently under study.

  Note. See also no-ruling position regarding the income tax and gift tax consequences of decanting, discussed below.

- **Notice 2011-101.** The Service has asked for comments from practitioners and other interested parties regarding the proper income, estate, gift, and GST tax treatment of decanting. It has asked for these comments by April 25, 2012. The specific questions regarding which it has asked for comments include:

Note. The Service is evidently preparing a formal ruling or regulations on the tax consequences of decanting. In light of the growing popularity of decanting as a means of modifying the terms of an irrevocable trust, this is important news. Whether it is good news or bad news depends upon the content of that guidance that the IRS provides.

3. Early Partial Distribution to Remainder Beneficiaries Does Not Void GST Effective Date Protection. PLR 201122007 (June 3, 2011)

Grantor created a trust that was irrevocable on September 25, 1985, for the lifetime benefit of Taxpayer and then for distribution to Taxpayer's three issue, *per stirpes*. The trust directs that income will be

accumulated unless the trustee determined, in the trustee's absolute discretion, that some or all of the income should be distributed to Taxpayer. Taxpayer also has a limited testamentary power of appointment. The trust instrument also states that the trustee may, in the trustee's discretion, distribute principal for the income beneficiary's health, support or maintenance. Taxpayer and the Co-Trustee provided affidavits showing that (1) Taxpayer's income and resources are sufficient to maintain her current standard of living for the remainder of her lifetime and any foreseeable emergencies; (2) Taxpayer's financial condition prevents her from receiving any income or principal from the trust pursuant to the terms of the trust; (3) Taxpayer has received no distributions from the trust in the past and does not anticipate any in the future; (4) distributions may be made to Taxpayer only in the case of emergency; and (5) from one year before Co-Trustee took office, no distributions had been made to Taxpayer. Taxpayer, the remainder beneficiaries, and Co-Trustee sought State court approval for an early distribution of a portion of the trust principal to the remainder beneficiaries (Taxpayer's children). The remainder of the principal will remain in Trust until Taxpayer's death under the terms of Trust, which will benefit Taxpayer in the event of an emergency and benefit the remainder beneficiaries as provided in Trust.

The Service ruled that Taxpayer will recognize no gain as a result of the early distribution of the trust principal to the remainder beneficiaries, the trust will retain its GST exemption under the effective date rules, and Taxpayer will be deemed to have made a gift as a result to the early distribution of a portion of the trust principal to the remainder beneficiaries. The distribution of trust assets would not result in a taxable disposition of Taxpayer's interest in the trust because it was a gift without reciprocal consideration, and therefore, not a realization event. Also, the Service noted, there was no accession of wealth to Taxpayer or the trust. The Service also stated that the distribution did not interfere with the effective date protection afforded the trust under section 1433(b)(2)(A) of the Tax Reform Act of 1986 and Reg. § 26.2601-1(b)(1)(I). The distribution is a "trustee action" and the court approval a "judicial reformation" that will not void the effective date protection, if it does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification, and that does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. The Service concluded that a state court order approving the early distribution of a portion of the trust principal to the remainder beneficiaries, will not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation than Taxpayer or the current remainder beneficiaries, nor will it extend the time for vesting

of any beneficial interest in the trust beyond the period provided for in the original instrument. Finally, the Service stated that there was a taxable gift by Taxpayer to the remainder beneficiaries. The Service noted that Taxpayer had an income interest entitling her to distributions of income in the case of emergency and at the discretion of the trustee, and that while the value of that interest may be nominal, the value of a gift does not affect whether or not a gift is deemed to occur. The Service would not rule on the value of the gift.

B. Code §§ 2631, 2632. The GST Exemption

1. GST Exemption Adjusted for Inflation. Rev. Proc. 2011-52 § 3.29, 2011-45 I.R.B. 701 (Nov. 7, 2011)

The IRS has adjusted the basic exclusion amount to $5,120,000 for 2012, which also raises the GST exemption to this level.

2. Service Provides a Particularly Good Illustration of the Operation of Both the Automatic and Individual Allocation Rules. PLR 201115005 (April 15, 2011)

Taxpayer 1 formed Trust, which directs distribution of income and corpus during Son's lifetime, for the health, support, maintenance, and education of Son, Son's wife, and Son's then living issue. After the youngest of Son's then living children reaches age 22 and certain payments are made to Son's issue, Son has an *inter vivos* limited power to appoint the trust corpus among Taxpayer 1's issue and their spouses. On Son's death, the unappointed trust funds are divided *per stirpes* among Son's issue, to be held shares are to be held as separate trusts until each beneficiary reaches 35 years of age. A beneficiary who dies before reaching 35 years of age has a testamentary limited power to appoint trust corpus among Taxpayer 1's issue. The trust gives Son and each of his then-living issue a Crummey withdrawal right as to additions to the trust. A person transferring assets to Trust may modify the withdrawal rights as to that gift. In Year 1, Taxpayers 1 and 2 each transferred $V and later $W to the trust. Son and his three children did not exercise their withdrawal rights over these transfers. Tax professionals hired by Taxpayers 1 and 2 prepared and timely filed gift tax returns, but no GST exemption was allocated to the portion of the taxpayers' transfers represented by Son's $Y withdrawal right. Also, the returns did not report part of the transfers and did not allocate GST exemption to the unreported portions. With respect to the taxpayers' transfers represented by the withdrawal rights of Son's children, the returns reflected: (1) an

election under § 2632(c)(5)(A)(i)(II) to have the automatic allocation rules not apply to these transfers; (2) an allocation of their respective GST exemption equal to the amount of these transfers; and (3) a formula allocation of their respective GST exemption in an amount necessary to produce an inclusion ratio which was closest to or equal to zero.

The Service ruled that Taxpayers 1 and 2 automatically allocated their respective GST exemption to the portion of their transfers represented by Son's $Y withdrawal right as well as their transfers of that they did not report on their gift tax returns; and (2) that their respective GST exemption was timely allocated to the portion of their transfers represented by the withdrawal rights of Son's children. The Service stated that the transfers Taxpayers 1 and 2 made to trust were indirect skips, under Section 2632(c)(3)(A) and Reg. § 26.2632 -1(b)(2)(i), so the GST exemption of Taxpayers 1 and 2 was automatically allocated to the portion of their transfers represented by Son's withdrawal right, effective as of the dates of transfer, and the unreported transfers, effective as of the dates of transfers, pursuant to Reg. § 26.2632-1(b)(2)(i) (providing that the automatic allocation is effective whether or not a Form 709 is filed reporting the transfer, and is effective as of the date of the transfer to which it relates). With respect to the portion of the taxpayers' transfers represented by the withdrawal rights of Son's children, Taxpayers 1 and 2 elected to have the Section 2632(c)(1) automatic allocation rules not apply to these transfers on their respective gift tax returns. Taxpayers, however, timely allocated their GST exemption to these transfers on their gift tax returns in an amount equal to the amount of these transfers and by a formula designed to allocate as much GST exemption to these transfers as was necessary to produce an inclusion ratio which was closest to or equal to zero. These timely allocations were effective as of the dates of transfer pursuant to Reg. § 26.2632-1(b)(4)(ii)(A)(1).

C. Code § 2642. Inclusion Ratio

President's 2012 Budget Proposals Include 90-Year Limit on GST Inclusion Ratio. Dept. of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" pp. 129-130 (Feb. 14, 2011)

The President's 2012 budget proposals would provide that the allocation of GST exemption to a transfer protects that transfer from GST tax for no more than 90 years. The Treasury explanation states that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would

terminate and the inclusion ratio would move to one. Contributions to a trust from different grantors are already deemed to be held in a separate trusts under Section 2654(b), so each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under Section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts will be deemed to have the same creation date as the initial trust, with one exception. If trust property is distributed to a trust for a beneficiary of the initial trust during the initial 90-year period, and the distributee trust is as described in Section 2642(c)(2), the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary's death will be included in the beneficiary's gross estate for Federal estate tax purposes. The other rules of Section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision. This proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).

D. Code §§ 6111 - 6112. Listed Transactions and Transactions of Interest

Final Regulations Issued on GST Tax Listed Transactions and Transactions of Interest. T.D. 9556, 76 Fed. Reg. 70340 (Nov. 14, 2011)

Treasury issued final regulations that require taxpayers to disclose transactions involving generation-skipping transfer taxes, if those transactions have been identified by the IRS as listed transactions or transactions of interest under Section 6111.

- **30-Day Period.** Once a GST tax transaction is added to the list of reportable transactions, the material adviser has 30 calendar days to prepare the list of advisees. Reg. § 301.6112-1(b)(1).

- **Separate Lists.** A separate list must be prepared and maintained for each reportable transaction, with one list maintained for substantially similar transactions.

- **Designation Agreements.** A single material adviser can be designated to maintain the list by written agreement, where more than one material adviser would otherwise be required to maintain a list of people in relation to a reportable transaction. The existence of a designation agreement, however, does not affect Service's power to request a list from any party to the agreement. Reg. § § 301.6112-1(f).

- **Fiduciaries as Material Advisers.** Fiduciaries are not treated as material advisers merely because they are an executor or trustee of an estate or trust that is incidental to a listed transaction or transaction of interest. A fiduciary is a material adviser to a tax shelter only if the fiduciary provides material aid, assistance, or advice. An executor or fiduciary must directly or indirectly derive gross income in excess of the threshold amount allowed under the Treasury rules, and the transaction would have to be entered into by the taxpayer, in order for the fiduciary to be a material adviser. 76 Fed. Reg. at 70340.

Note. The adoption of these rules does not necessarily mean that the Treasury or the Service have any plans to identify any generation-skipping transfer tax arrangement as a listed transaction – at this time.

IV. CHAPTER 14. SPECIAL VALUATION RULES

Code § 2702. Trusts with Reserved Interests

1. **Treasury 2011 Budget Proposal and Several 2010 Bills Would Require 10-Year Term for GRATs and Eliminate Zero-Gift GRATs. Dept. of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" p. 128 (Feb. 14, 2011); S.1286, 112th Cong., 1st Sess. (June 28, 2011).**

   The Treasury's explanation of the Administration's Fiscal Year 2011 budget includes proposals to limit seriously the utility of GRATs. This proposal is included in the Ways and Means version of H.R. 4849, the Small Business and Infrastructure Jobs Tax Act of 2010, which passed the House of Representatives on March 24, 2010, but obtained little support in the Senate; H.R. 5486, which passed the House of Representatives on June 15, 2010; H.R. 5297, which passed the House of Representatives on June 17, 2010; H.R. 4899, which passed the House of Representatives on July 1, 2010; and S.1286, which was introduced in the Senate on June 28, 2011 and referred to the Senate Finance Committee. This change in the law is estimated by the Staff of the Joint Committee on Taxation to raise $5.297 billion

over 10 years. The bills and proposals would make three major changes in the rules on GRATs.

- **Minimum 10-Year Term.** The proposals would eliminate the use of short-term GRATs by requiring that all GRATs last for at least 10 years, thus tending to limit the use of GRATs to taxpayers who are either under 75 years of age and in average health, or above 75 years of age and in extraordinarily good health, so that the taxpayer has a life expectancy in excess of 10 years. Older taxpayers would likely forego the use of GRATs in favor of installment sales to an intentional grantor trust, as a means of shifting a significant portion of the growth in the value of the transferred assets to selected donees.

- **Eliminate Zero Gift GRATs.** The proposals would require that all GRATs have some minimum remainder interest. The proposals do not state how much of a taxable gift would be required, and it may be just that the Treasury wants the GRAT creator to file a gift tax return that can be audited.

- **Eliminate Decreasing GRATs.** The proposals would preclude the use of GRATs with decreasing annuity payments. This is necessary to protect the required minimum term, but it also eliminates a good planning technique by which GRATs made very large payments in the first year and smaller payments in the second year, setting the stage for a more aggressive rolling schedule.

- **Effective Date.** This proposals would apply to transfers after the date of enactment.

Note. See also H.R. 4849 § 407, 111th Cong., 2d Sess. (Passed House of Representatives, March 24, 2010); H.R. 4899, 111th Cong., 2nd Sess. (Passed House of Representatives July 1, 2010) H.R. 5486, 111th Cong., 2nd Sess. (Passed House of Representatives June 15, 2010); H.R. 5297, 111th Cong., 2nd Sess. (Passed House of Representatives June 17, 2010).

2. **Return QPRT Continues to be Sustained. PLRs 201144001 (Nov. 4, 2011); 201131006 (Aug. 5, 2011), 201129017 (July 22, 2011) and 201118014 (May 6, 2011)**

- **PLR 201144026.** Settlor deeded his interest in Residence to a QPRT in which Settlor retains the residential use for X years. After X years, if Settlor is still living, Settlor's retained interest

will expire and Trust will continue for the benefit of Settlor's issue. On Settlor's death, Trust will terminate and be distributed *per stirpes* to Settlor's issue. Settlor is the sole trustee. Settlor is unmarried and has four children, all of whom are adults. On Date 2, Settlor, as trustee, with the joinder and consent of the four children, executed Modification, providing that after the retained use period, Settlor's children are granted the power to appoint an equal share of the trust corpus to themselves, or by unanimous agreement, to amend and restate Trust so as to provide a term interest to Settlor, Settlor's spouse, or both, as a gift by Settlor's children. The children exercised this power to grant Settlor a Y-year term interest to use Residence, renewable with the consent of the remainder beneficiaries.

The Service stated that Section 2702(a)(1) and 2702(a)(2) will not apply to the modification and amendment and restatement of Trust, as long as they transfer a term interest in Residence to Settlor in a form substantially similar to the sample form in Rev. Proc. 2003-42, 2003-2 C.B. 993, and if Residence qualifies as a personal residence under the QPRT regulations. Executing the amendment and restatement as well as any extensions, the children will be transferring a term interest in Residence to Settlor by gift, and that the gift tax value will be the actuarial value of the term interest in Residence transferred to Settlor.

- **PLRs 201131006 and 201129017.** Settlor assigned her interest in Residence to a QPRT, retaining a right to use the residence for X years. At the end of that term, the trust assets will be held in trust for descendants, until the death of the later to die of Settlor and Settlor's spouse, when the assets will be distributed to Settlor's descendants, *per stirpes*. Settlor has four children. Settlor, as trustee, together with the four children executed Modification to the trust, which grants each of Settlor's children the power to appoint an equal share of the corpus of the trust to themselves, at the end of Settlor's reserved use term. Modification also states that, by unanimous agreement, the four daughters may modify Trust to give Settlor the right to use Residence for an additional term of years. The children propose to exercise their power and restate Trust to grant Settlor the right to use Residence for Y years, after the expiration of the initial reserved use term. This right is renewable at the accord of Settlor.

  The Service ruled that the granting of the term interest and the modification of the trust would create a valid QPRT for

Settlor, if it complies with the requirements of the regs and has terms substantially similar to those in Rev. Proc. 2003-42, 2003-2 C.B. 993. Therefore, the value of the children's gift to Settlor determined under the traditional gift tax valuation rules, rather than under Sections 2702(a)(1) and 2702(a)(2). The value of that gift would be the actuarial value of Settlor's income interest in the trust. The Service declined to opine on the treatment of the trust under Section 2036(a).

- **PLR 201118014.** Mother transferred Residence to a QPRT, reserving the use of residence for y years, with a contingent use interest to Spouse, if Mother dies during the reserved use term. If Mother dies during the reserved use term and Spouse is not then-living, the remainder passes to Mother's issue. If Mother is still living when the reserved use term ends, the trust is to continue for the benefit of Mother's issue, until Mother's death or, if later, the death of Spouse. Mother was the trustee. Mother has one child, Daughter, and she is currently married to Spouse. Mother, Daughter and Spouse together executed Modification to the trust, providing that after the reserved use term, each of Mother's then living children is granted the power to appoint an equal share of the trust fund to themselves, or by unanimous agreement, they may direct the trustee to amend and restate the terms of trust to give a term interest to Mother, Spouse, or both, as a gift from the children. interest to Mother, Spouse, or both, as a gift by Mother's children. Daughter proposes now to exercise her power to grant Mother a term interest entitling Mother to occupy the residence for z years, after which the trust assets revert to Daughter. If Mother dies during this term interest, and if Spouse is then living, Spouse receives the balance of the term interest.

  The Service stated that the transfer by Daughter to Mother would be a gift of a term interest in real estate, the value of which will be determined under the traditional gift tax valuation rules, rather than under Sections 2702(a)(1) and 2702(a)(2). The trust, after the exercise of Daughter's power of appointment, will be a QPRT, if it complies with the requirements of the regs and has terms substantially similar to those in Rev. Proc. 2003-42, 2003-2 C.B. 993. The Service declined to opine on the treatment of the trust under Section 2036(a).

Note. See also similar rulings in PLRs 201019012 (March 14, 2010), 201019007 (March 14, 2010), 201019006 (March 14, 2010), 201014004 (April 9, 2010), 201006012 (Feb. 12, 2010), 200935004

(Aug. 28, 2009); 200901019 (Jan. 2, 2009); 200848003 (Nov. 28, 2008), 200848007 (Nov. 28, 2008), 200848008 (Nov. 28, 2008).

This is an alternative approach to having the initial QPRT continue and having the trustee lease the residence to the original donor for a fair market rent. This type of leaseback generally permits the original donor to continue residing in the residence, in exchange for the payment of a market rent, and should not result in the inclusion of the residence in the donor's gross estate. See *Barlow v. Comm'r,* 55 T.C. 666 (1971); also PLRs 200822011 (May 30, 2008); 200825004 (June 20, 2008); and 199931028 (Aug. 9, 1999). The most favorable attributes of the return QPRT are that, during times of very low interest rates, the gift is relatively small, and that it prevents the creation of a landlord/tenant relationship between child and parent or grandchild and grandparent. Such relationships are distasteful to certain clients, and avoiding it may outweigh several disadvantages, in the minds of certain clients.

The first disadvantage of the return QPRT is its uncertainty. The initial QPRTs in these rulings shared the fact that the remainder was to be distributed outright to the designated beneficiaries at the termination of the reserved use period. The beneficiary then could decide whether or not to give the use of the residence back to the original donor. This is important, because any requirement that the original donees retransfer the use of the residence to the donor, whether in the governing instrument or a collateral oral or written agreement, will cause the original donor to be deemed to have reserved the use of the residence for a term not ending before his or her lifetime. In turn, this would cause the residence to be included in the donor's gross estate. The gift-back to the donor must be an separate and independent act.

The second disadvantage of this arrangement is that the Service is likely to scrutinize the transaction carefully to assure that there is no express or implied agreement to retransfer the use of the residence to the original donor. The courts have stated that a donor will be deemed to have reserved the use of the transferred property for life or a period that does not end during his or her lifetime, whether the agreement is a legally enforceable written contract or an unenforceable understanding predicated upon an undocumented conversation.

The courts do, however, require more than just the actual continued use by the donor, though when the residence is owned by family members other than the donor's spouse, the actual residence by the donor is strong evidence of such an agreement or understanding. In order to minimize the risk that the entire residence will be included in the deceased donor's gross estate under Section 2036(a), the trust should distribute title to the beneficiaries at the end of the

initial residence period. The beneficiaries should then enter into a co-ownership agreement regarding the maintenance of the residence, and should maintain it and pay for all taxes, repairs, and other expenses (or rent it to someone other than the donor and have the tenant pay such items), for a reasonable period.

After a reasonable period of such rental or holding, the original beneficiaries can meet with counsel to discuss a gift back to the original donor. They should have their own attorney, rather than using the donor's attorney, and they should discuss and consider the gift tax and estate planning consequences of this arrangement. The beneficiaries can then execute a new QPRT transferring a lifetime residential interest to the original donor.

There is no bright line test to determine how long a period is sufficient to render the gift back to the donor an independent transaction. In a different but analogous context, the Tax Court has stated that the step transaction doctrine will not be applied to the creation and funding of a partnership and gifts of partnership interests, to treat the entire transaction as a direct gift of interests in the underlying partnership assets, if the time between the first step (formation and funding) and the second step (gifts of partnership interests) is sufficient that, considering the nature of the assets in question, the donor held a genuine risk of economic gain or loss during this period. See *Holman, Jr. v. Comm'r*, 130 T.C. 170 (2008), *aff'd on other grounds*, 601 F.3d 763 (8th Cir. April 7, 2010); *Gross v. Comm'r*, T.C. Memo. 2008-221; and *Estate of Mirowski v. Comm'r*, T.C. Memo. 2008-74. The more volatile the underlying assets, the shorter the period might be. When the assets were publicly-traded shares in a technology corporation, the Tax Court found that six days was a sufficient time to render the steps independent.

It is impossible to determine the economic volatility of a personal residence. Certainly, waiting for a year until a new property tax or other appraisal confirmed that the property had materially changed in value would be sufficient. In a market when interest rates are rising or falling quickly, a much shorter term might suffice. The safest approach is to obtain an appraisal of the value of the property when the initial term of the QPRT ends, and then to obtain update appraisals periodically, and to consider the gift back after there has been a ten percent (or other agreed percentage) change in the value of the residence.

Third, the gift back to the original donor is a taxable gift for gift tax purposes. The original beneficiaries must pay gift tax or utilize their $1 million lifetime gift tax exclusions for at least the present value of the lifetime interest given to the original donor, and possibly for the remainder interest, too. Currently, however, when interest rates are very low, the amount of this gift is likely to be quite small.

Therefore, the return QPRT is an option for providing the donor of a QPRT a right to stay in the residence for the rest of his or her lifetime after the expiration of the initial reserved use term. It may be inferior to a leaseback of the property to the donor for a fair market rental, but it does prevent a parent or grandparent from finding themselves a tenant of their child or grandchild.

See also discussion of return QPRTs in Aucutt & Zaritsky, *Structuring Estate Freezes* ¶ 10.05[8][f] (RIA/WG&L 2d ed.); Handler, Forgianni & Ring, "Tax Law Update: IRC Section 2701(a) Does Not Apply to Reverse Qualified Personal Residence Trusts,"148 Tr. & Est. 10 (Feb. 2009); and Handler, "Tax Law Update: Another Reverse QPRT Approved," 148 Tr. & Est. 9 (Aug. 2009).

V. INCOME TAXES

A. Code § 1. Income Tax Rates

Income Tax Rates Adjusted for Inflation. Rev. Proc. 2011-12 § 2.01, 2010-2 I.R.B. 297 (Jan. 10, 2011), Rev. Proc. 2011-52 § 3.01, 2011-45 I.R.B. 701 (Nov. 7, 2011)

The 2011 income tax rates for trusts and estates are:

Income	Rate
Not over $2,300	15%
Over $2,300 but not over $5,450	$345 + 25% on excess over $2,300
Over $5,350 but not over $8,300	$1,132.50 + 28% on excess over $5,450
Over $8,300 but not over $11,350	$1,930.50 + 33% on excess over $8,300
Over $11,350	$2,937 plus 35% on excess over $11,350

The 2012 income tax rates for trusts and estates are:

Income	Rate
Not over $2,400	15%
Over $2,400 but not over $5,600	$360 + 25% on excess over $2,400
Over $5,600 but not over $8,500	$1,160 + 28% on excess over $5,600

Over $8,500 but not over $11,650	$1,972 + 33% on excess over $8,500
Over $11,650	$3,011.50 plus 35% on excess over $11,650

Code § 1(e). Also, the kiddie tax applies to income over the $950 standard deduction for a dependent under Code § 63(c)(5)), and a parent may elect to include in gross income up to $9,500 of a child's income. Code § 1(g)(4)(A).

B. Code § 61. Gross Income

When a Loan is Not a Loan. *Todd v. Comm'r*, T.C. Memo. 2011-123 (June 6, 2011)

Frederick Todd was a practicing neurosurgeon employed by his own wholly-owned corporation. The corporation signed an agreement permitting the American Workers Master Contract Group (AWMCG) to represent it in negotiations with the National Production Workers Union Local 707 (Local 707), which represented the corporation's employees. The corporation agreed to provide eligible employees with a death benefit only (DBO) plan organized through the American Workers Benefit Fund (AWBF), a welfare benefit fund established between AWMCG and Local 707. Under the plan, AWBF provided the covered employee's beneficiary a death benefit equal to eight times the employee's annual income, up to a maximum $6 million death benefit. Death benefits would be paid unless the employee's employment with the corporation was terminated, the corporation ceased making contributions, or if the master contract between the union and the master contract group was not renewed. The taxpayer enrolled in the plan and named his wife as beneficiary of a $6 million death benefit. The fund bought a $6 million universal life insurance policy on the taxpayer's life, with an annual premium of $100,000. The corporation made yearly contributions to AWBF on behalf of petitioner and the other covered employees. The plan trust agreement gave the trustees discretionary authority to lend up to the present value of the death benefit to a plan participant, on an application and written evidence of an emergency or serious financial hardship. The taxpayer requested a $400,000 loan (the maximum amount that could be lent). The trustees considered borrowing against the policy cash value, but decided instead to make a partial surrender of the policy, withdrawing $400,000. The trustees issued a $400,000 check to the taxpayer, but they did not obtain a signed promissory note for six months, and that loan was at a one percent interest rate. The note also provided that, absent the required quarterly payments, the lender could deduct the outstanding loan balance from any

payment or distribution due from the trust to the participant or his beneficiary. The taxpayer quit making payments on the note, relying on the alternate payment provision that would allow the trustees to be repaid from the death benefit. The Service treated the $400,000 as taxable income, and assessed a deficiency and a late payment penalty and accuracy-related penalty.

The Tax Court (Judge Haines) held that the trustee's payment to the taxpayer was includible in gross income under the general definition in Section 61(a), and was not the actual extension of a loan. The court stated that whether a transaction constitutes a loan for income tax purposes is a factual question involving several considerations, and that the distinguishing characteristic of a loan is the intention of the parties that the money advanced be repaid. *Moore v. United States*, 412 F.2d 974, 978 (5th Cir. 1969). The court looked at seven factors, finding that: (1) A note or other instrument is indicative of a debtor-creditor relationship, but little weight is given to an instrument that does not comport with the substance of the transaction. *Teymourian v. Comm'r*, T.C. Memo. 2005-232; *Provost v. Comm'r*, T.C. Memo. 2000-177. Here, the taxpayer signed a note, but only six months after receiving the money, and neither party to the note adhered to its terms, including the failure of the taxpayer to make the required quarterly payments or the lender to charge reasonable interest and to attempt to collect on the debt upon default; (2) The payment of interest indicates the existence of a *bona fide* debt. *Welch v. Comm'r*, 204 F.3d 1228, 1230 (9th Cir. 2000), *aff'g*. T.C. Memo. 1998-121; *Teymourian v. Comm'r*, *supra*; *Morrison v. Comm'r*, T.C. Memo. 2005-53. Here, the trust agreement provided that a reasonable rate of interest should be charged, but the rate charged was well under that the trustees would pay the insurer to borrow against the policy, suggesting that there was no real debtor-creditor relationship; (3) A fixed schedule for repayment indicates a *bona fide* loan. *Welch v. Comm'r*, *supra* at 1231; *Teymourian v. Comm'r*, *supra*. Here, the taxpayer made no payments to the trustees and the trustees did not attempt to collect the amount owed after each default, indicating that there was no debtor-creditor relationship; (4) Adequate security evidences a *bona fide* debt, and while the insured did not own the policy and had no access to the cash values, he did effectively pledge the death benefits as security, suggesting that there was a bona fide debtor-creditor relationship; (5) Repayment indicates a *bona fide* loan. *Haber v. Comm'r*, 52 T.C. 255, 266 (1969), *aff'd*. 422 F.2d 198 (5th Cir. 1970). Here, however, the taxpayer signed a promissory note obligating him to make quarterly payments, but he had made none, by the start of the trial, suggesting that no *bona fide* debt existed. The provision for repayment out of the death benefits did not replace the actual payments, because there were several conditions that had to be met (including continued employment) before the death benefits would belong to the taxpayer's beneficiary. *Midkiff v. Comm'r*, 96 T.C. 724, 734-735 (1991) ("Indebtedness is 'an existing, unconditional, and legally enforceable obligation for the payment of a principal sum.'", *aff'd sub nom. Noguchi v. Comm'r*, 992 F.2d 226 (9th Cir.

1993); (6) A reasonable expectation of repayment in light of the economic realities of the situation suggests a *bona fide* debt. *Fisher v. Comm'r*, 54 T.C. 905, 909-910 (1970); *Welch v. Comm'r*, 204 F.3d at 1231. Here, the taxpayer earned a substantial living as a neurosurgeon, and there was a reasonable prospect of petitioner's repaying the purported loan; and (7) The conduct of the parties may be sufficient to indicate the existence of a debtor-creditor relationship. *Baird v. Comm'r*, 25 T.C. 387, 395 (1955); *Teymourian v. Comm'r*, T.C. Memo. 2005-232; *Morrison v. Comm'r*, T.C. Memo. 2005-53. Here, the parties did not conduct themselves in such a manner: the taxpayer failed to provide any written evidence of the hardship needed to obtain the loan and the trustees required no such evidence; the interest rate charged was well below market; the taxpayer failed to make any quarterly payments; the trustees never tried to collect on the defaulted loan; the note was not executed for almost six months after the funds were advanced; and the corporation quit making contributions to the trust to fund the taxpayer's death benefit shortly after he received the $400,000 distribution. All in all, the court held that the distribution of $400,000 did not constitute a bona fide loan, and that the distribution was taxable income. The court also sustained both late filing and an accuracy-related penalty.

C. Code § 67. Two-Percent Floor on Miscellaneous Itemized Deductions

1. Treasury Issues New Proposed Regulations on Deductibility of Trust Expenses for Investment Advice and Other Miscellaneous Itemized deductions. Prop. Reg. § 1.67-4, REG-1288224-06, 76 Fed. Reg. 55322-01 (Sept. 7, 2011)

The Service withdrew its outstanding 2007 proposed regulations (72 Fed. Reg. 41243 (July 27, 2007)) regarding which costs incurred by estates and nongrantor trusts are subject to the two-percent floor for miscellaneous itemized deductions under Section 67(a), and issued new proposed regulations. The new proposed regulations are designed to comply with the decision of the Supreme Court in *Knight, Trustee v. Comm'r*, 552 U.S. 181 (2008), which held that fees paid to an investment advisor by a non-grantor trust or estate are generally subject to the two-percent floor for miscellaneous itemized deductions under section 67(a). The Supreme Court stated that the proper reading of the language in Section 67(e), which asks whether the expense "would not have been incurred if the property were not held in such trust or estate," requires an inquiry into whether a hypothetical individual who held the same property outside of a trust "customarily" or "commonly" would incur such expenses. Expenses that are "customarily" or "commonly" incurred by individuals are subject to the 2-percent floor. The court noted that investment advisory fees are not

uncommonly incurred by individual investors and, thus, are subject to the two-percent floor. The Court noted, however, that it is conceivable "that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper" and that in such cases, the incremental expenses beyond those normally incurred by an ordinary taxpayer would not be subject to the two-percent floor. The proposed regulations provide guidance relating to the limited portion of the cost of investment advice that is not subject to the two-percent floor.

- In analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, the type of product or service rendered, rather than the cost, is determinative. Costs that are incurred commonly or customarily by individuals also include expenses that do not depend upon the identity of the payor (in particular, whether the payor is an individual or instead is an estate or trust), such as costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust. Prop. Reg. § 1.67-4(b)(1).

- Ownership costs are subject to the two-percent floor. Ownership costs are those costs incurred by an owner of property simply by reason of being the owner of the property, such as condominium fees, real estate taxes, insurance premiums, maintenance and lawn services, automobile registration and insurance costs, and partnership costs deemed to be passed through to and reportable by a partner. Prop. Reg. § 1.67 -4(b)(2).

- Costs of preparing estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the two-percent floor. Prop. Reg. § 1.67-4(b)(3).

- Costs of preparing other individual income tax returns, gift tax returns, and tax returns for a sole proprietorship or a retirement plan, for example, are subject to the two-percent floor. Prop. Reg. § 1.67-4(b)(3).

- Any investment advisory fees that exceed those usually charged to an individual investor, because of an unusual investment objective or a specialized balancing of the interests

of various parties such that a reasonable comparison with individual investors would be improper, are not subject to the two-percent floor. Investment costs that do not exceed the costs charged to an individual investor are subject to the two-percent floor. Prop. Reg. § 1.67-4(a).

- The portion of a bundled fee attributable to investment advice (including any related services that would be provided to any individual investor as part of the investment advisory fee) is subject to the two-percent floor. Prop. Reg. § 1.67- 4(c)(1).

- Except for the portion of a bundled fee so allocated to investment advice, a fiduciary fee not computed on an hourly basis is fully deductible with certain exceptions. The exceptions are (1) payments made to third parties out of the bundled fee that would have been subject to the two-percent floor if they had been paid directly by the non-grantor trust or estate; and (2) payments for expenses separately assessed (in addition to the usual or basic fiduciary fee or commission) by the fiduciary or other service provider that are commonly or customarily incurred by an individual owner of such property. For example, an additional fee charged by the fiduciary for managing rental real estate owned by the non-grantor trust or estate would be subject to the two-percent floor. Prop. Reg. § 1.67-4(c)(2).

- The fiduciary and/or return preparer may use any reasonable method to make these allocations, but the amount of any payment out of the fiduciary's fee or commission to a third party for expenses subject to the two-percent floor, and each separately assessed expense that is commonly or customarily incurred by an individual owner of such property, must be separately stated, without regard to the "reasonable method" standard. Prop. Reg. § 1.67-4(c)(3).

- Taxpayers will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the two-percent floor for taxable years beginning before the date that these regulations are published as final regulations in the Federal Register. Prop. Reg. § 1.67-4(d).

2. Unbundling of Trustee's Fees Not Required Until Final Regs. Notice 2011-37, 2011-20 I.R.B. 785 (April 14, 2011)

The Service extended until the issuance of final regulations, its earlier decisions that trustees will not be required to unbundle their fees to

identify those items, such as investment advice, that are subject to the two percent floor on excess itemized deductions under Section 67(a). See also Notice 2008-32, 2008-14 I.R.B. 593 (March 17, 2008) (adopting this rule for taxable years beginning before January 1, 2008), Notice 2008-116, 2008-52 I.R.B. 1372 (Dec. 29, 2008) (extending this rule for taxable years beginning before January 1, 2009); and Notice 2010-32, 2010-16 I.R.B. 594 (April 19, 2010) (extending this rule for taxable years beginning before January 1, 2010). The Service reiterated its intention to issue final regulations consistent with the Supreme Court's holding in *Knight v. United States*, 552 U.S. 181 (2008), *aff'g, Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149 (2nd Cir. 2006), *rehearing en banc denied* (2007). The final regulations will address what the Treasury deems to be the proper treatment of unbundled fiduciary fees that cover both items that are and are not subject to the two percent floor. For taxable years beginning before the issuance of final regulations, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to the two percent floor. The two percent floor does apply to expenses that are "readily identifiable", however, and these expenses must be treated separately from the otherwise bundled fee.

D. Code § 72. Life Insurance Policies and Annuities

1. Taxpayer Incurs Income on Termination of Encumbered Policy. *McGowen v. Comm'r*, 2011 WL 3873815, 108 A.F.T.R.2d 2011-6063 (10th Cir. Sept. 2, 2011) (slip copy), *aff'g* T.C. Memo. 2009-285; *Brown v. Comm'r*, T.C. Memo. 2011-83 (April 12, 2011); *Sanders v. Comm'r*, T.C. Memo. 2010-279 (Dec. 20, 2010); *Ledger v. Comm'r*, T.C. Memo. 2011-183 (Aug. 2, 2011)

- ***McGowen***. Carolyn McGowen bought a single-premium variable life insurance policy on her own life for $500,000. The policy provided a death benefit equal to the investments made by the insurer, plus a guaranteed amount, minus the policy debts incurred. Carolyn could cancel the policy and receive its net cash (surrender) value at any time. The net cash surrender value was the cash value, less any policy debt. The policy permitted Carolyn to borrow money at a 5.25 percent annual interest rate. The policy stated that any amount borrowed would cause a withdrawal of that amount from the investments and an allocation of that fund to a separate general account, where it would earn a 4.5 percent annual rate of return. Carolyn repeatedly borrowed from the policy, and the insurer periodically notified her that her investment base, net cash

surrender value, and death benefits would be decreased by the amount of the loans and accrued interest, and that the policy would be terminated if the loans and interest exceeded the cash value of the policy. On March 1, 2004, the insurer issued a notice warning Carolyn that her outstanding policy debt had exceeded the insurance policy's cash value and that the policy would be terminated within thirty-one days if she did not pay $108,313.42. That notice also stated that the cancellation of the insurance policy would be a taxable event, and that Carolyn would recognize a $562,746.04 gain, as of February 28, 2004. Carolyn did not make the payment. On March 30, 2004, the insurer sent a letter informing Carolyn of the cancellation of the policy and the issuance of an IRS Form 1099-R ("Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance, Contracts, etc."), reporting a gain of $565,224.11.

The Tax Court (Judge Paris) held that Carolyn recognized gain on the termination of the policy. The court explained that Section 61 specifically states that gross income includes any income from a life insurance contract and income from a discharge of indebtedness. *Ohio Nat'l Life Assur. Corp. v. Langkau*, 33 Fed. Appx. 244, 2009 WL 3824789 (11th Cir. Nov. 17, 2009). The Tax Court held that the McGowens received income attributable to the termination of their variable life insurance policy pursuant to Section 72(e). For federal income tax purposes, the policy loans were true loans. See *Atwood v. Comm'r*, T.C. Memo. 1999-61. The McGowens would not have had to recognize these loans as taxable income when they received them. *Comm'r v. Indianapolis Power & Light Co.*, 493 U.S. 203, 207-208 (1990); *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983). The court noted that a discharge of indebtedness occurs when "the debtor is no longer legally required to satisfy his debt either in part or in full." *Caton v. Comm'r*, T.C. Memo. 1995-80; *U.S. v. Centennial Savs. Bank FSB*, 499 U.S. 573, 580-581 (1991). The record here indicated that the loans were not discharged: they were extinguished after the insurer had applied the cash value of the insurance policy towards the debt owed by her. The insurance policy itself was the sole collateral for which the insurer can seek repayment of the amount she borrowed. Thus, the court stated that the McGowens' argument that the income, if derived from the discharge of indebtedness, should be excluded from their gross income under Section 108(g), was moot. The record supported the characterization of the McGowens' income as having been received from a life insurance contract, and any distribution from the policy would

be taxed under Section 72(e)(1), which requires that a taxpayer include in his gross income any amount that is received under an annuity, endowment, or life insurance contract and is not received as an annuity (limited by Section 72(e)(5) to the amount exceeding the taxpayer's investment in the contract). Carolyn never received any direct distributions from her life insurance policy, but the court held that she and her husband as joint taxpayers must recognize the indirect distribution of income she received from her insurance policy under Section 72(e). When the policy terminated, the loans, including capitalized interest, were charged against the available proceeds. This satisfaction of the loans had the effect of a pro tanto payment of the policy proceeds to the McGowens and constituted income to them at that time. Concluding otherwise would, the court stated, permit policy proceeds, including previously untaxed investment returns, to escape tax altogether. The distributed policy proceeds attributed to the return on investments must be taxed because the accruals on the investments (inside build-up) were not previously taxed.

The Tenth Circuit (Judge O'Brien) affirmed. The taxpayers contended that the Tax Court erred because the debt exceeded the face amount of the policy, so that their debt was discharged by the policy termination and any gain was excludable from taxation due to their insolvency. The Tax Court had not addressed the issue of insolvency, but the court stated that the record was sufficient to conclude, as a matter of law, that the insolvency exception did not apply in this case. The court noted that Section 108(d)(3) defines the term "insolvent," for this purpose, as "the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge." The court concluded that:

> [c]ontrary to the McGowens' assertions that the policy debt rendered them insolvent, they owed nothing if they made no payment prior to the policy's termination. The insurance contract limited the insurance company's ability to recoup payment of the debt on the contract to Carolyn McGowen's initial investment and the proceeds earned from that investment. . . . The McGowens were solvent immediately before the cancellation

of the policy and Section 108(d)(3) is inapplicable.

- ***Sanders*.** John Morgan Sanders bought a $25,000 face amount whole life insurance policy from New York Life Ins. Co. in 1979, and paid premiums of $31 per month until March, 2006. Between 1990 and 2004, John borrowed against the policy, which was permitted under the policy terms. His loans were made at an eight percent interest rate, with any accrued but unpaid interest added to the loan and bearing interest at the same rate. By its terms the policy terminated if any unpaid loan, including accrued interest, exceeded the sum of the policy's cash value and any dividend accumulations. In 2006, the loan balance, including interest, exceeded $17,200, which was more than the policy's cash value. The company terminated the policy. John received no cash on the termination. New York Life issued John a Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.", for 2006, reporting a gross distribution of $17,292, and a taxable amount of $7,175 (the gross amount, less the $10,117 of insurance premiums paid). Believing that this was incorrect, John did not report the $7,175 of income, and the Service assessed a deficiency.

  The Tax Court (Judge Thornton), held for the Service. The taxpayer's arguments were actually quite lame. He stated that he had never borrowed against the policy, but merely withdrawn his cash values. The policy, however, did not allow withdrawal of cash values, but only loans, and for tax purposes, they were properly characterized as such. *Atwood v. Comm'r*, T.C. Memo. 1999-61. The stipulated documentation showed the loan history that corroborated with the information reported on the Form 1099-R. The court held that the taxpayer could be taxed on the discharged indebtedness even though he received no cash distribution when the policy terminated. The court noted that Section 72(e) states that any amount received during the insured's lifetime in connection with a life insurance contract which is not received as an annuity generally constitutes gross income to the extent that the amount received exceeds the investment in the insurance contract. When it terminated petitioner's policy, New York Life applied the policy's cash value to the outstanding balance on the policy loans, which was economically equivalent to paying the taxpayer the policy proceeds, including untaxed inside buildup, and his using those proceeds to pay off the policy loans. This was a constructive distribution includible in gross income, to the extent it exceeded the taxpayer's investment in the

contract. See *McGowen v. Comm'r*, T.C. Memo. 2009-285; *Atwood v. Comm'r*, *supra*; *Dean v. Comm'r*, T.C. Memo. 1993-226.

- ***Brown.*** Bruce Brown bought a $100,000 life insurance contract with a $1,837 annual premium. Initially the taxpayer did not direct the dividends' use, so Northwestern applied them to purchase paid-up additional insurance, but in 2004, the taxpayer elected to have the insurer apply dividends first to premiums and then to policy debt. The taxpayer kept borrowing against the policy cash values to pay premiums and interest on the loans, and finally, the insurer terminated the policy and applied the entire $37,356.06 cash value to pay the debt outstanding against the policy. The insurer sent a Form 1099-R, showing a distribution of $37,365.06 and a taxable amount of $29,093.30, but the taxpayer did not include any amount in gross income. The Service assessed a deficiency, based on a recognition of $29,093.30 on the termination.

  The Tax Court (Judge Morrison) held for the Service. The court noted that, for federal income tax purposes, loans against a life insurance contract's cash value are true loans from the insurance company to the policyholder. *Minnis v. Comm'r*, 71 T.C. 1049, 1054 (1979); *Sanders v. Comm'r*, T.C. Memo. 2010-279; *McGowen v. Comm'r*, T.C. Memo. 2009-285; *Barr v. Comm'r*, T.C. Memo. 2009-250; *Atwood v. Comm'r*, T.C. Memo. 1999-61. Using the policy's cash values or proceeds to satisfy the loans has the same effect as paying the proceeds directly to the policyholder. Therefore, the termination of the policy in extinguishment of the debt equal to the cash values was a constructive distribution of that amount to the taxpayer, even though no cash was actually distributed. Amounts received under a life insurance contract before the death of the insured are taxable under Section 72. Therefore, as the payment was not an annuity, so under Section 72(e)(5), the taxpayer must include the amount of the distribution, less the taxpayer's investment in the contract. The investment in the contract, in this case, would be the total premiums or other consideration paid, less the total amount received under the contract and excludable from gross income.

  The court also agreed that the taxpayers were liable for a 20% accuracy-related penalty under Section 6662 for substantial understatement of income tax.

- ***Ledger.*** James Ledger bought a life insurance policy that was payable upon either the taxpayer's death or his reaching age

65. The taxpayer took 14 loans against the policy, and as of May 27, 2005, the loan balance and accrued interest totaled $56,219.61. The policy matured on April 12, 2006, with a gross maturity value of $61,787.72, and the insurer paid The taxpayer $5,568.11 (gross maturity value over the loan balance). The insurer determined The taxpayer's investment in the contract at the time of maturity to be $20,780.03. The insurer issued a Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc." identifying taxable distributions of $40,992.28 (maturity value considered for gain over cost basis). The Service assessed a $7,184 deficiency and a Section 6662(a) accuracy-related penalty.

The Tax Court (Judge Wherry) held for the Service. The court noted that, for Federal income tax purposes, loans against a life insurance contract's cash value are treated as true loans from the insurance company to the policyholder with the policy serving as collateral. See *Minnis v. Comm'r*, 71 T.C. 1049, 1054 (1979); *Sanders v. Comm'r*, T.C. Memo. 2010-279; *Atwood v. Comm'r*, T.C. Memo. 1999-61. Thus, using the policy's proceeds to satisfy the loans has the same effect as paying the proceeds directly to the policyholder. *Atwood v. Comm'r*, T.C. Memo. 1999-61. The court explained:

> When it terminated Mr. Ledger's policy in 2006, Prudential applied the policy's maturity value to the outstanding balance on the policy loans. That action was the economic equivalent of Prudential's paying petitioners the policy proceeds, including untaxed inside buildup, and petitioners' using most of those proceeds to pay off the policy loans. This constructive distribution is pro tanto a payment of the policy proceeds and as such is gross income to petitioners insofar as it exceeds their investment in the contract.

The court concluded that the evidence showed that, when the policy matured in 2006, its cash value for income tax purposes was $61,772.31, and the taxpayer's investment in the policy was $20,780.03. Therefore, the taxpayer received $40,992.28 as a constructive distribution, taxable as income.

2. Distribution of Partnership Interests in Satisfaction of Private Annuity Results in Recognition of Gain by Both Annuitant and Obligor. PLR 201149005 (Dec. 9, 2011)

The grantor established Trust 1, for the sole benefit of Beneficiary 1, and Trust 2, for the sole benefit of Beneficiary 2. The trusts each bought shares of stock from the grantor in exchange for unsecured private annuities in several independent transactions. The trusts, to date, have made all of the annuity payments as required by the contracts. The trusts also acquired some interests in Partnership. The grantor proposed to assign his rights and obligations under the annuity contracts to a grantor trust, and the trusts propose to sell their Partnership interests to the same grantor trust in exchange for the termination of the annuity contracts and a quantity of cash. The Partnership interest exchanged will be equal to the sum of the present value of the future annuity payments due under the contracts, and the cash payment.

The Service ruled that (a) the transfer by each trust of a portion of its Partnership interest in exchange for the termination of the annuity obligation is treated as an annuity payment in an amount equal to the annuity value made under each of the annuity contracts under Section 72, ending the income tax deferral for the grantor and causing recognition of any remaining gain; (b) each trust will recognize gain or loss as a result of such transfer, because it is distributing assets in satisfaction of a pecuniary annuity obligation; and (c) each trust will recognize gain or loss as a result of the sale of its Partnership interest in an amount equal to the difference between each trust's adjusted basis in its Partnership interest and the sum of the annuity value, the cash payment, and the trust's allocable share of the Partnership's liabilities immediately before the sale, pursuant to Section 752(d). The IRS explained that Section 752(d) provides that, in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. When a taxpayer conveys appreciated or depreciated property in satisfaction of an obligation or in exchange for the performance of services, that taxpayer must recognize gain or loss equal to the difference between the basis in the transferred property and the property's fair market value at the time of the transfer. See, *e.g.*, *United States v. Davis*, 370 U.S. 65 (1962), *International Freighting Corp. v. Comm'r*, 135 F.2d 310 (2nd Cir. 1943), *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960); *Wood v. Comm'r*, 39 T.C. 1 (1962). The Service also discussed Rev. Rul. 68-392, 1968-2 C.B. 284, in which the trustee of a trust created by the testator for the benefit of his daughter, was required to distribute $24x

to Daughter annually for her life. Trust distributed appreciated securities in satisfaction of part of the annuity. The ruling states that transfer of the securities to Daughter in partial satisfaction of the annuity obligation is treated as though the trustee had sold the securities to daughter for cash and immediately thereafter distributed the entire proceeds to her. The trustee, therefore recognized gain on the distribution. Similarly, the Service discussed Rev. Rul. 2007-40, 2007-1 C.B. 1426, which states that a partnership realizes gain upon the transfer of appreciated property to one of its partners as a guaranteed payment. The Service stated that, in determining the gain to be recognized by the trusts in connection with the proposed sale, their allocable share of liabilities with respect to their Partnership Interests must be taken into account both for purposes of determining the tax bases in their Partnership Interests and in determining the amount realized in connection with the proposed sale under Section 752(d).

E. Code § 101. Income Taxation of Life Insurance Proceeds

Treasury Would Require Reporting of Transactions Related to Sale of Life Insurance Policies. Dept. of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" p. 51 (Feb. 14, 2011)

The Administration's fiscal year 2012 budget (like its 2011 budget) proposes that a person or entity who buys an interest in an existing life insurance contract with a death benefit equal or exceeding $500,000 (2010 proposal set figure at $1 million) should be required to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the Service, to the insurance company that issued the policy, and to the seller. This proposal also would modify the transfer-for-value rules "to ensure that exceptions to that rule would not apply to buyers of policies." Furthermore, upon payment of any policy benefit to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the Service and to the payee.

If enacted, this proposal would apply to sales or assignments of interests in life insurance policies and to payments of death benefits for taxable years beginning after December 31, 2010.

Note. This proposal is intended to facilitate treating life insurance proceeds as ordinary income when the policies are bought in a transfer for value. The Service has difficult enforcing the transfer-for-value rules currently, because they do not receive information about the identity of parties to transfers of contracts, amounts paid for transferred contracts, and

payments under transferred contracts currently. See analysis of the Treasury's proposal in Staff of the Joint Committee on Taxation, 111th Cong., 1st Sess., "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal. Part Two: Business Tax Provisions," at 133-136 (Committee Print) (Sept. 2009).

F. Code § 213. Medical Expense Deduction

Adult Donee Can Deduct Medical Expenses and Property Taxes Paid as Gifts by Donor. *Lang v. Comm'r*, T.C. Memo. 2010-286 (Dec. 30, 2010)

Judith's mother, Frances Field, paid $24,559 directly to medical providers on account of Judith's medical expenses, and paid $5,508 directly to the city government to pay Judith's property taxes. Judith, an adult, claimed income tax deductions for these payments. The Service claimed that the deductions belonged to Judith's mother.

The Tax Court (Judge Goeke) held for the taxpayer. The court stated that, in substance, the payments were gifts to Judith from her mother, and thus should be deemed to have been paid to her for income tax purposes. The court noted that state law controls whether a gift at the time of payment affects who is the payor. *Ruch v. Comm'r*, T.C. Memo. 1982-493, *rev'd on another issue*, 718 F.2d 719 (5th Cir. 1983). Applying substance over form, the court treated Judith as having received from her mother gifts with which she paid her own expenses. The unreimbursed medical expenses were deductible under Section 213 and the property taxes under Section 164.

G. Code §§ 170, 642, 4940-4947. Charitable Gifts and Distributions

1. Legislative Proposals to Reform Charitable Giving Rules. H.R. 1593, 112nd Cong., 1st Sess. (April 15, 2011); H.R. 1964, 112nd Cong., 1st Sess. (May 24, 2011); S. 931, 112nd Cong., 1st Sess. (May 10, 2011)

- **H.R. 1593.** This bill, introduced by Rep. Tim Bishop (D-N.Y.), would allow an unlimited gift and estate tax deduction for contributions of conservation easements on farm and conservation land. There are provisions for recapture of the estate tax savings if the property is used in a manner inconsistent with the conservation easement, and carryover basis for the property for which the estate tax deduction is allowed.

- **H.R. 1964.** This bill, introduced by Rep. Jim Gerlach (R-Pa.), would make permanent the special rule for contributions of qualified conservation contributions (Section 170(b)(1)(E)).

- **S. 931.** This bill, introduced by Sen. Chuck Schumer (D-N.Y.), would amends the rules relating to the tax deduction for donations of fractional interests in tangible personal property to: (1) permit donors to claim an increased deduction based upon the market value of subsequent gifts of fractional interests; (2) extend to 20 years the period in which donors of fractional interests must contribute their entire interest in donated property; and (3) require donors of fractional interests greater than $1 million to attach a statement of value obtained from the Service to their tax returns.

2. **Tax Relief Unemployment Insurance Reauthorization, and Job Creation Act of 2010 Extends Expiring Charitable Gift Rules. Pub. L. 111-312, 111th Cong., 2nd Sess. (Dec. 17, 2010)**

- **Charitable Distributions from Individual Retirement Plans.** Section 725 of the 2010 Tax Act extended through 2010 the provision that permits tax-free distributions to charity from an Individual Retirement Account (IRA) of up to $100,000 per taxpayer, per taxable year. Code § 408(f)(8). In addition, the new law states that the taxpayer may elect to treat any qualified charitable distribution made after December 31, 2010, and before February 1, 2011, as having been made on December 31, 2010.

- **Conservation Contributions.** Section 723 of the 2010 Tax Act extended through 2011 the increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes. Code § 170(b)(1)(E).

- **Contributions of Food Inventory.** Section 740 of the 2010 Tax Act extended through 2011 the provision allowing businesses to claim an enhanced deduction for the contribution of food inventory. Code § 170(e)(3)(C).

- **Contributions of Book Inventories to Public Schools.** Section 741 of the 2010 Tax Act extended through 2011 the provision allowing C corporations to claim an enhanced deduction for contributions of book inventory to public schools (kindergarten through grade 12). Code § 170(e)(3)(D).

- **Corporate Contributions of Computer Equipment for Educational Purposes.** Section 742 of the 2010 Tax Act extended through 2011 the provision that encourages businesses to contribute computer equipment and software to elementary, secondary, and post-secondary schools by allowing an enhanced deduction for such contributions. Code § 170(e)(6).

- **Payments to Controlling Exempt Organizations.** Section 747 of the 2010 Tax Act extended through 2011 the special rules for interest, rents, royalties and annuities received by a tax exempt entity from a controlled entity. Code § 512(b)(13)(E).

- **S Corporation Charitable Contributions of Property.** Section 752 of the 2010 Tax Act extended through 2011 the provision allowing S corporation shareholders to take into account their pro rata share of charitable deductions even if such deductions would exceed such shareholder's adjusted basis in the S corporation. Code § 1367(a).

3. **Façade Easements Attract Extensive Litigation. *Simmons v. Comm'r*, 646 F.3d 6 (D.C. Cir. June 21, 2011), *aff'g* T.C. Memo. 2009-208; *Kaufman v. Comm'r*, 134 T.C. 182 (2010), *reh'g* 136 T.C. 194 (April 4, 2011); *Friedberg v. Comm' r*, T.C. Memo. 2011-238 (Oct. 3, 2011); *Schrimsher v. Comm'r*, T.C. Memo. 2011-71 (March 28, 2011); *1982 East LLC v. Comm'r*, T.C. Memo. 2011-84 (April 12, 2011)**

   - ***Simmons.*** Dorothy owned two rowhouses in Washington, D.C., each of which was subject to the Historic Landmark and Historic Preservation Act of 1978. Dorothy granted a façade easement over the two properties to the L'Enfant Trust, Inc., which then required that she affix a bronze plaque to the two façades, informing all who read the plaque that the façade will be preserved. The easement deeds provided that Dorothy could not make any material changes to the facades without the consent of the L'Enfant Trust, and required that she periodically clean the façades, keep the plaques polished and visible from the street, and maintain the properties in good condition, and that any work done on the properties must comply with all applicable federal, state, and local government laws and regulations. A professional appraiser determined that the easements reduced the value of the two properties by $162,500 and $93,000, respectively. Dorothy also made a

cash contribution with each easement, as required by the L'Enfant Trust. Dorothy deducted the appraised value of the façade easements, and the Service denied the deductions.

The Tax Court (Judge Goeke) held that Dorothy could deduct the value of the two conservation easements, finding the easements valid. The Service argued that the easements were not perpetual, because the L'Enfant Trust had the power to consent to changes in the façades, even if the changes were inappropriate, but the court held that this was permissible, as long as the changes were required to comply with all applicable federal, state, and local government laws and regulations. Reg. § 1.170A-14(d)(5). The Service also argued that Dorothy had not adequately documented the gifts, but the court disagreed, noting that the deeds themselves constituted contemporaneous acknowledgments, because they were signed by the donee's representative. The Tax Court also held that the appraisals were qualified appraisals, even though they did not state expressly that they were obtained for purposes of substantiating an income tax deduction, because they did state that the donor was contemplating a contribution of a façade easement. The court also generally accepted the "before" valuations prepared by the taxpayer, but reduced the depressing effect of the easements from 11% and 13%, suggested by the taxpayer, to five percent, rejecting the 0% reduction proposed by the Service.

The D.C. Circuit affirmed the decision of the Tax Court. The court (Judge Ginsburg) rejected the Service argument that the easements were not perpetual because of the Trust's ability to consent to changes. The court noted that the deeds imposed an "affirmative obligation upon Simmons 'in perpetuity' to maintain the properties in a manner consistent with their historic character and grant L'Enfant the authority to inspect the properties and to enforce the easements." The deeds did not state what would happen upon the dissolution of L'Enfant, but D.C. law provides the easements would be transferred to another organization that engages in "activities substantially similar to those of" L'Enfant. D.C. Code §§ 29301.48, 29-301.56. Also, the State Historic Preservation Officer testified the easement initially reverts to the District of Columbia, which then seeks to assign it to a conservation organization. The court also explained that the clauses permitting consent and abandonment did not affect the perpetuity of the easements. "Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so

at its peril." In an amicus brief, the National Trust for Historic Preservation, the L'Enfant Trust, and the Foundation for the Preservation of Historic Georgetown, also explained that this type of clause was important because it allows a charity to accommodate such change as may become necessary "to make a building livable or usable for future generations" while still ensuring the change is consistent with the conservation purpose of the easement. Furthermore, the court stated that the Service had not shown that the chance that the L'Enfant Trust would actually abandon its rights was more than negligible. The Trust had never in its history abandoned its right to enforce, and the Simmons's deeds expressly state the trust's intention to ensure her properties "remain essentially unchanged."

The Court of Appeals also rejected the Service contention that the appraisal was not a qualified appraisal. The Service claimed that the appraiser failed to explain its method of valuation or to include a substantive basis for the valuation. The appraiser stated that he relied on an article by an Service employee that stated that the Service had concluded that the proper valuation of a façade easement should range from approximately 10% to 15% of the value of the property. The Service stated that the appraiser, therefore, picked a percentage between 10 and 15 rather than stating any identifiable method to determine the "after-easement" value. The court accepted the Tax Court's finding that the appraiser properly applied the "before and after approach," calculating the difference between the fair market value of the property before and after the donation. Reg. § 1.170A14(h)(3). The court stated that the Tax Court did not "clearly err" in concluding the appraisals sufficiently identified the method and basis for the valuations.

- ***Kaufman.*** Gordon and Lorna Kaufman transferred a façade easement on their historic row house to a conservation organization along with a cash contribution. The taxpayers deducted $220,800 for the easement contribution in the year of the gift, of which $117,433 was carried over to the following year. The taxpayers also deducted as a charitable contribution a cash gift of $16,870 to the same organization, though they only paid it $16,840 in that year. The Service disallowed the deductions and imposed accuracy-related penalties.

  The Tax Court (Judge Halpern) granted the Service a partial summary judgment and denied a couple's deduction, finding that the requirements of Section 170(h) were not met,

though it allowed a deduction for the accompanying cash donation. Section 170(h) requires that the conservation contribution must grant a restriction on the property's use in perpetuity. Reg. § 1.170A-14(g). In this case, the property had a mortgage and the bank retained a "prior claim" to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property. The bank's rights had preference over those of the charity, until the mortgage was satisfied and discharged. This precluded any deduction for the contribution of the façade easement. The Tax Court also held that the taxpayers raised genuine issues of material fact regarding the deductibility of the cash donation and denied the Service's motion for summary judgment on that issue. The court also held that there were genuine issues of material fact regarding the taxpayers' liability for accuracy-related penalties, and denied the Service summary judgment regarding penalties.

On a motion to reconsider, the court (again, Judge Halpern) accepted the Service's argument that the cash donations were conditioned on a zero appraisal value of the easement and that they were not deductible. The taxpayers failed to show that the possibility of a zero appraisal at the end of 2003 was not so remote as to be negligible, so the court sustained the disallowance of a deduction for the cash donations. The court rejected the Service argument that the cash donations should be denied as a fee-for-services, because the trust's requirement that a cash donation accompany the easement contribution could feasibly be to cover the various expenses related to the easement. The court also rejected the Service's failure-to-substantiate argument, finding that the trust's letters acknowledged receipt of the cash donations and specified that they were not in return for any goods or services. The court therefore found that the taxpayers were entitled to a charitable deduction in 2004 for cash donations the couple made in 2003 and 2004. The court noted that the penalty issue was one of first impression and agreed with the parties that the taxpayers should not be liable for negligence or underpayment penalties based on the disallowance of the easement deduction under the enforcement-in-perpetuity rules. The court declined to rule on the Service argument that the taxpayers should be liable for penalties because they knew the easement would not diminish the value of the property. The court agreed to impose an accuracy-related penalty for the underpayment resulting from claimed deduction for the 2003 cash donations.

Note. This case highlights the serious problems that can arise in giving façade or other conservation easements over encumbered property.

- ***Friedberg.*** Barry Friedberg and his wife, Charlotte Moss, contributed to the National Architectural Trust a façade easement and development rights with respect to their historic Upper East Side Manhattan townhouse, which they had bought in 2002 for $9.4 million and on which they spent $4 million for renovations. The taxpayers paid $16,000 for a valuation report by an appraiser strongly recommended by the donee, who estimated that the property was worth $15,425,000 before the easement, that the conservation easement would be worth 11 percent of the fair market value of the property ($1,440,000), and that the additional contribution of development rights would be worth $2,335,000. The Service denied all of the deductions.

  The Tax Court (Judge Wells) held that the appraisal submitted by the taxpayers was not a "qualified appraisal" with respect to the façade easement, and that the contribution for that easement was not deductible. Section 170(a)(1), the court noted, states that a taxpayer who makes a noncash charitable contribution of more than $5,000 can deduct that gift only if the taxpayer: (1) obtains a qualified appraisal of the property contributed; (2) attaches a fully completed appraisal summary (Form 8283) to the tax return on which the deduction is claimed; and (3) maintains records pertaining to the claimed contribution in accordance with the regulations. The Service contended that the appraisal report was not qualified because it did not contain the date of the contribution, it was ambiguous as to the date the property was appraised, and it did not value the property as of the date it was actually contributed. The court agreed with the taxpayers that these were merely insubstantial typographical errors, that they had substantially complied with the appraisal requirements, and that the report was, in fact, completed within the requisite 60-day period before the date of contribution. See *Bond v. Comm'r*, 100 T.C. 32 (1993). The court agreed with the Service, however, that the report did not include the method and the specific basis for valuing the easement and development rights, which are essential elements. Citing *Friedman v. Comm'r*, T.C. Memo. 201045 (quoting *Jacobson v. Comm'r*, T.C. Memo. 1999-401); *Scheidelman v. Comm'r*, T.C. Memo. 2010-151, on appeal (2d Cir., Sept. 2, 2010). The court stated that the appraisal's valuation of the property before the gift was "a textbook example of how the comparable sales method works," but the

valuation of the property after the easement contribution did not accurately or reasonably use the comparable sales method that it claimed to apply. The appraiser did the "after" valuation using properties located in Washington, D.C. and New Orleans, without any attempt to explain why those areas are comparable, and selecting properties which were themselves not comparable. The use of other areas to produce an average diminution for the façade easement is not consistent with the comparable sales method. The court did, however, conclude that the report was a qualified appraisal with respect to the effect of the contribution of development rights, even though many of the contributions cited in the report were not truly comparable.

- ***1982 East LLC.*** 1982 East LLC donated to the National Architectural Trust (NAT) a facade easement for a building it owned in New York City. The building was subject to a mortgage with a bank at the time of the contribution. The Service disallowed the mortgage gave the bank rights in foreclosure that were inconsistent with the easement being made in perpetuity, as required by Section 170(h)(5)(A).

  The Tax Court (Judge Laro) held that the deduction was not allowed because the gift was not made in perpetuity. The court discussed *Kaufman v. Comm'r*, 134 T.C. 182 (2010), which had held that a façade easement was not made in perpetuity because the donee organization was not guaranteed a proportionate share of proceeds in the event of casualty or condemnation, as required under the income tax regulations. The LLC's mortgage agreement with the bank clearly gave the bank a prior claim to all condemnation and insurance proceeds until the mortgage was satisfied and discharged, so the façade easement was not deductible. The taxpayer's mortgage agreement with the bank clearly gave the bank a prior claim to all condemnation and insurance proceeds until the mortgage was satisfied and discharged, so the façade easement was not deductible. The court explained that, until the mortgage was repaid, the bank could deprive the charity of the value of the easement, which value "should have otherwise been dedicated to the conservation purpose." If, for example, the property were destroyed and the insurance only covered the mortgage, the charity would receive nothing.

  Note. The court also held that the taxpayer was not liable for a 20% accuracy-related penalty under Section 6662(a), because (a) the taxpayer's managing member acted in good faith; (b) the issue of the effect of a mortgage on a

contribution of a conservation easement was not decided until more than four years after the taxpayer's income tax return reporting the transfer; (c) the regulations interpreting the perpetuity requirement of Section 170(h)(5) are not "so crystal clear and unambiguous as to make the imposition of the accuracy-related penalty appropriate;" and (d) the taxpayer obtained three appraisals to support the transfer, but none of them addressed the issue of perpetuity and the mortgage.

- ***Schrimsher.*** Randal A. Schrimsher gave a façade easement to the Alabama Historical Commission, providing that no changes would be made to the façade of an historic building he owned in Huntsville, Alabama. The deed of gift recited that the easement was made in exchange for "$10 plus other good and valuable consideration." Randal filed IRS Form 8283, stating that the value of the easement was $705,000, but he did not include various required items of information and the form was not signed by any of the parties involved in the easement contribution.

  The Tax Court (Judge Thornton) held that no deduction was allowed, because Randal did not obtain a contemporaneous written acknowledgment of the easement from the Commission, as required by Section 170(f)(8). The taxpayer argued that the language in the agreement that stated that consideration was received was mere "boilerplate" and that it was clear that no compensation had been paid. The court, however, rejected the argument that the recitation in the deed was fictitious. The court stated that, even if the recitation was boilerplate, it certainly did not prove that there was no consideration received. Therefore, it was imperative that the taxpayer obtain a contemporaneous written acknowledgment that established what consideration was or was not paid for the easement.

4. Expenses Related to Feline Foster Care in the Taxpayer's House are Deductible. *Van Dusen v. Comm'r*, 136 T.C. ___ (No. 25) (June 2, 2011)

Jan Elizabeth Van Dusen provided foster care for Fix Our Ferals (FOF), a qualified charity that spays and neuters feral cats and then returns them to the wild. During their recovery, or if they cannot be safely released, the cats are placed in foster homes. Van Dusen provided a foster home for many FOF cats, as well as a few others from similar organizations, and paid most of her expenses out of pocket. The taxpayer devoted almost her entire non-work life to

caring for the cats. She daily fed, cleaned, and looked after them. She laundered the cats' bedding and sanitized the floors, household surfaces, and cages. The taxpayer even bought a house "with the idea of fostering in mind". Her house was so extensively used for cat care that she never had guests over for dinner. In the year in question, the taxpayer had between 70 and 80 cats total, of which approximately seven were pets. (The pet cats had names, but the foster cats generally did not.) Some cats lived in cages for taming. Others lived in cages because of illness. Most of the cats roamed freely around the taxpayer's house (except for bathrooms) and resided in common areas. Less domesticated cats stayed in a separate room called the "feral room". The taxpayer incurred extensive expenses for veterinary services, pet food, and similar items. She had to repair her wet/dry vacuum so she could easily clean the floors. The taxpayer also incurred higher electricity and gas bills because she laundered many loads of cat bedding and ran a special ventilation system to ensure fresh air. The frequent laundering also increased the taxpayer's water bills. Her garbage bills increased because of the high volume of cat-related waste. The taxpayer kept good records of some expenses, such as those for veterinary services. Some expenses, such as those related to cleaning, were commingled with her personal expenses for the same items. In the year in question, the taxpayer deducted $12,068 on as a noncash charitable contribution attributable to a "cat rescue operation", including $1,381 of supplies,$9,607 of veterinary bills, and $1,080 of utilities. The Service disallowed the deductions.

The court (Judge Morrison) held that the taxpayer's care for the cats were "expenditures made incident to the rendition of services" to a charity, and they were eligible for deduction, to the extent that she could establish their amount and show correct documentation. See Reg. § 1.170A-1(g). The court rejected the Service argument that the taxpayer was an independent cat rescue worker whose services were unrelated to the charity and did not benefit it, finding that the facts showing the strength of the taxpayer's affiliation with the organization as a regular volunteer who performed substantial services for the organization, the organization's ability to initiate or request services from the taxpayer by phone or interest, the organization's supervision over the taxpayer's work, and the taxpayer's accountability to the organization, supported her claim.. See, *e.g., Smith v. Comm'r*, 60 T.C. 988 (1973); *Saltzman v. Comm'r*, 54 T.C. 722 (1970). The taxpayer's inability to trace her cat rescue work exclusively to the charity was noteworthy, but the court concluded that she had performed most of her work in the year in question for Fix Our Ferals, and that the other organizations with which she was affiliated and for which she may have provided services were also qualified charities.

The court also held that the services were, as required for deductibility, directly connected with and solely attributable to the rendition of services to a charitable organization. See also *Babilonia v. Comm'r*, T.C. Memo. 1980-207, *aff'd per curiam*, 681 F.2d 678 (9th Cir. 1982). The court held that some expenses were directly related to the charity's operations, such as 90% of the taxpayer's veterinary expenses and pet supplies and 50% of her cleaning supplies and utility bills. The court disallowed expenses that it determined were not exclusively related to the feline foster care, such as repair of her wet/dry vacuum cleaner and Costco membership. The court held that the rules in Reg. § 1.170A-13(a) related to contributions of money applied to unreimbursed volunteer expenses, and applied this rule to the taxpayer's feline foster care expenses. The court found that the taxpayer's s documentation did not comply strictly with the regulations, but that she had substantiated her service-related expenses of less than $250 and was entitled to a deduction up to the percentage allowed by the court. The taxpayer, however, did not satisfy the substantiation requirements for expenses over $250, because she did not provide contemporaneous written acknowledgment from the charity. The court also held that Section 280A did not limit the deduction for part of the taxpayer's utility bills, because the taxpayer was not engaged in a trade or business of providing foster care.

5. Deduction for Conservation Easement Reduced Because Taxpayer's Expert Appraisal Deemed Unreliable and Irrelevant. *Boltar LLC v. Comm'r*, 136 T.C. 326 (April 5, 2011)

Boltar, LLC granted a conservation easement restricting the use of approximately eight acres of land to the Shirley Heinze Land Trust, Inc. The LLC claimed a $3,245,000 charitable contribution deduction for the easement. The taxpayer reported a fair market value of $3,270,000 for the easement, and reduced it by $25,000 because of a claimed enhancement in value to adjacent parcels owned by the LLC as a result of the donation of the subject easement. The LLC attached to its partnership income tax return a Form 8283, "Noncash Charitable Contributions," signed by an appraiser. They also attached an appraisal report, which determined that the "highest and best use" of the subject property was residential development and that the easement value was the difference between the "Foregone Development Opportunity of 174 Condominiums on Finished Sites, Discounted to" the date of the gift, less the "Value of Raw, Vacant and Developable Land." The Service determined that the value of the easement was only $42,400, and assessed a deficiency. Before trial, the Service asserted that the taxpayer's appraisal report was neither reliable nor

relevant, under the Federal Rules of Evidence and *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993).

The Tax Court (Judge Cohen) agreed with the Service that the taxpayer's appraisal was irrelevant and unreliable, and precluded its admission. The court explained that the court has a duty to exclude unreliable and irrelevant evidence, rather than admitting it "for what it is worth" and then giving it no weight, to increase the efficiency of trials and the objectivity of judgments. The receipt of unreliable evidence is an imposition on the opposing party and on the trial process. The court stated that "in the view of the trial Judge, the expert report is so far beyond the realm of usefulness that admission is inappropriate and exclusion serves salutary purposes." Furthermore, the court noted, the taxpayer's experts suggested no adjustments or corrections to their calculations that would have made them more reliable. The taxpayer's appraiser determined that sales of comparable land nearby were occurring at approximately $12,000 an acre, but they assigned a value of approximately $400,000 per acre. Additional factual errors made in the report "undermine the reliability of their conclusions and demonstrate the lack of sanity in their result."

6. Taxpayers Denied Deduction and Taxed on Gain From Charity's Sale of Contributed Stock Because of Retained Control. *Gundanna v. Comm'r*, 136 T.C. 151 (Feb. 14, 2011)

The taxpayer, Viralam, owned a 50% interest in a medical practice that he sold in 1998 for $2.3 million. In 1997, Viralam joined xelan, a financial planning company that represented and advised physicians. Viralam transferred stocks and cash to xelan in 1998. Xelan is organized under Section 501(c), but it is not a private foundation. Xelan sold the stocks in 1998 and maintained a segregated account for Viralam. During 2001 and 2002, xelan transferred $70,299 from the account to the University of Pennsylvania to pay the tuition of Viralam's son. The son signed loan documents that obligated him to repay the transferred amounts, plus interest, or to provide designated amounts of charitable services. Viralam claimed a charitable contribution deduction for the fair market value of the stocks and cash transferred to xelan.

The Tax Court (Judge Gale) held that the taxpayer had retained control over the appreciated stocks and cash he had transferred to xelan, and that he was both entitled to no charitable contribution deduction and taxable on the realized gains and income. The court stated that xelan's representations concerning the student loan program, the taxpayer's understanding of his ability to use the funds for personal noncharitable purposes (his children's schooling) demonstrated that the taxpayer never intended to and never did

relinquish dominion and control over the property. Furthermore, the court noted, the taxpayer failed to comply with the substantiation requirements of Section 170(f)(8). The foundation's written acknowledgment was required to state whether goods or services were provided in consideration of the contribution and to describe them and their value, none of which were done. The court sustained an accuracy-related penalty under Section 6662 for negligence or for substantial understatement of tax.

7. Lack of Contemporaneous Acknowledgment for Charitable Contribution of Conservation Easement Costs Taxpayer a $1,870,000 Deduction. *Bruce v. Comm'r*, T.C. Memo 2011-153 (June 29, 2011)

The taxpayer sued the county over a 50-foot-wide driveway easement. The taxpayer settled the dispute by a Memorandum of Settlement giving him a 35-foot-wide portion of the driveway, giving the county the remaining 15-foot-wide portion, and limiting the taxpayer's use of the parcel to a single family residence, and giving up all development rights to the subject parcel. The county agreed to provide written acknowledgment of a donation to the county of the taxpayer's development rights. The substantive rights and obligations under the settlement agreement were conditioned upon receipt of the statutory and regulatory approvals from several sources. The county sent the taxpayer a letter acknowledging and thanking him for his "donation" of the development rights to the parcel, advising him that the county did not independently appraise the donated property, and stating that the taxpayer was responsible for determining the value of the contributed easement for income tax purposes. The taxpayer deducted $1,870,000 as the value of the easement, and Service disallowed any deduction for lack of contemporaneous substantiation.

The Tax Court (Judge Laro) held for the Service, finding that the taxpayers did not substantiate the reported charitable contribution, because the taxpayer failed to obtain a contemporaneous written acknowledgment of the donated property as required by Section 170(f)(8). The court noted that Section 170(f)(8)(A) requires that the contemporaneous written acknowledgment be from a donee organization and that it must state: (1) the amount of cash and a description of any noncash property contributed by the taxpayer; (2) whether the donee organization provided any goods or services in consideration for the property contributed; and (3) a description and good faith estimate of the value of any goods or services contributed by the taxpayer. The court stated that the settlement agreement was not an "acknowledgment" for this purpose, because the substantive rights and obligations created by the settlement agreement were still

conditioned on the county's obtaining approval for the disposition of parkland from the commission, which did not approve the disposition for more than 15 months. Therefore, the county could not "acknowledge" the contribution, because it had not yet been made. Furthermore, the county could not acknowledge the contribution because the settlement agreement also provided that if any term therein was not satisfied, then the taxpayer and the county agreed to return to the special master for further proceedings. The outcome of those proceedings would replace any duty of the taxpayer to convey his development rights to the county.

Note. The Service also argued that the and deduction should be denied because the taxpayer did not attach to their 2004 income tax return a completed Form 8323 (appraisal summary) as required by Reg. § 1.170A-13(c)(2)(i)(B). Since there was no contemporaneous acknowledgment, the court did not need to reach that issue.

8. Gift of Artwork Deductible Only to Basis, Because One-Year Holding Period Not Begun with Option to Buy. *Williams v. Comm'r*, T.C. Memo. 2011-89 (April 21, 2011)

Joseph B. Williams entered into an arrangement by which he agreed to buy artwork from Abbey Art Consultants, and then contribute the art to charity. In each case, he bought the artwork in December under a contract stating that he wished to buy the artwork for a price that was a fixed dollar amount or, if less, a fixed percentage of its appraised value. The appraisals would be obtained a year later, and the art would be delivered to the taxpayer or a charitable designee. The seller would select the appraiser. The taxpayer paid a five percent deposit, with the balance due before transfer of physical possession. If the taxpayer failed to make the final payment, the sole remedy of the seller would be to retain ownership of the art and the deposit. In each case, the artwork was appraised for several times the purchase price, the taxpayer made the final payment, and the art was delivered to a charity selected by the taxpayer, just over a year after the taxpayer signed the initial purchase agreement. The Service reduced the taxpayer's deductions to the taxpayer's basis in the artwork, noting that the taxpayer had not held the artwork for one year before its contribution. The Service also assessed accuracy-related penalties under Section 6662.

The Tax Court (Judge Gustafson) held for the Service, both disallowing the charitable deduction and sustaining the accuracy-related penalties. The court noted that the taxpayer can deduct the fair market value of the artwork only if it has been held for more than one year. Code §§ 170(e), 1222(3). The court explained that the agreement stated that the seller would hold the deposit in escrow to

apply against the purchase price, and that if the taxpayer failed to pay amounts owed to the seller, the seller's sole remedy was "to retain as liquidated damages all previous payments Client has made toward the purchase of the Art and, in addition, to reclaim ownership of the Art." The court noted that a draft agreement originally provided that, in the event that the taxpayer failed to pay the seller, after the seller transferred the art to the charity, it could require specific performance (payment). The taxpayer had crossed out that sentence, and the seller accepted the agreement without any explicit right to force the taxpayer's payment obligation. Therefore, the court concluded, the taxpayer had the power unilaterally to decide whether to pay the remainder of the purchase price and execute a bill of sale, and the downpayment was, in effect, an option to buy the art, rather than a purchase of the art. The taxpayer's holding period, therefore, began when he exercised the option by making the final payment, not when he paid for the option. The court also sustained the accuracy related penalty, noting that a taxpayer is negligent whenever the taxpayer puts his or her faith in a scheme that clearly offers improbably high tax advantages, and the taxpayer does not obtain an objective and independent opinion on the validity of the transaction.

9. Tax Court Rejects Both Side's Appraisals in Valuing Conservation Easement and Applies 30% of Contribution Base Limitation to Gift by LLC. *Trout Ranch LLC v. Comm'r*, T.C. Memo. 2010-283 (Dec. 27, 2010)

Trout Ranch was formed in late 2002 and in January, 2003, the LLC bought certain land and water rights. The LLC intended to develop a residential subdivision with amenities that would include a clubhouse, a guest house, fishing, a riding arena and stable, ponds, a boathouse, duck blinds, and an archery range. In December, 2003, the LLC donated to the Crested Butte Land Trust a conservation easement in the form of water rights. The remaining acres were to be divided into 21 three-acre lots and a clubhouse. On its 2003 Form 1065, the LLC claimed a charitable contribution of $2.2 million for the contribution of the conservation easement. The Service initially reduced the deduction to $485,000, but at trial disallowed the entire deduction.

The Tax Court (Judge Halpern) rejected the analysis of both sets of appraisers. The Service's appraiser stated that the easement was worth nothing, applying the income approach to calculate and compare the highest and best use of the property. The LLC's expert stated that the easement was worth $2.2 million, using the original value of the property, sales of similar properties, and estimating how the conservation easement decreased the value of the property. The Tax Court concluded that the residential subdivision had, "at the time

of the donation of the conservation easement, a present value of approximately $4.45 million" and, after the easement, a value of $3.89 million (as a 21-lot shared ranch). Therefore, the court allowed a deduction of $560,000. The court noted Section 170(b)(1) percentage limitation rules is a partnership item best applied at the partnership level, rather than at the partner level.

10. Service Provides Guidance on Relying on IRS Publications for Deductibility of Charitable Contributions. Rev. Proc. 2011-33, 2011-25 I.R.B. 887 (June 20, 2011)

The Service stated that taxpayers may rely on IRS Pub. 78, which is a list of organizations recognized as exempt, which is available only on-line (http://www.irs.gov/app/pub-78) for purposes of deduction of contributions to the organizations. The Pub. 78 is updated every six months. Taxpayers may also rely on a ruling or determination letter received by an organization, until the Service makes public any change in the organization's status, unless the taxpayer was responsible for, or aware of, the act or failure that resulted in the termination of the organization's exempt status. Reg. § 1.509(a)-7(a). Taxpayers may also rely on the more-detailed data that can be found in the IRS Business Master File (BMF), which is available on-line and updated monthly (http://www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html).

H. Code §§ 661 and 662. Taxation of Trust Distributions

1. Taxpayer Taxed on All Distributions from Domestic and Foreign Trusts. *Rahall v. Comm'r*; T.C. Memo. 2011-101 (May 16, 2011)

Jeffrey Rahall, the taxpayer, was the beneficiary of several domestic and foreign trusts, some of which had been created by his parents. He received substantial distributions from each trust, both by direct payment of cash to him and by the trusts' payment of his expenses and those of his friend. The taxpayer contended that these were largely distributions of principal.

The Tax Court (Judge Cohen) held that the taxpayer was taxable on the distributions from the trusts, except to the extent that he could prove that they were not made from income, and that the taxpayer had not proved that any of the distributions were made from principal. The court noted that the trustees of two 1964 trusts, one domestic and one foreign, authorized the trustees to accumulate or distribute income and corpus. Therefore, to the extent that the amounts the taxpayer received from the 1964 trusts represented trust

income, he must include them in his taxable income. The court held that the taxpayer failed to provide supporting documentation that would distinguish between corpus and income and failed to prove that the amounts he received were principal, rather than income. The taxpayer must, therefore, include the entire amounts he received from the 1964 trusts in income. The court held that a 1978 domestic trust was a grantor trust with respect to the taxpayer, because the taxpayer had full control over the trust, as indicated by the trust instrument. None of the other trustees or other persons could limit the distribution of either principal or income to the taxpayer, so the taxpayer was taxable on all of the income of that trust, whether or not distributed.

2. Service Adds Income Tax Consequences of Decanting to No-Ruling List and Requests Comments. Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (Jan. 3, 2011); Notice 2011-101, 2011-2 I.R.B. ___ (Dec. 27, 2011)

- **Rev. Proc. 2011-3.** The Service added to its no-rulings list the question of whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust by decanting that results in a change in beneficial interests is a distribution for which an income tax deduction is allowable under Section 661 or which requires an amount to be included in the gross income of any person under Section 662. This issue is designated one that is currently under study.

  Note. See also no-ruling position regarding the gift tax and GST tax consequences of decanting, discussed below.

- **Notice 2011-101.** The Service has asked for comments from practitioners and other interested parties regarding the proper income, estate, gift, and GST tax treatment of decanting. It has asked for these comments by April 25, 2012. The specific questions regarding which it has asked for comments include:

Note. The Service is evidently preparing a formal ruling or regulations on the tax consequences of decanting. In light of the growing popularity of decanting as a means of modifying the terms of an irrevocable trust, this is important news. Whether it is good news or bad news depends upon the content of that guidance that the IRS provides.

I. Code § 664. Charitable Remainder Trusts

Service Permits Charitable Remainder Trust to Fund Noncharitable Interest with Commercial Annuities. PLR 201126007 (July 1, 2011)

Taxpayer proposes forming a charitable remainder annuity trust that will include a statement that the trustee may buy commercial annuity contracts to provide for the annuity payment retained by Taxpayer. The trust specifically directed:

> The Trustee shall have the discretion to provide for the annuity payment to Trustor by allocating a portion of the trust assets to purchase an annuity contract which will guarantee to pay to the trust a sum equal to or greater than the Trustor's computed annual annuity payout for the duration of the trust. If the Trustee chooses to provide for the Trustor's annuity payment in this manner, the Trustee may only purchase such contract from an insurer with an A.M. Best Company Insurer Financial Strength Rating of "Superior" (A++, A+) or "Excellent" (A, A). After securing such contract, the Trustee may distribute any amount other than the amount described in Treas. Reg. Section 1.664-2(a)(1) to the charities named in Schedule B any time during the term of the trust. Upon the termination of all noncharitable interests, the Trustee shall distribute all of the principal and income of the trust (other than any amount due to the Annuity Recipient or the estate of the Annuity Recipient) to the charitable organizations, in the percentages designated, as provided in Schedule B.

Taxpayer anticipates that the trustee will actually buy the annuity, possess all incidence of ownership, and be entitled to all payments, that the annuity contract will pay the annuity amount annually to the trust, and that the trustee will then pay the annuity amount to the grantor.

The Service stated that the trust was a qualified CRAT. Taxpayer represented that the trust would otherwise contain all of the terms in Rev. Proc. 2003-53, 2003-2 C.B. 230. The Service reviewed the requirements for a CRAT, and concluded summarily that the provision for investing the trust in a commercial annuity would not prevent the trust from qualifying as a CRAT under Section 664(d)(1).

Note. Commercial annuities are a convenient way to fund a charitable remainder annuity trust. They are a single asset that may hold internally a professionally managed diversified portfolio, providing a single report for review by the trustee. Furthermore, the withdrawals can be made precisely equal to the amounts that the trustee requires for payment.

This ruling is consistent with TAM 9825001 (June 19, 1998), but it represents a change from PLRs 9609009 (March 1, 1996) and 9643014 (Oct. 25, 1996), in which the Service specifically withheld any opinion whether the trustee's control over the timing and amount of realized income from the sale of trust assets would constitute an act of self-dealing under Section 4941(d). This was apparently based on the notion that a trustee's actions that are intended to defer income until the grantor desires to receive the income amount to a transfer to the grantor of an economic asset of the income option charitable remainder unitrust—its investment opportunity to recognize a current gain or income.

J. Code §§ 671-679. Grantor Trusts

Proposed Regs Treat Grantor Trust and Other Disregarded Entities as Synonymous with the Grantor for Some Discharge of Indebtedness Purposes. Prop. Reg. § 1.108-9, 76 FR 20593-01 (April 13, 2011)

Section 108(a)(1)(A) and (B) excludes from gross income any amount that would be includible in gross income by reason of the discharge of indebtedness of the taxpayer, if the discharge occurs in a bankruptcy under Title 11 of the U.S. Code, or to the extent that the taxpayer is insolvent when the discharge occurs. The proposed regulations will treat references to the "taxpayer" in those subsections as referring to the owner of the grantor trust or disregarded entity. Therefore, a grantor trust or other disregarded entity (such as a single-member LLC) is treated as bankrupt only if the grantor or owner is insolvent or bankrupt.

Note. The proposed regulations also provide that, in the case of a partnership, the owner rules apply at the partner level to the partners of the partnership to whom the discharge of indebtedness income is allocable. Any partner that is a grantor trust or disregarded entity will be looked through for purposes of these discharge of indebtedness rules. The regulations will apply to any discharge of indebtedness income occurring on or after the date final regulations are published in the Federal Register, and no inference is intended that the proposed regulations are not current law.

K. Code § 877A. Recognition of Gain by Expatriates

Two Key Figures Are Adjusted for Inflation. Rev. Proc. 2011-52 §§ 3.26, 3.27, 2011-45 I.R.B. 701 (Nov. 7, 2011)

The $600,000 exemption from appreciation in assets recognized by a covered expatriate is increased to $651,000 for expatriations that occur in 2012. Also, the standards for determining whether an expatriate is a covered

expatriate based on whether his or her average annual net income tax exceeded $140,000 for the five taxable years ending before the date of expatriation, is increased to $151,000 for taxable years beginning in 2012.

L. Code §§ 1014, 1015, 1022. Basis of Property Received by Gift or Received From a Decedent

Treasury Would Require that Basis Be Based on Transfer Tax Values. Dept. of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" pp. 125-126 (Feb. 14, 2011)

The Administration's 2012 budget proposes that taxpayers who receive property by gift or from a decedent must use the relevant gift or estate tax value as their basis, even if they disagree with the valuation reported for gift or estate tax purposes.

- **Property Received from a Decedent.** A taxpayer who receives property from a decedent under conditions in which the basis is determined under Section 1014, would be required to use as his or her basis the value as reported for estate tax purposes (subject to later adjustments).

- **Property Received by Gift.** A taxpayer who receives property by gift would be required to use as his or her basis the donor's basis determined under Section 1015, and as reported for gift tax purposes (subject to later adjustments).

- **Reporting.** A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the Service.

- **Regulatory Authority.** A grant of regulatory authority would permit the Treasury to provide details about the implementation and administration of these requirements, including rules for: (a) situations in which no estate tax return is required to be filed; (b) situations in which gifts are excluded from gift tax under Section 2503; (c) situations in which the surviving joint tenant or other recipient may have better information than the executor; and (d) the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

- **Effective Date.** This proposal, if enacted, would be effective as of the date of enactment.

Note. See also analysis of the Treasury's similar 2009 proposal in Staff of the Joint Committee on Taxation, 111th Cong., 1st Sess., "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal. Part One: Individual Income Tax and Estate and Gift Tax Provisions," at 133-136 (Committee Print) (Sept. 2009). According to the Joint Committee, beneficiaries would be required to use as basis the value reported on the estate tax return, or a lower figure if the value were ultimately reduced, even if the estate tax value of the asset were increased on examination. The Joint Committee states that this provides an incentive to value assets "more realistically" on the estate tax returns. This appears to be different from the Treasury's actual proposal, which provided that the beneficiaries must use the estate tax value as finally adjusted. Also, the consistency rule will not protect beneficiaries from incurring a liability for overstatement of basis if the Service determines on examination (presumably of the beneficiary's income tax return) that the estate assets were overvalued for estate tax purposes.

M. Code § 1035. Exchange of Life Insurance Contracts

Service Provides New Guidance on Partial Tax-free Exchanges of Annuity Contracts. Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (July 25, 2011)

The Service provided new and clearer guidance regarding the tax treatment of partially tax-free exchanges of annuity contracts under Sections 72(e) and 1035, continuing and expanding upon an eight-year chain of guidance. The new procedure establishes a general rule that any partial exchange of annuity contracts that falls within the guidelines set out in the procedure will be treated as a tax-free exchange under Section 1035, as long as no amount is received under either the original or the new contract (except amounts received as an annuity for one or more lives or for a period of 10 years or more), during the 180 days beginning on the date of the transfer (or, in the case of a new contract, the date the contract is placed in-force). A later direct transfer of all or a portion of either contract involved in such an exchange will not be taken into account for purposes of applying these rules, if that subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange under Section 1035. A partial exchange of annuity contracts that does not meet these requirements will be characterized in a manner consistent with its substance, based on general tax principles and all the facts and circumstances. Therefore, it will either be taxable as boot from a Section 1035 exchange, or as a taxable withdrawal from an annuity contract under Section 72(a). This procedure is effective for covered transfers completed on or after October 24, 2011. Rev. Proc. 2008-24, 2008-13 I.R.B. 684 (March 31, 2008), which this procedure supersedes, will continue to apply to transfers that are completed before that date, with the clarification

that the requirement that one of the prescribed conditions of Section 72(q)(2) must have "occurred between" the date of the transfer and the date of the withdrawal or surrender will be deemed satisfied if the condition was satisfied as of the date of the withdrawal or surrender. Thus, for example, an individual who attained the age of 59 ½ before both the date of the transfer and the date of the withdrawal or surrender has satisfied the condition of Section 72(q)(2)(A) and will be treated as satisfying the requirements of Revenue Procedure 2008-24.

SELECTED ATTACHMENTS

PLEASE NOTE

THESE ATTACHMENTS INCLUDE SEVERAL FORMS INSPIRED BY SPECIFIC CASES OR RULINGS. THESE FORMS ARE THESE ARE NOT THE ACTUAL DOCUMENTS ON WHICH THE IRS OR COURT OPINED. THEY ARE MY INTERPRETATION BASED ON THE RULINGS OR CASES CITED, OR OF TECHNIQUES THAT MAY ADDRESS PROBLEMS RAISED BY THESE CASES OR RULINGS.

THESE FORMS HAVE NOT BEEN SUBMITTED TO OR APPROVED BY THE IRS OR ANY OTHER AGENCY OR COURT, AND THEY MAY CONTAIN PROVISIONS WITH WHICH VARIOUS IRS AGENTS AND ATTORNEYS MAY NOT AGREE.

USE YOUR INDEPENDENT JUDGMENT -- NEITHER THE AUTHOR NOR THE CONFERENCE SPONSOR CAN TAKE ANY RESPONSIBILITY WHATSOEVER FOR THE INDIVIDUAL USE OF THESE SAMPLE DOCUMENTS.

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1. Family Limited Partnership/Limited Liability Company Checklist

PLANNING AND DRAFTING

○ **Create Partnership in a Good State.** Assure that the state whose law governs the partnership provides, as default rules:

- No requirement that the partnership certificate state the time at which the limited partnership is to be dissolved;

- Partnership does not terminate upon the withdrawal or death of a general partner (usually if there is another general partner or if a majority of the limited partners elect to continue the business);

- Majority of the limited partners cannot remove the general partner and indirectly effect the dissolution of the partnership;

- Transferee of a partnership interest becomes only an assignee, rather than a partner, without the vote of the remaining partners; and

- A withdrawing partner is not entitled to his or her capital account. Often, the withdrawing partner is entitled to "fair value," but this should be based his or her right to share in reasonably anticipated future distributions from the continuing entity. Alternatively, state law may not permit a partner to withdraw without the consent of the other partners. The Tax Court and Fifth Circuit have held that a right to withdraw is not a right to liquidate under Section 2704(b), but it is just as well that the partners have no specific right to withdraw.

○ **Have and Document Nontax Purposes.** Carefully document in the agreement or collateral instruments or letters the various nontax purposes for which the partnership is created. Among the nontax purposes that the courts may accept are:

- Avoiding likely creditors, such as spouses of children, if there is a realistic basis for worrying about creditor claims, such as prior divorces by some of the children;

- Assuring the continued management of assets according to a specific and definite investment philosophy, whether or not it is one that the donor espouses. This may also be combined with teaching this philosophy to the various family members;

- Forcing the children to work together to manage key family assets, but the children must then actually work together to manage these assets;

- Dividing key assets among children through the use of separate partnerships, to reduce family discord; and

- Consolidating assets of various family members (or dividing interests in gifts from donor among various family members) to facilitate purchase of investments with minimum entry costs, such as hedge funds that require that the investors have at least $10 million in net worth, though it is important to show that there were actual purchases of such investments or that they were under serious consideration.

○ **Consider Annual Exclusion.** Avoid undue restrictions on transfer, or give a donee partner the right to withdraw up to the annual exclusion from the partnership at the time of the gift, to assure that such gifts qualify for the gift tax annual exclusion.

○ **Create Partnership ASAP.** The partnership should be created and funded while the donor is in good health and as young as practicable. Once the donor is terminally ill, the chances of the partnership being respected for tax purposes drops precipitously.

- **Fund Partnership with Active Management Assets.** Fund the partnership with assets that require active management, though favorable cases do exist regarding partnerships that hold solely passive assets.

- **Do Not Fund Partnership with Personal Use Assets.** Do not transfer personal use assets to the partnership, even if the donor then leases them from the partnership. This includes, among other things, the donor's residences.

- **Donor Should Not Control Partnership Distributions.** The donor should not be the general partner, if possible. Family members or trusts to whom the client wishes to pass the bulk of the partnership assets should themselves be general partners and participate in the operations of the enterprises. There are several ways to limit or avoid control by the donor of the partnership distributions.

    - A corporate or LLC general partner could be named in which the donor has only a minority interest;

    - You can have two classes of general partnership interests, one of which has control over distributions, and the other which manages the partnership assets. The donor can then transfer the former, retaining the latter; and

    - The partnership can prohibit all distributions during the donor's lifetime.

- **Each Partner Should Have Separate Representation.** All prospective partners should be represented by legal and financial counsel and should have input into the terms of the governing instruments.

- **Avoid Participation Via Powers of Attorney.** Consider a provision that precludes voting for a general partner through a power of attorney.

- **Assure that Significant Interests Are Held by Others.** Give or sell significant limited partnership interests to others, particularly including trusts with independent trustees. The retention of 99% of the partnership interests will encourage a court to ignore the transaction.

- **Assure that Limited Partners Pay for Their Interests**. Limited partners should pay for their partnership interests with their own assets. If they do not have assets, the donors should make gifts and let the gifts gather some age, before creating the partnership.

- **Reserve Adequate Assets.** Never put too much of the donor's wealth in the partnerships; the donors should retain enough assets on which to live comfortably and pay any expected estate taxes or claims. The donor should retain sufficient liquid assets, as well as sufficient wealth. It is not a bad idea if the other family member partners only contribute excess assets, too.

- **Have A Charitable Partner.** Consider giving at least a one percent interest to a charity or other unrelated person, to make it impossible for the family to remove any restrictions on liquidation in the agreement.

- **Use Independent Trustees.** Each trust that holds a partnership interest should have an independent trustee.

- **Use Good Timing to Avoid Step Transaction and Indirect Gift Doctrines.**

  - **Do Not Plan Specific Gifts at Start of Transaction.** The attorney and client should not make definite plans to make gifts until they have formed the partnership and obtained an independent professional appraisal of the value of the limited partnership interests. Only then will they have enough financial data to make intelligent gift plans.

  - **Form the Entity in a No-Gift Situation.** The client should first form the partnership in a non-gift environment, such as having the client and his or her U.S. spouse as the only initial owners, or having the client and a controlled corporation as the only initial owners. Similarly, you can form the entity by having each prospective partner contribute a proportionate share of the nominal initial consideration. Thus, any constructive gifts would not produce a gift tax.

  - **Do All Paperwork to Form Entity.** Make sure that the client signs the partnership agreement and that the partnership certificate is promptly filed. The client (and spouse, if relevant) should then transfer to the entity whatever assets they want the entity to hold.

  - **Reflect the Transfers in the Donor's Capital Account.** The contributions to the partnership must be reflected in the donor's capital account. This will mean that the donor has a substantial increase in his or her (or their) proportionate partnership interest. Assure that capital accounts determine distributions on liquidation or termination.

  - **Get Appraisal.** Next, obtain the best professional appraisal the client can afford. The appraiser makes an independent judgment, and the amount of gifts (or the existence of gifts at all) depends upon the judgment of the appraiser. This usually puts at least several weeks between the formation and funding of the entity and any gifts. Two or three months is even better.

  - **Then Make Transfers.** Once you have an appraisal, and a reasonable time has passed, meet with the client and decide whether gifts will be made, to whom they will be made and the amount of the gifts. Execute a document of transfer and make all necessary amendments to the partnership or operating agreement, including any required waivers of buy-sell restrictions.

- **Adjust Capital Accounts.** Reduce the capital accounts of the donor and transfer the capital to the donees.

○ **File a Timely Gift Tax Return.** File the gift tax return and, where appropriate, allocate GST exemption.

ADMINISTRATION

○ **Have Partnership (or GP) Stationery.** The partnership should have stationery that identifies precisely who the general partners are, to assure that the general partner never acts in a different capacity.

○ **Have Partnership Bank and Security Accounts.** The partnership must have its own bank and securities accounts, accessible only by the general partners.

○ **Hold Regular Partners' Meetings.** The general partners should meet at least quarterly to discuss partnership activities. If possible, the attorney or paralegal should be present.

○ **Keep Good Records.** The general partners should keep books of account and detailed records of their decisions and activities.

○ **Inform Limited Partners.** The general partners should send copies of the minutes of the partnership meetings to the limited partners.

○ **Avoid Commingling.** Never, never commingle partnership and personal assets.

○ **Avoid Paying Personal Expenses.** Never, never pay personal expenses from the partnership assets, even if capital account adjustments are made.

○ **Avoid Paying Estate Expenses.** Generally, the partnership should not pay estate expenses for the principal partner.

○ **Avoid Non-*Pro Rata* Distributions.** Generally, the partnership should avoid making non-*pro rata* distributions.

○ **Avoid Loans to the Donor or Donor's Estate.** Generally, the partnership should not make loans to the principal partner or his or her estate.

○ **Do Not Unwind Partnership (Even Partially) After Donor's Death.** The partnership should not be unwound or make large distributions after the death of the donor partner.

2. Family Limited Partnership Agreement Giving Donee Limited Partners Full Right to Sell their Interests (Subject to a Right of First Refusal) -- Includes Deed of Gift Granting Donee a 30-Day Put Right, Which Should Cause Gifts of Limited Partnership Interests to Qualify for the Gift Tax Annual Exclusion Under *Fisher v. United States*, 2010 WL 935491, 105 A.F.T.R. 2d 2010-1347 (S.D. Ind. 2010)(slip copy); *Price v. Comm'r*, T.C. Memo. 2010-2; and *Hackl v. Comm'r*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003) -- Formed Under 2001 Revised Uniform Limited Partnership Act – Corporate General Partner Limits Lapse of Liquidation Rights[2]

Limited Partnership Agreement

On [date], *GeneralPartner*, of [locality, state] (the general partner, defined below) and *LimitedPartner1*, of [locality, state] , and *LimitedPartner2*, of [locality, state] (together the limited partners and individually a limited partner, defined below), agreed to form this limited partnership (the partnership, defined below), to be referred to sometimes as *Name*.

Recitals

A. The partners (defined below) desire to enter into this agreement (the agreement, defined below) to establish a limited partnership to own certain property and transact certain business;

B. The partners desire to share in the risks, benefits, profits, and losses of the partnership's activities;

C. The partners desire that any gift of a partnership interest and any gratuitous addition to a partner's capital account qualify for the federal gift tax annual exclusion by providing the donee partner with a substantial and immediate present economic benefit;

D. The partners desire that *GeneralPartner* be the sole general partner and that all other partners be limited partners.

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[2] **KEY:**

GeneralPartner	-	Full name of general partner
LimitedPartner1	-	Full name of first limited partner
LimitedPartner2	-	Full name of second limited partner
Name	-	Full Name of the partnership
Agent	-	Full name of registered agent
State	-	State in which the partnership is formed

Agreements

Section 1. Name

The Partnership's name is *Name*.

Section 2. Place of business and agent

2.1 Place of business. The partnership's principal place of business is at [full street address], but the general partner may change the partnership's principal place of business to another location and add additional places of business.

2.2 Agent. The partnership's agent for service of process shall be *Agent*, of [address]. All records that the partnership is required to keep at a specified office shall be kept at its principal place of business.

Section 3. Business

The partnership is formed to own and manage certain real and personal property as the general partner may buy for the partnership, and to conduct any other legal business.

Section 4. Term

4.1 Initial term. The partnership begins on the date of the agreement and ends on December 31, 2052, unless terminated earlier.

4.2 Extension. The partnership may be continued beyond its scheduled termination date by an affirmative vote of all of the then-remaining partners.

Section 5. Capital and Partnership Interests

5.1 Partnership Interests. Each partner's partnership interest (defined below) and each partner's percentage of the total partnership capital accounts (defined below) shall be set forth in a schedule to the agreement [omitted form this exemplar]. A partner's percentage of partnership interest shall always be the same as his, her, or its percentage of the total partnership capital accounts, and a change in a partner's percentage of the total partnership capital accounts shall automatically be reflected in the partner's percentage of partnership interest.

5.2 Additions. A partner shall not be compelled to make any additional capital contributions.

5.3 Adjustments. Each partner's capital account shall be adjusted as necessary to reflect the economic conditions of the partners and their partnership interests. These adjustments shall include, but are not limited to, the following:

5.3.1 Adjustments to reflect each partner's distributive share of partnership profits and losses, including capital gains and losses, and tax-exempt income;

5.3.2 Adjustments to reflect each partner's additional contributions to the partnership;

5.3.3 Adjustments to reflect distributions made by the partnership to each partner;

5.3.4 Tax-sensitive adjustments (defined below).

5.4 Loans. A partner's loans to the partnership shall not be added to that partner's capital account.

5.5 Amount of contributions. The amount of a partner's contributions of property to the partnership and of the partnership's distributions of property to a partner shall be reflected in the partner's capital account at the fair market value of the property on the date of the contribution or distribution, reduced by any liabilities secured by that property, if those liabilities are treated under applicable federal income tax laws as being assumed by or taken subject to by the transferee.

5.6 No Interest Paid. A partner shall receive no interest on his, her, or its capital contributions or partnership interest.

5.7 Withdrawals. A partner may not withdraw any of his, her, or its capital account.

Section 6. Profits, Losses, and Cash Flow

6.1 Profits and Losses. The partnership's net profits and losses (and each item of income, deduction, gain, loss, and credit that makes up net profits and losses) shall be computed in accordance with generally accepted accounting principles, consistently applied, and shall be allocated among the partners in proportion to their partnership interests.

6.1.1 Notwithstanding the general rule stated in Section 6.1., any income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of any variation between the basis and the fair market value of the contributed property at the time of the contribution, in accordance with any applicable U.S. Treasury regulations.

6.1.2 There shall be an income offset (defined below), under which net losses that would otherwise be allocated to a limited partner and that would cause the limited partner's capital account to be in deficit shall instead be allocated to the general partner. After such an allocation of net losses, net profits shall be allocated to the general

partner, until the general partner shall have received an allocation of net profits equal to the aggregate allocation of net losses allocated under this paragraph.

6.1.3 Profits and losses shall, whenever a partner is dissociated (defined below) from the partnership be allocated among the partners based on the number of days (defined below) in that year during which each partner owned a partnership interest, or on any other reasonable basis selected by the managing general partner, consistent with applicable United States tax laws and regulations.

6.2 Cash Flow. The general partner shall cause the partnership to distribute its net cash flow (defined below) to the partners annually, in proportion to their partnership interests.

Section 7. Management

7.1 General Partner. The general partner shall have the full and exclusive power on the partnership's behalf to manage its business and affairs and to do or cause to be done anything deemed necessary or appropriate for the partnership's business. This authority includes, but is not limited to, the following:

7.1.1 The general partner may sell real or personal property to any person, giving any warranties or assurances deemed appropriate;

7.1.2 The general partner may buy, lease, or otherwise acquire real or personal property to carry on and conduct the partnership's business;

7.1.3 The general partner may borrow money for the partnership's business;

7.1.4 The general partner may issue promissory notes and other debt instruments (negotiable or nonnegotiable), in any amounts and secured by any encumbrance on all or any part of the partnership's assets;

7.1.5 The general partner may assign any debts owing to the partnership;

7.1.6 The general partner may engage in any other means of financing;

7.1.7 The general partner may enter into any agreement for sharing of profits and any joint venture agreement with any person or entity engaging in any business or venture in which this partnership may engage;

7.1.8 The general partner may manage, administer, conserve, improve, develop, operate, lease, utilize, and defend the partnership's assets, directly or through third parties;

7.1.9 The general partner may execute any type of agreement or instrument in connection with any other partnership power;

7.1.10 The general partner may employ all types of agents and employees (including lawyers and accountants), even if they are related by blood, marriage, or business relationship to the general partner, and pay them reasonable compensation;

7.1.11 The general partner may buy or otherwise obtain the use of any type of equipment or other property that may be convenient or advisable in connection with any partnership business;

7.1.12 The general partner may incur any reasonable expense for travel, telephone, telegraph, insurance, taxes, and such other things, in carrying on the partnership's business;

7.1.13 The general partner may sue and be sued, complain and defend in the partnership's name and on its behalf; and

7.1.14 The general partner may quitclaim, release, or abandon any partnership assets with or without consideration.

7.2 Multiple General Partners. Multiple general partners shall act by unanimous agreement.

7.3 Compensation and Expenses. Each general partner shall receive reasonable compensation for management of the partnership, and all reasonable expenses incurred by the general partner in managing and conducting the partnership's business, including (but not limited to) overhead, administrative and travel expenses, and such professional, technical, and other services, shall be reimbursed by the partnership.

7.4 Limited Partners. A limited partner (other than one who is also a general partner) shall take no part in the management of the partnership, except to the extent expressly provided by applicable state law.

7.5 Tax Matters Partner. *GeneralPartner* shall be the tax matters partner and, as such, shall be solely responsible for representing the partnership in all dealings with the U.S. Internal Revenue Service and any state, local, and any foreign tax authorities. The tax matters partner shall keep the other partners reasonably informed of any partnership dealings with any tax agency.

Section 8. Financial statements

Within a reasonable period after the close of each fiscal year, the general partner shall, at the partnership's expense, give a written report to each partner who requests it, indicating that partner's share of the partnership income or loss and any changes in that

partner's capital account. This requirement may be satisfied by giving each partner a copy of any tax form which includes such information.

Section 9. Banking

All partnership funds shall be deposited in the partnership's name in such accounts as the general partner may designate. The general partner may authorize other persons to draw checks on partnership bank accounts, but such authority must be in writing. Each bank in which a partnership account is maintained is relieved of any responsibility to inquire into a partner's authority to deal with such funds, and is absolved of all liability with respect to withdrawals from such partnership accounts by any person duly authorized by the general partner.

Section 10. Admission, Expulsion, and Transferees

10.1 Admission. A person may be admitted as an additional partner by the unanimous vote of the other partners, and the new partner's consent in writing to be bound by the agreement.

10.2 Expulsion. Any partner may be expelled from the partnership on the unanimous decision of the other partners. The partnership must pay an expelled partner an amount equal to the fair market value of his, her, or its partnership interest. The fair market value of an expelled partner's partnership interest shall be determined by an independent appraisal performed by a professional appraiser selected by the partnership whose decision in this matter shall be conclusive.

10.3 Transferable Interest. A partner’s only transferable interest in the partnership is his, her, or its share of the profits and losses of the partnership and his, her, or its right to receive distributions.

10.3.1 A partner’s transfer (defined below) of his, her, or its transferable interest in the partnership shall not, by itself, cause the partner's dissociation or a dissolution of the partnership.

10.3.2 A person to whom a partner attempts to transfer his, her, or its partnership interest, and to whom a partner does transfer his, her, or its transferable interest in the partnership, shall not become a partner unless admitted into the partnership pursuant to Section 10.1. A transferee of a partner’s transferable interest in the partnership shall not be entitled to participate in the management or conduct of the partnership business, to require access to information concerning partnership transactions, or to inspect or copy the partnership books or records, unless admitted into the partnership pursuant to Section 10.1.

Section 11. Transfer of Partnership Interests

A partner shall not transfer any of his, her, or its transferable interest in the partnership except in accordance with the terms of this Section 11. An attempted transfer of any transferable interest in the partnership not in accordance with the terms of this Section11 shall not be valid and shall not be reflected on the partnership's books.

11.1 Right of First Refusal. A partner who wishes to transfer any transferable interest in the partnership, or who has reason to believe that an involuntary transfer (defined below) or a transfer by operation of law is reasonably foreseeable (an offering partner), shall first give each other partner written notice of the intent to transfer such transferable interest in the partnership (the offered interest) or of the knowledge that an involuntary transfer or transfer by operation of law is reasonably foreseeable. This notice must contain a description of the portion of interest in the partnership to be transferred, the consideration (if any) to be paid, the terms of transfer and of the payment of consideration (including, but not limited to, the relative percentages of cash and debt, and the terms of any debt instruments), and the name, address (both home and office), and business or occupation of the person to whom the transferable interest in the partnership would be transferred, and any other facts that are or would reasonably be deemed material to the proposed transfer.

11.1.1 Upon the receipt of such notice, each other partner shall have a right to buy that share of the offered interest having the same proportion to all of the offering partner's partnership interest as the buying partner's partnership interest bears to the partnership interests of all partners (except the offering partner).

11.1.2 Each partner may exercise this purchase option by giving the offering partner written notice within thirty (30) days after receipt of the latter's notice.

11.1.3 If the partners do not agree to buy all of the offered interest, the offering partner may complete the intended transfer. If this transfer is not completed within thirty (30) days after expiration of the option period, any attempted transfer shall be deemed pursuant to a new offer and this Section 11 shall again apply.

11.2 Purchase Price. The purchase price that the partners must pay for the offered interest under this Section 11 shall be the same as those of any proposed transfer if the proposed transfer for which notice was given is to be made for any valuable consideration in money or money's worth of property. Otherwise, the purchase price that the partners must pay for the offered interest under this Section 11 shall be the fair market value of the offered interest. The fair market value of a partnership interest shall be determined by an independent appraisal performed by a professional appraiser, selected by the general partner, whose decision in this matter shall be conclusive.

11.3 Purchase Terms. One quarter (1/4) of the purchase price shall be paid in cash or by good personal check at the closing for the sale of such partnership interest, and

the balance shall be paid in twenty (20) equal quarterly principal payments beginning three (3) months after the date of such closing. Simple interest shall be added to each installment, computed against the outstanding principal balance at the applicable federal rate determined for federal income tax purposes on the date of the closing. The buyer shall give the offering partner a promissory note as evidence of this debt, and the buyer may prepay all or any part of the principal balance of the note at any time without penalty or premium.

11.4 The Closing. The purchase of a transferable interest in the partnership under this Section 11 shall take place at a closing to be held not later than the tenth (10th) day after the earlier of the date on which the partners' purchase options have all expired, or the earliest date on which the partners in the aggregate exercise their purchase options, if any, to buy all of the offered interest. The closing shall be held during normal business hours at the partnership's principal business office, or at any other place to which the parties agree. If the offering partner is not present at the closing, then the buyer shall deposit the purchase price by check, note, or both, as this Section 11 requires, with any state or federally chartered bank with which the partnership has an account, as escrow agent, to be paid to the offering partner as soon as is reasonably practicable, less an appropriate fee to the partnership (not to exceed one thousand dollars) to cover additional administrative costs, and the partnership shall adjust its books to reflect the transfer of these transferable interest in the partnership.

11.5 Condition Precedent to Admission of Substitute Partner. No person to whom an interest in the partnership is transferred shall become a new partner in place of the offering partner until:

11.5.1 The transferee agrees in writing to assume all of the obligations and undertakings of the offering partner under the agreement;

11.5.2 The transferee pays the partnership a fee not to exceed one thousand dollars ($1,000.00) to cover the costs of preparing, executing, and recording all pertinent documents; and

11.5.3 The transferee is elected a partner by a unanimous vote of the other partners.

Section 12. Dissociation

12.1 Dissociation as Limited Partner. A limited partner who dissociates from the partnership shall have no further rights as a limited partner, and shall own his, her, or its interest as a transferee, and not as a partner.

12.2 Dissociation Events. A general or limited partner shall be dissociated from the partnership if any of the following events shall occur.

12.2.1 The partner notifies the partnership of his, her, or its intention to withdraw as a partner.

12.2.2 The partner is expelled from the partnership.

12.2.3 The partner, if a trust or if acting as a partner by virtue of being a trustee of a trust, distributes the trust's entire transferable interest in the partnership.

12.2.4 The partner, if an estate or if acting as a partner by virtue of being a personal representative of an estate, distributes the estate's entire transferable interest in the partnership.

12.2.5 The partner's termination, if the partner is not an individual, partnership, corporation, trust, or estate.

12.3 Dissociation by a General Partner. A general partner may dissociate as a general partner at any time, rightfully or wrongfully.

12.3.1 A general partner who dissociates from the partnership shall have no right to participate as a general partner in the management and conduct of the partnership's activities and shall own his, her, or its interest as a transferee, and not as a partner.

12.3.2 In addition to the provisions of Section 12.2, a general partner also dissociates from the partnership if:

(A) The partner dies, has appointed a guardian or general conservator, or is the subject of a judicial determination that the partner has otherwise become incapable of performing the partner's duties under the partnership agreement.

(B) The partner becomes a debtor in bankruptcy, executes an assignment for the benefit of creditors, seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of that partner or of all or substantially all of that partner's property.

(C) The partner fails, within ninety (90) days after the appointment, to have vacated or stayed the appointment of a trustee, receiver, or liquidator of the partner or of all or substantially all of the partner's property obtained without the partner's consent or acquiescence, or fails within ninety (90) days after the expiration of a stay to have the appointment vacated.

12.3 Wrongful Dissociation.

12.3.1 A limited partner's dissociation from the partnership before December 31, 2050, or such earlier date as the partnership shall otherwise terminate, shall be a wrongful dissociation.

12.3.2 A general partner's dissociation is wrongful if it occurs before December 31, 2050, or such earlier date as the partners shall elect to terminate the partnership, and the general partner dissociates by voluntary withdrawal, by expulsion by judicial order, or pursuant to Sections 12.3.2 or 12.3.3, or 12.2.5.

12.3.2 A partner who wrongfully dissociates is liable to the partnership and to the other partners for damages caused by the dissociation. The liability is in addition to any other obligation of the partner to the partnership or to the other partners.

Section 13. Dissolution

13.1 Dissolution. The partnership shall be dissolved upon the expiration of its stated term, the written vote of all of the partners, or the happening of any of the following:

13.1.1 The consent of all of the general partners and of limited partners owning a majority of the rights to receive distributions as limited partners;

13.1.2 After the dissociation of a person as a general partner, except that if the partnership then has at least one remaining general partner, the partnership shall be dissolved only with the consent of the owners of a majority of the rights to receive distributions at the time the consent is to be effective, such consent to be given within ninety (90) days after the dissociation;

13.1.3 After the dissociation of a person as a general partner, except that if the partnership then has no remaining general partners, the partnership shall be dissolved unless, within ninety (90) days after the dissociation, the limited partners holding a majority of the rights to receive distributions at the time the consent is to be effective, vote to continue the partnership and to elect a new general partner, and a new general partner is, in fact, admitted;

13.1.4 Ninety (90) days after the dissociation of the limited partnership's last limited partner, unless before the end of this period the partnership admits at least one limited partner; or

13.1.5 The Secretary of State signs a declaration of dissolution.

13.2 Upon Dissolution. Upon its dissolution, the partnership shall end and commence to wind up its affairs. The partners shall continue to share in profits and losses during liquidation as they did before dissolution. The partnership's assets may be sold, if a price deemed reasonable by the managing general partner can be obtained. The proceeds from liquidation of partnership assets shall be applied as follows:

13.2.1 First, all of the partnership's debts and liabilities to persons other than partners shall be paid and discharged in the order of priority as provided by law;

13.2.2 Second, all debts and liabilities to partners shall be paid and discharged in the order of priority as provided by law;

13.2.3 Third, all remaining assets shall be distributed proportionately among the partners based on their respective positive capital accounts.

13.3 Gain or Loss. Any gain or loss on the disposition of partnership properties in the process of liquidation shall be credited or charged to the partners in proportion to their positive capital accounts, except that gain or loss with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of any variation between the basis of the property so contributed and its fair market value at the time of contribution, in accordance with any applicable U.S. Treasury regulations. Any property distributed in kind in the liquidation shall be valued and treated as though it were sold and the cash proceeds distributed. The difference between the value of property distributed in kind and its book value shall be treated as a gain or loss on the sale of property, and shall be credited or charged to the partners accordingly.

13.4 Partnership Assets Sole Source. The partners shall look solely to the partnership's assets for the payment of any debts or liabilities owed by the partnership to the partners and for the return of their capital contributions and liquidation amounts. If the partnership property remaining after the payment or discharge of all of its debts and liabilities to persons other than partners is insufficient to return the partners' capital contributions, they shall have no recourse therefor against the partnership or any other partners, except to the extent that such other partners may have outstanding debts or obligations owing to the partnership.

Section 14. Amendments

The agreement shall be amended automatically to reflect any valid transfers of partnership interests. Otherwise, the agreement shall be amended only with the unanimous consent of the partners.

Section 15. Power of Attorney

15.1 General. Each limited partner names the general partner as the limited partner's attorney-in-fact, and gives the general partner full power and authority, in the place of the limited partner, to file and record any written instruments that are necessary or appropriate to: (a) amend the certificate of partnership; (b) satisfy requirements of the laws of any state in which the partnership is doing business; (c) continue the partnership, admit additional or substituted partners, dissolve or terminate the partnership or any interest in it; (d) obtain or settle any loan; and (e) transfer any partnership assets.

15.2 Power with an Interest. The power of attorney granted under this Section 15 is coupled with an interest, is irrevocable, and survives the Limited partner's incompetency. The general partner may exercise this power of attorney by a facsimile signature or by

listing all of the limited partners with the signature of the general partner as the attorney-in-fact for all of them. This power of attorney survives the assignment of a limited partner's interest, and empowers each general partner to act to the same extent for any successor limited partner.

Section 16. Miscellaneous

16.1 Notices. Any notice under the agreement shall be given and served either by personal delivery to the party to whom it is directed, or by registered or certified mail, postage and charges prepaid, and if it is sent to a partner, it shall be addressed with his, her, or its address as it appears on the records of the partnership.

16.1.1 Any notice shall be deemed given when it is personally delivered, or, if mailed, on the date it is postmarked by the United States Postal Service, if it was addressed as required in this Section 16.

16.1.2 Any partner may change his, her, or its address for purposes of the agreement by written notice to a general partner, stating his, her, or its new address. A change of address shall be effective fifteen (15) days after the notice is received by a general partner.

16.2 Non-waiver. Any party's failure to seek redress for violation of or to insist upon the strict performance of any provision of the agreement shall not prevent a subsequent act, which would have originally constituted a violation, from having the effect of an original violation.

16.3 Severability. Every provision of the agreement is intended to be severable. If any term or provision hereof is invalid for any reason whatsoever, its invalidity shall not affect the validity of the remainder of the agreement.

16.4 Good Faith. The performance of any act, or the failure to perform any act, by a partner or the partnership, the effect of which causes any loss or damage to the partnership, shall not subject such partner or the partnership to any liability, if the decision to perform or not to perform the act was made pursuant to advice of the partnership's legal counsel or in good faith to promote the partnership's best interests.

16.5 Governing Law. The agreement is to be construed according to the laws of the state of *state*.

16.6 Cumulative Rights. The rights and remedies provided in the agreement are cumulative and the use of any right or remedy does not limit a party's right to use any or all other remedies. All rights and remedies in the agreement are in addition to any other legal rights the parties may have.

16.7 Other Activities. A partner may engage in whatever activities he or she chooses without any obligation to offer any interest in such activities to any party hereof.

16.8 Confidentiality. No partner may, without every general partner's express written consent, divulge to others any information not already known to the public pertinent to the services, clients, customers, or operations of the partnership, whether before or after the partnership's dissolution.

16.9 Counterparts. The agreement may be executed in any number of counterparts with the same effect as if all parties hereto had all signed the same document. All counterparts shall be construed together and shall constitute one (1) agreement.

16.10 Waiver of Partition. Each partner waives any right to maintain any action for partition with respect to the partnership's property or assets during the partnership's term.

16.11 Binding Terms. The terms of the agreement are binding upon and inure to the benefit of the parties and, to the extent permitted by the agreement, their heirs, executors, administrators, legal representatives, successors and assigns.

16.12 Personal Property. The interests of each partner in the partnership are personal property.

16.13 Gender and Number. Unless the context requires otherwise, the use of a masculine pronoun includes the feminine and the neuter, and vice versa, and the use of the singular includes the plural, and vice versa.

Section 17. Definitions

17.1 Agreement. The "agreement" is the agreement of *Name*, as amended from time to time. The agreement shall include all schedules, as they may be amended from time to time.

17.2 Capital Accounts. The "capital accounts" or "partnership capital" is the total of the partners' capital contributions, adjusted as provided in the agreement.

17.3 Certificate. The "certificate" is the certificate of limited partnership filed on behalf of the partnership, as amended from time to time.

17.4 Days. "Day" or "days" refers to a calendar day, including any days which fall on legal holidays or weekends.

17.5 General Partner. The "general partner" shall refer to *GeneralPartner*, and any additional or successor general partner.

17.6 Income Offset. The "income offset" shall be synonymous with and interpreted consistently with the "qualified income offset" defined in U.S. Treasury Regulations § 1.704-1(b)(2)(ii)(d), as amended.

17.7 Limited Partner. The "limited partner" or "limited partners" shall refer to *LimitedPartner1*, *LimitedPartner2*, and *Partner3*, and any persons who later become limited partners, each of whom is a limited partner.

17.8 Net Cash Flow. "Net cash flow" is the partnership's total net income, computed for federal income tax purposes, increased by any depreciation or depletion deductions taken into account in computing taxable income and any nontaxable income or receipts (other than capital contributions and the proceeds of any partnership borrowing); and reduced by any principal payments on any partnership debts, expenditures to acquire or improve partnership assets, any proceeds from the sale or exchange of partnership assets, and such reasonable reserves and additions thereto as the general partner shall determine to be advisable and in the best interests of the partnership, having due regard to the interests of the limited partners.

17.9 Partners. The "partners" or a "partner", when used without the words "general" or "limited," shall refer to both the general partners and the limited partners.

17.10 Partnership. The "partnership" refers to *Name*.

17.11 Partnership Capital. The "partnership capital" is the total of the partners' capital contributions, as adjusted pursuant to the agreement.

17.12 Partnership Interests. The "partnership interests" are the relative interests of the individual partners in the partnership, as listed on a schedule to the agreement.

17.13 Tax-Sensitive Adjustments. The "tax-sensitive adjustments" are all adjustments to a partner's capital account that are not specifically required under the terms of the agreement, but that are required by U.S. Treasury Regulations § 1.704-1(b)(2)(iv) ("Maintenance of Capital accounts"), as amended. Such adjustments shall be made annually, unless these regulations require a more frequent adjustment.

17.14 Transfer. A "transfer" of a partnership interest includes any sale, pledge, encumbrance, gift, bequest, or other transfer or disposition of the partnership interest or permitting it to be sold, encumbered, attached, or otherwise disposed of, or changing its ownership in any manner, whether voluntarily, involuntarily, or by operation of law. A "transfer" does not include any assignment of any partnership interest to another partner or to any trust that is entirely revocable by the assignor, but such trust shall be treated as the agent of the assignor, and any subsequent disposition of such partnership interest by such trust shall be deemed to have been made by the trust's settlor or grantor.

AGREED on the date first noted above.

[Signature and notarial clauses and schedule omitted from this exemplar]

Deed of Gift of Limited Partnership Interest[3]

I, *Donor*, of [address], do hereby transfer a limited partnership interest in *Name*, a [state] limited partnership, to *Donee* (sometimes referred to as *Short4Donee*).

Section 1. Amount Transferred

I transfer by this deed of gift an interest representing a [percentage] limited partnership interest in *Name*.

Section 2. Put Right

For sixty (60) days immediately following the date of this gift, *Short4Donee* shall have the right to require that I buy the interest that I have given *him/her* pursuant to this instrument.

A. *Short4Donee* may exercise this put right by a writing delivered to me. The put right may be exercised on behalf of *Short4Donee*, if *he/she* is unable to exercise this right because of a legal disability (including minority), by a legally authorized guardian or other personal representative. If *Short4Donee* is so disabled and if *he/she* has no then-serving personal. representative, the general partner shall appoint an appropriate adult individual to act for *Short4Donee* in this matter.

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[3] KEY:

Donor	-	Full name of donor of limited partnership interest
Donee	--	Full name of donee of limited partnership interest
Short4Donee	--	Shorthand for donee of limited partnership interest, such as "Howard" or "Mr. Zaritsky" or "Shorty" or "the Donee".
Name	--	Full name of the partnership
he/she	--	"he" or "she", referring to the donee
him/her	--	"him" or "her", referring to the donee

B. The maximum amount that *Short4Donee* may require me to buy under this put right, with respect to the partnership interest gift under this deed of gift, shall be the lesser of: (a) the total amount of the partnership interest gifts under this deed of gift, valued as for federal gift tax purposes; and (b) the amount of the federal gift tax annual exclusion in effect on the date of this gift, reduced by the amount of any other gifts I shall have made to *Short4Donee* in the same calendar year as this gift (or twice that amount if I am married to a U.S. citizen on the date of this gift).

C. The price that I shall pay for a partnership interest under this Section 2 shall be the fair market value of that interest, as determined for federal gift tax purposes, ignoring the existence of this put right.

Section 3. Date of this Gift

This gift shall be effective on the date on which I have signed it, regardless of the date on which *Short4Donee* shall have signed it.

[Signature, dates, and notarial clause for donor, and signature of donee omitted from this exemplar]

3. Defined Value Deed of Gift – Based on *Estate of Petter v. Comm'r*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. Aug. 4, 2011); and *Hendrix v. Comm'r*, T.C. Memo. 2011-133 (June 15, 2011)[4]

DEED OF GIFT

On [date], I, *Grantor* (referred to in the first person), do hereby make this declaration of gift, in order to give certain property to various parties, as described below.

Recitals:

A. I own [number] of units of membership interest in [name of LLC] (the "Units"); and

B. I wish to give away all of my Units to *FamilyDonee* (sometimes referred to as *Short4FamilyDonee*) and to *Charity* (sometimes referred to as *Short4Charity*); and

C. I do not wish to incur any federal gift tax on this transfer; and

D. *Short4FamilyDonee* and *Short4Charity* wish to receive these gifts, on the terms and subject to the conditions set forth in this agreement;

NOW, THEREFORE, I do hereby make the following gifts:

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[4] **KEY:**

Grantor	--	Full name of the grantor
FamilyDonee	--	Full name of noncharitable donee; if a trust, the donee should be identified with the name of the trustee and the name of the trust, such as "Trust Company of Virginia, trustee for the Howard M. Zaritsky Intentional Grantor Trust, dated January 1, 2009"
Short4FamilyDonee	--	Shorthand description of the noncharitable donee, such as "Ms. Jones" or "Lolla" or "the Trust"
Charity	--	Full name of charitable donee
Short4Charity	--	Shorthand description of the charity, such as "the Foundation" or "Emory"
he/she/it	--	"he" "she" or "it", referring to the noncharitable donee

Article 1. Gift to *FamilyDonee*

I hereby give and transfer to *Short4FamilyDonee* that number of Units the value of which is equal to the maximum dollar amount that can pass free of federal gift tax by reason of my applicable exclusion amount allowed by Code Section 2010(c), as finally determined for federal gift tax purposes. I understand that my unused applicable exclusion amount to be One Million Dollars ($1,000,000), so that the amount of this gift to "Short4FamilyDonee" should be One Million Dollars ($1,000,000), but if my understanding is determined to be incorrect, the amount of this gift to *Short4FamilyDonee* shall be the actual maximum dollar amount described in the first sentence of this Article 1.

Article 2. Gift to *Charity*

I also hereby give and transfer to *Short4Charity* all of the Units remaining after my gift to *Short4FamilyDonee* under Article 1. This gift shall be held and applied by *Short4Charity* for its general charitable purposes.

Article 3. Determination of Value

3.1 Initial Division. Within thirty (30) days following the date of this deed of gift, *Short4FamilyDonee* and *Short4Charity* shall agree to the division of this gift between them.

3.2 Disagreement. If, within thirty (30) days following the date of this deed of gift, *Short4FamilyDonee* and *Short4Charity* are unable to agree to the division of this gift between them, the number of Units going to *Short4FamilyDonee* and, by subtraction, the number of Units going to *Short4Charity* shall be determined as follows:

3.2.1. The number of Units passing to *Short4FamilyDonee* shall be that number of Units having a fair market value equal to the maximum dollar amount that can pass free of federal gift tax by reason of my applicable exclusion amount allowed by Code Section 2010(c), as finally determined for federal gift tax purposes, determined under the methods and rules established by Federal gift tax law. This number of Units shall be determined by one (1) or more qualified appraisers (defined below), under the procedures in this section 3.2.

3.2.2. *Short4 FamilyDonee* and *Short4Seller* shall each have the opportunity to appoint, at each of their own expense, a qualified appraiser, within five (5) days following the expiration of the thirty (30)-day period following this deed of gift. If either of them shall fail to appoint a qualified appraiser within this five (5)-day period, the other qualified appraiser shall unilaterally establish the number of Units passing to *Short4FamilyDonee* and the number of Units passing to *Short4Charity*.

3.2.3. If both parties appoint qualified appraisers within this five (5)-day period, these two (2) qualified appraisers shall together establish the number of Units passing to *Short4FamilyDonee* and the number of Units passing to *Short4Charity*, in a single written opinion agreed to by both of them.

3.2.4. If these two (2) qualified appraisers cannot agree on the number of Units passing to *Short4FamilyDonee* and the number of Units passing to *Short4Charity*, within ten (10) days following the appointment of the later of them, they shall each prepare an independent written appraisal, and the average of the number of Units passing to *Short4FamilyDonee* determined under these two (2) appraisals shall control.

3.3 Adjustment to Gift to *FamilyDonee*. *Short4FamilyDonee* agrees that, if the value of my Units given to *him/her/it* under Article 1 is finally determined for federal gift tax purposes to exceed the maximum dollar amount that can pass free of federal gift tax by reason of my applicable exclusion amount allowed by Code Section 2010(c), as also finally determined for federal gift tax purposes, *he/she/it* will, as a condition of the gift under Article 1, transfer the excess Units to *Short4Charity* as soon as practicable.

[signature and notarial clause]

4. IRS/Treasury Priority Guidance List for 2012 – Issues Related to Estate Planning

DEPARTMENT OF THE TREASURY
Washington, DC 20220

OFFICE OF TAX POLICY
AND
INTERNAL REVENUE SERVICE
2011-2012 PRIORITY GUIDANCE PLAN
September 2, 2011

* * * *

GENERAL TAX ISSUES

19. Final regulations under §§ 108 and 7701 regarding the bankruptcy and insolvency rules and disregarded entities. Proposed regulations were published on April 13, 2011.[5]

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26. Final regulations under § 170 regarding charitable contributions. Proposed regulations were published on August 7, 2008.[6]

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GIFTS AND ESTATES AND TRUSTS

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

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[5] See Prop. Reg. § 1.108-9, 76 FR 20593-01 (April 13, 2011).

[6] See REG-140029-07, 73 Fed. Reg. 45908 (Aug. 7, 2008), regarding changes in substantiation and reporting of charitable contributions.

2. Final regulations under §642(c) concerning the ordering rules for charitable payments made by a charitable lead trust. Proposed regulations were published on June 18, 2008.[7]

3. Guidance concerning adjustments to sample charitable remainder trust forms under §664.

4. Guidance concerning private trust companies under §§671, 2036, 2038, 2041, 2042, 2511, and 2601.

5. Regulations under §1014 regarding uniform basis of charitable remainder trusts.

6. Guidance under §1022 concerning estates of decedents who die during 2010.

   - PUBLISHED 08/29/11 in IRB 2011-35 as REV. PROC. 2011-41 (RELEASED 08/05/11).

   - PUBLISHED 08/29/11 in IRB 2011-35 as NOT. 2011-66 (RELEASED 08/05/11).

7. Guidance on portability of Unified Credit between spouses under §2010(c).

8. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on April 25, 2008.[8]

9. Final regulations under §2036 regarding graduated retained annuity trusts. Proposed regulations were published on April 30, 2009.[9]

10. Guidance on whether a grantor's retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor's gross estate under §2042.

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[7] See REG-101258-08, 73 Fed. Reg. 34670 (June 18, 2008), correction 73 Fed. Reg. 40793 (July 16, 2008), further correction in Ann. 2008-73, 2008-33 I.R.B. 391 (Aug. 18, 2008).

[8] See REG-112196-07, 73 Fed. Reg. 22300 (April 24, 2008).

[9] See Prop. Reg. §§ 20.2036-1(b)(1)(ii), 20.2036-1(c)(1)(ii), 20.2036-1(c)(2), 74 Fed. Reg. 19913 (April 30, 2009), corrected 74 Fed. Reg. 26597 (June 3, 2009), corrected Ann. 2009-50, 2009-25 I.R.B. 1105 (June 22, 2009).

11. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

12. Revenue procedure providing procedures for filing protective claims for refunds for amounts deductible under §2053.

13. Notice on decanting of trusts under §§ 2501 and 2601.

14. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.[10]

15. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.

16. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

17. Final regulations under §7520 updating the mortality-based actuarial tables to be used in valuing annuity interests for life, or term of years, and remainder or reversionary interests. Proposed regulations were published on May 4, 2009.

    - PUBLISHED 08/10/11 in FR as TD 9540.[11]

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INSURANCE COMPANIES AND PRODUCTS

1. Final regulations under §72 on the exchange of property for a private annuity contract. Proposed regulations were published on October 18, 2006.[12]

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9. Regulations under §7702 defining cash surrender value.

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[10] See REG-147775-06, 73 Fed. Reg. 20870-01 (April 17, 2008).

[11] See T.D. 9540, 76 Fed. Reg. 49570 (Aug. 10, 2011).

[12] See REG-141901-05, 71 Fed. Reg. 61441 (Oct. 18, 2006).

TAX ADMINISTRATION

14. Regulations under §6166 regarding the furnishing of security in connection with an election to pay the estate tax in installments.

5. IRS No-Rulings List for 2011 – Estate, Gift, GST Tax and Related Issues. Excerpts from Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (Jan. 3, 2011)

SECTION 3. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED

.01 Specific questions and problems.

* * * *

(2) Section 61. -- Gross Income Defined. -- Whether a split-dollar life insurance arrangement is "materially modified" within the meaning of § 1.61-22(j)(2) of the Income Tax Regulations. (Also §§ 83, 301, 1401, 2501, 3121, 3231, 3306, 3401, and 7872.)

* * * *

(7) Section 101. -- Certain Death Benefits. -- Whether there has been a transfer for value for purposes of § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

(8) Sections 101, 761, and 7701. -- Definitions. -- Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of § 101, when substantially all of the organization's assets consists or will consist of life insurance policies on the lives of the members.

(9) Section 102. -- Gifts and Inheritances. -- Whether a transfer is a gift within the meaning of § 102(a).

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(22) Section 170. -- Charitable, Etc., Contributions and Gifts. -- Whether a charitable contribution deduction under § 170 is allowed for a transfer of an interest in a limited partnership or a limited liability company taxed as a partnership to an organization described in § 170(c).

(23) Section 170. -- Charitable, Etc., Contributions and Gifts. -- Whether a taxpayer who advances funds to a charitable organization and receives therefor a promissory note may deduct as contributions, in one taxable year or in each of several years, amounts forgiven by the taxpayer in each of several years by endorsement on the note.

* * * *

SIGNIFICANT ISSUE: A significant issue is an issue of law that meets the three following tests: (1) the issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin; (2) the resolution of the issue is not essentially free from doubt; and (3) the issue is legally significant and germane to determining the major tax consequences of the transaction. An issue of law will be considered not clearly and adequately addressed by the authorities above, and its resolution will not be essentially free from doubt when, because of concern over a legal issue (as opposed to a factual issue), taxpayer's counsel is unable to render an unqualified opinion on what the tax consequences of the transaction will be.

OBTAINING A RULING: To obtain a ruling on a transaction involving a significant issue, the taxpayer must in its ruling request explain the significance of the issue, set forth the authorities most closely related to the issue, and explain why the issue is not resolved by these authorities.

* * * *

(51) Section 641. -- Imposition of Tax. -- Whether the period of administration or settlement of an estate or a trust (other than a trust described in § 664) is reasonable or unduly prolonged.

(52) Section 642(c). -- Deduction for Amounts Paid or Permanently Set Aside for a Charitable Purpose. -- Allowance of an unlimited deduction for amounts set aside by a trust or estate for charitable purposes when there is a possibility that the corpus of the trust or estate may be invaded.

(53) Section 664. -- Charitable Remainder Trusts. -- Whether the settlement of a charitable remainder trust upon the termination of the noncharitable interest is made within a reasonable period of time.

(54) Section 671. -- Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners. -- Whether the grantor will be considered the owner of any portion of a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate

or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

* * * *

(65) Section 2031. -- Definition of Gross Estate. -- Actuarial factors for valuing interests in the prospective gross estate of a living person.

(66) Section 2055. -- Transfers for Public, Charitable, and Religious Uses. -- Whether a charitable contribution deduction under § 2055 is allowed for the transfer of an interest in a limited partnership or a limited liability company taxed as a partnership to an organization described in § 2055(a).

(67) Section 2512. -- Valuation of Gifts. -- Actuarial factors for valuing prospective or hypothetical gifts of a donor.

(68) Section 2522. -- Charitable and Similar Gifts. -- Whether a charitable contribution deduction under § 2522 is allowable for a transfer of an interest in a limited partnership or a limited liability company taxed as a partnership to an organization described in § 2522(a).

(69) Section 2601. -- Tax Imposed. Exceptions: Retention of Trust's Generation-Skipping Transfer Tax Exempt Status in the Case of Modifications, Etc. -- Whether a trust exempt from generation-skipping transfer (GST) tax under § 26.2601-1(b)(1), (2), or (3) of the Generation-Skipping Transfer Tax Regulations will retain its GST exempt status when there is a modification of a trust, change in the administration of a trust, or a distribution from a trust in a factual scenario that is similar to a factual scenario set forth in one or more of the examples contained in § 26.2601-1(b)(4)(i)(E).

* * * *

(74) Section 6166 -Estates consisting largely of an interest in a closely held business -Requests involving section 6166 where there is no decedent.

* * * *

SECTION 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED

.01 Specific questions and problems.

* * * *

(14) Section 170. -- Charitable, Etc., Contributions and Gifts. -- Whether a transfer to a pooled income fund described in § 642(c)(5) qualifies for a charitable contribution deduction under § 170(f)(2)(A).

(15) Section 170(c). -- Charitable, Etc., Contributions and Gifts. -- Whether a taxpayer who transfers property to a charitable organization and thereafter leases back all or a portion of the transferred property may deduct the fair market value of the property transferred and leased back as a charitable contribution.

(16) Section 170. -- Charitable, Etc., Contributions and Gifts. -- Whether a transfer to a charitable remainder trust described in § 664 that provides for annuity or unitrust payments for one or two measuring lives qualifies for a charitable deduction under § 170(f)(2)(A).

* * * *

(36) Section 642. -- Special Rules for Credits and Deductions; Pooled Income Fund.-Whether a pooled income fund satisfies the requirements described in § 642(c)(5).

(37) Section 664. -- Charitable Remainder Trusts. -- Whether a charitable remainder trust that provides for annuity or unitrust payments for one or two measuring lives or for annuity or unitrust payments for a term of years satisfies the requirements described in § 664.

(38) Section 664. -- Charitable Remainder Trusts. -- Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

(39) Section 664. -- Charitable Remainder Trusts. -- Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of § 664.

(40) Sections 671 to 679. -- Grantors and Others Treated as Substantial Owners. -- In a nonqualified, unfunded deferred compensation arrangement described in Rev. Proc. 92-64, the tax consequences of the use of a trust, other than the model trust described in that revenue procedure.

(41) Sections 671 to 679. -- Grantors and Others Treated as Substantial Owners -Whether an Indian tribe (as defined in 25 U.S.C. § 2703(5)) that establishes a trust to

receive and invest per capita payments for its members who are minors or legal incompetents under the Indian Gaming Regulatory Act (25 U.S.C. §§ 2701-2721) is the grantor and owner of the trust, if the trust meets the requirements of section 5.02 of Rev. Proc. 2003-14, 2003-1 C.B. 319.

(42) Section 1001. -- Determination of Amount of and Recognition of Gain or Loss. -- Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, is treated as a sale or other disposition by the beneficiaries of their interests in the trust.

* * * *

(47) Section 2055. -- Transfers for Public, Charitable, and Religious Uses. -- Whether a transfer to a pooled income fund described in § 642(c)(5) qualifies for a charitable deduction under § 2055(e)(2)(A).

(48) Section 2055. -- Transfers for Public, Charitable, and Religious Uses. -- Whether a transfer to a charitable remainder trust described in § 664 that provides for annuity or unitrust payments for one or two measuring lives or a term of years qualifies for a charitable deduction under § 2055(e)(2)(A).

(49) Section 2503. -- Taxable Gifts. -- Whether the transfer of property to a trust will be a gift of a present interest in property when (i) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (iv) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (v) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

(50) Section 2514. -- Powers of Appointment. -- If the beneficiaries of a trust permit a power of withdrawal to lapse, whether § 2514(e) will be applicable to each beneficiary in regard to the power when (i) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (iv) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (v) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

(51) Section 2522. -- Charitable and Similar Gifts. -- Whether a transfer to a pooled income fund described in § 642(c)(5) qualifies for a charitable deduction under § 2522(c)(2)(A).

(52) Section 2522. -- Charitable and Similar Gifts. -- Whether a transfer to a charitable remainder trust described in § 664 that provides for annuity or unitrust payments for one or two measuring lives or a term of years qualifies for a charitable deduction under § 2522(c)(2)(A).

(53) Section 2601. -- Tax Imposed. -- Whether a trust that is exempt from the application of the generation-skipping transfer tax because it was irrevocable on September 25, 1985, will lose its exempt status if the situs of the trust is changed from the United States to a situs outside of the United States.

(54) Section 2702. -- Special Valuation Rules in Case of Transfers of Interests in Trusts. -- Whether annuity interests are qualified annuity interests under § 2702 if the amount of the annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10 percent of the initial net fair market value of the property transferred to the trust. For purposes of the 10 percent test, the value of the remainder interest is the present value determined under § 7520 of the right to receive the trust corpus at the expiration of the term of the trust. The possibility that the grantor may die prior to the expiration of the specified term is not taken into account, nor is the value of any reversion retained by the grantor or the grantor's estate.

(55) Section 2702 -Special Valuation Rules in Case of Transfers of Interests in Trusts. -- Whether a trust with one term holder satisfies the requirements of § 2702(a)(3)(A) and § 25.2702-5(c) to be a qualified personal residence trust.

* * * *

SECTION 5. AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, REVENUE PROCEDURE, REGULATIONS OR OTHERWISE

* * * *

.02 Sections 101 and 7702. -- Certain Death Benefits; Life Insurance Contract Defined. -- Whether amounts received under an arrangement that is not regulated as an insurance company may be treated as received under a "life insurance contract" within the meaning of §§ 101(a) and 7702.

* * * *

.09 Sections 661 and 662. -- Deduction for Estates and Trusts Accumulating Income or Distributing Corpus; Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus. -- Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under § 661 or which requires an amount to be included in the gross income of any person under § 662.

.10 Sections 671 to 679. -- Grantors and Others Treated as Substantial Owners. -- Whether an Indian tribe (as defined in 25 U.S.C. § 2703(5)) that establishes a trust to receive and invest per capita payments for its members (regardless of whether they are minors or legal incompetents) under the Indian Gaming Regulatory Act (25 U.S.C. §§ 2701-2721) is the grantor and owner of the trust if the trust does not meet the requirements of section 5.02 of Rev. Proc. 2003-14, 2003-1 C.B. 319.

* * * *

.13 Section 2036. -- Transfers with Retained Life Estate. -- Whether the corpus of a trust will be included in a grantor's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the grantor's family.

.14 Section 2038. -- Revocable Transfers.-Whether the corpus of a trust will be included in a grantor's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the grantor's family.

.15 Section 2041. -- Powers of Appointment. -- Whether the corpus of a trust will be included in an individual's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the individual's family.

.16 Section 2501. -- Imposition of Tax. -- Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a gift under § 2501.

.17 Sections 2601 and 2663. -- Tax Imposed; Regulations. -- Whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under § 2612.

6. Clause Allowing Disinterested Trustee to Grant Surviving Spouse General Power of Appointment Over Appreciated Assets in Nonmarital Trust, to Take Advantage of Increased Applicable Exclusion Amount under Tax Relief Act of 2010, Pub. L. 111-312, 111th Cong., 2nd Sess. (Dec. 27, 2010) – Used for Trusts that Do Not Continue Long After Surviving Spouse's Death

ARTICLE __. Grant of a General Power of Appointment

A "disinterested trustee" (defined below) may at any time and from time to time grant to my *husband/wife*, if *he/she* survives me, a power to appoint at *his/her* death, all or a portion of the assets of the family trust.

A. Granting the Power. A disinterested trustee shall grant this power of appointment by an instrument in writing delivered to my *husband/wife*, designating the specific trust assets or fractional share of the trust, which may include the entire trust, over which my *husband/wife* shall hold this power of appointment.

B. Changing or Rescinding a Granted Power. A disinterested trustee may revoke any prior grant of a general power of appointment under this article, or change the property to which such previously granted power shall be exercisable, or the terms under which such previously granted power may be exercised.

C. Permissible Appointees. My *husband/wife* may exercise this power to appoint the subject trust assets to and among a class that includes the estate of my *husband/wife* and the persons who are otherwise current or potential beneficiaries of this trust.

1. Appointment Outright or in Further Trust. My *husband/wife* may exercise this power to appoint the trust assets outright or in further trust, and if exercised to appoint in further trust, may appoint on such terms and conditions as *he/she* shall select.

2. Unequal Appointment. My *husband/wife* may appoint the trust assets among this class of appointees unequally and in such proportions as *he/she* deems appropriate for any purpose whatsoever.

3. Appointment to My *Husband/Wife*'s Estate. My *husband/wife* may appoint trust assets to *his/her* estate only with the express signed written consent of a "nonadverse person" (defined below) designated by the disinterested trustee in the instrument granting the power of appointment under this article. For this purpose, a "nonadverse person" is any person who has no substantial interest in the property subject to the power of appointment, which interest is adverse to the exercise of the power in favor of my *husband/wife*'s estate. Any attempted appointment to my *husband/wife*'s estate without the express signed written consent of the nonadverse party designated by the

disinterested trustee who granted *him/her* this power of appointment shall be void and of no effect, and this power of appointment shall be deemed not to have been validly exercised.

D. Exercise of This Power. My *husband/wife* may exercise this power of appointment by express reference to this power in *his/her* last will, or by express reference to this power in another dated and notarized writing signed by *him/her*, which writing shall be revocable and ineffective during *his/her* life and effective only upon the death of my *husband/wife*.

E. Disclaimers. The power of appointment under this article may not be granted with respect to any assets or share added to the trust as a result of a disclaimer by my *husband/wife*.

F. No Liability. I recognize the difficulty attendant in the exercise of the power of the disinterested trustee to grant my *husband/wife* a general power of appointment in a manner that best reduces income taxes on the disposition of the distributed assets without also increasing the estate tax obligation of the estate of my *husband/wife*. I direct that the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for the disinterested trustee's actions under this article. Without exclusion, the disinterested trustee shall have no liability to any beneficiary or any other person for: (1) failing to grant my *husband/wife* a power of appointment; (2) granting my *husband/wife* a power of appointment that does not cause an amount of trust assets to be included in my *husband/wife*'s gross estate for Federal estate tax purposes that will obtain the optimal income tax benefit for the trust; (3) granting a power of appointment to my *husband/wife* under this instrument, even if such granting causes adverse income or estate tax results; (4) granting a power of appointment to my *husband/wife* that causes more property to be included in *his/her* gross estate than can be sheltered from Federal or state estate taxes by my *husband/wife*'s available exemptions and deductions; and (5) the actions of any nonadverse party in consenting or refusing to consent to the exercise of a granted power of appointed in favor of the estate of my *husband/wife*, or the action of the disinterested trustee in naming or refusing to name such a nonadverse party. A nonadverse party named by the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for consenting or refusing to consent to the exercise of any granted power of appointment in favor of the estate of my *husband/wife*.

G. Disinterested Trustee" Defined. A "disinterested trustee" means a trustee who is not an interested trustee. An "interested trustee" means a trustee who is also (1) a beneficiary of the trust of which he or she is the insured under a policy of insurance owned by a trust of which he or she is a trustee; (2) married to and living together with a beneficiary of the trust of which he or she is a trustee; (3) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (4) an employee of a beneficiary of the trust of which he or she is a trustee; (5) a corporation or any employee of a corporation in which the stock holdings of the trustee and the trust are significant from

the viewpoint of voting control; or (6) a subordinate employee of a corporation in which the trustee is an executive.

7. Clause Allowing Disinterested Trustee to Grant Any Beneficiary a General Power of Appointment Over Appreciated Assets in Nonmarital Trust, to Take Advantage of Increased Applicable Exclusion Amount under Tax Relief Act of 2010, Pub. L. 111-312, 111th Cong., 2nd Sess. (Dec. 27, 2010) – Used for Trusts that Continue Long After Surviving Spouse's Death

ARTICLE __. Grant of a General Power of Appointment

A "disinterested trustee" (defined below) may at any time and from time to time grant to any beneficiary of the family trust (the "appointing beneficiary") a power to appoint at his or her death, all or a portion of the assets of the family trust.

A. Granting the Power. A disinterested trustee shall grant this power of appointment by an instrument in writing delivered to the appointing beneficiary, designating the specific trust assets or fractional share of the trust, which may include the entire trust, over which the appointing beneficiary shall hold this power of appointment.

B. Changing or Rescinding a Granted Power. A disinterested trustee may revoke any prior grant of a general power of appointment under this article, or change the property to which such previously granted power shall be exercisable, or the terms under which such previously granted power may be exercised.

C. Permissible Appointees. An appointing beneficiary may exercise this power to appoint the subject trust assets to and among a class that includes his or her estate and the persons who are otherwise current or potential beneficiaries of this trust.

1. Appointment Outright or in Further Trust. The appointing beneficiary may exercise this power to appoint the trust assets outright or in further trust, and if exercised to appoint in further trust, may appoint on such terms and conditions as he or she shall select.

2. Unequal Appointment. The appointing beneficiary may appoint the trust assets among this class of appointees unequally and in such proportions as *he/she* deems appropriate for any purpose whatsoever.

3. Appointment to The Appointing Beneficiary's Estate. The appointing beneficiary may appoint trust assets to his or her estate only with the express signed written consent of a "nonadverse person" (defined below) designated by the disinterested trustee in the instrument granting the power of appointment under this article. For this purpose, a "nonadverse person" is any person who has no substantial interest in the property subject to the power held by the appointing beneficiary, which interest is adverse to the exercise of the power in favor of the appointing beneficiary's estate. Any attempted appointment to the appointing beneficiary's estate without the express signed written consent of the nonadverse party designated by the disinterested trustee who granted him

or her this power of appointment shall be void and of no effect, and this power of appointment shall be deemed not to have been validly exercised.

D. Exercise of This Power. The appointing beneficiary may exercise this power of appointment by express reference to this power in his or her last will, or by express reference to this power in another dated and notarized writing signed by him or her, which writing shall be revocable and ineffective during his or her life and effective only upon the death of the appointing beneficiary.

E. Disclaimers. The power of appointment under this article may not be granted to any person with respect to any assets or share added to the trust as a result of a disclaimer by that person.

F. No Liability. I recognize the difficulty attendant in the exercise of the power of the disinterested trustee to grant the appointing beneficiary a general power of appointment in a manner that best reduces income taxes on the disposition of the distributed assets without also increasing the estate tax obligation of the estate of the appointing beneficiary. I direct that the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for the disinterested trustee's actions under this article. Without exclusion, the disinterested trustee shall have no liability to any beneficiary or any other person for: (1) failing to grant any beneficiary a power of appointment; (2) granting any beneficiary a power of appointment that does not cause an amount of trust assets to be included in such beneficiary's gross estate for Federal estate tax purposes that will obtain the optimal income tax benefit for the trust; (3) granting a power of appointment to any beneficiary under this instrument, even if such granting causes adverse income or estate tax results; (4) granting a power of appointment to any beneficiary that causes more property to be included in his or her gross estate than can be sheltered from Federal or state estate taxes by the appointing beneficiary's available exemptions and deductions; and (5) the actions of any nonadverse party in consenting or refusing to consent to the exercise of a granted power of appointed in favor of the estate of an appointing beneficiary, or the action of the disinterested trustee in naming or refusing to name such a nonadverse party. A nonadverse party named by the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for consenting or refusing to consent to the exercise of any granted power of appointment in favor of the estate of an appointing beneficiary.

G. Disinterested Trustee" Defined. A "disinterested trustee" means a trustee who is not an interested trustee. An "interested trustee" means a trustee who is also (1) a beneficiary of the trust of which he or she is insured under a policy of insurance owned by a trust of which he or she is a trustee; (2) married to and living together with a beneficiary of the trust of which he or she is a trustee; (3) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (4) an employee of a beneficiary of the trust of which he or she is a trustee; (5) a corporation or any employee of a corporation in which the stock holdings of the trustee and the trust are significant from the

viewpoint of voting control; or (6) a subordinate employee of a corporation in which the trustee is an executive.

9. Direction to Executor to Elect to Give the Surviving Spouse the Decedent's Unused Applicable Exclusion Amount.

__. **Deceased Spousal Unused Exclusion Amount Election.** I direct that my executor shall do all things necessary to make a valid election to allow my surviving spouse to have the benefit of my deceased spousal unused exclusion amount, to the greatest extent permitted under applicable federal estate tax law. My surviving spouse shall have no obligation to make any payment to my estate or to the other beneficiaries of my estate in order for my executor to make or because my executor has made this election, nor shall any equitable adjustment be made with respect to the dispositions under my estate because my executor has made this election.

10. American College of Trust & Estates Counsel Comments on Portability

October 28, 2011

CC:PA:LPD:PR (Notice 2011-82)
Internal Revenue Service
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Via Electronic Mail:

Notice.Comments@irscollnsel.treas.gov

Re: Comments of The American College of Trust and Estate Counsel on Guidance on Electing Portability of Deceased Spousal Unused Exclusion Amount (Notice 2011-82) Released on September 29, 2011

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College") is pleased to submit these comments on the Guidance on Electing Portability of Deceased Spousal Unused Exclusion Amount, Notice 2011-82, released on September 29, 2011. The College recognizes that drafting guidance and regulations is a difficult task. The College appreciates the Internal Revenue Service's and Treasury Department's efforts to provide guidance on the manner in which an executor of the estate of a decedent dying after December 31, 2010 makes the election under Section 2010(c)(5)(A) of the Internal Revenue Code to allow the decedent's surviving spouse to use the decedent's unused exclusion amount. The College also appreciates the opportunity to respond to the request for comments on the topics set forth at the end of Notice 2011-82 in advance of the issuance of proposed regulations.

The College is a professional association of over 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities. Fellows of the College have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate and gift tax planning and compliance. The College offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

Background

In Notice 2011-82, 2011-42 I.R.B. 516 (September 29, 2011), the IRS provided guidance on the portability of a deceased spousal unused exclusion amount ("DSUEA"), allowed under section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312 (124 Stat. 3302) ("TRUIRJCA") and Section 20 I 0(c)(5)(A).[1] In this notice, the Service and Treasury invited comments on the following specific issues, for consideration in forthcoming regulations:

1. The determination in various circumstances of the deceased spousal unused exclusion amount and the applicable exclusion amount;

2. The order in which exclusions are deemed to be used;

3. The effect of the last predeceasing spouse limitation described in section 2010(c)(4)(B)(i);

4. The scope of the Service's right to examine a return of the first spouse to die without regard to any period of limitation in section 6501; and

5. Any additional issues that should be considered for inclusion in the proposed regulations.

Specific Comments and Proposals

1. Determination in various circumstances of the DSUEA and the applicable exclusion amount

Generally, the DSUEA and the applicable exclusion amount should be easily determined in accordance with the plain language of the Code. The first two examples of the operation of the DSUEA and the applicable exclusion amount included in the Joint Committee on Taxation's Technical Explanation of the TRUIRJCA provide a good basis for examples in the regulations. Staff of the Joint Committee on Taxation, 111th Cong., 2d Sess., "Technical Explanation of the Revenue Provisions Contained in the 'Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010' Scheduled for Consideration by the United States Senate," p. 52 (Dec. 10, 2010) (Committee Print) ("JCT Technical Explanation"). These two examples are as follows:

> Example 1.—Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on

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[1] All references to "Section," unless otherwise indicated, refer to the Internal Revenue Code of 1986, as amended.

> Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.
>
> Example 2.—Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

The College agrees with the substance of Examples 1 and 2 and recommends that they be incorporated into the proposed regulations.

The third example in the JCT Technical Explanation, however, creates a widely acknowledged potential problem. The third example states:

> Example 3.—Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). W made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

JCT Technical Explanation at 52-53.

This third example appears to conflict with Section 2010(c)(4). Section 2010(c)(2) states that an individual's applicable exclusion amount is equal to the sum of his or her

basic exclusion amount ($5 million indexed for inflation after 2011) and DSUEA. Section 2010(c)(4) provides that the DSUEA is the lesser of (1) the basic exclusion amount or (2) the excess of: (i) the basic exclusion amount of the last deceased spouse of the surviving spouse over (ii) the taxable estate plus adjusted taxable gifts. Example 3 calculates Wife's DSUEA as her applicable exclusion amount less her taxable estate, rather than as her basic exclusion amount less her taxable estate.

The Joint Committee staff stated in 2011 that:

> The provision adds new section 2010(c)(4), which generally defines "deceased spousal unused exclusion amount" of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the provision.

Joint Committee on Taxation, 111th Cong., 2d Sess., "ERRATA—'General Explanation Of Tax Legislation Enacted In The 111th Congress'" p. 1 (March 23, 2011) ("JCT ERRATA").

The conflict between the JCT Technical Explanation and the statute puts taxpayers in an untenable position that should be addressed by regulation or other guidance.

The College believes that the present language of Section 2010(c)(4), if read literally, does not reflect Congress' intent and, in any event, makes no sense. Read literally, the statute provides for a comparison of two limiting amounts, permitting a surviving spouse to utilize the lower of those two amounts in addition to the surviving spouse's own basic exclusion amount. Those two limiting amounts are: (1) the basic exclusion amount and (2) the basic exclusion amount of the predeceased spouse reduced by the predeceased spouse's tax base (i.e., the sum of the predeceased spouse's taxable estate and adjusted taxable gifts). Because the second amount cannot be greater than the first amount, the first amount can never result in capping the amount of the deceased spouse's exclusion amount to be enjoyed by the surviving spouse.[2] As Example 3 in the Joint JCT Technical

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[2] One could speculate that Congress chose to make the first limiting amount at least equal to the second limiting amount—even though the first limiting amount would thereby be denied significance—in anticipation of the possibility that the basic exclusion amount might be reduced in the future. If, for example, the basic exclusion amount were reduced to $3.5 million in 2013 and the surviving spouse died thereafter, the first limiting amount ($3.5 million) would constitute a cap on the amount of the DSUEA available to the surviving

Explanation indicates, and as is confirmed by the JCT ERRATA, Congress intended the calculation of the second amount to begin with the "applicable exclusion amount," not the "basic exclusion amount," reduced by the predeceased spouse's tax base. When the statute is read that way, as Congress intended, the absurdity disappears. The predeceased spouse's applicable exclusion amount could indeed be greater than the basic exclusion amount (because it could include the predeceased spouse's DSUEA), thus permitting the first amount to have significance by capping the amount of the predeceased spouse's exclusion to be enjoyed by the surviving spouse.

As a matter of traditional statutory construction, courts can ignore a literal reading of a statute in order to avoid an absurd result. See Comm'r v. Brown, 380 U.S. 563, 571 (1965), quoting Helvering v. Hammel, 311 U.S. 504, 510-11 (1941) ("courts, in interpreting a statute, have some 'scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results … or would thwart the obvious purpose of the statute'"); Mangels v. United States, 828 F.2d 1324, 1329 (8th Cir. 1987) ("plain meaning rule is inapplicable … when it yields absurd consequences and there is an alternative interpretation that reasonably effects the statute's purpose"). Moreover, courts can cure a scrivener's error contained in a statute. See us. Nat. Bank of Oregon v. Independent Ins. Agents of America, 508 U.S. 439 (1993); United States v . Pabon-Cruz, 391 F.3d 86 (2d Cir. 2004). Thus, the College believes that a court would hold that the statute should be construed in accordance with Congress' intent. As a result, Treasury should certainly be able to achieve the same result by regulation. See PSB Holdings, Inc. v. Comm'r, 129 T.C. 131, 138-141 (2007).

Under the first step of analysis under Chevron US.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984), an agency is only foreclosed from adopting a regulation if the statute unambiguously provides a contrary result. In the context of Section 2010(c)(4)(i), given the statute's failure to make sense on its face, as well as the reflection in the legislative history, the suggested regulation could not be invalidated under Chevron's first step. Indeed, at the very least, the statute is ambiguous, thus giving Treasury the authority under Chevron to resolve it in accordance with Congress' intent. In addition, it should be noted that, under Section 2010(c)(6) Treasury is expressly given the authority "to prescribe such regulations as may be necessary or appropriate to carry out this

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spouse. This assumes that the second limiting amount would not also be adjusted to $3.5 million, because, even though the first and second limiting amounts both refer to the "basic exclusion amount," the second limiting amount adds the phrase "of the last such deceased spouse of such surviving spouse." To the extent this is viewed as ambiguous, it is appropriate for the regulations to consider the legislative history, which reveals no indication that Congress was concerned about the possibility of future reductions in the basic exclusion amount. Indeed, the statutory language of Section 2010(c)(4) may be traced to section 304 of the "Middle Class Tax Cut Act of 2010," Senator Baucus's Senate Amendment to H.R. 4863, of December 2, 2010, which would have made the estate tax rules (of 2009) permanent.

subsection.” This specific grant of authority could certainly be cited in support of the suggested regulation. See Mayo Foundation for Medical Educ. and Research v. United States, _ U.S. _ 131 S. Ct. 704 (2011) (applying JCT Technical Explanation to an interpretive tax regulation issued under Section 7805 and indicating that such a regulation should receive no less deference than a specific-grant regulation). Finally, as a tax-payer-friendly regulation, the suggested regulation could not, and would not, be challenged by a taxpayer. In fact, no taxpayer would have standing to make such a challenge. Thus, we respectfully suggest that the regulations adopt the approach we outline on this issue.

If Treasury and the Service do not believe that they have the authority to issue regulations interpreting the Code in a manner consistent with the JCT ERRATA, however, the regulations or other guidance should at least provide a safe harbor for surviving spouses who wish to make gifts and executors who must administer estates such that neither will be penalized for treating Section 2010(c)(4) as limiting the surviving spouse's DSUEA to the lesser of the basic exclusion amount or the excess of: (i) the applicable exclusion amount of the last deceased spouse of the surviving spouse over (ii) the taxable estate plus adjusted taxable gifts. Taxpayers should not be forced to plan for two different interpretations of the portability rules, and they should be protected from penalty exposure for relying on what the Joint Committee staff states was Congress's actual intent.

2. The order in which exclusions are deemed to be used

The Code does not address the manner in which the gift tax on lifetime transfers by a surviving spouse should be deemed to be offset by the spouse's basic exclusion amount and DSUEA. Whether this issue is important depends upon the interpretation adopted by Treasury and the Service regarding the use of the phrase “basic exclusion amount of the last deceased spouse” in Section 2010(c)(4)(B)(i). The College has suggested, as discussed above, that Treasury and the Service interpret Section 2010(c)(4)(B)(i) as actually referring to the “applicable exclusion amount of the last deceased spouse.”

If the interpretation of Section 2010(c)(4)(B)(i) recommended by the College is adopted, then the Code would make an ordering rule irrelevant and we recommend that the regulations not attempt to create one.[3]

Section 2010(c)(2) states that the applicable exclusion amount (from which the applicable credit amount is derived) consists of the basic exclusion amount and the DSUEA. The only point in either the estate or gift tax rules in which the basic exclusion amount is relevant is in computing the DSUEA. It is not used to compute the estate or gift tax directly. The estate and gift tax are always calculated using the applicable exclusion

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[3] Issues related to multiple marriages, which could be among the potential issues contemplated by this question, are addressed below in the discussion of “DSUEA and gift tax payable under Section 2001(b)(2).”

amount, unified credit, or applicable credit amount. Once an individual survives a predeceased spouse and receives a DSUEA, that amount becomes an increased applicable exclusion amount or applicable credit amount. An ordering rule would be inconsistent with this concept.

Furthermore, an ordering rule would make no difference in the computation of gift or estate taxes, other than in computing the DSUEA of a surviving spouse. This can be illustrated by the following examples:[4]

> Example 1. Hand Ware married and both are U.S. citizens. Neither H nor W has ever made an adjusted taxable gift. H dies in Year One. H has no taxable estate, and W receives a DSUEA of$5 million. W's applicable exclusion amount (from which her applicable credit amount is calculated) becomes $10 million. W makes $10 million of taxable gifts in Year Two. W pays no gift tax on these transfers because of her $10 million applicable exclusion amount. In Year Three, W marries H2. In Year Four, H2 dies, leaving his entire $5 million taxable estate to individuals other than W. W's DSUEA is now zero and her applicable exclusion amount is zero (one cannot have a negative applicable exclusion amount).
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> W makes $1 million of gifts later in Year Five. In determining the tax owed by W on this gift, Section 2505(a) permits her a credit for an amount equal to
>
> (1) The applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by
>
> (2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.
>
> The applicable credit amount in effect under Section 2010(c), had W died at the end of Year Five, is $1,730,800. The sum of amounts previously allowed as a credit is $3,480,800. The credit allowed for W against the Year Five gift tax is zero.
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> Example 2. Assume the same facts as in Example 1, except that the gift made by W in Year Two is $7 million. In determining the tax owed by W on the Year Five gift, the credit available to her under Section 2505(a) is still

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[4] In all examples in this letter: (a) future inflation adjustments to the basic exclusion amount are ignored: (b) it is presumed that the portability rules are in effect in all years; and (c) it is presumed that the tax rates and basic exclusion amount applicable in 2011 are in effect in all years.

zero ($1,730,800 - $2,430,800). The ratio of DSUEA and basic exclusion amount that constituted the applicable exclusion amount used to offset the tax on the Year Two gifts is irrelevant.

Example 3. Assume the same facts as in Example 2, except that W dies in Year Five, rather than making a gift in that year. W's taxable estate is $5 million. The tentative tax on W's estate is imposed on the sum of the taxable estate ($5 million) and the amount of W's adjusted taxable gifts ($7 million). The tentative estate tax imposed on this $12 million amount is $4,180,800. This amount is then reduced by the total gift tax paid or payable with respect to adjusted taxable gifts, and by W's $1,730,000 unified credit. The proportion of the Year Two gifts that was sheltered from tax by DSUEA is irrelevant.

On the other hand, if Treasury and the Service do not interpret Section 2010(c)(4)(i) as if it referred to the "applicable exclusion amount of the last deceased spouse," then an ordering rule is necessary to calculate accurately the DSUEA of a surviving spouse who makes a lifetime taxable gift before remarriage. The question becomes whether a surviving spouse who makes a lifetime taxable gift offsets the gift tax with DSUEA, the donor's basic exclusion amount, or some combination of the two, and, if with a combination of the two, how that combination is determined.

There are at least four general approaches (each no doubt with many variations) that the regulations could take on this issue:

(a) The regulations could require a donor to apply his or her basic exclusion amount and DSUEA to lifetime transfers, but allow a donor to elect the amount and order in which each would be applied. The donor would, consistent with present law, be required to use one or both of these amounts to offset gift tax, to the greatest extent possible; the donor could not elect to pay gift tax and reserve the use of the basic exclusion amount, the DSUEA, or both, for future transfers.

(b) The regulations could require that a donor use his or her basic exclusion amount to offset the tax on a lifetime transfer, and only permit use of the DSUEA after the donor's basic exclusion amount had been exhausted.

(c) The regulations could require that a donor use his or her DSUEA to offset the tax on a lifetime transfer, and only permit the use of the basic exclusion amount after the donor's DSUEA had been exhausted.

(d) The regulations could require that the donor use basic exclusion amount and DSUEA proportionately.

The approach that has the most to commend it is requiring that the surviving spouse use all of his or her DSUEA before using any of his or her basic exclusion amount. This approach is the most consistent with the purpose and function of the portability rules. This

approach is consistent with Example 3 of the Jet Technical Explanation and would, therefore, preserve and continue an approach that many practitioners believe already to be required.

This approach also implements the purpose of the portability concept, to facilitate a decedent's making all or a substantial amount of his or her estate fully available to the surviving spouse, rather than leaving a substantial amount to a nonmarital trust, in order to take full advantage of the first deceased spouse's applicable exclusion amount. A decedent who leaves his or her estate to a surviving spouse necessarily anticipates that the surviving spouse will dispose of at least a portion of those assets by lifetime or testamentary transfer to or for the benefit of the children of the marriage and their descendants, A surviving spouse who wants to make such gifts from the property received from the first deceased spouse is, in effect, conferring the benefits on the family that the deceased spouse might have otherwise conferred through a nonmarital trust. The surviving spouse is, in effect, distributing the deceased spouse's assets and should, therefore, be able to make use of the deceased spouse's applicable exclusion amount.

This suggests that the surviving spouse should be able to use the DSUEA received from the first deceased spouse's estate before using his or her own basic exclusion amount. This rule could be illustrated by the following examples:

> Example 1. Hand Ware married and both are U.S. citizens. W dies in Year One leaving an estate of$5 million. W's entire estate passes outright to H, a U.S. citizen. Neither W nor H has ever made lifetime taxable gifts. W's executor files a timely Form 706 and, by not taking any of the designated actions to avoid the election, allocates W's unused exemption to H. H's applicable exclusion amount is then $10 million ($5 million basic exclusion amount + $5 million DSUEA). In Year Two, H makes a $3 million taxable gift. H must use $3 million of the DSUEA to offset the gift tax on this transfer. Thereafter, H's applicable exclusion amount is $7 million ($5 million basic exclusion amount + $2 million DSUEA).
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> In Year Three, H marries W2, who is also a U.S. citizen.
>
> In Year Four, H dies, survived by W2. H leaves his entire estate outright to W2. W2 receives a DSUEA from H, calculated under Section 2010(c)(4) as the lesser of: (i) the basic exclusion amount ($5 million) or (ii) the basic exclusion amount of the last deceased spouse ($5 million) over the amount with respect to which the tentative tax is determined under section 2001(b)(I) on the last deceased spouse's estate ($3 million). W2's DSUEA is $2 million.
>
> Example 2. Assume the same facts, except that in Year Four, W2 dies, leaving $5 million to her children. H's applicable exclusion amount is thereafter $5 million (his $5 million basic exclusion amount + $0 DSUEA).

Example 3. Assume the same facts as in Example 2, except that in Year Two, H makes a $6 million taxable gift. H must use all of his DSUEA and $1 million of his basic exclusion amount to offset the gift tax on this transfer. Thereafter, H's applicable exclusion amount is $4 million ($0 DSUEA + $4 million basic exclusion amount). After the death ofW2, H's applicable exclusion amount is still $4 million.

3. The effect of the last predeceasing spouse limitation described in section 2010(c)(4)(B)(i)

Lifetime taxable gifts. The effect of the last predeceased spouse limitation in Section 2010(c)(4)(B)(i) should be clarified by regulation with respect to the treatment of taxable gifts made by a last deceased spouse on which gift tax is actually paid.

Section 2010(c)(3) states that the basic exclusion amount is $5 million, adjusted for inflation after 2011. Section 2010(c)(4) states that the DSUEA is the lesser of (a) the basic exclusion amount or (b) the excess of the basic exclusion amount of the surviving spouse's last deceased spouse, over “the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.”

Section 2505(a) states that the unified credit, for gift tax purposes, shall be “(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by (2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.” This definition applies until December 31, 2012.

The flush language of Section 2505(a) then adds that, for purposes of calculating the amounts allowable as a credit in preceding periods, “the rates of tax in effect under section 2502(a)(2) for such calendar year shall, in lieu of the rates of tax in effect for preceding calendar periods, be used in determining the amounts allowable as a credit under this section for all preceding calendar periods.”

We believe that there is an ambiguity in the manner in which Section 2010(c)(4) takes into account gifts that were made in prior calendar periods on which gift tax was actually paid, where the applicable exclusion amount has been increased in later years. The requirement in Section 2010(c)(4)(ii) that the last deceased spouse's basic exclusion amount be reduced by “the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse” could be construed, absent clarifying regulations, to ignore the fact that the last deceased spouse paid a gift tax on the transfers that were above the applicable exclusion amount at that time, but which are below the applicable exclusion amount on the date of death.

Example. In 2008, the applicable exclusion amount for gift taxes is $1 million, and H makes a $4 million taxable gift, utilizing all of his applicable exclusion amount and paying

a $1,335,000 gift tax. H dies in 2011, survived by W, who is a U.S. citizen. H has a taxable estate of $1 million and the 2008 taxable gift is the only gift he has ever made. The DSUEA available to W should be $3 million (H's $5 million basic exclusion amount - $1 million lifetime use of applicable exclusion amount - $1 million taxable estate), but Section 2010(c)(4)(B)(ii) could be read as requiring that the DSUEA available to W is reduced by H's entire $4 million adjusted taxable gift, including the portion for which no applicable exclusion amount was available and therefore gift taxes were paid.

As discussed earlier, regulations typically construe statutory language in a manner that avoids an unanticipated and arguably “absurd” result. The regulations should, we submit, construe Section 2010(c)(4)(B)(ii) as limited to those adjusted taxable gifts the tax on which was offset by the unified credit available at the time of the gift.

Remarriage and divorce. The regulations should also clarify the effect of the remarriage by a surviving spouse who has a DSUEA, if that later marriage is terminated by divorce or annulment. The Code appears to leave a surviving spouse's DSUEA intact even after the surviving spouse's remarriage, unless the more recent new spouse dies and is survived by the original surviving spouse. It would be very useful for the regulations to verity that the surviving spouse's DSUEA is unaffected by mere remarriage, and if that subsequent marriage is terminated by divorce or annulment, the surviving spouse's DSUEA from the first spouse remains intact unless and until it is used against lifetime taxable gifts or a taxable estate. This may be illustrated as follows:

> Example 1. Hand Ware married and both are U.S. citizens. H dies in Year One, survived by his spouse, W. H has never made any lifetime taxable gifts, and his taxable estate is $1 million. The DSUEA available to W on account of H's death is $4 million ($5 million basic exclusion amount - $1 million taxable estate). W has previously made $5 million in taxable gifts, so her applicable exclusion amount after H's death is $4 million ($4 million DSUEA + $0 basic exclusion amount). In Year Two, W marries H2, who is also a U.S. citizen. In Year Three, while H2 is still alive, W makes a taxable gift of$2 million. W can use her applicable exclusion amount attributable to the DSUEA she received from H to offset the gift tax on her taxable gift made in Year Three.
>
> Example 2. Assume the same facts as in Example 1, except that before W makes her taxable gift, H2 dies. H2 is also a U.S. citizen, and his entire $10 million estate is left outright to W. H2's gift to W qualifies for the estate tax marital deduction, and H2 has no taxable estate. W's DSUEA after the death of H2 is $5 million - H2's unused basic exclusion amount. W may use the $5 million DSUEA from H2 to offset the gift tax on her taxable gift in Year Three.

DSUEA and gift tax payable under Section 2001(b)(2). A surviving spouse who remarries continues to have an applicable exclusion amount that includes the same DSUEA that he or she had before remarriage. The Code does not require a change in the

DSUEA unless a surviving spouse both remarries and survives the later spouse. In such cases. however. the surviving spouse calculates his or her applicable exclusion amount using the amount of DSUEA received from the last spouse survived. The surviving spouse's applicable exclusion amount no longer then takes into account the DSUEA received from the first deceased spouse.

A surviving spouse in this situation may acquire a DSUEA that is smaller than that which the surviving spouse has already used to satisfy a gift tax liability. This has caused some to question whether such a reduction of a surviving spouse's DSUEA below the level that the surviving spouse has already used to offset gift taxes may produce additional estate taxes at the surviving spouse's death. This concept is sometimes referred to as a “DSUEA clawback” or “portability clawback”. This could be seen as economically similar to the issues related to the “ordering” of the use of the DSUEA, but, for reasons stated above, is better addressed as a separate issue in its own right.

A deceased donor's adjusted taxable gifts are added to the donor's taxable estate in the calculation of the tentative tax under Section 2001(b)(1). The deceased donor's estate then reduces the tentative estate tax by the gift tax payable with respect to post-1976 gifts. Int. Rev. Code §2001(b)(2).

The question distills to whether the gift taxes that are offset with applicable exclusion amount attributable to DSUEA are treated as gift taxes payable under Section 2001(b)(2), even if that DSUEA is later reduced by remarriage and survival of a later spouse. That in turn could be phrased as a question whether the total DSUEA available over a lifetime (following the death of the first predeceased spouse) should in effect be maximized or minimized. This can be illustrated by the following:

> Example. H and W are married and both are U.S. citizens. H dies in Year One, and W receives a $5 million DSUEA because of an election by the executor of H's estate. W then has a $5 million DSUEA and a $5 million basic exclusion amount, for a $ 10 million applicable exclusion amount. Later in Year One, W makes a $9 million taxable gift, offsetting the tax on this gift with her applicable exclusion amount. Thereafter, W marries H2, who is also a U.S. citizen. H2 dies in Year Two, survived by W. H2 leaves his $5 million estate to his children. W's DSUEA is reduced to zero. W dies in Year Three, leaving a taxable estate of $1 million. W's estate tax will be initially calculated on a base of $10 million ($ 1 million taxable estate + $9 million post-1976 adjusted taxable gifts). The tentative estate tax on $10 million would be $3,480,800. Because W had no DSUEA, the unified credit is $1,730,800.
>
> “Maximizing” approach: The gift tax that “would have been payable” for purposes of Section 2001(b)(2), computed without regard to the DSUEA, is $1,400,000, and the estate tax is $350,000 ($3,480,800 - $1,400,000 - $1,730,800), or 35% of the $1million taxable estate.

"Minimizing" approach: The gift tax that "would have been payable" for purposes of Section 2001(b)(2), computed with regard to the DSUEA, is zero, and the estate tax is $1,750,000 ($3,480,800 - $1,730,800), which happens to be 35% of $5 million (and presumably $750,000 more than the assets available to the executor to pay the tax).

The choice between these two applications of the "last such deceased spouse" limitation may depend on the policies that Congress intended that limitation to serve. We assume that the limitation to the "last such deceased spouse" is intended, at least in part, to serve the policy of simplifying portability by limiting both the number of predeceased spouse's estates (one) that would have to be examined to verify the DSUEA and the span of time (to the most recent) that such an examination would have to reach back. The "maximizing" approach, which disregards the DSUEA for purposes of Section 2001(b)(2), would serve that policy. At the time each gift is made, there is only one predeceased spouse, the most recent, whose estate needs to be reviewed to verify the DSUEA.

The "maximizing" approach would also reduce the likelihood of an estate tax that is larger than the estate from which it must be paid, which is the result in the above example under the "minimizing" approach. Such a result would present a problem for the Service, because it is not clear that either the executor or the donees would be liable for the $750,000 of estate taxes owed in excess of the decedent's estate.[5] We do not believe that regulations can make the donees liable for additional estate taxes attributable to the increased adjusted taxable gifts. We would, however, have serious concerns about a rule that could result in an uncollectible tax liability, embarrass and frustrate some taxpayers, appear to treat otherwise similarly situated taxpayers unevenly, and appear to taxpayers as a tax policy or tax administration mistake that could reduce taxpayer confidence in the fairness of the tax system. If possible, we would prefer to avoid that result or make it less likely. That could be done by adopting the "maximizing" approach, even if the donor later remarries, survives another spouse, and receives from the last deceased spouse a DSUEA that is less than that used with respect to the gift already made. In addition, we note that the "maximizing" approach would resemble the approach of the Tax Court in Estate of Smith v. Comm'r, 94 T.C. 872 (1990), acq. 1990-2 C.B. 1, treating as gift taxes payable for purposes of Section 2001(b)(2) those taxes that would have been payable on the increased value of adjusted taxable gifts determined in an estate tax audit.

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[5] The executor is required to pay all federal estate taxes from the total assets under the executor's control. Int. Rev. Code §2002; 31 U.S.C. §§ 3713(a) and 3713(b). The executor is not responsible for paying more taxes than the assets includible in the decedent's gross estate for estate tax purposes. Treas. Reg. §20.2002-1. A donee may be liable as a transferee for unpaid gift taxes, and for estate taxes imposed on gifts that are themselves included in the decedent's gross estate for estate tax purposes. Int. Rev. Code §§ 6324(a)(2), 6901(a)(1). Section 2035(c)(1)(C) gives the IRS a lien for estate taxes on gifts made within three years of death. This lien does not extend to gifts made more than three years prior to death and included in the decedent's estate tax base under Section 2001(b).

On the other hand, if the limitation to the "last such deceased spouse" is intended also to serve a policy of providing a proxy for an anti-abuse rule that ignores multiple marriages in certain cases, then the "minimizing" approach, in which the DSUEA enters into the calculation of the offset under Section 2001(b)(2), might seem more appropriate. In addition, there is the limitation of Section 2010(c)(4)(A), which effectively prevents the applicable exclusion amount from being greater than double the basic exclusion amount. The estate planning community has speculated about the need for both the "last such deceased spouse" limitation and the Section 2010(c)(4)(A) limitation, which seem to be redundant in a time of increasing or constant exemptions. We suggest that, if necessary, one way to acknowledge an independent role for both limitations and achieve, as closely as possible, all of the objectives we have identified, would be to adopt the "maximizing" approach to the "last such deceased spouse" limitation, while interpreting the Section 2010(c)(4)(A) limitation as applying to the aggregate of all DSUEA used by any surviving spouse, by gift or at death, since January 1, 2011, without regard to the number of intervening remarriages ended by death. As this appears to us to be the most balanced approach, with the least unintended adverse consequences, we recommend it.

In either case, the rules applicable to the use of the DSUEA by gift rather than at death should be consistent, so that Section 2505(a)(2) and the following flush language are applied consistently with Section 2001(b)(2) and (g).

4. The scope of the Service's right to examine a return of the first spouse to die without regard to any period of limitation in section 6501

General scope. The Code is quite clear on the scope of any examination of the estate of a predeceased spouse, and the regulations should confirm and illustrate that such an examination cannot be used to assess an estate tax deficiency with respect to the estate of such predeceased spouse after the limitations period of Section 6501 has expired, but that it can be used to reduce or eliminate the DSUEA of the surviving spouse, and to assess an estate or gift tax deficiency with respect to the predeceased spouse's estate for which the limitations period of Section 6501 has not expired.

Section 2010(c)(5)(B) states that:

> Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

This language, we believe, clearly restricts the post-limitations period examinations to those issues that can affect the surviving spouse's DSUEA. We believe that the appropriate scope of the examination of the estate of the predeceasing spouse would

include all issues relating to the determination of the predeceased spouse's taxable estate, which can include questions of valuation, includibility, and deductibility, but that such re-determinations can be used only to adjust the DSUEA of the surviving spouse.

The following examples illustrate what we propose is the correct operation of Section 2010(c)(5)(B):

> Example 1. H and W are married and both are U.S. citizens. H died in Year One, and his executor filed a timely estate tax return reporting a gross estate of $10 million, a marital deduction of$6 million, and a taxable estate of $4 million. H's estate tax return also reported that H had made no lifetime taxable gifts.
>
> W dies in Year Two, after the expiration of the period for assessment of a deficiency with respect to H's estate under Section 6501(a). As part of the examination of W's estate tax return, H's estate tax return is examined and it is discovered that H possessed incidents of ownership with respect to a $3 million life insurance policy, the proceeds of which were paid to H's children. No estate tax deficiency can be assessed with respect to H's estate by virtue of the examination of his estate after the expiration of the period for assessment under Section 6501(a), but W's DSUEA is reduced to zero.
>
> Example 2. H and W are married and both are U.S. citizens. H died in Year One, and his executor filed a timely estate tax return reporting a gross estate of $10 million, a marital deduction of $4 million, and a taxable estate of $6 million. H's estate tax return also reported that H had made no lifetime taxable gifts.
>
> W dies in Year Two, after the expiration of the period for assessment of a deficiency with respect to H's estate under Section 6501(a). As part of the examination of H's estate after W's death results, it is discovered that H actually did not hold incidents of ownership over a $3 million life insurance policy, the proceeds of which were paid to H's children. Those $3 million proceeds had been included in H's gross estate on his estate tax return (thus constituting, as a matter of computation, half of the $6 million taxable estate). H's estate cannot claim a refund by virtue of the examination of his estate after the expiration of the period for assessment under Section 6501(a), but W's DSUEA can be increased to reflect the removal of the $3 million life insurance proceeds from H's taxable estate.
>
> Example 3. Assume the same facts as in Example 1, except that the examination of H's estate after W's death results in a $5 million increase in the value of the assets passing to H's children. No estate tax deficiency can be assessed with respect to H's estate by virtue of the examination of his

> estate after the expiration of the period for assessment under Section 6501(a), but W's DSUEA is reduced to zero.

Notwithstanding the breadth of the statutory language, we believe that it would be unduly burdensome on taxpayers if questions with respect to the value of the assets, debts and administrative expenses of the predeceased spouse's estate remain open until the death of the surviving spouse. Many years may elapse until the death of the surviving spouse during which records could become unavailable and evidence become stale and unreliable. Errors in the computation of the DSUEA (including by reason of omissions from the estate tax return of the predeceased spouse) could be taken into account for purposes of determining the correct amount of the DSUEA, but it would seem unreasonable to require that the value of each item adequately disclosed on the predeceased spouse's estate tax return be re-established by the executor of the surviving spouse's estate for purposes of computing the DSUEA on the death of the surviving spouse. We believe that a limited administrative rule should presume that all information adequately reported on a timely-filed estate tax return for the predeceased spouse is correct, but that this presumption could be overcome. See, however, discussion below of what constitutes a "complete Form 706."

Unreported taxable gifts. Another problem may arise where the Service, in examination of the first spouse's estate after the expiration of the limitations period, discovers unreported taxable gifts. Technically, the gift tax on these gifts could still be assessable and collectable from the donees. This result can be illustrated by the following example:

> Example. H and W are married and both are U.S. citizens. H dies in Year One, and his executor filed a timely estate tax return reporting a gross estate of $10 million, a marital deduction of$9 million, and a taxable estate of $1 million. H's estate tax return also reported that H had made no lifetime taxable gifts.
>
> W dies in Year Two, after the expiration of the period for assessment of a deficiency with respect to H's estate under Section 6501(a). The examination of H's estate after W's death results in the discovery of$8 million in unreported lifetime taxable gifts by H to his children. No gift tax returns were filed for the years of these transfers, and the statute of limitations on the assessment of a gift tax deficiency has not expired under Section 6501(a). Therefore, the examination of H's estate can result in both the assessment of a gift tax deficiency and action to collect this deficiency from the donees as transferees, and the reduction to zero of W's DSUEA.

This result is harsh and may unduly inhibit the election of portability by executors. Executors are likely to believe that they should not elect portability unless they know to a virtual absolute certainty that there have been no unreported taxable gifts. Such certainty will very rarely exist.

We recommend that the regulations adopt a limited administrative exception to the Service's well-established right to assess a gift tax without an applicable limitation period on taxable gifts that were never reported on a gift tax return. This pronouncement would be similar to Notice 2009-84, 2009-44 I.R.B. 592, which was recently reaffirmed in Rev. Proc. 2011-48, 2011-42 I.R.B. 527, in the context of reexamining estate tax returns in the consideration of protective claims for refund under Section 2053. An announcement of similar forbearance with regard to portability would do much to allay the concern of many executors that electing portability will expose the estate of the first spouse to die to an extended period of tax uncertainty. Reversing the result illustrated in the previous example would mean that some tax properly owed might go uncollected, but it is necessary to do this if portability is to be comfortably available for use by most estates.

5. Additional issues that should be considered for inclusion in the proposed regulations

Other estate tax credits and the DSUEA. The Code does not state explicitly whether the DSUEA is determined before or after the application of the other available credits, such as the credit for tax on prior transfers (Section 2013), the credit for foreign death taxes (Section 2014), and the credit for death taxes on remainders (Section 2015). The purpose of the DSUEA rules is to leave the surviving spouse the full benefit of the first deceased spouse's unused basic exclusion amount, and we believe that it would be both useful and appropriate for the regulations to state explicitly that the DSUEA is determined after first taking full advantage of all other available credits. The following example illustrates this rule.

> Example. H and W are married and both are U.S. citizens. H dies in Year One, leaving an estate of $10 million, of which $5 million is left to H's children and $5 million to W. H has made no lifetime taxable gifts. H's gross estate includes property with a value of $6 million that was previously taxed in the estate of A, a U.S. citizen who died one year earlier. H's estate is entitled to a $X credit for the tax on prior transfers with respect to the property received from A. The DSUEA available to W with respect to H's estate is determined by reducing H's estate tax liability by $X, before using any of H's basic exclusion amount to offset that liability.

Portability and nonresident aliens. The regulations should explain the effect of portability on the estate of a deceased nonresident alien (“NRA”). Section 21 02(b)(1) gives each NRA a unified credit of $13,000, which is equivalent to a $60,000 exemption. This credit may be used only against U.S. estate tax imposed on the NRA's estate.

Section 2010(c)(4) computes the DSUEA with reference to the deceased spouse's basic exclusion amount, which is itself based on the unified credit under Section 2010. Section 2010(c) does not refer to the unified credit under Section 2102. We recommend, therefore, that the regulations state that, generally, there is no DSUEA of the credit under

Section 2102, regardless of whether the surviving spouse is or is not a U.S. citizen. This rule could be illustrated by the following example.

> Example. H is a nonresident alien individual who dies in Year One. H's U.S. estate is $10,000. H has a $13,000 unified credit under Section 2102(b). H's executor files a timely Form 706NA and takes no actions needed to prevent the election of portability. W is H's surviving spouse. W receives no portion of H's unused $50,000 exclusion amount as a DSUEA. It is immaterial whether W is a U.S. citizen for this purpose.

The regulations should also address the effect of certain treaty provisions on the availability of portability for the estate of an NRA. Section 2102(b)(3)(A) states that the unified credit otherwise available to an NRA is increased, to the extent required under any treaty obligation of the United States, to:

> the amount which bears the same ratio to the applicable credit amount in effect under section 2010(c) for the calendar year which includes the date of death as the value of the part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

A ratable share of the full $5 million basic exclusion amount is available to an NRA who dies leaving U.S.-situs property to an NRA surviving spouse, therefore, if an applicable treaty so provides. In such situations, it seems entirely correct that the surviving spouse also be entitled to receive the deceased spouse's unused basic exclusion amount under the portability rules.

The United States treaty with Canada, for example, provides that, with respect to the estate tax (but not the gift tax), Canadian nationals who have U.S.-situs assets are entitled to a unified credit equal to the greater of:

> (a) the unified credit allowed to the estates of U.S. citizens multiplied by the fraction of the total worldwide gross estate situated in the United States; and
>
> (b) the unified credit allowed to a nonresident not a citizen of the United States.

U.S.-Canada Income Tax Treaty, art. XXIX,B,2. There is no reciprocal rule for Canadian tax credits, because Canada does not have a concept comparable to the U.S. unified credit.

Section 2010(c)(1)(A) states that the applicable credit amount is tied to the applicable exclusion amount. The treaty alteration of the applicable credit amount should logically increase the foreign national's applicable exclusion amount for purposes of

computing the DSUEA. Where the treaty increases the applicable credit amount of an NRA, Section 2010(c) ought to permit the creation of a DSUEA for such surviving spouse. This should apply whether the surviving spouse is or is not a U.S. citizen, although the marital deduction would be available for assets passing to a surviving spouse who is not a U.S. citizen only if they are held in a Qualified Domestic Trust. Int. Rev. Code §2106(a)(3).

We recommend that the regulations state that:

(1) no DSUEA is available under Section 2010(c) with respect to the United States estate of an NRA, in the absence of relevant treaty provisions; and

(2) a DSUEA may be created where a treaty assures an NRA of a unified credit against his or her U.S. estate tax liability equal to the same proportion of the credit available under Section 2010 that the decedent's U.S. assets bears to his or her worldwide estate (or some comparable portion). In such limited situations, the DSUEA available to the surviving spouse should be equal to the lesser of (a) the basic exclusion amount of the surviving spouse's last deceased spouse, or (b) the excess of the basic exclusion amount of the surviving spouse's last deceased spouse, over "the amount with respect to which the tentative tax is determined under section 2101(b)(1) on the estate of such deceased spouse."

These rules can be illustrated as follows:

Example 1. H, a citizen and resident of Nation A, dies in Year One, with a total worldwide estate of $10 million and a U.S. estate of $5 million. There is no treaty between the United States and Nation A relating to estate taxes. H is entitled to a $13,000 unified credit against his U.S. estate tax. H leaves his entire estate outright to W, who is a U.S. citizen. W receives no DSUEA from H, because H has no applicable exclusion amount or basic exclusion amount under U.S. estate tax law.

Example 2. H, a citizen and resident of Nation B, dies in Year One, with a total worldwide estate of $5 million and a U.S. estate of $2.5 million. Under the treaty between the United States and Nation B, H is entitled to a unified credit against his U.S. estate tax equal to that same proportion of the basic exclusion amount that would have been available to H had he been a U.S. citizen, as the U.S. estate of H bears to his worldwide estate. The basic exclusion amount for a similarly-situated U.S. decedent would have been $5 million, so H's basic exclusion amount and applicable exclusion amount would be $2.5 million [($2.5 million/$5 million) x $5 million). H leaves his entire estate to a charity for which an unlimited deduction is allowed under Section 2106(a)(2). W, who is also a citizen and resident of Nation B, receives a DSUEA from H equal to $2.5 million, H's unused exclusion amount.

Portability and Qualified Domestic Trusts. We recommend that the regulations explain how the portability rules work when the surviving spouse is an NRA and the deceased spouse creates a Qualified Domestic Trust (QDOT). The U.S. estate tax is imposed on certain distributions of principal from a QDOT and on the principal of a QDOT when the surviving spouse dies. Int. Rev. Code §2056A(b). The tax imposed on the QDOT is the additional tax that would have been imposed on the first deceased spouse's estate had the assets of the QDOT been included in his or her estate. This is not computed with reference to the other assets, deductions, or credits available to the estate of the surviving spouse.

One could argue that it is appropriate for the deceased U.S. spouse's unused exemption amount to be reserved for use against the tax imposed on a QDOT, because these assets are not themselves taxable as part of the surviving spouse's estate. Also, a surviving spouse who is not a U.S. citizen is often not subject to U.S. estate or gift taxes, and making the deceased spouse's unused exemption available to an NRA spouse could waste that exemption.

This rule, however, may work a hardship on a surviving spouse, if the QDOT assets are less than the decedent's unused exclusion amount. Therefore, it is recommended that the regulations provide that the portability rules apply in full to a U.S. decedent's unused exemption amount, except to the extent that the decedent's executor elects otherwise.

Furthermore, it is recommended that the executor of the estate of a U.S. decedent who creates a QDOT be allowed to elect portability on less than all of the deceased spouse's unused exemption amount. This may be necessary where the QDOT is unlikely to require the entire exemption amount to eliminate all of its taxes, and the surviving spouse may also be able to use some of the unused exclusion amount to offset his or her own estate taxes. This rule may be illustrated by the following examples.

> Example 1. H is a U.S. citizen who dies in Year One. H's U.S. estate is $3 million. H's will creates a Qualified Domestic Trust (QDOT) for the benefit of W, H's surviving spouse, and leaves H's entire estate to this trust. W is a nonresident alien (NRA) individual. H has a $5 million basic exclusion amount unused. H's executor files a timely Form 706 and takes no actions needed to prevent the election of portability. W may use H's $5 million unused basic exclusion amount as DSUEA. This exclusion amount will not be taken into account in calculating the taxes later imposed on the QDOT.
>
> Example 2. Assume the same facts as in Example I, except that H's executor files a statement with the Form 706 for H's estate, electing portability with respect to $2 million of the decedent's unused exclusion amount. $3 million of the unused exclusion amount remains in place for calculating the taxes on the QDOT. The other $2 million of DSUEA is available to the surviving spouse to offset his or her own estate or gift tax liabilities.

Defining "a complete Form 706". Notice 2011-82 states that portability is deemed elected by the filing of a "complete Form 706". We recognize that the Service needs a basis for determining the amount of the DSUEA available to the surviving spouse, but requiring the executor of the first spouse's estate to file a complete Form 706, with all of the usual schedules and attachments, makes it impractical for executors to elect portability where the first deceased spouse's estate is relatively modest. In fact, it makes it impossible to elect portability when the first spouse's estate is very small or insolvent, because there will be no funds from which to pay for preparation of an estate tax return. This will severely frustrate the purpose of the portability rules and make them available only to relatively large estates.

We recommend that Treasury and the Service, by regulation, deem an estate tax return to be complete, for purpose of electing portability, if it includes parts 1, 2 and 4 of Form 706, without any of the additional parts, schedules, or attachments. The regulation could also require that the surviving spouse maintain records to substantiate the information reported on parts 1, 2, and 4 of the Form 706, as a condition to establishing the DSUEA at the time of later taxable gifts or the surviving spouse's death.

We would anticipate, however, that if this rule is adopted, the regulations could also provide that the value of the assets, debts and administrative expenses of the predeceased spouse's estate reported on such an abbreviated Form 706 would not be subject to the administrative limitation on redetermination, discussed above.

Conclusion

These comments were prepared by Howard M. Zaritsky (540-854-8453) (the principal author), Jonathan G. Blattmachr (212-328-0312), M. Patricia Culler (216-274-2534), Mitchell M. Gans (516-463-5870), and Diana S.C. Zeydel (305-579-0575), members of the College's Estate and Gift Tax Committee, and were reviewed and approved by Ronald D. Aucutt (703-712-5497) on behalf of the College's Washington Affairs Committee. We appreciate this opportunity to comment with respect to Notice 2011-82 and would be pleased to offer additional comments if desired.

Respectfully submitted,

/s/

Mary F. Radford
President

11. Irrevocable Life Insurance Trust With Grantor Trust Power to Substitute Trust Assets for Assets of Equivalent Value – Trust Continues for Benefit of Descendants for Maximum Period of the Rule Against Perpetuities – GST Exemption Will Be Allocated to All Transfers to the Trust[6]

The *Grantor* Irrevocable Grantor Life Insurance Trust

On [date], I *Grantor*, of [address] (sometimes referred to in the first person and sometimes as the "grantor", and *Trustee*, of [address] (sometimes referred to as the "trustee"), agreed to make this trust.

Article 1. My Family

I am married to *husband/wife* (sometimes referred to as my "*husband/wife*") and any reference to my *husband/wife* shall be to *him/her*. I have [number of children] children, *Children*.

Article 2. I Cannot Revoke or Amend this Trust

The trust is irrevocable and I shall have no power to alter, amend, revoke, or terminate it in any way, except as may be expressly provided later in this instrument.

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[6] **KEY:**

Grantor	—	Full name of thegrantor
Trustee	—	Full name of the initial trustee
spouse	—	Full name of the grantor's spouse
Husband/Wife	—	"husband" for female grantor; "wife" for male grantor
him/her	—	"him" or "her" referring to the grantor's spouse
Children	—	Full name(s) of the grantor's child(ren)
2ndTrustee	—	Full name of the successor trustee
Protector	—	Full name of independent person to hold right to re-grant grantor trust powers
2ndProtector	—	Full name of alternate independent person to right to re-grant grantor trust powers

Article 3. Transfers to the Trust

The trustee (defined below) shall hold certain property transferred to the trust by me, which may be listed in Schedule A, to be administered according to the terms of this trust instrument.

A. Trustee May Accept Additional Transfers. I and anyone else may transfer additional property (including life insurance proceeds, where appropriate), to the trustee, and the trustee may refuse to accept such transfers if the trustee deems acceptance not to be in the best interests of the trust and the beneficiaries. The trustee shall hold all transfers to the trust by me that are accepted by the trust, to be held and administered according to the terms of the trust instrument.

B. Transfers During My Lifetime By Someone Other than Me. The trustee shall hold all transfers to the trust by someone other than me, if made during my lifetime, in a segregated fund, as a separate and independent trust from the trust created by assets transferred by me. Such a separate and independent trust shall be held for the benefit of the same beneficiaries and on the same terms and conditions as the trust created and funded by transfers by me, but the assets of such separate and independent trust shall not be commingled or otherwise mixed with those assets contributed by or attributable to contributions by me. Such separate and independent trust shall not be deemed owned by me for Federal income tax purposes, notwithstanding any other provisions of this instrument.

Article 4. Annual Withdrawal Power

Each of my then-living children and each of my then-living more remote descendants, shall have the right to withdraw an amount equal to a proportionate share of each contribution to the trust (other than a contribution by reason of a transferor's death), subject to the guidelines described below.

Article 5. Dynasty Trust for My *Husband/Wife*, Children, and Descendants

The trustee shall hold all of the trust assets for the benefit of my *husband/wife*, my children and my more remote descendants, as provided in this article.

A. Distributions of Income and Principal. Until the termination date (defined below), the trustee shall distribute to or expend for the benefit of my *husband/wife*, *spouse*, my then-living children and my then-living more remote descendants, as much of the net income and principal of this trust as the trustee deems appropriate for any purpose, annually adding to principal any undistributed income.

1. Unequal Distributions Permitted. The trustee may distribute income and principal of the trust unequally and may make distributions to some beneficiaries and not to others.

2. Long-Term Operations are Primary Concern. The trustee shall make distributions recognizing that my primary concern in establishing the trust is the conservation and management of its principal and accumulated income for as long as shall be practicable. The trustee shall, therefore, lend trust assets to beneficiaries or hold them for the personal use of beneficiaries, rather than making outright distributions, to the greatest extent that the trustee deems it practicable.

3. Other Resources. The trustee shall determine the amount and timing of all distributions from the trust, taking into account other resources available to each beneficiary from all sources, including all other trusts created by me.

4. Support. The trustee shall not distribute income or principal in a manner that discharges my legal obligation to support any beneficiary of this trust.

B. Upon the Termination Date. Upon the termination date, the trustee shall distribute the remaining trust funds to my then-living descendants, per stirpes, outright and free of trust, but subject to the provisions of the article entitled "Contingent Trust for Certain Beneficiaries".

C. "Termination Date' Defined. The termination date for the trust maintained under this article shall be the date twenty (20) years after the death of the last to die of me, my *husband/wife*, and my descendants alive on the date this trust is created.

Article 6. Trust for Certain Beneficiaries

If a beneficiary is entitled to receive any trust funds outright, and the beneficiary is under the age of *TerminationAge* years, the trustee may retain those trust funds in a separate trust for that beneficiary.

A. Until the Vesting Date. Until the vesting date (defined below), the trustee shall distribute to or for the benefit of the beneficiary as much of the net income and principal as the trustee shall consider appropriate for the beneficiary's health, education, support, or maintenance, annually adding to principal any undistributed income.

B. Upon the Vesting Date. Upon the vesting date, the trustee shall distribute the remaining assets to the beneficiary if the beneficiary is then living or otherwise to the beneficiary's estate to be distributed as part of that estate.

C. "Vesting Date" Defined. "Vesting date" is the earliest of (1) the date on which the beneficiary dies; (2) the date on which the beneficiary reaches the age of

TerminationAge years; and (3) the date twenty-one (21) years after the death of the last to die of me, my *husband/wife*, and those of my descendants alive on the date of this trust.

Article 7. My Right to Substitute Assets

A. Right Reserved. I reserve and shall have the right, exercisable at any time and from time to time, to demand that the trustee transfer to me any or all of the trust assets in exchange for assets of equivalent value. This power shall be exercisable by me solely in a nonfiduciary capacity, and without the consent or approval of any other person who has a fiduciary duty. This power shall enable me to determine the occurrence and timing of any such exchange, but the trustee shall have the sole and absolute right to ascertain and determine, in the exercise of the trustee's fiduciary duties to the beneficiaries, the equivalent value to the trust assets transferred to me. For purposes of this article, “equivalent value” shall have the same meaning given that phrase in Code Section 675(4)(C) of the Internal Revenue Code of 1986, as amended (the “Code”).

B. Inapplicability. Notwithstanding the provisions of paragraph A, I shall have no right to require that the trustee transfer to me any shares of the voting stock of any corporation in which I have directly or indirectly, including ownership by attribution under Code Section 318, the right to vote stock constituting at least twenty percent (20%) of the total combined voting power of all classes of the said corporations' stock.

C. Exercise. I may exercise this power only by an instrument in writing signed by me and delivered to the trustee and to each then-living current adult beneficiary of the trust.

1. Certification of Value. In the writing by which I exercise this power, I shall certify to the trustee the value of the assets transferred by me to the trust in exchange for trust assets, to the extent that the assets I transfer are not cash, cash equivalents, or stock or other securities that is regularly listed on a major U.S. stock exchange.

2. Effective Date. Such writing shall state the date on which such exchange shall occur, but not earlier than thirty (30) days after the date on which such instrument is received by the trustee.

D. Trustee's Fiduciary Duties. In addition to all other fiduciary duties imposed upon the trustee under local law and this instrument, the trustee shall have the following duties.

1. Assure Equivalence. The trustee shall have a fiduciary obligation to ensure my compliance with the terms of this power by the trustee being satisfied that the properties acquired and substituted by me are in fact of equivalent value.

2. Impartiality. The trustee shall have the power to invest and reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries.

E. I Cannot Shift Beneficial Enjoyment. I shall not be able to exercise this power in any manner that shifts benefits among the trust beneficiaries. The trustee shall not honor an attempt to exercise this power if the trustee believes that such effectuation of my attempted exercise of this power would shift benefits among the trust beneficiaries.

F. Waiver. I may waive the power created under this article by a writing delivered to a trustee, and such waiver shall bind me, the trustee, and all other persons.

G. Cancellation and Recreation of Power. *Protector* may cancel my power under this article by a writing delivered to me and to the trustee, designating the effective date of the cancellation. *Protector* may re-grant the power under this article to me, by a writing delivered to me, with a copy to the trustee and to each then-living adult beneficiary of the trust, designating the effective date of the re-grant of this power. *Protector* shall act in all matters without any fiduciary duty of impartiality or fairness to any beneficiaries.

H. Alternate Holders of the Right to Re-Grant. If *Protector* shall be unable or unwilling to serve under this article, *2ndProtector*, of [address] shall hold and exercise the power granted first to *Protector* under this article. If both *Protector* and *2ndProtector* are unable or unwilling to serve under this article, the trustee shall name as the holder of this power an individual who is neither related nor subservient to me, as defined in Code Section 672(c).

Article 8. The Trustees

A. Named Trustees. *FirstTrustee* is the initial trustee of this trust. No trustee named in this instrument or by the trustee shall be required to provide surety or other security on a bond.

B. Successor Trustees. *SecondTrustee*, of [locality, state], shall be the successor trustee, to serve if *FirstTrustee* is unable or unwilling to serve or to continue serving.

C. Bond. No trustee named by me or by another trustee shall be required to provide surety or other security on a bond.

D. Additional Trustee. The trustee may appoint any person as an additional trustee, to serve at the pleasure of the appointing trustee.

E. Delegation. The trustee may delegate to another trustee any power or authority granted by me to the trustee, to continue at the pleasure of the delegating trustee, unless otherwise agreed. Any person dealing in good faith with a trustee may rely on that trustee's

representation that a delegation has been made and remains in effect under this paragraph.

F. Resignation. A trustee may resign by giving written notice specifying the effective date of the resignation to the designated successor. If no successor is designated, the resigning trustee shall give notice to the then-living adult beneficiaries to whom income is or may then be distributed.

G. Vacancies. A corporation no substantial portion of the stock of which is owned by me or by beneficiaries of this trust, may be named as successor trustee to fill any vacancy, by the majority vote of the then-living adult beneficiaries to whom income is or may then be distributed.

H. Responsibility of Successors. No trustee shall be responsible for or need inquire into any acts or omissions of a prior trustee.

I. Compensation. In addition to reimbursement for expenses, each individual trustee is entitled to reasonable compensation for services. Each corporate trustee is entitled to compensation based on its written fee schedule in effect at the time its services are rendered or as otherwise agreed, and its compensation may vary from time to time based on that schedule.

J. Management Powers. The trustee may exercise the powers described below, in a fiduciary capacity.

1. Invest and Reinvest. The trustee shall invest and reinvest the trust assets (or leave them temporarily uninvested) in any type of property and every kind of investment, in the same manner as a prudent investor would invest his or her own assets.

2. Sell or Exchange. The trustee may sell or exchange any real or personal property contained in the trust, for cash or credit, at public or private sale, and with such warranties or indemnifications as the trustee may deem advisable.

3. Borrow. The trustee may borrow money (even from the trustee and from any beneficiary of the trust), for the benefit of the trust and secure these debts with assets of the trust.

4. Grant Security Interests. The trustee may grant security interests and execute all instruments creating such interests upon such terms as the trustee may deem appropriate.

5. Compromise and Adjust Claims. The trustee may compromise and adjust claims against or on behalf of the trust on such terms as the trustee may deem appropriate.

6. Taking Title Through Nominee. The trustee may take title to any securities in the name of any custodian or nominee, without disclosing this relationship.

7. Principal and Income. The trustee may determine whether receipts are income or principal and whether disbursements are to be charged against income or principal, to the extent not established clearly by state law. Determinations made by the trustee in good faith shall not require equitable adjustments.

8. Tax Elections. The trustee may make all tax elections and allocations the trustee may consider appropriate; however, this authority is to be exercised only in a fiduciary capacity and may not be used to enlarge or shift any beneficial interest except as an incidental consequence of the discharge of fiduciary duties. All tax elections and allocations made by the trustee in good faith shall not require equitable adjustments.

9. Distributions to Minors. The trustee may distribute any of the trust assets to a minor by distributing them to any appropriate person chosen by the tustee (who may be a trustee), as custodian under any appropriate Uniform Transfers (or Gifts) to Minors Act, to be held for the maximum period allowed by law. The trustee may also sell any asset that cannot legally be held under this custodianship and invest the sales proceeds in assets that can be held under this custodianship.

10. Hiring Advisers. The trustee may employ such lawyers, accountants, and other advisers as the trustee may deem useful and appropriate for the administration of the trust. The trustee may employ a professional investment adviser in managing the investments of the trust (including any investments in mutual funds, investment trusts, or managed accounts), delegate to this adviser any discretionary investment authorities, and rely on the adviser's investment recommendations without liability to any beneficiary.

11. Distributions in Kind. The trustee may divide and distribute the trust in kind or in cash, or partly in each, without regard to the income tax basis of any asset and without the consent of any beneficiary. The decision of the trustee in dividing any portion of the trust between or among two or more beneficiaries shall be binding on all persons.

K. Life Insurance.

1. Paying Premiums. The trustee may use some or all of the net income and principal of the trust to buy and maintain policies of life insurance on my life. The trustee may pay any such premiums or other charges from income or principal. If the trust funds are inadequate to pay such premiums or charges, the trustee may (after receiving written notice that a premium or charge has not been paid), do one or more of the following: (a) use any automatic premium loan feature, (b) borrow against any policy cash reserves (whether or not on the policy for which premium or charges shall be paid), or (c) elect any automatic nonforfeiture feature.

2. Contingent Marital Gift. If my *husband/wife* survives me, the trustee shall distribute the proceeds of any life insurance policies on my life that are included in my gross estate for federal estate tax purposes, to my *husband/wife*, outright and free of trust, notwithstanding the provisions of the article entitled "Dynasty Trust for My *Husband/Wife*, Children, and Descendants".

3. Incidents of Ownership. The trustee may exercise all incidents of ownership over any life insurance policies held as part of the trust funds.

4. Litigation. The trustee may decline to enter into or maintain any litigation, endorse policy payments, or take other action respecting any trust insurance policies, until the trustee shall have been indemnified against all expenses and liabilities involved in such action.

5. Beneficial Designation. Upon receipt of written notice that the trustee or the trust is a beneficiary of life insurance policy death or other benefits, the trustee shall take all actions to assure the collection of such funds. Otherwise, the trustee may decline to inquire whether the trustee or the trust shall have been designated beneficiary of any insurance policy or other death benefit, until receipt of written notice that the trustee or the trust may be a beneficiary.

6. Liabilities. The trustee shall not be liable to anyone for buying or maintaining any insurance policies on my life, even if that investment represents an overconcentration, does not meet the applicable standard of prudence, or is inferior to another investment that the trustee might have made. The trustee shall not be responsible for any loss resulting from the failure of any insurer to pay its claims under any policy held by the trust, or because of the exercise or nonexercise of any benefit, option or privilege under any life insurance policy, including the ability to borrow against the cash values to obtain a higher investment yield outside the policy.

L. Disabled Trustee. A trustee may not serve during a disability.

1. Defining "Disabled" and "Disability". An individual trustee is "disabled" or "under a disability" if: (a) he or she is determined to be legally incompetent by a court of competent jurisdiction; (b) a conservator or guardian for such person has been appointed, based upon his or her incapacity; (c) two (2) physicians licensed to practice medicine in [state] certify in writing to another trustee or a person who would become the successor trustee upon such disability, that in the opinion of such physicians, such individual trustee, as a result of illness, age or other cause, no longer has the capacity to act prudently or effectively in financial affairs; or (d) thirty (30) days after any other trustee or a person who would become the successor trustee upon such disability, requests that such individual trustee provide a certificate from a physician licensed to practice medicine that, in the opinion of such physician, such individual trustee has the capacity to act prudently or effectively in financial affairs and such individual trustee fails to provide such certification. The effective date of such incapacity shall be the date of the order or decree adjudicating

the incapacity, the date of the order or decree appointing the guardian or conservator, the date of the certificate of incapacity of the two (2) physicians described above, or thirty (30) days after other trustee or any person who would become the successor trustee upon such disability requests a certificate of capacity and one is not provided, whichever first occurs.

2. Liability. No person is liable to anyone for actions taken in reliance on these certifications or for dealing with a trustee other than the one removed for disability based on these certifications. This trust shall indemnify any physician for liability for any opinion rendered in good faith as to the existence or recovery from any disability.

M. Special Limits on Interested Trustee. No interested trustee (defined below) may participate in the exercise of any discretion to distribute principal to himself or herself, except as is appropriate for his or her health, education, support, or maintenance. No interested trustee may participate in the exercise of any discretion to distribute or expend principal or income in a manner that would discharge that trustee's personal obligation to support the beneficiary to whom such distribution is or may be made. No interested trustee may participate in the exercise of any incident of ownership over any policy owned by the trust insuring the life of such interested trustee.

1. Disinterested Co-Trustee. A disinterested trustee who is serving as a co-trustee with an interested trustee, may exercise those discretions granted under this instrument the exercise of which by an interested trustee is precluded.

2. Multiple Trustees. The number of trustee who must consent to the exercise of a power granted under this instrument, as determined under this article shall be determined by treating the interested trustee who are not entitled, under this article, to participate in the exercise of the power or discretion, as if they were not then serving. If this article precludes every then-serving trustee from exercising a power otherwise granted to my trustee under this instrument, the then-serving trustee shall appoint a disinterested trustee who may exercise such power (or decline to exercise it) as if that disinterested trustee were the sole then-serving trustee.

3. "Interested Trustee" Defined. An "interested trustee" is a trustee who is also (a) a beneficiary of the trust of which he or she is a trustee or the insured under a policy of insurance owned by a trust of which he or she is a trustee; (b) married to and living together with a beneficiary of the trust of which he or she is a trustee; (c) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (d) an employee of a beneficiary of the trust of which he or she is a trustee; (e) a corporation or any employee of a corporation in which the stock holdings of my trustee and the trust are significant from the viewpoint of voting control; or (f) a subordinate employee of a corporation in which such trustee is an executive.

4. "Disinterested Trustee" Defined. A "disinterested trustee" means a trustee who is not an interested trustee.

Article 9. Tax Purposes

This article states some of my purposes in creating this trust, and all provisions of this trust shall be construed so as best to effect these purposes. No trustee shall exercise any discretion in a manner that could reasonably be expected to frustrate the effectuation of these purposes.

A. Income Tax. The trust, to the extent attributable to transfers by me, shall be a grantor trust deemed owned by me for federal income tax purposes, unless and until the powers under the article entitled “Reserved Right to Substitute Assets” is removed and not re-granted and my *husband/wife* ceases to be a beneficiary of this trust.

B. Gift Tax. All transfers to the trust shall be completed gifts for federal gift tax purposes and shall be gifts of a present interest that will qualify for the gift tax annual exclusion.

C. Estate Tax. The assets of the trust shall be excluded from my gross estate for Federal estate tax purposes.

D. Generation-Skipping Transfer Tax. I intend that no distributions from or terminations of interests in this trust or any trust under this instrument shall be subject to the federal tax on generation-skipping transfers.

E. Right to Amend. A disinterested trustee may, without the consent of any other person, amend the trust to the extent required for the sole purpose of ensuring that the trust meets these tax objectives.

G. Income Taxes. The trustee shall not pay or reimburse me for the payment of any incremental income taxes imposed upon me with respect to income or gains received by the trustee and not distributed to me, notwithstanding any requirement of state law that I be paid or reimbursed for such tax payments.

Article 10. Trust Administration

A. Accountings. The trustee shall not be required to file annual accounts with any court or court official in any jurisdiction.

B. Disabled Beneficiaries. The trustee may distribute income, principal, or both to a minor or disabled beneficiary to his or her parent, guardian, personal representative, or the person with whom the beneficiary resides, without looking to the proper application of those payments.

C. Change of Situs. The trustee may change the situs of any trust (and to the extent necessary or appropriate, the trust assets) to a state or country other than the one

in which the trust is then administered, if the trustee believes it to be in the best interests of the trust or the beneficiaries. The trustee may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances.

D. Additional Transfers. Any person may transfer property to the trustee at any time. The trustee may refuse to accept a transfer if acceptance is not in the trust's best interests. The trustee may accept a gift subject to one or more conditions imposed by the donor or the trustee if it is in the best interests of the trust and the beneficiaries and if the condition does not change the rights of a beneficiary with respect to any prior gift. The trustee shall hold all transfers to the trust by someone other than me, if made during my lifetime, in a segregated fund, as a separate and independent trust from the trust created by assets transferred by me to the trust. Such a separate and independent trust shall be held for the benefit of the same beneficiaries and on the same terms and conditions as the trust created and funded by transfers by me, but the assets of such separate and independent trust shall not be commingled or otherwise mixed with those assets contributed by or attributable to contributions by me. Such separate and independent trust shall not be deemed owned by me for Federal income tax purposes, notwithstanding any other provisions of this instrument.

E. Spendthrift Clause. No interest in the trust shall be subject to the beneficiary's liabilities or creditor claims, assignment, or anticipation, voluntary or involuntary. If the trustee determines that a beneficiary would not benefit as greatly from any outright distribution of trust income or principal because of the availability of the distribution to the beneficiary's creditors, the trustee shall instead expend those amounts for the benefit of the beneficiary. This direction is intended to enable the trustee to give the beneficiary the maximum possible benefit and enjoyment of all of the trust income and principal to which the beneficiary is entitled.

F. Multiple Trusts and Shares. The trustee may invest the assets of multiple trusts in a single fund if the interests of the trusts are accounted for separately. The trustee may merge or consolidate any trust into any other trust that has the same trustee and substantially the same dispositive provisions. The trustee may divide any trust into multiple separate trusts.

Article 11. Annual Withdrawal Power: Guidelines

This article applies to the annual withdrawal power created in Article 4 of this instrument.

A. Immediate Power. This withdrawal power shall arise immediately after each contribution to the trust (defined below).

B. Shares. Each child's proportionate share of a contribution is the amount of such contribution, divided by the number of my then-living children (excluding *Beneficiary*) and more remote descendants.

C. Annual Limit. The maximum amount that any child or descendant may withdraw with respect to all contributions made by the same donor in a single calendar year shall be the lesser of (1) the total amount of the donor's contributions to this trust during that year and (2) the amount of the federal gift tax annual exclusion in effect on the date of the earliest of such contributions or twice the gift tax annual exclusion if the donor is married on the date of the last of all contributions made during that year.

D. Priority. This withdrawal power takes precedence over any other power or discretion granted the trustee or any other person.

E. Exercise. Each child or descendant can exercise this withdrawal power by a written request delivered to a trustee. The legally authorized personal representative of any person unable to exercise a withdrawal power because of a legal disability, including minority, may make the demand on the child's or descendant's behalf. If there is no legally authorized personal representative, the trustee shall designate an appropriate adult individual (who may be a trustee but may not be me) who may make the demand on such child's or descendant's behalf.

F. Notice. The trustee must reasonably notify the person who would exercise a child's or descendant's withdrawal power of its existence and that of any contributions made to the trust that are subject to the power.

G. Lapse. The unexercised withdrawal power of each child or descendant shall lapse on the last day of each calendar year or, if earlier, sixty (60) days after the contribution to which it relates, but it shall then lapse only in an amount equal to the greater of that sum referred to in Code Section 2514(e)(1) (currently, five thousand dollars ($5,000)) or that percentage referred to in Code Section 2514(e)(2) (currently, five percent (5%)) of the trust corpus out of which, or the proceeds of which, the exercise of this withdrawal right could be satisfied. These rights of withdrawal that do not lapse at the end of a calendar year shall continue to be exercisable by the child or descendant subject to this same limited annual lapse. These rights of withdrawal respecting a contribution made fewer than sixty (60) days before the end of a calendar year shall not then lapse but shall remain exercisable until the end of the term otherwise designated in this instrument, without respect to the fact that it occurs during the following calendar year.

H. "Contribution" Defined. "Contribution" means any cash or other assets transferred to the trustee to be held as part of the trust funds, and any payment of premiums on life insurance policies owned by the trust. The amount of any contribution is its federal gift tax value, as determined by the trustee at the time of the transfer.

Article 12. Arbitration and Contests

The provisions of this article are included in order to avoid or minimize the cost of court proceedings and promote the prompt resolution of any disputes regarding the interpretation of this instrument.

A. Arbitration. Any dispute over the administration or distribution of any trust created under this instrument shall be decided by binding arbitration before an arbitrator who shall be a Fellow of the American College of Trust and Estate Counsel selected by its chair of the state that has jurisdiction the trust in question. The arbitrator shall establish the procedures which govern the arbitration. The arbitrator's decision shall not be appealable to any court and shall be final and binding on any and all persons who have or may have an interest in the trust under discussion, including unborn or incapacitated persons, such as minors or incompetents. No guardian or trustee ad litem shall be appointed to represent the interests of unborn or incapacitated persons in any such arbitration. The arbitrator's fee shall be paid by the trustee from the principal of the trust in question.

B. Contests. The terms of this instrument reflect my carefully considered objectives for the disposition of the trust funds and I intend that this paragraph discourage any beneficiary from frustrating my objectives by disinheriting that beneficiary and his or her descendants.

1. Revocation for Contest. I revoke every disposition under this instrument to any person who participates in any contest (defined below), regardless of good faith or subsequent withdrawal of the contest, and I revoke any dispositions to his or her descendants.

a. I leave all of these revoked shares of the trusts under this instrument to [Name of Charity], [locality, state], for its general charitable purposes.

b. If at the time of such Contest, [Name of Charity] is not an existing organization to which deductible transfers may be made for Federal estate tax purposes, I leave the revoked shares of the trusts under this instrument to another organization selected by the trustee to which such deductible transfers may be made, that is organized and operated for purposes similar to those for which [Name of Charity] is organized and operated on the date of this instrument.

2. Expenses. The trustee may defend, at the expense of the trust fund, any contest or other attack of any nature on this instrument or any of its provisions.

3. "Contest" Defined. "Contest" shall, for purposes of this article, be interpreted in the broadest possible manner, and shall include any direct or indirect attempt to challenge the validity or all or any portion of this trust instrument. It shall also include, but not be limited to, abetting, commencing, conducting, and inciting any action, caveat, claim, demand, dispute, proceeding, or suit to resist, oppose, upset, or object to the validity

of any trust under this instrument, asserting, filing, or raising an objection to any such trust based upon any allegation, including, but not limited to, forgery, lack of capacity, duress, fraud, undue influence, or failure of due execution; and impairing, invalidating, modifying, setting aside, or preventing the carrying out of any part of any trust under this instrument. “Contest” also includes, but is not limited to, agreeing with or procuring any other person to do any of the foregoing acts.

Article 13. Definitions and Miscellaneous

A. Definitions.

1. “Children” and “Descendants.” “Children” and “descendants” include those now living and those later born, subject to the following rules:

a. “Children” and “descendants” include an adopted person and that adopted person’s descendants if, that adopted person is adopted before reaching eighteen (18) years of age.

b. “Children” and “descendants” includes those born outside of wedlock, if, during such child’s or descendant’s lifetime, his or her parent through whom such child or descendant claims hereunder, has acknowledged such person as his or her child in a writing duly signed and notarized during such parent's lifetime; and

c. “Children” and “descendants” include a child produced before the parent’s death by donor artificial insemination, in vitro fertilization or other form of surrogate parenthood, whether or not such child was legally adopted by such parent before such parent’s death.

2. “Code.” Any reference to the “Code” or to the “Internal Revenue Code” means the U.S. Internal Revenue Code of 1986, as amended, or any similar successor provision of Federal tax law.

3. “My *Husband/Wife*”. I am currently married to *Spouse*, but any reference to my “*husband/wife", whether or not it includes a reference to *Spous* by name, shall refer to the person to whom I am married at the time of any distribution or event for which the identity of my *husband/wife* is relevant, or if it relates to an event that would occur on or after the date of my death, it shall refer to the person to whom I am married on the date of my death, whether or not such person later remarries.

3. “Trust.” The “trust,” without further qualification or specification, shall refer to all trusts under this instrument.

4. "Trustee." The "trustee" shall include each trustee, multiple trustee, and any successor trustees.

B. Absence of Trust Beneficiaries. If all of the beneficiaries of the trust should die before the trust assets have vested in them, the trustees shall distribute all of the remaining assets of that trust as follows:

1. My Heirs and Distributees. One half (1/2) (or all, if there are no persons to take under item 2 of this paragraph) to the heirs and distributees who would have inherited my personal estate, and in such shares as they would have inherited it, had I died unmarried and without a valid will, determined on the later of the date of my death or that of the death of the last of the beneficiaries to die; and

2. My *Husband/Wife*'s Heirs and Distributees. One-half (1/2) (or all, if there are no persons to take under item 1 of this paragraph) to the heirs and distributees who would have inherited the personal estate of my *husband/wife*, and in such shares as they would have inherited it, had my *husband/wife* died unmarried and without a valid will, determined on the later of the date of my death or that of the last of the beneficiaries to die.

C. Tax-Related Terms. All tax-related terms shall have the same meaning in this instrument that they have in the Internal Revenue Code of 1986, as amended.

D. Number. Whenever the context requires, the singular number includes the plural and the plural, the singular.

E. Applicable Law. The trust shall be governed by and construed according to the laws of the state of [state].

F. Copies. There is only one signed original of this instrument. Anyone may rely on a copy of this instrument certified by a notary public or similar official to be a true copy of the signed original (and of any amendments) as if that copy were the signed original. Anyone may rely upon any statement of fact certified by the person who appears from the original document or a certified copy to be a trustee.

DECLARED AND AGREED on the date indicated above.

[Insert signatures, notary clauses, and schedule]

WAIVER OF CERTAIN RIGHTS

I, *husband/wife*, waive all of my right, title, and interest in any property transferred to the attached trust, dated [date] (the trust), by *Grantor*. This waiver shall apply both to current and inchoate interests that I may have, including, but not limited to, rights to an

intestate share of *Grantor*'s estate, to a statutory share of *Grantor*'s augmented estate, to another statutory share of *Grantor*'s estate, to a share as an omitted spouse, and to a share in the nature of dower or curtesy. The waiver shall constitute a third-party beneficiary contract for the benefit of all the beneficiaries of the trust, and these beneficiaries or the trustee of this said trust may enforce this waiver by appropriate legal action.

Dated: [date]

[Insert signature and notary clause]