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TRUST ADVISORS FORUM
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HOT TOPICS
FEDERAL TRANSFER TAX UPDATE

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1. Obama Plans to Keep Estate Tax

The above caption was the title of the lead article on the front page of "The Wall Street Journal", Monday, January 12, 2009. According to the article, then President-Elect, Barack Obama, and congressional leaders plan to block the estate tax from disappearing in 2010. Under The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the unified credit and the estate tax applicable exclusion amount (exemption equivalent of the unified credit) rose steadily from the 2001 levels. In 2009, the unified credit is $1,455,800.00 and the estate tax applicable exclusion amount is $3,500,000.00. Next year, in 2010, the estate tax will disappear under EGTRRA. However, in 2011, the estate tax reappears at the 2001 levels, with a unified credit of $345,800.00 and an estate tax applicable exclusion amount of $1,000,000.00. The Democrats are determined to act quickly to prevent the estate tax from being repealed next year. Under the Obama plan, the unified credit and estate tax applicable exclusion amount would be locked in at the 2009 figures, i.e. $1,455,800.00 and $3,500,000.00, respectively. This would exempt estates of $3,500,000.00, or $7,000,000.00 for couples, from federal estate taxation. Under the Obama plan, there would be a flat estate tax rate of 45%. No other components of the wealth transfer taxes would be changed. There is urgency to act in 2009, before the estate tax is scheduled to expire. First, there are record deficits to be dealt with. Second, Congress knows that it would be much harder to resurrect the estate tax once it has disappeared. If the Obama plan is adopted, all but the largest estates, fewer than 2% of annual deaths, would escape death taxation. According to the Joint Committee on Taxation, over ten years, the Obama plan would cost the Treasury approximately $324 billion more than if the estate tax levels in effect with Clinton were maintained. Full repeal would cost more than $500 billion over a decade. The "Journal" article describes a "sharp division" between the "super rich" and the "merely rich". The merely rich sought the largest possible applicable exclusion amount to shelter them entirely from the estate tax. For the merely rich, the rate of taxation above the applicable exclusion amount was of little concern, if, in fact, the applicable exclusion amount was large enough to shelter them from all estate taxation. The super rich knew that regardless of the size of the applicable exclusion amount the bulk of their estates would still be subject to the death tax. Accordingly, their main concern was the rate of taxation, not the applicable exclusion amount.

As noted, with the current applicable exclusion amount of $3,500,000.00, the estate tax is effectively repealed for 98% of the American public. This should eliminate the need for aggressive

estate planning techniques for all but a few estates. Of course, to make full use of the applicable exclusion amount at each death, each spouse will need a taxable estate of at least $3,500,000.00, reduced by his or her taxable gifts. In many cases, this will require gifts to be made from one spouse to the other spouse. With the larger applicable exclusion amount, additional consideration should be given to fractional share apportionment. Pecuniary credit shelter apportionment followed by a marital deduction residuary disposition raises the very real possibility of Kenan gain on funding the pecuniary amount. The Kenan gain issue may be less likely, but still a possibility, with pecuniary amount marital deduction apportionment followed by a residuary disposition of the credit shelter share. Whenever pecuniary apportionment is used the smaller of the credit shelter share or the marital deduction share should be the pecuniary amount, with the larger disposition being the residue, to reduce the possibility of a "bankrupt residue" and/or Kenan gain. Again, the bankrupt residue problem and the Kenan gain problem can be avoided with a fractional share apportionment. The bankrupt residue problem can be especially problematic if the residue is the marital share. Consider the taxpayer with a $3,000,000.00 estate in 2005. His Will provides for a credit shelter pecuniary bequest outright to the children, with the residue passing to his spouse. The exemption equivalent in 2005 was $1,500,000.00. Accordingly, in 2005, the taxpayer's estate would be split equally between his children and his spouse, i.e. $1,500,000.00 to the children, and $1,500,000.00 to the spouse. The same form of disposition in 2009 would result in the children receiving the entire $3,000,000.00 estate, with the spouse receiving nothing.

The generation skipping tax exemption also rises to $3,500,000.00 in 2009. Because of this increase, you may see an increase in generation skipping trusts and generation skipping bequests.

2. Private Letter Ruling 200744001

The Decedent set up a Revocable Trust and entered into a contract to sell a parcel of real property on Date 1, with an intended closing date of Date 2. Before Date 2, however, a gas pipeline was discovered underneath the property, causing the parties to delay the sale until the Decedent, the Buyer, and the pipeline company could resolve a number of issues, such as providing for an easement for the pipeline company. Before the parties could resolve the issues, the Decedent died on Date 3. The sale did not actually close until Date 4.

IRC, §691(a)(1) provides that the amount of all items of gross income in respect of a decedent (IRD) which are not properly

includible in respect to the taxable period which falls on the date of the decedent's death or a prior period shall be included in the gross income, for the taxable year when received. The Regulations, §1.691(a)-(b) provide that the term income in respect of a decedent refers to those amounts to which a decedent was entitled a gross income, but which were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of the decedent's death or for a previous taxable year. Thus, the term includes income to which the decedent had a contingent claim at the time of the decedent's death. IRC, §1014(a) provides for a step-up in basis at death to the fair market value of the property included in the decedent's gross estate at the date of the Decedent's death. However, §1014(e) provides that there is no step-up in basis with respect to items of IRD.

In this case, important issues needed to be addressed before the sale of the property could be closed. The closing was delayed until Date 4 because of these issues. The Decedent needed to attend to substantive, as well as ministerial matters. Based on these facts, the Service held that any gain realized by the sale of the property after the Decedent's death did not constitute income in respect of a decedent. Accordingly, the basis for the subject property in the Decedent's hands was determined under §1014(a). The Service cited Revenue Ruling 78-32. In that Ruling, a decedent had entered into a binding contract to sell real estate, had substantially completed all of the substantive prerequisites of consummation of the sale, and was unconditionally entitled to the proceeds of the sale at the time of death. That Ruling holds that the gain recognized from the sale of real estate that was completed by the decedent's Executor is income in respect of a decedent within the meaning of IRC, §691(a).

3. Private Letter Ruling 200744005

Under the Decedent's Will, the residue of the Decedent's estate is to be distributed to a trust. The trust provides that one-third of the trust residue is to be distributed outright to the Taxpayer, except that if the Taxpayer disclaims all or a portion of the property that would otherwise pass to the Taxpayer, the disclaimed property shall be distributed to a Foundation. The Foundation was an organization described under §501(c)(3). Further, the Foundation was a private foundation within the meaning of §509(a). The Taxpayer, who is one of the directors of the Foundation, proposed to disclaim a portion of the property passing under the trust. Prior to the time that the Taxpayer executes the disclaimer, the directors of the Foundation proposed to amend the Foundation's By-Laws. Those amendments will provide that the

property passing to the Foundation pursuant to the Taxpayer's disclaimer will at all times during the Taxpayer's lifetime be segregated from the other property of the Foundation and maintained in a separate fund of the Foundation. The separate fund will be overseen by a committee that shall have the sole authority over the disposition and disbursement of this separate fund. The Taxpayer shall have no rights or powers with respect to the disposition or disbursement of the separate fund or with respect to the election or removal of members of the separate fund committee.

The Service analyzed §2518. IRC, §2518(a) provides that if a person makes a qualified disclaimer with respect to any interest in property, the disclaimed interest is treated as if it had never been transferred to the person making the qualified disclaimer for purposes of Federal estate, gift, and generation skipping transfer tax provisions. IRC, §2518(b) provides that a "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property, but only if: (i) the disclaimer is in writing; (ii) the writing is received by the transferor of the interest no later than 9 months after the date of the transfer; (iii) the person making the disclaimer has not accepted the interest or any of its benefits; and (iv) as a result of the disclaimer, the interest passes without any direction on the part of the person making the disclaimer to the Decedent's spouse or to a person other than the person making the disclaimer.

The Service cited Revenue Ruling 72-522. In that Revenue Ruling, a decedent who was the President and Director of a §501(c)(3) charity transferred property to the charity. In his capacity as President and Director, the Decedent, in conjunction with other directors of the charity, had the power to direct the disposition of the charity's funds for charitable purposes. The Ruling holds that because the decedent retained the right, in conjunction with others, to designate the entities that would possess or enjoy the property transferred to the charity, the property transferred by the decedent to the charity was included in the decedent's gross estate at the time of his death under §2036. What Private Letter Ruling 200744005 does not state is the other holdings in Revenue Ruling 72-522. That Revenue Ruling goes on to conclude that while the subject property is included in the decedent's estate under §2036, the decedent's estate is entitled to a charitable deduction for the same under §2055.

Based on the facts submitted by the Taxpayer, the Service held that the Taxpayer's disclaimer would constitute a qualified disclaimer under §2518. The Service further held that the property

passing to the Foundation as a result of the disclaimer would qualify for the estate tax charitable deduction under §2055.

4. Private Letter Ruling 200745015

The Decedent created a trust under his Will for the benefit of his daughter. The trust was created prior to January 1, 1977. The trust provides that the Trustees are to pay to the daughter so much of the net income as they deem necessary for her support. The Trustees have the discretion to distribute principal to the daughter. The trust grants the daughter a testamentary non-general power to appoint principal to the Decedent's lineal descendants. Absent such an appointment, the trust assets will be divided among the daughter's children at the time of the daughter's death. The daughter proposes to renounce her entire beneficial interest in certain stock held in the trust. As a result of the renunciation, the renounced shares will pass into subtrusts for the benefit of the daughter's children. The daughter also proposes to release her testamentary non-general power of appointment over the subject shares. As a result of the disclaimer, the subtrusts for the daughter's children, containing the disclaimed shares, will continue until the daughter's death, at which time the shares will be distributed to her children.

The Service first held that the proposed disclaimer would result in a taxable gift by the daughter. The disclaimer was not made within nine (9) months as prescribed by §2518. Nor was the disclaimer made within a reasonable time which is required with respect to transfers before January 1, 1977. The Service noted that there can be no disclaimer of ownership of property after its acceptance. The Service further noted that the value of the gift is a question of fact and that the Service does not rule on such factual determinations. However, since the gift is not an absolute right to distributions of income or principal, it cannot be valued by use of the tables contained in §2512. Rather, the value of the gift would be determined under the general valuation principles contained in Regulations, §25.2512-1. The Service did hold that the value of the gift would have more than nominal value.

IRC, §2514(b) provides that the exercise or release of a general power of appointment shall be deemed a transfer of property by the individual possessing the power. The Service held that the daughter did not possess a general power of appointment. Accordingly, the daughter's release of the testamentary non-general power of appointment over the shares disclaimed would not constitute a gift of such property for purposes of IRC, §2514.

The Service finally reviewed the generation skipping tax consequences of the disclaimer. The Service noted that the trust was executed prior to September 25, 1985, and that there had been no additions (actual or constructive) to the trust since that date. Accordingly, the trust was not subject to Chapter 13. The Service noted that the daughter's renunciation of her beneficial interest in the shares was a taxable gift for gift tax purposes. The subject shares will be transferred into subtrusts in which the daughter will have no interest. The property remaining in the trust continues to be subject to the original trust provisions, with no modifications to those provisions. Based upon those facts, the Service concluded that the daughter's disclaimer of her beneficial interest in the shares would not cause the trust to become subject to Chapter 13. The Service further concluded that the daughter's release of the testamentary non-general power of appointment over the shares would not cause the trust to become subject to Chapter 13. Further, the Service held that under §2652, for purposes of Chapter 13, the daughter is the transferor of the subject shares that will be transferred into the subtrusts for her children. Accordingly, the subtrusts for the daughter's children are not exempt from Chapter 13 by virtue of the trust's exemption. The daughter may allocate her GST exemption to the subtrusts at the time of the transfer, or the daughter's GST exemption may be automatically allocated under §2632(c)(1). The daughter will be deemed to be the transferor of the shares that will be transferred into the subtrusts for her children for purposes of Chapter 13. Accordingly, distributions and terminating distributions from the subtrusts to skip persons will be subject to GST tax.

5. Private Letter Ruling 200747002

The Grantor created and funded a revocable trust prior to his death. The Grantor also created and funded two (2) irrevocable trusts prior to his death. One of the irrevocable trusts was established for the benefit of Child A. The other irrevocable trust was established for the benefit of Child B. The revocable and irrevocable trusts owned shares of stock in Company A. Company A owned a ninety-nine (99) percent limited partnership interest in Company C. Company B was a limited liability company which managed business operations for the other entities. The outstanding stock in Company A was owned by the various trusts. The outstanding membership interest in Company B was owned by the various trusts. In addition, Child A and Child B owned life insurance policies held pursuant to the terms of a Buy-Sell Agreement covering Company A and Company B. Child A owned policies insuring the life of Child B. Child B owned policies insuring the life of Child A. There were also other irrevocable trusts owning policies on the lives of Child A and Child B.

The parties proposed to establish an "Insurance LLC". The Insurance LLC was to be a vehicle to secure the use of life insurance proceeds to effect a buy-out of Child A and/or Child B. The Insurance LLC was to be designated as the owner and beneficiary of the subject policies. The Insurance LLC was to maintain capital accounts in accordance with §704. Under the Operating Agreement of the Insurance LLC, the management of the company was to be invested in the manager and not in the members. A national bank association was to be the initial manager. Any replacement manager must be a corporate trustee. The Operating Agreement of the Insurance LLC further provided that in no event may an individual whose life is insured by one of the policies held by the Insurance LLC have the right to vote on the exercise of incidents of ownership with respect to the policies. Each of the members of the LLC was required to make contributions to the LLC equal to the premium on the insurance policies contributed by the member.

The Service first reviewed §2042(2). Under Regulations, §20.2042-1(c)(4), a decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, either alone or in conjunction with any other person or persons, has the power, as Trustee or otherwise, to change the beneficial ownership of the policy or its proceeds or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Regulations, §20.2042-1(c)(6) provides that, in the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling shareholder, the corporation's incidents of ownership will not be attributable to the decedent through stock ownership to the extent the proceeds of the policy are payable to the corporation. However, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of §2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through the stock ownership where the decedent is the sole or controlling shareholder.

The Service cited Revenue Ruling 83-147 which considered whether incidents of ownership in an insurance policy owned by a general partnership would be attributed to the insured general partner. In the subject case, the insurance proceeds on the insured partner's life were paid to the insured partner's child. The Revenue Ruling distinguishes Estate of Knipp, where insurance proceeds were paid

to the partnership and the inclusion of the proceeds in the gross estate under §2042 would have resulted in an "unwarranted double taxation" of a substantial portion of the proceeds, because the proceeds were reflected in the value of the decedent's partnership interest. In contrast, in Revenue Ruling §83-147, the proceeds were payable to a third party. Accordingly, the Ruling concludes that under those circumstances the incidents of ownership are treated as held by the insured partner in conjunction with the other partners. In light of these precedents, and in light of the terms of the Operating Agreement of the Insurance LLC, the Service held that Child A and Child B would not possess any incidents of ownership with respect to the policies contributed by them to the Insurance LLC.

6. Private Letter Ruling 200801009

The Grantor created a trust which became irrevocable upon his death. The trust provided that if the spouse survived the Grantor, the trust was to be divided into two (2) separate shares: Trust A and Trust B. Trust B was the credit shelter share. Trust A was the marital share. Further, the document provided that the spouse may disclaim her interest in Trust A, in whole or in part. Any disclaimed property would be added to Trust B. The QTIP election was made with respect to Trust A. Trust B provided for the Grantor's children and more remote descendants. The spouse wished to disclaim her interest in Trust A. The spouse proposed to pay any income taxes arising from her disclaimer of the income interest in Trust A. The spouse proposed to exercise her right of recovery with respect to gift tax relating to the transfer of the remaining interest pursuant to §2207A(b).

IRC, §2519 provides that for gift tax purposes, any disposition by the surviving spouse of all or part of a qualifying income interest for life in property for which a deduction was allowed under §2056(b)(7) is treated as a transfer by the surviving spouse of all interest in the property other than the qualifying income interest. The transfer of the qualifying income interest is a transfer subject to gift tax under §2511. Regulations, §25.2519-1(c)(1) provides that the amount treated as a transfer under §2519 upon a disposition of all or part of the qualifying income interest for life is equal to the fair market value of the entire property subject to the qualifying income interest for life, determined on the date of the disposition, less the value of the qualifying income interest for life. The gift tax consequences of the disposition of the qualifying income interest for life are determined separately under Regulations, §25.2511-2. Regulations, §25.2207A-1(a) provides that if an individual is treated as transferring the interest in property by reason of §2519, the

individual is entitled to recover from the person receiving the property the amount of gift tax attributable to that property. The value of the property to which this paragraph applies is the value of all interests in the property other than the qualifying income interest. Further, Revenue Ruling 75-72 provides that if a gift is made subject to a condition that the gift taxes to be paid by the donee or out of the transferred property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under §2512(b), the value of the gift is the fair market value of the property passing from the donor, less the amount of gift tax to be paid by the donee or from the property itself. Revenue Ruling 81-223 holds that in determining the amount of gift tax liability that is to be subtracted from the value of the transferred property, the donor's available unified credit must be used to reduce the gift tax liability that the donee has assumed to the extent the unified credit is available.

Based on these facts and precedents, the Service held that the spouse would be deemed to make a transfer of all of Trust A's assets other than her qualifying income interest. The spouse is treated as making a gift under §2519 of the fair market value of Trust A, determined on the date of the disposition, reduced by the value of the spouse's qualifying income interest for life, and further reduced by the amount the spouse is entitled to recover under §2207A(b). The amount of the gift tax recoverable is determined by an interrelated computation. The transfer of the spouse's income interest in Trust A resulting from the disclaimer is a transfer by the spouse under §2511. After the spouse disclaims her entire interest in Trust A, no portion of the Trust A assets that are deemed transferred under §2519 will be included in the spouse's gross estate pursuant to §2044(b).

The Service further held that the standard §7520 income factors and standard §7520 remainder factors, respectively, should be used to determine the value of the disclaimed income interest and the value of the remainder interest.

The Service next turned to the income from discharge of indebtedness issue. The Service cited §61(a)(12). The Supreme Court in *Diedrich vs. Commissioner* held that in a net gift situation, where a donor makes a gift of property on the condition that the donee pays the resulting gift taxes, the donor realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in property. A net gift transfer is treated as if the donor sold the property for less than fair market value. The sales price is the amount of the gift tax paid by the donee and the remaining value of the property is treated as a gift. The donor's gain is equal to the excess of the gift tax

liability over the donor's adjusted basis. In this case, the Service acknowledged that the spouse's basis in the disclaimed property is equal to or greater than the gift tax recovered from the Grantor's children. Accordingly, the spouse would not generate income from discharge of indebtedness as a result of the disclaimer.

Finally, the Service turned to the issue as to the basis of the disclaimed property. Under §1015(a), the basis of the property gifted in the hands of the donee shall be the same as it would be in the hands of the donor, except if such basis is greater than the fair market value of the property at the time of the gift, then for purposes of determining loss, the basis shall be such fair market value. Regulations, §1.1015-4(a) provides that where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of: (1) whichever of the following is greater: (i) the amount paid by the transferee for the property, or (ii) the transferor's adjusted basis at the time of the transfer; and (2) the amount of increase, if any, in basis authorized by §1015(d) for gift tax paid.

7. Private Letter Ruling 200802024

The Taxpayer created two (2) trusts, both intended to qualify as charitable remainder unitrusts. Under the terms of both charitable remainder unitrusts, the Taxpayer is to receive a five (5) percent unitrust amount for his life, and upon his death, his spouse is to receive a five (5) percent unitrust amount for her life. The Taxpayer retained the power to revoke the spouse's successor unitrust interest. The remainder beneficiary of each respective trust would be one or more charities as designated by the Taxpayer. The Taxpayer and his spouse proposed to assign their respective unitrust interest in both trusts to a designated remainder charitable beneficiary of each of the trusts. As a result of the transfer, the interests will merge and thereby entitle the charitable beneficiary to all of the assets of the trust. The Taxpayer had received consent for such a transfer from the office of the Attorney General of the State in which the trusts were set up.

The Service first concluded that the proposed modification to the charitable trusts would not effect the respective trust's status as a charitable remainder unitrust within the meaning of §644(d)(2). The Service next ruled that the proposed gift by the Taxpayer and his spouse of their respective unitrust interest in both trusts was analogous to the gift addressed in Revenue Ruling 86-60. The Service held that the Taxpayer and his spouse would

each qualify for a charitable contribution deduction under §170(c). The Taxpayer and his spouse would each be entitled to charitable income tax deductions under §170(a)(1) for the value of their respective unitrust interest in both trusts. The Service next held that in the year that the Taxpayer and his spouse assigned their respective unitrust interest in the charitable trusts to the charitable beneficiary, the Taxpayer and his spouse would be entitled to a gift tax charitable deduction under §2522(a) to the extent of the present value of their respective unitrust interest transferred as of the date of the assignment. Finally, the Service held that when the Taxpayer released his right to revoke the spouse's successor unitrust interest in each trust, the gifts to his spouse would become complete. Accordingly, the spouse's survivorship interest in both Trust A and Trust B would qualify for the gift tax marital deduction under §2523(g).

8. Private Letter Ruling 200808018

The Taxpayer created a charitable trust which qualified as a net-income with make-up charitable remainder unitrust (NIMCRUT) under the provisions of §644(d)(2). The remainder beneficiary under the trust was a qualified charity. The Taxpayer proposed to make a contribution of an undivided portion of his unitrust interest to the charity. In order to accomplish this result, the Trustee would divide the trust into two (2) separate trusts, Trust A and Trust B. The two (2) trusts would have the same terms and the division of assets would be on a basis that fairly represented the aggregate adjusted basis of the trust assets and on a pro rata basis as to each class of investment. Trust A is to consist of approximately two-thirds (2/3) of the pre-division value of the charitable trust. Trust B is to consist of the remaining portion of such value. The Taxpayer intends to contribute his undivided unitrust interest in Trust B to the charity. The Taxpayer represented that under state law, the contribution to the charity of the Taxpayer's unitrust interest in Trust B, and the designation of the charity as a remainder beneficiary of Trust B, will result in a merger of the unitrust and remainder interest in Trust B. The Taxpayer further represented that he did not divide his interest in the charitable trusts in order to avoid the partial interest rule of §170(f)(3)(A).

The Service first ruled that the division of the trust into Trust A and Trust B and inter vivos distribution of the entire trust corpus of Trust B to the charity would not cause Trust A to cease to function as a charitable remainder unitrust within the meaning of §664(d)(2). The Service further ruled that the Taxpayer would be entitled to a charitable contribution deduction for a contribution of an undivided portion of his unitrust interest in

the trust to the charity under §170(f)(3)(B)(ii). Therefore, the Taxpayer's transfer of his interest in Trust B would qualify for a charitable contribution deduction under §170. The value of the Taxpayer's contribution under §170 would be the present value of the right to receive the unitrust payments as provided in Trust B for a term starting on the date of the transfer of the unitrust interest to the charity and ending on the Taxpayer's date of death. The Service went on to conclude that in the year in which the Taxpayer transferred his entire balance of his unitrust interest in Trust B to the charity, the Taxpayer would be entitled to a gift tax charitable deduction under §2522(a) to the extent of the present value of the unitrust interest transferred as of the date of the transfer. Finally, the Service concluded that no amounts would be included in the Taxpayer's gross income by reason of the prior capital gains realized by the trust, in connection with the Taxpayer's charitable contribution of a portion of the unitrust amount.

9. Private Letter Ruling 200812022

The Decedent created a trust which became irrevocable prior to September 25, 1985. The beneficiaries of the trust were the Decedent's spouse, child, and grandchild. Upon the death of the grandchild, the trust was to be paid over and delivered as the grandchild may by her Will appoint, or in the absence of such appointment to the personal representatives of the grandchild, to be distributed in accordance with the intestacy laws of the grandchild's domicile. In 1991, the grandchild signed a partial renunciation and release of her power of appointment whereby she relinquished the power to appoint to herself, her creditors, her estate, or the creditor's of her estate. The grandchild then proposed to exercise her special testamentary power of appointment in favor of her issue. The Service first concluded that the child's earlier renunciation to reduce her power of appointment to a special power of appointment was effective. Accordingly, the power retained by the grandchild was not a general power of appointment. The Service next reviewed the grandfather rules with respect to generation skipping trusts. Under §1433(b)(2)(A) of the Tax Reform Act of 1986 and Regulations, §26.2601-1(b)(1)(i), the generation skipping transfer tax shall not apply to any generation skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added). Regulations, §26.2601-1(b)(1)(v)(A) provides that where 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 an addition to the trust. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under Chapter 11 or Chapter 12. In the latter case, the transferor for purposes of Chapter 11 or Chapter 12 is the transferor for purposes of Chapter 13. The Service noted that the subject trust was exempt from generation skipping transfer tax. The Service noted that after the grandchild's renunciation, the grandchild retained only a limited power of appointment. Therefore, the exercise of the grandchild's limited power of appointment would not be deemed to constitute a constructive addition to the trust.

10. Private Letter Ruling 200821030

The Decedent, a United States citizen, died survived by his spouse who was a resident of the United States but not a United States citizen. Upon the Decedent's death, his revocable inter vivos trust was to be divided into three (3) separate trusts. Trust A was to be funded with the surviving spouse's share of community property. Trust B was a marital trust intended to qualify as a Qualified Domestic Trust (QDOT). The QDOT was to be funded with the minimum amount necessary to reduce the federal estate tax to zero. The third trust, Trust C, was to be funded with the balance of the trust property. Upon the Decedent's death, certain insurance policies and IRAs passed directly to the Decedent's spouse outside the probate estate. The Estate hired a CPA to prepare Form 706. On Schedule M of the Form 706, the Estate listed a portion of the QDOT as qualifying for the marital deduction. In addition, the Estate listed the assets passing outside of probate to the surviving spouse as qualifying for the marital deduction. Certain other joint interests passed to the spouse by operation of law were not listed on Schedule M. The spouse was not advised to assign the IRAs and insurance policies that passed outside of probate to her to the QDOT, as is required under §2056A. The Estate requested an extension of time pursuant to Regulations, §301.9100-3 of the Procedure and Administration Regulations to make a QDOT election with respect to the Decedent's interest in the joint property and to assign the Decedent's interest in the joint property and the proceeds of life insurance policies to the QDOT. The Service first reviewed the requirements in order for a trust to qualify as a QDOT. The Service next noted that under §2056(d)(2)(B), if an interest in property passes outright from the Decedent to a non-citizen surviving spouse either by testamentary bequest or devise, by operation of law, or pursuant to an annuity or other similar plan or arrangement, and such

property interest otherwise qualifies for the marital deduction except that it does not pass in a QDOT, then solely for purposes of §2056(d)(2)(A), the property is treated as passing to the surviving spouse in a QDOT if the property interest is assigned to the QDOT under an enforceable and irrevocable written assignment made on or before the date on which the return is filed and on or before the last date prescribed by law that the QDOT election may be made. Regulations, §20.2056A-4(c) prescribes rules for implementing §2056A(e) in the case of certain non-assignable annuities or other arrangements payable under retirement plans. Under those rules, property will be treated as passing in the form of the QDOT, notwithstanding that the spouse does not irrevocably transfer or assign the property to the QDOT. Those rules were not followed timely by the surviving spouse and Estate.

The Service noted that request for relief under Regulations, §301.9100-3 will be granted when the Taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the Taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interest of the government. Based on all of the facts, the Service concluded that the Executor made a valid QTIP election with respect to the Decedent's interest and the insurance policies listed on Schedule M of the 706. The Service further concluded that the requirements of Regulations, §301.9100-3 have been satisfied. Therefore, an extension of time was granted to make the QDOT election with respect to the joint property not listed on Schedule M.

11. Private Letter Ruling 200822003

The Taxpayer established an irrevocable trust for the benefit of his issue. The trust was the owner and beneficiary of second to die life insurance policies insuring the Taxpayer and his spouse. The Trustee of the trust was one of the Taxpayer's children. Upon the death of the Taxpayer and his spouse, the trust was to be divided in equal shares for his children. The Taxpayer, his spouse, and the Trustee, entered into a collateral assignment split-dollar life insurance agreement. Under the agreement, the trust is designated as the owner of the policies. The owner may exercise all rights of ownership except the right of the collateral assignees (the Taxpayer and his spouse) upon termination of the agreement to be repaid the cash surrender value in the policies. While the Taxpayer and his spouse were living, the trust was obligated to pay that portion of the annual premiums equal to the economic benefit cost of current life insurance protection on the joint lives of the Taxpayer and his spouse. During the life of the survivor of the Taxpayer and his spouse,

they will pay the remaining portion of the annual premiums. Under the agreement, upon the death of the survivor of the Taxpayer and his spouse, the agreement terminates and the survivor's estate is to receive a portion of the proceeds of each policy equal to the cash surrender value of the policies prior to termination. The trust is designated the beneficiary of the balance of the insurance proceeds. To secure the Taxpayer and his spouse's respective estates' interest in the policies and its proceeds, the Trustee of the trust executed a collateral assignment. The Trustee specifically retained all rights of ownership in the policies subject to the rights of the Taxpayer and his spouse, or the estate of the survivor of them to receive the amount due on termination under the agreement. The Service reviewed Revenue Ruling 64-328, Notice 2002-8, and Revenue Ruling 2003-105. The Service noted that in the present case, under the terms of the agreement, the trust will pay the portion of the premium equal to the cost of current life insurance protection. The Taxpayer and his spouse would pay the balance of the premium, and the Taxpayer and/or his spouse (or the estate of the survivor) will be entitled to receive an amount equal to the policy cash surrender value on termination of the agreement, or the death of the survivor. The Service concluded that the payment of the premiums by the Taxpayer and his spouse, pursuant to the terms of the agreement, would not result in a gift by the Taxpayer and his spouse under §2511, provided that the amounts paid by the trust for life insurance benefits that the trust receives under the agreement are at least equal to the amount prescribed under Revenue Ruling 64-328, Revenue Ruling 66-110, and Notice 2002-8. The Service also concluded that if some or all of the cash surrender value is used (either directly or indirectly through loans) to fund the trust obligation to pay premiums, the Taxpayer and his spouse would be treated as making a gift at that time. The Service further provided that in the present case, under the agreement and the collateral assignment, neither the Taxpayer nor his spouse would hold any incidents of ownership over the policies. Accordingly, the Service concluded that the proceeds of the policy payable to the trust would not be included in the gross estate of the second to die of the Taxpayer and his spouse under §2042(2). The portion of the proceeds payable to the estate of the survivor of the Taxpayer and his spouse will be included under §2042(1).

12. Private Letter Ruling 200822008

After September 25, 1985, the Grantor executed an inter vivos irrevocable trust. The trust was to be divided into two (2) separate trusts: the "Exempt Trust" and the "Non-Exempt Trust". The Exempt Trust was to be exempt from generation skipping tax by virtue of the GST exemption available to the Grantor and his

spouse. The Exempt Trust and the Non-Exempt Trust were designed to be Grantor trusts. The trust document acknowledges that the Grantor would be treated as the owner of the trust under §671 and as a consequence would be required to include the trust income in determining his income tax liability. That provision further provides that the Trustee was prohibited from reimbursing the Grantor for any income tax and the Grantor expressly waives any right he may have to receive a reimbursement.

The Trustee proposed to petition the Court seeking a judgment modifying the trust. Under the proposed modification, the Trustee is authorized, subject to the approval of the "reimbursement committee" to pay to the Grantor those amounts sufficient to satisfy the Grantor's federal, state, or local income tax liability actually incurred by the Grantor attributable to the "pass through" of the trust's taxable income.

The Service first acknowledged there was nothing in the proposed reimbursement provision that would jeopardize the trust's status as a Grantor Trust, assuming it was a Grantor Trust.

The Service next reviewed the application of Revenue Ruling 2004-64 to the situation at hand. In this case, under the proposed amendment, the Trustee would have the discretion to reimburse the Grantor with respect to income tax liability actually incurred by the Grantor attributable to trust items. The distribution must be approved by the reimbursement committee, which must consist of an individual or individuals who are not related to or subordinate to the Grantor within the meaning of §672(c). Accordingly, assuming that there is no understanding, expressed or implied, between the Grantor, the members of the reimbursement committee, and the Trustee regarding the Trustee's exercise of discretion, the Trustee's discretion to satisfy the Grantor's obligation would not alone cause the inclusion of the trust in the Grantor's gross estate for federal estate tax purposes. The subject trust was executed after September 25, 1985. The generation skipping tax does not apply to any generation skipping transfer under a trust that was irrevocable on September 25, 1985. With respect to grandfathered trusts, Regulations §26.2601-1(b)(4)(i)(D) provides that a modification in the governing instrument of an exempt trust will not cause the exempt trust to be subject to the provisions of Chapter 13, if the modification 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 the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. The Service reasoned that a modification that does not affect the

exempt status of a trust that is not subject to the GST tax because it was irrevocable on September 25, 1985, should similarly not effect the inclusion ratio of a trust created after September 25, 1985. Accordingly, the Service concluded that the proposed modification would not affect the inclusion ratio of the exempt trust for GST tax purposes.

13. Revenue Procedure 2007-45

The Service has previously issued forms for qualified charitable remainder trust provisions, both mandatory clauses and alternative options. Revenue Procedures 2005-52 through 2005-59 provide charitable remainder unitrust forms. Revenue Procedures 2003-53 through 2003-60 provide charitable remainder annuity trust forms. For the first time, the Service has issued sample forms with respect to charitable lead trusts. Revenue Procedure 2007-45 provides forms for inter vivos charitable lead annuity trusts. This Revenue Procedure provides a sample trust that meets the requirements for an inter vivos charitable lead annuity trust that provides for annuity payments to one or more charitable beneficiaries for an annuity period followed by asset distribution to one or more non-charitable remaindermen. Guidance is provided for both Grantor and non-Grantor charitable lead annuity trusts. If the requirements of the forms are met, the gift to the charitable lead annuity trust qualifies for the §2055 estate tax charitable deduction, the §2522 gift tax charitable deduction, and possible income tax charitable deduction under §170.

14. Revenue Procedure 2007-46

Revenue Procedure 2007-46 provides forms with respect to testamentary charitable lead annuity trusts. Provided is a sample trust that meets the requirements for a testamentary charitable lead annuity trust that provides for annuity payments to one or more charitable beneficiaries for an annuity period followed by asset distribution to one or more non-charitable remaindermen. If the forms are followed, the value of the charitable lead annuity trust will be deductible by the Estate under §2055, and payment of the annuity amount to the charitable lead beneficiary will be deductible under §642(c)(1).

15. Revenue Procedure 2008-66

This Revenue Procedure provides tax rates and brackets with respect to 2009 inflation adjustments.

The gift tax annual exclusion is increased to $13,000.00 per donee for transfers made in 2009. The annual exclusion for gifts to a

non-U.S. citizen spouse is raised to $133,000.00 for transfers made in 2009.

The 2009 income tax rates for trusts and estates are:

Income	Rate
Not over $2,300.00	15%
Over $2,300.00 but not over $5,350.00	$345.00 + 25% on excess over $2,300.00
Over $5,350.00 but not over $8,200.00	$1,107.50 + 28% on excess over $5,350.00
Over $8,200.00 but not over $11,150.00	$1,905.50 + 33% on excess over $8,200.00
Over $11,150.00	$2,879.00 + 35% on excess over $11,150.00

16. Revenue Ruling 2008-22

In this Ruling, the Service provided that, for estate tax purposes, a substitution power will not, by itself, cause the value of the trust corpus to be includible in the Grantor's gross estate, provided the Trustee has fiduciary obligations (under local law) to ensure the Grantor's compliance with the terms of this power by satisfying itself that property acquired and substituted by the Grantor is of equivalent value and further provided that substitution power cannot be exercised in the manner that can shift benefits among the trust beneficiaries.

The Taxpayer established and funded an irrevocable inter vivos trust for the benefit of his descendants. The governing instrument provided that the Taxpayer had the power, exercisable at any time, to acquire any properties held in the trust by substituting other property of equivalent value. The power was exercisable by the Taxpayer in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, the Taxpayer must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. In addition, under local law, the Trustee had a fiduciary obligation to ensure that the properties being exchanged are of equivalent value. Also under local law, if a trust has two or more beneficiaries, the Trustee has a duty to act impartially in investing and managing the trust, taking into account any differing interest of the beneficiaries. Further, the Trustee had the discretionary power to acquire, invest, reinvest, etc. and manage the trust property in accordance

with the standards provided by law. The Service analyzed §2036(a) and §2038(a). The Service also cited *Estate of Jordahl vs. Commissioner*. Under Jordahl, the Tax Court held that the Decedent's power to substitute assets of equal value was not a power to alter, amend, or revoke the trust within the meaning of §2038. The Service went on to analyze the Trustee's general fiduciary duties to the trust and its beneficiaries. It was noted that the Grantor of the trust holds the nonfiduciary power to replace trust assets with assets of equivalent value, but the Trustee has the duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. Further, the Trustee's duty of impartiality meant that the Trustee must prevent any shifting of benefits between and among the beneficiaries that could otherwise result from a substitution of property.

The Service held that a Grantor's retained power, exercisable in a non-fiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the Grantor's gross estate under §2036 or §2038, provided the Trustee has the 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 property acquired and substituted by the Grantor is, in fact, of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner to shift benefits if: (a) the Trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiary; or (b) the nature of the trust investments or the level of income produced by any or all of the trust investments do 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.

17. Revenue Ruling 2008-35

The Taxpayer/depositor entered into an agreement with a bank pursuant to which the Taxpayer agreed to deposit marketable securities and cash into an account described as a restricted management account (RMA). The terms of the RMA were designed to enhance the investment performance of this portfolio by allowing the bank and any investment advisor appointed by the bank to maximize the portfolio's long term performance without the risk of withdrawal of assets from the RMA before the expiration of the

selected term of the RMA. The bank agreed to accept a reduced investment management fee because the bank was guaranteed a fee over the fixed term of the RMA. During the term of the RMA, the bank will manage the RMA and have complete discretion regarding investment of the assets held in the RMA. All dividends, interest, and other income earned within the RMA are to be retained and reinvested, and no distributions of income or principal may be made from the RMA during the agreement term. The subject RMA provided that it would terminate on the fifth anniversary of the date of its execution. The Taxpayer funded the RMA with marketable securities and cash having a total value of $50x. Later when the total fair market value of the assets held in the RMA is $60x, the Taxpayer assigns one-sixth of the RMA to his child. A new RMA is established for the child with assets having a fair market value of $10x. Later, the Taxpayer dies at a time when his RMA is $55x.

The Service dealt with the issues concerning the fair market value of the gifted interest, as well as the fair market value of the interest retained until death. The Service analyzed §2512, §2031, §2036, and §2703. The Service held that the RMA agreement to manage the Taxpayer's assets reduced neither the fair market value of the transferred property for gift tax purposes nor the fair market value of the property included in the Taxpayer's gross estate for estate tax purposes. The Service held that notwithstanding the restrictions on the Taxpayer's ability to withdraw assets from the RMA and on the Taxpayer's ability to terminate or transfer an interest in the RMA, that the Taxpayer remains the sole and outright owner of the assets in the RMA and the income from those assets. The Taxpayer has not changed the nature of the Taxpayer's property by entering into the RMA agreement. Consequently, the Taxpayer's assets held in the RMA constitute the property to be valued for estate and gift tax purposes. The Service reasoned that any restrictions imposed by the RMA agreement relate primarily to the performance of the management contract, rather than to substantive restrictions on the underlying assets held in the RMA. Any restrictions on the Taxpayer's ability to withdraw assets, terminate the agreement, or transfer interest in the RMA, do not impact the price at which those assets would change hands between a willing buyer and willing seller. In that regard, the RMA is comparable to a retirement fund or an individual retirement account. In addition, §2036 applies to the Taxpayer's retained interest in the assets in the RMA. Further, §2703(a)(2) applies to disregard the restrictions on the sale or use of property for federal transfer tax valuation purposes. The Service held that the fair market value of the assets in an RMA for gift and estate tax purposes is determined based on the fair market value of the assets held in the RMA, without any reduction or discount to reflect restrictions

imposed by the RMA agreement on the transfer of any part or all of the RMA or on the use of the assets held in the RMA.

18. Revenue Ruling 2008-41

In one of the circumstances dealt with under this Revenue Ruling, a charitable remainder annuity trust or unitrust has two (2) or more individual beneficiaries, each of whom is entitled to an equal share of the annuity or unitrust amount, payable annually, during the recipient's lifetime and upon the death of one recipient, each surviving recipient becomes entitled for life to an equal share of the deceased recipient's annuity or unitrust amount. Upon the last recipient to die, the trust assets are to go to one or more charitable organizations. At issue is the division of the trust into separate and equal trusts, with one for each then living recipient. Each separate trust will continue to function as the same type of qualified charitable remainder trust as before the division. The trust fund is to be divided equally among and transferred to the new separate trusts. Each new separate trust is deemed to have an equal share of the pre-division trust income. The individuals involved will pay all the costs associated with the division of the single trust into the separate trusts, including legal fees. Each of the separate trusts will have the same provisions as before except that: the separate trust may have different Trustees; after the division, each separate trust has only one recipient of the annuity or unitrust amount from that separate trust; each separate trust is administered and invested independently by its Trustees; upon the death of a recipient, the assets of that separate trust must be transferred to the separate trust of the surviving recipients; and upon the death of the last surviving recipient, the separate trust terminates and the assets are to be distributed to the charitable remainder beneficiaries. The charitable remainder beneficiaries of the prior trust are the remainder beneficiaries of each separate trust and are entitled to the same total remainder interest after the division of the trust as before.

The Service ruled favorably on the trust division. The Service held that the transfer of assets from a deceased recipient's separate trust to the separate trusts of the surviving recipients would not be treated as a prohibited additional contribution to a charitable remainder annuity trust. The Service held that the division of one trust into separate trusts does not cause the pre-division trust or any separate trust to fail to be a qualified charitable remainder trust. The Service further held that the division was not a sale or exchange or other disposition which would produce a taxable gain or loss to the trust or the beneficiaries. The Ruling also dealt favorably with the basis of

the property in the separate trusts, the holding period, and other such issues.

19. Announcement 2008-17

The Service issued an Advance Notice regarding transfer tax issues expected to be addressed in forthcoming proposed Regulations dealing with §529 plans. The IRS also requested comments on several income tax issues and on rules relating to the election to treat contributions under §529 plans as being made over a five-year period. The Service is concerned with potential abuse of §529 plans.

The Service indicated that the forthcoming proposed Regulations will contain an anti-abuse rule. One potential abuse is the creation of multiple §529 plans to take advantage of multiple annual exclusions, with the intention of subsequently changing all of the plans to a single beneficiary. Another example is naming one person as the account owner of multiple plans, with the intention of making multiple annual exclusion gifts to the plans, but with the single owner withdrawing all of the funds at a later time.

The Announcement proposes to treat a change of beneficiary as a gift by the account owner, not the old beneficiary as under existing rules, by treating the change as a deemed distribution to the account owner followed by a new gift. Distributions to the account owner will be taxed to the account owner on the entire amount distributed, less that owner's contributions to the plan. This would mean that if the account owner has made no contributions to the plan, the entire amount distributed to him, rather than just the earnings on the plan, is subject to income tax. The Notice asked for comments as to whether account owners should be limited to individuals and UTMA accounts. This would eliminate the possibility of using trusts as owners. The Notice suggest that UTMA's can contribute to the §529 plans, and the contribution would not be treated as a gift. The Notice indicates that if an individual creates a §529 account naming himself as the beneficiary, the contribution is not a gift. However, transfer taxes would be imposed if the beneficiary changed. Several rules are proposed with respect to when the account will be included in the beneficiary's estate if the beneficiary dies before the account has been completely distributed or changes the name to a new beneficiary. Estate inclusion would result if the account is distributed to the beneficiary's estate within six months of death. No estate inclusion would occur if a successor beneficiary is named who is in the same or older generation of the deceased beneficiary. No inclusion occurs if the account owner withdraws

the funds from the account. There is no inclusion in the beneficiary's estate if the account owner allows funds to remain in the account without naming a new beneficiary by the due date of filing the deceased beneficiary's estate tax return. The account will be deemed distributed to the account owner, making the account owner liable for income tax. The five year annual exclusion election may be made on the last gift tax return filed by the donor before the due date, or if a timely return is not filed, on the first gift tax return filed by the donor after the due date. The election is irrevocable. If the contribution in the year exceeds five years of annual exclusions, the excess is treated as a gift in the year of the contribution. The election may be made by the donor and the donor's spouse by making the split gift election under §2513.

20. Notice 2008-42

This Notice provides guidance regarding the application of §101(j) and §264(f) to life insurance contracts that are subject to split-dollar life insurance arrangements. IRC, §101(j) applies to life insurance contracts issued after August 17, 2006. IRC, §264(f) applies to contracts issued after June 8, 1997. IRC, §101(j)(i) provides that in the case of an employer owned life insurance contract, the amount of death benefits excluded from gross income of the applicable policy holder under §101(a)(1) shall not exceed the amount equal to the sum of the premiums and other amounts paid by the policy holder for the contracts. For this purpose, an employee-owned life insurance contract is a life insurance contract that: (i) is owned by a person engaged in a trade or business and under which such person is directly or indirectly a beneficiary under the contract; and (ii) covers the life on an insured who is an employee with respect to the trade or business on the date the contract was issued. An applicable policy holder is generally a person who owns an employer-owned life insurance contract. IRC, §101(j)(2) provides exceptions to the general rule of §101(j)(1) in the case of certain employer-owned life insurance contracts with respect to which certain notice and consent requirements are met. IRC, §264(f)(1) provides that no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash value with respect to a life insurance policy or an annuity or endowment contract.

Both §101(j) and §264(f) apply to "life insurance contracts" as defined in §7702. That is any contract that is a life insurance contract under applicable law. Under §7702, the term "life insurance contract" generally does not encompass the terms of an arrangement, such as a split-dollar arrangement, of which the

contract is a part. A modification of a split-dollar insurance arrangement that does not involve any change to the life insurance contract underlying the arrangement, will not be treated as a material change in the life insurance contract for purposes of §101(j) and §264(f).

21. Notice 2008-116

On January 16, 2008, the Supreme Court issued its decision in *Knight vs. Commissioner*, holding that costs paid to an investment advisor by a nongrantor trust or estate generally are subject to the two percent floor for miscellaneous itemized deductions under §67(a). The IRS is expected to issue regulations under §67 consistent with the Supreme Court's holding in Knight. The Regulations will also address the issue raised when a nongrantor trust or estate pays a bundled fiduciary fee for costs incurred in-house by the fiduciary, some of which are subject to the two percent floor and some of which are fully deductible without regard to the two percent floor. The Regulations were not issued in time to be applicable for the 2008 tax year. In Notice 2008-32, interim guidance was provided that specifically addressed the treatment of a bundled fiduciary fee. In short, Notice 2008-32 provided that taxpayers would not be required to determine the portion of the bundled fiduciary fee that is subject to the two percent floor under §67 for any taxable year beginning before January 1, 2008. Notice 2008-116 extended the interim guidance for any taxable year beginning before January 1, 2009. Accordingly, for each such taxable year, taxpayers may deduct the full amount of the bundled fiduciary fee without regard to two percent floor. Query how bundled fiduciary fees are to be treated for 2009?

22. CCA 200803016

At the time of his death, the Decedent owned an interest in an LLC. The LLC was the owner of a seventy-five percent interest in real property comprising a retail shopping center. At the time of the Decedent's death, the LLC was treated as a partnership with fifteen or fewer members and considered a closely held business within the meaning of §6166(b). The estate tax return for the Decedent's estate was promptly filed and an election under §6166 was made. The Executors of the estate drafted a written agreement as required under §6324A(c) consenting to the creation of a special estate tax lien. In lieu of the bond required by §6165, the Executors consented to the placement of a 15-year estate tax lien under §6324A on the interest in the LLC to secure the payment of the deferred taxes. In addition to the §6324A(c) written agreement, the Estate submitted a proposed Pledge and Escrow Agreement.

Under §6166, an Executor may elect to defer the payment of taxes for five years and pay the balance of interest and tax due in installments over a period of ten years if the estate consists largely of interest in a closely held business. IRC, §6324A provides that in the case of an election under IRC, §6166, if the Executor makes an election and files an agreement described in §6324A(c), the deferred amount, plus interest, penalties and accruals, shall be a lien in favor of the United States on the §6166 property. A special lien is created by §6324A in lieu of the general estate tax lien of §6324, and in lieu of the bond required under §6165. IRC, §6324A(c)(1)(A) provides that the collateral offered to secure the lien may be an interest in "real or other property". The interest offered by the Estate in the LLC qualified as "other property". However, the Service may accept the interest in the LLC only when three statutory requirements in §6324A(b) are met. First, the collateral must be expected to survive the deferral period. Second, the collateral must be identified in the agreement. Third, the value of the collateral must be sufficient to pay the estate tax liability plus the aggregate amount of interest payable over the first four years of the accrual period. The Service determines whether such provisions have been met. If the three requirements under §6324A are met, the §6324A special lien arises and the collateral must be accepted by the Service. The Service does not have the authority to reject collateral proffered by the Estate on the grounds that it would be burdensome for the Service to determine the value. Nor does the Service have the authority to reject collateral proffered by the Estate because the Service would prefer other collateral. Congress gave the Service a very limited role in the creation of the §6324A special lien; i.e. the Service determines whether the statutory requirements have been met. If the statutory requirements have been met, the special lien arises under the statute and the Service must accept the interest in the LLC. If the Service concludes that the requirements have not been met, the Service has the right to reject the interest in the LLC as collateral.

IRC, §6324A(c) requires a written agreement protecting the Service's interest in the collateral securing the §6324A special lien. Except for the §6324A(c) written agreement, the Code does not require the Service to enter into any additional agreements, such as a Pledge or Escrow Agreement. Nor does the Code preclude the Service from entering into such types of additional agreements. Whether they enter into a Pledge or Escrow Agreement in addition to the required §6324A(c) written agreement is a matter to be determined by the facts and circumstances of each particular case.

23. CCA 200836027

Under §6161, the Taxpayer requested and was granted (due to economic hardship) an extension of time for paying the estate tax. During the period of extension for paying the estate tax, interest on the unpaid estate tax continued to accrue. The Taxpayer filed a Form 1041 and claimed a deduction on the income tax return for the amount of interest due on the unpaid estate tax. The issue addressed was whether or not the interest on estate tax accrued during the period of extension for paying tax under §6161 is deductible under §163. The Service noted that §163(a) provides that a deduction is allowed for interest paid or accrued on indebtedness. However, under §163(h)(i), no deduction is allowed for personal interest paid. Only six types of interest listed in §163(h)(2)(A) thru (F) qualify as deductible, non-personal interest. IRC, §163(h)(2)(E) states that where an extension of time for payment of estate taxes in effect under §6163, interest payable on the estate tax during that period of extension is allowable as an income tax deduction. Other than interest payable on estate tax during the period of extension under §6163, all interest with respect to other extensions of time for paying estate tax are considered personal interest for purposes of the income tax deduction, and thus are not allowed as an income tax deduction.

This Chief Counsel Advice cites Jeffrey M. Pennell for the proposition that the deduction of interest paid under §6161 is open to debate. This Chief Counsel Advice indicates that the plain language of the statute indicates that no deduction is available.

24. Action on Decision 2008-001

The Service has announced that it will not acquiesce in the Tax Court's decision in *Kohler vs. Commissioner*. In Kohler, the Decedent owned common stock in the Kohler Company at the time of his death. The stock was not subject to restrictions. Subject to the Decedent's death, and prior to the alternate valuation date, the company underwent a tax-free reorganization under §368(a). Pursuant to reorganization, the Decedent's estate opted to exchange its stock for stock that was subject to restrictions. The Estate then elected to use a six month alternate valuation date under §2032(a)(2). In determining the value of the Kohler stock on that date, the Estate discounted the fair market value of the stock to account for the post-death restrictions. The Commissioner determined that no discount for post-death restrictions was permitted and the Estate then filed a petition with the Tax Court. The Tax Court disagreed with the Commissioner and held for the Taxpayer. The Tax Court focused on whether or not the

reorganization was a disposition for purposes of §2032(a)(1). The Tax Court reasoned that since the tax-free reorganization under §368(a) did not constitute a disposition (which would otherwise require valuation on the date of disposition under §2032(a)(1)), the Court had to value the property in the condition it existed as of the date six months after the Decedent's death, pursuant to §2032(a)(2). The Service believes that the Tax Court erred in focusing on whether a disposition had occurred rather than on whether it should take into account a change in character of the property that had occurred during the alternate valuation period. Regulations, §20.2032-1(c)(1) addresses what constitutes a disposition for purposes of determining when to value the property, not the character of the property to be valued. The character of the property to be valued in Kohler was established for valuation purposes as of the date of death. Consequently, the Service believes that the Tax Court should have ignored changes in the character of the stock due to post-death restrictions in determining the value of the stock on the alternate valuation date.

25. Proposed Regulations §20.2032-1

In response to Kohler, and in accordance with Action on Decision 2008-001, the Service has issued new proposed Regulations under §20.2032-1. Proposed Regulations, §20.2032-1(f)(1) provides as follows:

"In general. The election to use the alternate valuation method under section 2032 permits the property included in the gross estate to be valued as of the alternate valuation date to the extent that the change in value during the alternate valuation period is the result of market conditions. The term market conditions is defined as events outside the control of the decedent (or the decedent's executor or trustee) or other persons whose property is being valued that affect the fair market value of the property being valued. Changes in value due to mere lapse of time or to other post-death events other than market conditions will be ignored in determining the value of the Decedent's gross estate under the alternate valuation method."

Proposed Regulations, §20.2032-1(f)(3)(i) provides as follows:

"In general. In order to eliminate changes in value due to post-death events other than market conditions, any interest or estate affected by post-death events other than market conditions is included in a decedent's gross estate under the alternate valuation method at its value as of the date of the decedent's death, with adjustment for any change in value that is due to

market conditions. The term post-death events includes, but is not limited to, a reorganization of the entity (for example, corporation, partnership, or limited liability company) in which the estate holds an interest, a distribution of cash or other property to the estate from such entity, or one or more distributions by the estate of a fractional interest in such entity."

The Proposed Regulations offer a series of examples dealing with post-death market conditions and other post-death events. Example (1) is the "anti-Kohler" example. This example deals specifically with a tax-free reorganization occurring after the date of death and prior to the alternate valuation date. The Proposed Regulations, when they become final, are to be applicable to estates of decedent's dying on or after April 25, 2008.

26. Anthony vs. U.S., 101 AFTR 2d 2008-983

The Decedent sustained serious injuries in an automobile accident. The Decedent agreed to a structured settlement of his claims and thereby became the beneficiary of three (3) annuities. The payments due under two (2) of the annuities could not be "anticipated, sold, assigned, or encumbered". The Decedent died after having entered into the structured settlement. At the time of his death, the Decedent was scheduled to receive ten (10) additional annual payments from one annuity and monthly payments for a period of ten (10) years from the other two. The Decedent's estate initially estimated the present value of the Decedent's right in the guaranteed payments using the tables in §7520. Later, the Estate claimed it had overvalued the annuities. According to the Estate, the annuities should have been assigned their fair market value without regard to the annuity tables, because the nontransferability clauses rendered the annuities subject to a restriction under Regulations, §20.7520-3(b)(1)(ii).

Based on this reported overvaluation, the Estate filed a claim for refund. The IRS denied the claim. The Estate filed suit for refund in Federal District Court. The District Court found that the annuities were properly valued under the tables and that no tax refund was due. The Estate appealed to the Fifth Circuit Court of Appeals.

The Court of Appeals first indicated that while a mathematical computation of fair market value is an issue of fact, the determination of the proper valuation method under the Code is a question of law that the Court reviewed de novo. The Court then discussed general valuation principles regarding fair market value. The fair market value of an annuity is generally determined

by resorting to the annuity tables prescribed by the Service. The Court recognized that in enacting the annuity tables, Congress displayed a preference for convenience and certainty over accuracy in individual cases. While the tables inevitably lead to departures from true value, whatever that may be, the error costs are perceived as small in the aggregate. The tables provide some measure of certainty and administrative convenience that would be disrupted if every attempt to value an annuity deteriorated into a battle of experts regarding market value. However, when the tables result in a value that is unrealistic or unreasonable, other valuation methods should be employed. The Regulations provide an extensive exception to the tables for "restrictive beneficial interest". Regulations, §20.7520-3(b)(ii) & (c). The Regulations define a "restrictive beneficial interest" as an "annuity, income remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided by the terms of the trust, will or other governing instrument or is caused by other circumstances". Generally, a restricted beneficial interest should be assigned its fair market value without regard to the annuity tables.

The Estate cited the language in Regulations, §20.7520-3(b)(1)(ii) and suggested that the term "other restriction" should be read to create an exception to the tables based on the type of marketability restrictions placed on the Decedent's annuity interest. The Court looked at the language of the Regulations and the circumstances surrounding their promulgation. The Court held that in light of its language, structure, and purpose, Regulations, §20.7520-3(b) did not require a non-marketability exception from the annuity tables with respect to the Decedent's structured settlement annuities.

27. <u>Jane Z. Astleford vs. Commissioner</u>, T.C. Memo 2008-128

The husband was a real estate investor who, together with the Taxpayer, his wife, owned real estate interests in Minnesota. Most of these holdings were themselves held in a general partnership (Pine Bend), that was owned with unrelated parties as equal partners. The agreement for Pine Bend did not restrict transfers of partnership interests. Among the assets held by the husband and the Taxpayer were 3,000 acres of undeveloped land near St. Paul, Minnesota. The husband died and left his real estate interests to a marital trust for the Taxpayer's lifetime benefit. The Taxpayer created the Astleford Family Limited Partnership (AFLP) and funded it with her interest in an eldercare assisted living facility. Shortly there after the Taxpayer gave each of her three children a 30% limited partnership interest, retaining for herself a 10% general partnership interest. The next year, the Taxpayer

contributed her interest in Pine Bend and other real estate properties to the AFLP, allocated them to her capital account, and then gave her children additional limited partnership interests, restoring the 30%-30%-30%-10% ownership percentages. The Service disputed the values of the various assets transferred to the AFLP and the discounts allowable on the gifts of AFLP interests. The Taxpayer and the Service agreed on the value of the underlying assets, but disagreed on the appropriate control and marketability discounts.

The Tax Court found that the appropriate values and discounts lay somewhere between what the Taxpayer claimed and what the Service claimed, and awarded the Taxpayer discounts of 30% and 36% for the parent and subordinate partnership interests. The Taxpayer's appraiser claimed a 25% discount for market absorption with respect to a large tract of property, but the Service's expert contended that no such discount was required because he found comparables of similar size, and the subject property itself was bought as a single block. The court found the Service's expert was particularly credible and highly experienced and that he possessed a unique knowledge of property. However, the Court held that the large tract was not likely be sold as a single unit, and allowed a market absorption discount of 10%. The Taxpayer claimed a 5% discount on the transfer of Pine Bend interests to AFLP, because AFLP would only be an assignee of that interest, rather than a new general partner.

The Court agreed with the Service that the substance over form doctrine should apply and that the Pine Bend interest transferred to AFLP should be treated as a general partnership interest. The court stressed that the Taxpayer was the sole general partner of AFLP, so that her position relative to Pine Bend did not change because of the transfer.

28. <u>Bianca Gross vs. Commissioner</u>, T.C. Memo 2008-221

The Taxpayer created a family limited partnership to hold her $2,000,000.00 portfolio of publicly-traded securities. The Taxpayer thought one of her daughters extravagant, but did not create a trust for her benefit because her other daughter refused to serve as trustee. The Taxpayer believed that a family limited partnership would encourage her daughters to work together and learn from her own experience, while she retained control over her assets as the sole general partner. She discussed the partnership with her daughters, and prepared a partnership agreement. She and her daughters each contributed a nominal amount of cash to the partnership, after which the Taxpayer contributed her stock portfolio. The Taxpayer was the sole general partner, with au-

thority to make major decisions concerning the partnership. The daughters could not transfer their interests in the partnership without the Taxpayer's approval, nor could they withdraw from the partnership or withdraw their capital contributions. The daughters could not cause the partnership to be dissolved. Each partner's interest in the partnership was based on the amount of her contribution of capital to the partnership. The certificate of limited partnership was filed and notice of the formation of the partnership was published on July 15, 1998. The Taxpayer held a family meeting with her daughters on or shortly before December 15, 1998, at which they all signed gift documents that provided that the Taxpayer transferred to each daughter a 22.25% limited partnership interest. The Taxpayer and her daughters signed the partnership agreement at that time. The Taxpayer filed a gift tax return and reported the gifts and valued each at $312,500.00, which included a 35% combined minority and marketability discount. The Service denied the discounts, and claimed that all of the relevant events actually occurred on the same day, i.e. December 15, 1998, so that the transfers were really gifts of the underlying securities, rather than gifts of the partnership interests.

The Tax Court held that the partnership was first formed, and then each daughter acquired a 22.25% limited partnership interest. The Taxpayer argued that, under applicable state law, the partnership was validly formed when the certificate was filed with the state. The Service contended that the partnership was not validly formed until the partnership agreement was signed, and that the transfers made before this date were, therefore, indirect gifts of the underlying assets. The Court looked at whether, if a limited partnership was not formed by filing the certificate, state law would deem that the Taxpayer and her daughters had formed a general partnership on July 15, 1998. The Court explained that when parties seeking to form a limited partnership do not satisfy the requirements necessary to form a limited partnership, they may be deemed to have formed a general partnership if their conduct indicates that they have agreed on all the essential terms and conditions of their partnership arrangement. The Court found that on the date that the certificate was filed, the Taxpayer and her daughters had agreed to form a partnership on the terms set forth in the partnership agreement. The Court noted that the daughters each contributed $10.00 cash on July 31, 1998, and the Taxpayer began contributing securities to the partnership no later than November 10, 1998, and made her $100.00 cash contribution on November 16, 1998. The Taxpayer kept a record of her contributions in a notebook and kept computer records of the performance of the portfolio. All of these facts pointed to the creation of the partnership in July, rather than December. The Service also argued

that the Taxpayer made indirect gifts to her daughters because she contributed the securities to the partnership for inadequate consideration, because, proportionate to her interest in the partnership, only 55.5% of the value of the securities was credited to her capital account. The Court stated that this was the same as saying that the gifts of limited partnership interests preceded the Taxpayer's contributions.

The Service argued the step transaction doctrine applied so that the gifts occurred before the securities were transferred to the partnership. The Court held that the Taxpayer made no indirect gift of the securities to her daughters, because 100% of the value of the securities she contributed to the partnership was credited to her capital account before she made gifts of partnership interests to her daughters. The Court discussed its prior holdings in *Jones Estate* v. *Commissioner*, *Shepherd* v. *Commissioner*, and *Holman* v. *Commissioner*, noting that there are cases in which the step transaction will apply to the creation of a family limited partnership and gifts of partnership interests. Here, however, the Court stated that eleven days passed between the Taxpayer's transfer of securities to the partnership and her gifts of partnership interests to her daughters, and the securities were common shares of well-known companies with some volatility. The court refused to apply the step transaction doctrine to change the actual order of the transactions.

The parties stipulated that the 35% discount was appropriate, if the Taxpayer was deemed to have made gifts of limited partnership interests, and the Court applied that discount.

29. Thomas H. Holman, Jr. vs. Commissioner, 130 T.C. No. 12

The Taxpayers, husband and wife, transferred a large quantity of Dell Corporation stock to a newly formed family limited partnership and then made gifts of limited partnership units to a custodian for one of their children and to the trustee of a trust for the benefit of all of their children. The Taxpayers made large gifts in 1999 and smaller gifts in 2000 and 2001. The 1999 gifts were made six days after the Taxpayers funded the partnership. The 2000 gifts were made two months after the Taxpayers funded the partnership. In valuing the gifts for gift tax purposes, the Taxpayers applied a 49.25% discount for minority interest status and lack of marketability. The Service argued that the 1999 gift was not a gift of limited partnership interests, but rather an indirect gift of the Dell stock, for which no discount would be appropriate. The Service asserted that this result followed from the indirect gift rule of Regs. §25.2511-2(a). Alternatively, the Service argued that the formation and funding of the family

limited partnership and the gifts of limited partnership interests were steps of an integrated donative transaction, which should be collapsed under the step transaction doctrine and treated as a gift of the Dell stock. The Service also argued that certain buy-sell restrictions in the partnership agreement should be ignored in valuing the 2000 and 2001 gifts of limited partnership interests.

The Court rejected the application of the indirect gift and step-transaction doctrines in this situation, because the creation and funding of the partnership and the gifts of limited partnership interests were separate and independent acts, occurring six days apart. The Court distinguished both *Shepherd v. Commissioner* and *Senda v. Commissioner,* from the facts at hand. In Shepherd, the Court noted that the taxpayer transferred real property and shares of stock to a newly formed family partnership in which he was a 50% owner and his two sons were each 25% owners. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated *pro rata* to the capital accounts of each partner according to ownership. Thus, the Court there held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25% interests in the real property and shares of stock. In Senda, the transfers of shares of stock to two family limited partnerships, and the transfers of limited partnership interests to the donees, occurred on the same day. The Court stated in Senda that the transactions were, at best, integrated and, in effect, simultaneous. In Holman, however, the Court stated that the facts were distinguishable from those in both Shepherd and Senda. The Taxpayers in Holman did not first transfer limited partnership interests to the donees and then fund the partnership, nor did they simultaneously fund the partnership and transfer partnership interests. Six days separated these steps.

The Court rejected the Service's argument that the two steps were interdependent, causing the step transaction doctrine to apply. The interdependence test requires that the steps be so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. The Court noted that, first, the transfers in this case were not made the same day. Second, there was a real economic risk of a change in value of the Dell stock and the value of the partnership interests.

The Court found as a matter of fact that the Taxpayers planned to make the 1999, 2000 and 2001 gifts when they formed the partnership. However, the legal relations created by the

partnership agreement would not necessarily have been fruitless had the Taxpayers not also made the 1999 gift. The Court noted that the Taxpayers retained the risks of changes in the value of the Dell stock held by the partnership during the days between the funding and the gifts. The Court noted that the Service had not asserted the step transaction doctrine on the gifts made two or fifteen months after the funding. The Court refused to adopt a bright line test. The economic risk borne by the Taxpayers for six days was sufficient to preclude application of the step transaction doctrine.

The Court held that the restrictions on transfer in the partnership agreement could not be taken into account in valuing the partnership interests, under §2703(a). Section 2703(a) ignores, for gift tax purposes, any right or restriction relating to transferred property, unless the restriction: (1) is a *bona fide* business arrangement; (2) is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) has terms comparable to similar arrangements entered into by persons in an arm's length transaction. The Court found that the transfer restrictions failed the first two tests. The Court noted that the purposes of the partnership transfer restrictions were not business purposes and that the restrictions were not a *bona fide* business arrangement.

The Court also held that the transfer restrictions were a device to transfer the encumbered property to members of the decedent's family for less than full and adequate consideration in money or money's worth. The partnership's purchase of the interest of a child redistributes the difference between the net asset value of the partnership assets and the value of the assignees' interest among the remaining partners. The partners benefiting from the redemption would include the natural objects of the Taxpayers' bounty.

The Court rejected the 49.25% discount claimed by the Taxpayers' appraiser. The Court allowed discounts for minority interest and marketability in the aggregate amounts of 22.405% in 1999, 25.09% in 2000, and 11.561% in 2001.

30. <u>Estate of Frazier Jelke, III vs. Commissioner</u>, 100 AFTR 2d 2007-6694

In <u>Jelke</u>, the Decedent's gross estate included a 6.44% interest in a company, substantially all of the assets of which were marketable securities. The company had been in existence for many years, and during this same period there was no action taken to

liquidate the company. On the date of death, the company's net asset value was approximately $178,000,000.00 and it had a built-in capital gain tax liability of approximately $51,000,000.00. The estate valued the decedent's interest by reducing the company's net asset value by the entire $51,000,000.00 potential capital gain, and then applying discounts for lack of control and marketability. The Tax Court held that the built-in capital gain tax liability must be discounted to reflect the fact that the company was unlikely to be liquidated for many years after the decedents death.

The Tax Court held that the company's profitability suggested that it would not be liquidated or sold quickly, and reduced the capital gain tax offset for the 16 years it estimated would be required to sell all of the company's securities, at the present turnover rate. This reduced the capital gain tax offset from $51,000,000.00 to $21,000,000.00 for the entire company, and the decedent's share of that discount from $3,284,400.00 to $1,352,400.00.

The Tax Court also rejected the 25% minority discount and 35% marketability discount, and allowed a 10% minority discount and a 15% marketability discount (23.5% aggregate discount).

The Eleventh Circuit reversed, finding that the entire tax offset was an appropriate adjustment. The Eleventh Circuit upheld the Tax Court's adjustments to the discounts for lack of control and lack of marketability. The Court reviewed the judicial history of the deduction for the capital gain inherent in a C corporation.

The Supreme Court denied certiorari in the Jelke case on October 6, 2008. It agreed with the Fifth Circuit, that the value of the corporation must be reduced by 100% of the estimated capital gain tax, regardless of when the liquidation was likely to occur.

31. Estate of Anna Mirowski vs. Commissioner, T.C. Memo 2008-74

The Decedent was married to a physician (the "Doctor"). The Doctor invented the automatic implantable cardioverter defibrillator (ICD), which monitored and corrected abnormal heart rhythms. The Doctor licensed the device and, during his lifetime, received modest royalties. The Decedent's family held annual family meetings during their vacations, and invited their accountants or attorneys to attend to assist in their discussions of family business and investment matters. The Doctor died, leaving the bulk of his assets, including the ICD patents and interests in the licenses, to the Decedent. The Decedent maintained a long and continuous history of making charitable gifts and gifts to her

daughters, her grandchildren, and other family members and friends. The Decedent created irrevocable spendthrift trusts for each of her three daughters and their respective issue. The Decedent named all three of her daughters as co-trustees of each of the daughters' trusts, because she wanted her daughters to work together and have a close working relationship. The Decedent funded each trust with part of her interest in the ICD patents licensing agreement. Sales of ICDs increased significantly after the Doctor died and the royalties received under the license agreement increased from thousands of dollars a year to millions of dollars a year. The Decedent was primarily responsible for managing her own financial affairs. The Decedent hired Goldman Sachs to assist in managing some of her investments, and ultimately brought all of her investments under its management. Representatives of U.S. Trust introduced the Decedent to the concept of a limited liability company (LLC). The Decedent discussed the matter with her attorney, who then drafted articles of organization and a draft operating agreement for a family limited liability company (the "LLC"). Copies were sent to the daughters for their review and comments. In 2001, the Decedent's daughters and their families took their annual vacation and held their annual family meeting to which they had invited the Decedent's lawyer. At that meeting, they discussed the Decedent's plans to form the LLC, her plans to make gifts of interests in the LLC to the daughters' trusts, and the manner in which the LLC would function. The Decedent did not attend this meeting, because she was receiving medical treatment. After the family meeting, the Decedent's attorney finalized the documents required to form the LLC. In September of 2001, the Decedent made several transfers of ICD patents and the licensing agreement, and over $62,000,000.00 in cash and securities in her Goldman Sachs account to the LLC. After these transfers, the Decedent was the only member of the LLC. The Decedent gave an interest in the LLC to each of her daughters' trusts later that month. The Decedent retained substantial personal assets outside the LLC, including over $3,000,000.00 in cash and cash equivalents and another $4,500,000.00 in various assets. From these retained assets and other sources of income, the Decedent could support her lifestyle, and pay the gift taxes. The LLC credited the Decedent's capital account with her contributions, and allocated a share of the Decedent's capital account to each daughter's trust when she made gifts of the LLC interests. The Decedent was the initial general manager of the LLC. Although the Decedent held a 52% interest in the LLC and was its general manager, she could not sell or otherwise dispose of any of the LLC assets, other than in the ordinary course of the LLC's operations, without the approval of all the members. The Decedent also could not liquidate and dissolve or admit additional members without the approval of all

the members of the LLC. The Decedent died in September of 2001, from unexpected complications from treatment for a foot ulcer.

The Tax Court held that the transfers to the LLC were *bona fide* transfers for full and adequate consideration, not subject to §2036(a), §2038(a), or §2035(a). The Court cited *Bongard Est. v. Commissioner*. The Court stated that, while the Decedent understood that certain tax benefits could result from forming the LLC, they were not the most significant factor in her decision to form the LLC. The Court found that the Decedent formed the LLC: (i) to provide joint management of the family's assets by her daughters and eventually her grandchildren; (ii) to maintain the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if the Decedent were to make a separate gift of a portion of her assets to each of her daughters or their trusts; and (iii) to provide for each of her daughters and eventually each of her grandchildren on an equal basis. She wanted her daughters, and eventually her grandchildren, to work together, remain closely knit, and be jointly involved in managing the investments derived from the royalties received from the ICD.

The Court found that the LLC was a valid functioning investment company and managed business matters relating to the ICD patents. The Service argued that the Decedent failed to retain sufficient assets outside of the LLC for her anticipated financial obligations, that the LLC lacked any valid functioning business operation, and that the Decedent delayed forming and funding the LLC until shortly before her death and her health had begun to fail. The Court rejected all these contentions as not supported by the facts. The Service argued that the Decedent sat on both sides of her transfers to the LLC. The Court found that the §2036(a) and §2038(a) exception for *bona fide* sales for adequate and full consideration applied notwithstanding that the transferee was a single-member LLC. The Service further argued that the LLC should be ignored because, soon after the Decedent's death, it distributed to her estate over $36,000,000.00, which was used to pay estate taxes and expenses. The Court rejected this because the Decedent's death was unexpected. The Court noted that the gifts of interests in the LLC were made without any understanding that the Decedent retained any interest in the LLC interests given away, and that this case did not involve the kinds of facts that have led the Court to find implied agreements that a decedent had retained an interest in the transferred property. The Court also rejected the argument that the authority the Decedent held as general manager of the LLC constituted a right to control the beneficial enjoyment of the transferred assets. Any authority the Decedent had under the agreement was in her capacity as the member

who owned a majority of the outstanding interests, and her majority interest did not give her the authority to determine the timing and the amount of distributions from the LLC.

The Service also argued that, because the Decedent did not at any time contemplate forming and funding the LLC without making gifts of interests in the LLC to her daughters' trusts, the transaction should be treated as a gift of the underlying assets. The Court stated that the Decedent made two separate, but related, transfers of property and that the transfers of the property to the LLC were made in exchange for 100% of the LLC membership interests.

32. <u>Estate of Kwang Lee vs. Commissioner</u>, T.C. Memo 2007-371

The Decedent died 46 days after his spouse. The Decedent's estate claimed a marital deduction for property that was transferred to the predeceased spouse, as if she had survived the Decedent. The spouse's will stated that the Decedent would be deemed to have predeceased her for purposes of her will if he died within six months after her death. Most of the couple's assets were titled in the Decedent's name. The Service disallowed the estate tax marital deduction for the bequest to the Decedent's predeceased spouse.

The Tax Court granted summary judgment to the Service and held that the marital deduction cannot be allowed for a bequest to a spouse who does not actually survive the deceased spouse.

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