
RECENT DEVELOPMENTS 2011:

**SELECTED FEDERAL AND ILLINOIS
CASES, RULINGS AND STATUTES**

**Chicago Estate Planning Council
February 15, 2012**

**Robert E. Hamilton
Hamilton Thies & Lorch LLP
200 South Wacker Drive, Suite 3800
Chicago, Illinois 60606**

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SELECTED FEDERAL RECENT DEVELOPMENTS

1. ADMINISTRATIVE ISSUES.

A. Rev. Proc. 2011-50, 2011-45 I.R.B. at 701 (November 7, 2011) sets forth the inflation-adjusted figures for exclusions, deductions and credits for 2012. In the estate and gift tax area these figures are the following:

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|-------------------------------------|--------------------------|
| • Annual Exclusion: | Remains at \$13,000 |
| • Foreign Spouse Annual Exclusion: | Increases to \$139,000 |
| • §2032A Aggregate Decrease: | Increases to \$1,040,000 |
| • §6601(j) 2% Amount: | Increases to \$1,390,000 |
| • §2010 Basic Exclusion Amount | Increases to \$5,120,000 |
| • §6039F Gifts From Foreign Persons | \$14,723 |

B. 2011-12 Priority Guidance Plan.

On September 2, 2011, Treasury and the Internal Revenue Service announced their joint priority guidance plan for 2011-2012. The plan includes the following initiatives:

GIFTS AND ESTATES AND TRUSTS:

1. Regulations under §67 regarding miscellaneous itemized deductions of trusts and estates. New proposed regulations were published on October 17, 2011. See page 7 *infra*.
2. Final regulations under §642(c) concerning the ordering rules for charitable payments made by a charitable lead trust. Proposed regulations were published on June 18, 2008.
3. Guidance concerning adjustments to sample charitable remainder trust forms under §664
4. Guidance concerning private trust companies under §§671, 2036, 2038, 2041 2042, 2511, and 2601.

COMMENT: On June 22, 2011 the Securities and Exchange Commission published a rule regarding the "family office" exception to registration as an investment adviser under the 1940 Investment Advisers Act. See Release No. IA-3220; File No. S7-25-10. The new rule was prompted by the Dodd-Frank Wall Street Reform and Consumer Protection Act's repeal of the private adviser exemption from registration contained in section 203(b)(3) of the Advisers Act, effective July 21, 2011, upon which many family offices had relied for exemption from registration. The text of the rule is at 17 CFR 275.202(a)(11)(G)-1.

5. Regulations under §1014 regarding uniform basis of charitable remainder trusts.

6. Guidance under §1022 concerning estates of decedents who die during 2010. Notice 2011-66 and Rev. Proc 2011-41 were published in 2011-35 I.R.B. at 184 and 188 respectively on August 29, 2011.
7. Guidance on portability of unified credit between spouses under §2010(c). Notice 2011-82 was published on October 17, 2011. See page 16 *infra*.
8. Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on April 25, 2008. The former proposed regulations were withdrawn and new proposed regulations were published on December 19, 2011. See page 13 *infra*.
9. Final regulations under §2036 regarding graduated grantor retained annuity trusts. Proposed regulations were published on April 30, 2009.
10. Revenue ruling on whether a grantor's retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor's gross estate under §2042. Rev. Rul. 2011-28 was published on December 5, 2011. See page 10 *infra*.
11. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
12. Revenue procedure providing procedures for filing protective claims for refunds for amounts deductible under §2053. Rev. Proc. 2011-48 was published on October 14, 2011. See page 17 *infra*.
13. Notice on decanting of trusts under §§2501 and 2601. Public comments have been solicited via Notice 2011-101, published on December 27, 2011. See page 22 *infra*.
14. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed Regulations were published on April 17, 2008.
15. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.
16. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.
17. Final regulations under §7520 updating the mortality-based actuarial tables to be used in valuing annuity interests for life, or term of years, and remainder or reversionary interests. Proposed regulations were published on May 4, 2009. Final Regulations were published in T.D. 9540, 2011-38 I.R.B. at 341 (September 19, 2011).

EXEMPT ORGANIZATIONS:

1. Final regulations under §§170, 507, 509, 6033 & 6043 to implement Form 990 revisions and to modify the public support test. Temporary regulations were published on September 9, 2008.
2. Revenue procedures updating grantor and contributor reliance criteria under §§170 and 509.
3. Guidance under §501(c)(29), as added by §1322 of the Affordable Care Act, relating to tax exemption for certain qualified nonprofit health insurance issuers.
4. Regulations under §§501(r) and 6033 on additional requirements for charitable hospitals as added by §9007 of the Affordable Care Act.
5. Notice under §§501(r) and 6033 on additional requirements for charitable hospitals as added by §9007 of the Affordable Care Act. Notice 2011-30 was published in 2011-30 I.R.B. at 60 (July 25, 2011).
6. Final regulations under §§509 and 4943 regarding the new requirements for supporting organizations, as added by §1241 of the Pension Protection Act of 2006. Proposed regulations were published on September 24, 2009.
7. Additional guidance on §509(a)(3) supporting organizations.
8. Update to Revenue Procedure 92-94 on §§4942 and 4945.
9. Notice under §4943, as amended by §§1233 and 1243 of the Pension Protection Act of 2006, on excess business holdings rules.
10. Guidance under §4944 on program-related investments.
11. Regulations regarding the new excise taxes on donor advised funds and fund management under §4966 as added by §1231 of the Pension Protection Act of 2006.
12. Regulations under §6033 on group returns.
13. Final regulations under §7611 relating to church tax inquiries and examinations. Proposed regulations were published on August 5, 2009.

C. President's Greenbook Proposals.

The general explanations of the administration's fiscal year 2013 revenue proposals were published on February 13, 2012. See <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

- . The proposals affecting estate, gift and generation-skipping taxes are the following:
 - A. Restore the Estate, Gift and Generation-Skipping Transfer Tax Parameters in Effect in 2009. The explanation states that the 2010 Tax Act which ushered in the

\$5,000,000 exemptions "provided a substantial tax cut to the most affluent taxpayers that we cannot afford to continue. We need a permanent estate tax law that provides certainty to taxpayers, is fair, and raises an appropriate amount of revenue." The proposal is to make permanent the estate, GST and gift tax parameters as they applied during 2009. The exclusion amount for estate and GST purposes would be \$3.5 million, and the gift tax exclusion amount would be rolled back to \$1 million. The top tax rate would be 45%. The proposal also states that the portability of unused estate tax exclusion between spouses would be made permanent. The proposal would be effect for estates of decedents dying, or gifts made, after December 31, 2012.

- B. Require Consistency in Value for Transfer and Income Tax Purposes. The explanation states that taxpayers should be required to take consistent positions in dealing with the Internal Revenue Service, whether or not principles of privity apply. The proposal would impose both a consistency and a reporting requirement.

Under the proposal, the basis of property received by reason of death under section 1014 should equal the value of that property for estate tax purposes, and the basis of property received by gift during the life of the donor should equal the donor's basis determined under section 1015. The basis of property acquired from a decedent to whose estate section 1022 is applicable is the basis of the property, including any additional basis allocated by the executor, as reported on the Form 8939 that the executor filed. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary valuation information to both the recipient and the Internal Revenue Service. A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return. The proposal would be effective as of the date of enactment.

- C. Modify Rules on Valuation Discounts. This proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transfer's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or to hold an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing

documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions. This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

- D. Require a Minimum Term for Grantor Retained Annuity Trusts (GRATs). This proposal would impose the requirement that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal states that although a minimum term would not prevent “zeroing-out” the gift tax value of the remainder interest, it would increase the risk of the grantor’s death during the GRAT term and the resulting loss of any anticipated transfer tax benefit. However, the proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. This proposal would apply to trusts created after the date of enactment.
- E. Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption. The proposal is that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. This would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. The proposal states that because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust, with one exception. The exception is that if, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as described in section 2642(c)(2),¹ the inclusion ratio of the distributee trust will not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary’s distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary’s death will be included in the beneficiary’s gross estate for Federal estate tax purposes. The other rules of section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision. This proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).

¹ A trust that does not allow distributions except to a single individual and that is includible in the individual's estate if the trust has not terminated before the individual's death.

- F. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts. This proposal is new. The explanation states that the lack of coordination between income and transfer tax rules applicable to a grantor trust "creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences. The proposal reads in full as follows:

To the extent that the income tax rules treat a grantor of a trust as an owner of the trust, the proposal would (1) include the assets of that trust in the gross estate of that grantor for estate tax purposes, (2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life, and (3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax purposes. In addition, the proposal would apply to any non-grantor who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would have been subject to capital gains tax if the person had not been a deemed owner of the trust. In such a case, the proposal would subject to transfer tax the portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction. The proposal would reduce the amount subject to transfer tax by the value of any taxable gift made to the trust by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts (GRITs); grantor retained annuity trusts (GRATs); personal residence trusts (PRTs); and qualified personal residence trusts (QPRTs).

The proposal would be effective with regard to trusts created on or after the date of enactment and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment. Regulatory authority would be granted, including the ability to create transition relief for certain types of automatic, periodic contributions to existing grantor trusts.

- G. Extend the Lien on Estate Tax Deferrals Provided Under Section 6166 of the Internal Revenue Code. This proposal is also new. Under current law the Section 6324(a)(1) lien generally applies for 10 years following the decedent's death. The maximum deferral period of 14 years is longer than the lien. The proposal would extend the estate tax lien under Section 6324(a)(1) throughout the Section 6166 deferral period. The proposal would be effective for the estates of all decedents dying on or after the effective date, as well as for all estates of decedents dying before the date of enactment as to which the Section 6324(a)(1) lien has not expired as of the effective date.

D. Legislation Regarding Patents for Tax Strategies: Public Law 112-29 (H.R. 1249).

The “Leahy-Smith America Invents Act” was signed by President Obama and became law on September 16, 2011. The law addresses the issue of filing patents for certain tax strategies. This issue became somewhat infamous as a result of the stock-option GRAT strategy that was patented and became the subject of a consent judgment entered March 9, 2007, in *Wealth Transfer Group, Inc. v. Rowe*, Case No. 3:06CV00024 (D. Conn.). The Act now provides in relevant part:

14. TAX STRATEGIES DEEMED WITHIN THE PRIOR ART.

(a) **IN GENERAL.**—For purposes of evaluating an invention under section 102 or 103 of title 35, United States Code, any strategy for reducing, avoiding, or deferring tax liability, whether known or unknown at the time of the invention or application for patent, shall be deemed insufficient to differentiate a claimed invention from the prior art.

(b) **DEFINITION.**—For purposes of this section, the term “tax liability” refers to any liability for a tax under any Federal, State, or local law, or the law of any foreign jurisdiction, including any statute, rule, regulation, or ordinance that levies, imposes, or assesses such tax liability.

(c) **EXCLUSIONS.**—This section does not apply to that part of an invention that—

(1) is a method, apparatus, technology, computer program product, or system, that is used solely for preparing a tax or information return or other tax filing, including one that records, transmits, transfers, or organizes data related to such filing; or

(2) is a method, apparatus, technology, computer program product, or system used solely for financial management, to the extent that it is severable from any tax strategy or does not limit the use of any tax strategy by any taxpayer or tax advisor.

(d) **RULE OF CONSTRUCTION.**—Nothing in this section shall be construed to imply that other business methods are patentable or that other business method patents are valid.

(e) **EFFECTIVE DATE; APPLICABILITY.**—This section shall take effect on the date of the enactment of this Act and shall apply to any patent application that is pending on, or filed on or after, that date, and to any patent that is issued on or after that date.

2. REGULATIONS AND IRS NOTICES.

A. New Proposed Regulations Under Section 67: 2011-42 I.R.B. at 533 (October 17, 2011).

This concerns which administration costs of a trust or estate are subject to the 2% floor on miscellaneous itemized deductions imposed by Code Section 67. The Internal Revenue Service has withdrawn its previously proposed regulations, issued before the Supreme Court's decision in *Knight v. Commissioner*, 552 U.S. 181, 128 S. Ct. 782, 169 L. Ed. 2d 652 (2008), and has issued new proposed regulations. The prior proposed regulations imposed a "unique" test for deductibility which the *Knight* opinion's test of "common or customary" rendered untenable.

The preamble to the proposed regulations state:

These proposed regulations reflect the reasoning and holding in Knigh and provide guidance relating to the limited portion of the cost of investment advice that is not subject to the 2-percent floor. To the extent that a portion (if any) of an investment advisory fee exceeds the fee generally charged to an individual investor, and that excess is attributable to an unusual investment objective of the trust or estate or to a specialized balancing of the interests of various parties such that a reasonable comparison with individual investors would be improper, that excess is not subject to the 2-percent floor. Thus, where the costs charged to the trust do not exceed the costs charged to an individual investor, the cost attributable to taking into account the varying interests of current beneficiaries and remaindermen is included in the usual investment advisory fees and is not the type of cost that is excluded from the 2-percent floor under this narrow exception. Individual investors commonly have investment objectives that may require a balance between investing for income and investing for growth and/or a specialized approach for particular assets. Comments are requested on the types of incremental charges, as described in this paragraph, that may be incurred by trusts or estates, as well as a specific description and rationale for any such charges.

New Proposed Reg. §1.67-4(b) provides the following definition of commonly or customarily incurred:

(b) **“Commonly” or “Customarily” Incurred—(1) In general.** In analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, it is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative. In addition to the types of costs described in paragraphs (b)(2), (3) and (4) of this section, costs that are incurred commonly or customarily by individuals also include expenses that do not depend upon the identity of the payor (in particular, whether the payor is an individual or instead is an estate or trust). Such commonly or customarily incurred costs include, but are not limited to, costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust.

(2) **Ownership costs.** Ownership costs are costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property, such as condominium fees, real estate taxes, insurance premiums, maintenance and lawn services, automobile registration and insurance costs, and partnership costs deemed to be passed through to and reportable by a partner. For purposes of section 67(e), ownership costs are commonly or customarily incurred by a hypothetical individual owner of such property.

(3) **Tax preparation fees.** The application of the 2-percent floor to the cost of preparing tax returns on behalf of the estate, decedent, or non-grantor trust will depend upon the particular tax return. All estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent’s final individual

income tax returns are not subject to the 2-percent floor. The costs of preparing other individual income tax returns, gift tax returns, and tax returns for a sole proprietorship or a retirement plan, for example, are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

(4) **Investment advisory fees.** Fees for investment advice (including any related services that could be provided to any individual investor as part of an investment advisory fee) are incurred commonly or customarily by a hypothetical individual investor and therefore are subject to the 2-percent floor. However, certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2-percent floor. For this purpose, such an incremental cost is a special, additional charge added solely because the investment advice is rendered to a trust or estate instead of to an individual, that is attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen), in each case such that a reasonable comparison with individual investors would be improper.

In general, "bundled" fees must be unbundled in order to separate the portion of the fees subject to the 2% floor from those (in more than a *de minimus* amount) that are not. Out-of-pocket expenses are treated as separate from the bundled fee. There is an exception for a bundled fee that is not computed on an hourly basis. In that case, only the portion of that fee that is attributable to investment advice is subject to the 2-percent floor; the remaining portion is not subject to that floor. In addition, payments made from the bundled fee to third parties that would have been subject to the 2-percent floor if they had been paid directly by the non-grantor trust or estate are subject to the 2-percent floor, as are any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee (in addition to the usual or basic bundled fee) for services rendered to the trust or estate that are commonly or customarily incurred by an individual. The Proposed Regulations give an example of where a corporate trustee charges a percentage of the value of the trust income and corpus as its annual commission and bills a separate amount to the trust each year as compensation for leasing and managing the trust's rental real estate. The separate real estate management fee is subject to the 2-percent floor because it is a fee commonly or customarily incurred by an individual owner of rental real estate.

The proposed regulations state that any reasonable method may be used to determine the allocation of a bundled fee. The Service offers no safe harbors for how to unbundle a fee, instead requesting comments on potential safe harbor methods that are not based on percentage or numerical standards, and the related substantiation to satisfy the standard. However, the reasonable method standard of the proposed regulations will not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2-percent floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer. The new rules will apply to taxable years beginning on or after the date that these regulations are published as final regulations in the Federal Register. Since the regulations were not final as of January 1, 2012, the earliest they could apply to calendar year taxpayers would be 2013.

B. Section 675(4) Power to Substitute: Rev. Rul. 2011-28, 2011-49 I.R.B. (December 5, 2011) at 831..

Rev. Rul. 2008–22, 2008–16 I.R.B. 796 held that a power to substitute assets by itself does not cause the trust property to be includible in the decedent's estate under Code Section 2036 and 2038 as long as the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and the substitution power cannot be exercised in a manner that would cause the shifting of benefits among the trust beneficiaries.

This was a landmark ruling but left a couple of issues open, including whether the power to substitute would constitute an incident of ownership when the assets of the trust included a life insurance policy on the grantor's life. The Service has now ruled that a non-fiduciary substitution power under Code Section 675(4) will not by itself cause inclusion of a life insurance policy held under an irrevocable trust. The ruling has been long anticipated and is very positive, because the Section 675(4) power is one of the most popular powers employed to cause grantor trust status.

The ruling posited an irrevocable trust established by "D," a United States citizen, for his descendants and funded with cash. Thereafter, the trust purchased a life insurance policy on the grantor's life. The grantor, of course was not the trustee of the trust, and the terms of the trust prohibited the grantor from ever serving as trustee. The grantor made gifts every year to the trust, and the trust paid the premium on the insurance policy. On the grantor's death, the proceeds of the policy were payable to the trust. The grantor could not revoke, alter, amend, or terminate the trust. The governing instrument provided the grantor with the power, exercisable at any time, to acquire any property held in the trust by substituting other property of equivalent value. The trust instrument provided that the power is exercisable by the grantor in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, the grantor had to certify in writing that the substituted property and the trust property for which it was substituted were of equivalent value. In addition, under local law, the trustee had a fiduciary obligation to ensure that the property that the grantor sought to substitute was equivalent in value to the property distributed to the grantor. Moreover, if a trust had two or more beneficiaries, local law required the trustee to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Finally, under local law and without restriction in the trust instrument, the trustee had the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, subdivide, partition, and manage the trust property in accordance with the standards provided by law. The grantor had no incidents of ownership in the insurance policy unless the right of substitution was considered an incident of ownership. The grantor died without having exercised the power to substitute with respect to the life insurance policy.

The Ruling examines the regulations under Code Section 2042 and three other sources of law that relate to this issue - Rev. Rul. 2008-22, mentioned above, Rev. Rul. 84-179, 1984-2 C.B. 195, and Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), *acq. in result*, 1977–2 C.B. 1.

Rev. Rul. 84–179 dealt with a situation where a taxpayer had transferred an insurance policy on his life to his spouse. The spouse had died creating a trust for the benefit of the couple's adult child, and the taxpayer acted as trustee. The ruling held that the taxpayer-decedent would not be considered to possess incidents of ownership in the policy for purposes

of § 2042(2), provided the decedent could not exercise the powers for the decedent's personal benefit, the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers to the decedent was not part of a prearranged plan involving the participation of decedent. The ruling further stated, however, that the decedent would be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, without regard to how those powers were acquired and without consideration of whether the decedent transferred property to the trust.

In Jordahl the taxpayer created a trust, which included insurance policies on his life, and retained a power exercisable in a fiduciary capacity to substitute assets of an equal value. The Service argued that the taxpayer's retained power to substitute assets was a power to control beneficial enjoyment under Section 2038 and constituted an incident of ownership under Code Section 2042. The Tax Court determined that, because the decedent was bound by fiduciary standards and was therefore accountable in equity to the succeeding income beneficiary and remaindermen, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries. Accordingly, the Tax Court held that the substitution power was not a Section 2038 power and also concluded that the decedent's power to substitute an insurance policy was merely a power to exchange at arm's length, in effect a power to purchase the policy, which could not be considered an incident of ownership.

After citing these cases, Rev. Rul. 2011-28 states:

In the instant case, like the situation presented in Rev. Rul. 2008-22, the trust instrument expressly prohibits D from serving as trustee and states that D's power to substitute assets of equivalent value is held in a nonfiduciary capacity. However, under the terms of Trust, the assets that D may transfer into Trust must be equivalent in value to the insurance policies that D will receive. In addition, T has a fiduciary obligation to ensure that the assets substituted are of equivalent value. Thus, D cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase D's net worth. Further, in view of T's ability to reinvest the assets and T's duty of impartiality to the trust beneficiaries, there will be no shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by D. Under these circumstances, D's retained power to substitute assets of equivalent value for a life insurance policy held by Trust is not, by itself, an incident of ownership under § 2042(2).

HOLDING

A grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and 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 that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

C. Final Regulations Under Section 2036: 2011-50 I.R.B at 838 (December 12, 2011).

Final Regulations have been published to provide guidance on the portion of property (held in trust or otherwise) includible in the grantor's gross estate if the grantor has retained the use of the property, the right to an annuity, unitrust, graduated retained interest, or other payment from the property for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death. The Final Regulations generally follow the Proposed Regulations, which were published in 2009.

In the case of a retained annuity or unitrust, the portion of the trust's corpus includible in the decedent's gross estate is that portion of the trust corpus necessary to generate sufficient income to satisfy the retained annuity or unitrust (without reducing or invading principal), using the interest rates provided in section 7520 and the adjustment factors prescribed in §20.2031-7 (or §20.2031-7A), if applicable.

If the decedent retained the right to receive an annuity or other payment (rather than income) after the death of the current recipient of that interest, then the amount includible in the decedent's gross estate is the amount of trust corpus required to produce sufficient income to satisfy the entire annuity or other payment the decedent would have been entitled to receive if the decedent had survived the current recipient (thus, also including the portion of that entire amount payable to the decedent before the current recipient's death), reduced by the present value of the current recipient's interest. However, the amount includible cannot be less than the amount of corpus required to produce sufficient income to satisfy the annuity or other payment the decedent was entitled, at the time of the decedent's death, to receive for each year. In no event shall the amount includible exceed the value of the trust corpus on the date of death. Also, in calculating the present value of the current recipient's interest, the exhaustion of trust corpus test described in §20.7520-3(b)(2) is not to be applied, even in cases where §20.7520-3(b)(2) would otherwise require it to be applied. Commentators believed that this approach could overstate the amount includible in the decedent's estate where a prior beneficiary was receiving a payment geared to a rate that was higher than the Section 7520 rate at the time of the decedent's death. The Service refused to change the approach, but clarified in the Final Regulations, as noted above, that the exhaustion of trust corpus test described in §20.7520-3(b)(2) is not to be applied in cases in valuing the preceding interest.

In response to a commentator's request, the Regulations offer the following step-by-step illustration of the method of inclusion when the retained right of the decedent is subject to a prior interest:

Step 1: Determine the fair market value of the trust corpus on the decedent's date of death.

Step 2: Determine the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment (determined on the date of the decedent's death) payable to the decedent for the trust year in which the decedent's death occurred.

Step 3: Determine the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment that the decedent would have been entitled to receive for each trust year if the decedent had survived the current recipient.

Step 4: Determine the present value of the current recipient's annuity, unitrust, or other payment (without applying the exhaustion test).

Step 5: Reduce the amount determined in Step 3 by the amount determined in Step 4, but not to below the amount determined in Step 2.

Step 6: The amount includible in the decedent's gross estate is the lesser of the amounts determined in Step 5 and Step 1.

The Final Regulations contain an example of how to calculate inclusion when a the grantor was receiving an annuity payment that was increasing by 20% each year.

The Final Regulations also slightly modify Example 1, under which the decedent had created a trust under which the income was payable 50% to himself and 50% to his son, or all to the survivor. In the Example, the decedent dies, survived by the son. The inclusion in D's estate is reduced by the value of his son's outstanding life estate. The Final Regulations clarify that the value of the son's outstanding life estate reduces only the 50 percent of trust corpus from which it is payable. The Final Regulations also clarify that in situations like a Walton GRAT, where payments that become payable to the decedent's estate after the decedent's death (as opposed to payments that are payable to the decedent prior to the decedent's death but are not paid until after the decedent's death) are not subject to inclusion under section 2033, if section 2036 is applied to include all or a portion of the trust corpus in the gross estate. These payments are to be distinguished, however, from annuity or other payments payable to the decedent prior to the decedent's date of death, but that are not paid until after death. Such payments are includible in the decedent's gross estate under section 2033 as a separate receivable. In this situation the amount payable by the trust reduces the fair market value of the trust as of the date of death, but is included in the decedent's gross estate under section 2033 as a receivable amount.

D. New Proposed Regulations for Alternate Value: 2011-51 I.R.B. at 865 (December 19, 2011).

Newly revised proposed regulations have been published for alternate valuation. The Service first published proposed regulations under Section 2032 in 2008 following the Tax Court decision in Kohler v. Commissioner, 92 TCM 48 (2006). In Kohler closely-held stock was valued at the alternate date. Between the date of death and the alternate valuation date, the company underwent a reorganization whereby the decedent's share of the stock in the company rose from 12.85% at the date of death to 14.45% at the alternate valuation date. Despite this rise in percentage ownership, the estate successfully maintained that the attributes of the stock received in the reorganization resulted in the value of the stock declining from approximately \$50 million at date of death to approximately \$47 million at the 6-month alternate valuation date. The Service argued that the reorganization was a "disposition" that fixed the alternate value at

that date. The Tax Court did not believe that the reorganization itself was a disposition, in part because it was a tax-free transaction under the Internal Revenue Code.

The prior proposed regulations provided that a transaction during the alternate period would not be considered a distribution, sale, exchange or other disposition if it was the result of market conditions. The term “market conditions” was defined as events outside of the control of the decedent (or the decedent’s executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued. Changes in value due to mere lapse of time or to other post-death events other than market conditions would be ignored in determining the value of decedent’s gross estate under the alternate valuation method.

The newly proposed regulations abandon the “market conditions” approach. They first provide an expansive definition of what it means to sell, exchange or dispose of an interest:

(c) Meaning of “distributed, sold, exchanged, or otherwise disposed of”—(1) In general.

(i) Transactions included. The phrase “distributed, sold, exchanged, or otherwise disposed of” comprehends all possible ways by which property ceases to form a part of the gross estate. This phrase includes, but is not limited to:

(A) The use of money on hand at the date of the decedent’s death to pay funeral or other expenses of the decedent’s estate;

(B) The use of money on hand at the date of the decedent’s death to invest in other property;

(C) The exercise of employee stock options;

(D) The surrender of stock for corporate assets in partial or complete liquidation of a corporation, and similar transactions involving partnerships or other entities;

(E) The distribution by the estate (or other holder) of included property as defined in paragraph (d) of this section;

(F) The transfer or exchange of property for other property, whether or not gain or loss is currently recognized for income tax purposes;

(G) The contribution of cash or other property to a corporation, partnership, or other entity, whether or not gain or loss is currently recognized for income tax purposes;

(H) The exchange of interests in a corporation, partnership, or other entity (entity) for one or more different interests (for example, a different class of stock) in the same entity or in an acquiring or resulting entity or entities (see, however, paragraph (c)(1)(ii) of this section); and

(I) Any other change in the ownership structure or interests in, or in the assets of, a corporation, partnership, or other entity, an interest in which is includible in the gross estate, such that the included property after the change does not reasonably represent the included property at the decedent’s date of death (see, however, paragraph (c)(1)(iii)(A) of this section). Such a change in the ownership structure or interests in or in the assets of an entity includes, without limitation—

(1) The dilution of the decedent’s ownership interest in the entity due to the issuance of additional ownership interests in that entity;

(2) An increase in the decedent's ownership interest in the entity due to the entity's redemption of the interest of a different owner;

(3) Reinvestment of the entity's assets; and

(4) A distribution or disbursement of property (other than excluded property as defined in paragraph (d) of this section) by the entity (other than expenses, such as rents and salaries, paid in the ordinary course of the entity's business), with the effect that the fair market value of the entity before the occurrence does not equal the fair market value of the entity immediately thereafter.

Several exceptions to the foregoing expansive definitions are provided.

- A. First, if an interest in a corporation, partnership, or other entity (entity) is includible in the gross estate at death and that interest is exchanged as described in paragraph (H) above for one or more different interests in the same entity or in an acquiring or resulting entity or entities, the transaction will not result in an exchange or disposition under section 2032(a)(1) and paragraph (H) if, on the date of the exchange, the fair market value of the interest in the entity equals the fair market value of the interest(s) in the same entity or the acquiring or resulting entity or entities. Such transactions may include, without limitation, reorganizations, recapitalizations, mergers, or similar transactions. In determining whether the exchanged properties have the same fair market value, a difference in value equal to or less than 5 percent of the fair market value, as of the transaction date, of the property interest includible in the gross estate on the decedent's date of death is ignored. If the transaction falls within this exception, the property to be valued on the 6-month date (or on the transaction date, if any, subsequent to this transaction) is the property received in the exchange, rather than the property includible in the decedent's gross estate at the date of death. The Proposed Regulations provide that this exception has no effect on any other provision of the Internal Revenue Code that is applicable to the transaction. For example, even if the transaction is not a deemed exchange for alternate value purposes, the provisions of chapter 14 may be applicable to determine fair market value for Federal estate tax purposes.
- B. The second exception concerns a distribution during the alternate valuation period of "included property" from a partnership, corporation, trust (including an IRA, Roth IRA, 403(b), 401(k), Thrift Savings Plan, etc.), bank account or similar asset, or other entity (entity), and an interest in that entity is includible in the gross estate. The payment will not result in a distribution under paragraph (I) above if, on the date of the payment, the fair market value of the decedent's interest in the entity before the payment equals the sum of the fair market value of the payment made to the estate (or other holder of the decedent's interest in the entity) and the fair market value of the decedent's interest in the entity, not including any excluded property, after the payment. In this case, the alternate valuation date of the payment is the date of the payment, and the alternate valuation date of the decedent's remaining interest in the entity, if any, is the 6-month date (or the transaction date, if any, subsequent to this payment). If this exception is not met, the payment is a distribution for alternate valuation purposes, and the alternate valuation date of the decedent's entire interest in the entity is the date of the payment. For purposes of this exception, a distribution or disbursement is deemed to consist first of excluded property, if any, and then of included property.

If under this second exception the decedent's interest in an entity that is includible in the gross estate consists of the amount needed to produce an annuity, unitrust, remainder, or other such payment valued under section 2036, then assuming the distribution satisfies the general rule for this exception, the value of each distribution (to the extent it is deemed to consist of included property) payable (whether or not actually paid) during the alternate valuation period shall be added to the value of the entity on the alternate valuation date. The sum of the fair market value of these distributions when made and the fair market value of the entity on the alternate valuation date will constitute the fair market value of the entity in computing the amount, valued as of the alternate valuation date, to be included in the decedent's gross estate under section 2036.

- C. The third exception is that property is not considered "distributed" merely because property passes directly at death as a result of a beneficiary designation or other contractual arrangement or by operation of law.

A special aggregation rule applies where, during the alternate valuation period, less than all of the interest includible in the decedent's gross estate in a particular property is the subject of a transaction described above. In one situation, one or more portions of the includible interest are subject to such a transaction and a portion is still held on the 6-month date. In the other situation, the entire interest includible in the gross estate is disposed of in two or more such transactions during the alternate valuation period, so that no part of that interest remains on the 6-month date. In both of these situations, the fair market value of each portion of the interest includible in the gross estate is to be determined as follows. The fair market value of each portion subject to such a transaction, and the portion remaining, if any, on the 6-month date, is the fair market value, as of the transaction date, or the 6-month date for any remaining portion, of the entire interest includible in the gross estate on the decedent's date of death, multiplied by a fraction. The numerator of that fraction is the portion of the interest subject to that transaction, or the portion remaining on the 6-month date, and the denominator is the entire interest includible in the gross estate at the decedent's date of death.

Certain post-death events that are deemed to occur under other provisions of the Internal Revenue Code, such as the grant, during the alternate valuation period, of a qualified conservation easement in accordance with Code Section 2031(c), will not be considered a sale, exchange or disposition of the asset.

E. Portability Guidance. Notice 2011-82, 2011-42 I.R.B. at 616 (October 17, 2011).

The Service has published guidance on portability elections. The timely filing (including extensions) of a complete Form 706, regardless of whether the estate has a value in excess of the exclusion amount or is otherwise obligated to file a Form 706, will constitute the election without the need to check any box or otherwise affirmatively elect portability. To ensure the correct exclusion amount and tax rates, the executor must be sure to use the Form 706 issued for the decedent's year of death. Until the Service revises the Form 706 to expressly contain the computation of the DSUEA, a complete and properly-prepared Form 706 will be deemed to contain such computation.

If an estate is required to file a Form 706 but does not wish to elect portability, the executor must follow the instructions for the Form 706 that will describe the steps to notify the Service that the decedent's estate is not making the election. The instructions to Form 706, released in

August 2011 for estates of decedents who die in 2011, include the following statement on page 1:

If the estate chooses not to allow the surviving spouse to take into account, for estate and gift tax purposes, the decedent's unused exclusion amount, then do one of the following: attach a statement to the Form 706 indicating that the estate is not making the election under section 2010(c)(5) or enter "No Election Under Section 2010(c)(5)" across the top of the first page of Form 706.

F. Protective Claims for Refund under Section 2053: Rev. Proc. 2011-48, 2011-42 I.R.B. at 527 (October 14, 2011)

In 2009 the Service published final regulations regarding deductions for claims. The general thrust of the final regulations is to deny deductions for amounts of claims that are unpaid as of the date of filing the Federal estate tax return. In order to preserve the potential benefit of the deduction, the taxpayer must file a protective claim for refund. The protective claim must be filed on or before the expiration of the limitations period under §6511(a). This period is the longer of three years from the time that the return was filed or 2 years from the time the tax was paid, except that the 2-year period will apply if no return was filed.

Revenue Procedure 2011-48, 2011-42 I.R.B. (October 17, 2011) at 527, now provides guidance on how to file a protective claim. Section 4.04(1) of the Revenue Procedure provides for two methods of filing:

(a) **Schedule PC.** One method permits the taxpayer to file one or more Schedules PC with the Form 706 when it is filed. This method is available only for decedents dying on or after January 1, 2012. The Revenue Procedure states that Schedule PC is expected to be first available as part of the 2012 Form 706. That Form has not yet been published. The Revenue Procedure also states that the Form 706 should state that one or more Schedules PC are being filed with the return "in order to facilitate the proper processing of Schedule(s) PC, in accordance with the instructions for the schedule."

(b) **Form 843.** The second method involves filing a Form 843. This method must be used for decedents who die after October 19, 2009 and before January 1, 2012. The form should bear the notation "Protective Claim for Refund under Section 2053" entered across the top of page 1 of the form. The form should be filed with the IRS at its Cincinnati campus or as otherwise specified in the form. The Revenue Procedure gives the following address for the Cincinnati campus:

Department of Treasury
Internal Revenue Service Center
300 Madison Avenue Stop 823G
Covington, KY 41011

The Revenue Procedure provides guidance on who can file a protective claim:

A protective claim for refund must be accompanied by documentary evidence, including certified copies of the letters testamentary, letters of administration, or other similar evidence, to establish the legal authority of a fiduciary or other person to file and pursue a protective claim for refund on behalf of the estate of a decedent. See § 301.6402-2(e) of the Procedure and Administration

Regulations. In the estate tax context, proof of legal authority typically is established at the time of filing the *Federal Estate (and Generation-Skipping Transfer) Tax Return* (Form 706). Accordingly, if the fiduciary or other person filing the protective claim for refund on behalf of a decedent's estate is the same fiduciary or other person who filed the decedent's Form 706, the protective claim for refund need only include a statement affirming that the fiduciary or other person filing the protective claim for refund also filed the Form 706 and that such fiduciary or other person is still acting in a representative capacity on behalf of the estate. If the fiduciary or other person filing the protective claim for refund on behalf of a decedent's estate is not the same fiduciary or other person who filed the decedent's Form 706, the protective claim for refund must be accompanied by the necessary documentary evidence establishing proof of legal authority.

Section 4.04(2) of the Revenue Procedure also clarifies that each item is treated separately and requires a separate claim:

To be properly filed under this revenue procedure, a separate section 2053 protective claim for refund must be filed as described in section 4.04(1) of this revenue procedure for each claim or expense for which a deduction may be claimed in the future under section 2053 (section 2053 claim or expense). Specifically, a Form 706 may include more than one Schedule PC. In addition, a section 2053 protective claim for refund must not include any claim for refund not based on a deduction under section 2053. Each section 2053 protective claim for refund should indicate whether other protective claims for refund are being filed or were previously filed and the approximate date on which each was filed.

The Revenue Procedure states that the outstanding claim or expense that forms the basis of a potential deduction under Section 2053 must be "clearly identified" so that the Service has notice of what will be claimed as a deduction. The Revenue Procedure goes on to state:

In addition, as provided in § 20.2053-1(d)(5), proper identification of the claim or expense must include an explanation of the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense. Finally, except as provided in section 4.05(2) of this revenue procedure, claims or expenses related to but separate from a particular section 2053 claim or expense must be separately identified. The use of vague or broad language that does not describe a specific claim or expense that would be deductible under section 2053 does not provide clear identification of a section 2053 claim or expense for purposes of this revenue procedure.

Section 4.05(2), referenced in the foregoing language, deals with "certain related and ancillary expenses relating to resolving, defending or satisfying the identified claim or expense as well as certain expenses relating to pursuing the claim for for refund for the identified claim or expense." These related and ancillary expenses are deemed to be included in a claim that is adequately identified, without the related and ancillary expenses being separately identified. The Revenue Procedure gives as examples attorneys' fees, court costs, appraisal fees, and accountant fees relating to the underlying claim, but cautions that relaxing the requirement of separate identification of these expenses will not be construed to concede that such expenses are deductible under Section 2053 in all events: all claims and expenses must be the substantive requirements under Section 2053 and its corresponding regulations.

If the claim is contested, the protective claim must notify the Service of the contested matter and the potential liability of the estate. The Revenue Procedure states that the following will be sufficient to appropriately notify the Service of the contested nature of the claim:

. . . The name or names of the claimant(s), the basis of the claim or other description of the subject matter of the contested matter, the extent or amount of the liability claimed, and a brief statement reporting the status of the contested matter at the time the protective claim for refund is filed with the Service. For a contested matter that is being litigated, attaching a copy of the relevant pleadings and making reference thereto on the section 2053 protective claim for refund generally will be sufficient to identify appropriately the claim.

If the claim involves a matter that is not likely to be resolved prior to the running of the statute of limitations, and is not otherwise fully covered by an exception to the final regulations (generally, amounts that are "ascertainable," certain claims and counterclaims in related matters, and claims totaling not more than \$500,000), then in addition to satisfying all of the other requirements of the Revenue Procedure, the estate must disclose the amount of the deduction already taken on the Form 706 for the subject claim or expense and must reference the regulatory provision under which the deduction was claimed in order to identify properly the Section 2053 claim or expense. Section 5.04 of the revenue procedure provides guidance on the authority of a transferee or other person to represent the estate in pursuing a section 2053 claim for refund.

The Revenue Procedure explains the procedure of filing a protective claim and then receiving verification that the protective claim has been filed. This is an important portion of the procedure, because if the estate fails to obtain proper verification that the protective claim has been received by the Service, it may lose its right to "cure" an improperly filed claim. The Service states:

.06 Period after filing the section 2053 protective claim for refund.

(1) *Initial processing of section 2053 claim for refund by the Service.* Although the Service generally will not engage in a substantive review of a section 2053 protective claim for refund until the amount of the section 2053 claim or expense has been established, when a section 2053 protective claim for refund is received by the Service, the Service may reject the claim if it appears that one or more preliminary procedural requirements for a valid claim for refund have not been satisfied. For example, the Service may reject a claim that (a) is not timely filed by a fiduciary or other person having legal authority to file a claim for refund on behalf of the estate, (b) does not include a properly executed penalty of perjury statement, or (c) does not adequately describe a claim or expense that, if substantiated at a later time, would support a deduction under section 2053. For those section 2053 protective claims for refund that are not initially rejected by the Service, the Service will acknowledge in written correspondence that the claim has been received. Note, however, that the Service's written acknowledgement that the claim has been received does not constitute a determination that the preliminary procedural requirements for a valid protective claim for refund have been satisfied. Accordingly, upon consideration of the claim once the amount of the section 2053 claim or expense has been established, the

Service nevertheless may determine that one or more procedural requirements are not satisfied and the claim for refund then may be denied.

(2) *Contacting the Service when no communication received.* Although a timely-filed section 2053 protective claim for refund will be timely filed even if the Service does not acknowledge its receipt and/or process the protective claim, the fiduciary or other person filing the form on behalf of the estate promptly should contact the Service at (866) 699-4083 (or other appropriate number) to inquire into the Service's receipt and processing of that protective claim for refund if the estate does not receive from the Service the written acknowledgement of receipt described in section 4.06(1) of this revenue procedure within 180 days of filing a section 2053 protective claim for refund on a Schedule PC attached to the Form 706, or within 60 days of filing a section 2053 protective claim for refund on a Form 843. ***A certified mail receipt or other evidence of delivery to the Service is not sufficient to ensure and confirm the Service's receipt and processing of the protective claim for purposes of this revenue procedure.*** See section 4.06(3) of this revenue procedure regarding the possible consequences of not contacting the Service within 30 days after the expiration of these periods.

(3) *Opportunity to cure an inadequately identified section 2053 protective claim for refund.* A section 2053 protective claim for refund must satisfy the timely-filing requirement set forth in section 4.01 of this revenue procedure. The failure of a section 2053 protective claim for refund to satisfy certain other preliminary procedural requirements for a valid claim for refund, including the penalty of perjury statement requirement set forth in section 4.02 of this revenue procedure, may be cured before the expiration of the period of limitation prescribed in section 6511(a). However, the failure of a section 2053 protective claim for refund to satisfy the identification requirement set forth in section 4.05 of this revenue procedure may be cured, as further described below, after the expiration of the period of limitation prescribed in section 6511(a), as long as the section 2053 protective claim for refund as originally filed was timely and properly executed under the penalty of perjury. To cure the section 2053 protective claim for refund, the fiduciary or other person must adequately identify the section 2053 claim or expense in accordance with section 4.05 of this revenue procedure by submitting a corrected (and signed) protective claim for refund before the expiration of the period of limitation prescribed in section 6511(a) or within 45 days after the date of the Service's notice, if any, to the fiduciary or other person of the defect, whichever occurs later. ***If the Service fails to provide the written acknowledgement of receipt described in section 4.06(1) of this revenue procedure and the fiduciary or other person who filed the section 2053 protective claim for refund fails to contact the Service within 30 days after the applicable time period described in section 4.06(2) of this revenue procedure to confirm the Service's receipt and processing of that section 2053 protective claim for refund, the fiduciary or other person will not have the opportunity to cure the inadequate identification of the section 2053 protective claim for refund after the expiration of the period of limitation prescribed in section 6511(a).*** [Emphasis added].

Once the contingency that is delaying the claim has been resolved, the taxpayer must notify the Service with a "reasonable period" that the reason or contingency delaying the actual payment

of the claim or expense has been resolved, or that the amount that is deductible has been established. A reasonable period is deemed to be notification within 90 days after the date the claim or expense is paid, or 90 days after the date on which the amount of the claim or expense become certain and is no longer subject to any contingency, whichever occurs later. If notification occurs after the 90-day period, the fiduciary or other person should provide an explanation sufficient to establish that there is reasonable cause for the delay. If there are multiple or recurring payments, the 90-day notification period will begin with regard to the entire claim on the date of the last and final payment. One notifies the Service by either filing a Supplemental 706 (including an updated Schedule PC for each claim) or filing one or more updated and signed Forms 843. A Supplemental Form 706 must contain the notation "Supplemental Information -- Notification for Consideration of Section 2053 Protective Claim for Refund filed on [DATE OF PROTECTIVE CLAIM]" across the top of the return. A Form 843 must contain the the notation "Notification for Consideration of Section 2053 Protective Claim for Refund filed on [DATE OF PROTECTIVE CLAIM]" entered across the top of page 1 of the form. Each claim requires a separate Form PC or Form 843, as the case may be. The Supplemental 706, or the Forms 843, are filed with the same office where the original 706 or Form 843 was filed.

Neither the marital nor the charitable deduction is reduced by the amount of any claim or expense that may be the subject of a Section 2053 protective claim. See Treas. Reg. §20.2053-1(d)(5)(ii). The computation of the amount to be refunded under Section 2053, as required on the Supplemental 706 or Form 843, must identify any necessary adjustment to these amounts.

**G. Generation-Skipping Tax and Listed Transactions and Transactions of Interest.
T.D. 9556, 2011-52 I.R.B. at 862 (December 19, 2011).**

The Service has issued final regulations concerning procedures that taxpayers must follow if Treasury identifies certain generation-skipping transfers as listed transactions or transactions of interest. A concern was expressed when the Proposed Regulations were issued in 2009 that if the IRS and Treasury Department designate a transaction involving gift, estate, or generation-skipping transfer taxes as a listed transaction or transaction of interest, a corporate fiduciary, merely by acting as an executor or trustee with respect to an estate or trust that is incidental to the transaction, would be treated as a material advisor under section 6112 and the regulations thereunder. One suggestion was that final regulations under sections 6011, 6111, and 6112 be amended to require public comment before a transaction involving Chapters 11, 12, and 13 of the Code can be designated as a listed transaction or transaction of interest. The IRS and Treasury Department believed that the existing regulations under sections 6111 and 6112 properly address which parties are material advisors, and transactions involving gift, estate, or generation-skipping transfer taxes should not be treated differently than other transactions. A fiduciary will not be treated as a material advisor merely by acting as an executor or trustee with respect to an estate or trust that is incidental to a transaction. A fiduciary will be treated as a material advisor only if the fiduciary provides material aid, assistance or advice as described in §301.6111-3(b)(2), the fiduciary directly or indirectly derives gross income in excess of the threshold amount as described in §301.6111-3(b)(3), and the transaction is entered into by the taxpayer.

H. Comments Solicited for Transfer Tax Issues of Decanting. Notice 2011-101, 2011-52 I.R.B. at 932 (December 27, 2011).

The Service has invited comments from the public regarding the income, gift, estate and GST tax issues and consequences arising from decanting transfers. The comments were invited as to the relevance and effect of the various facts and circumstances listed below and the identification of other factors that may affect the tax consequences:

1. A beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary);
2. Trust principal and/or income may be used to benefit new (additional) beneficiaries;
3. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;
4. The transfer takes place from a trust treated as partially or wholly owned by a person under §§ 671 through 678 of the Internal Revenue Code (a "grantor trust") to one which is not a grantor trust, or vice versa;
5. The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust;
6. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law;
7. The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;
8. The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;
9. Consent of the beneficiaries and/or a court order (or approval of the state attorney General) is not required but is obtained;
10. The effect of state law or the silence of state law on any of the above scenarios;
11. A change in the identity of a donor or transferor for gift and/or GST tax purposes;
12. The Distributing Trust is exempt from GST tax under § 26.2601-1, has an inclusion ratio of zero under § 2632, or is exempt from GST under § 2663; and
13. None of the changes described above are made, but a future power to make any such changes is created.

3. CASES AND RULINGS²

A. Mayo Foundation for Medical Education and Research v. United States, 131 S. Ct. 704; 178 L. Ed. 2d 588; 2011 U.S. LEXIS 609 (2011).

This case arose over whether Treasury regulations published in 2004 were valid. In determining the validity of regulations, courts must determine the degree of deference to accord to the government's interpretation of the law. In 1979, in National Muffler Dealers Assn., Inc. v. United States, 440 U.S. 472, 99 S. Ct. 1304, 59 L. Ed. 2d 519 (1979), the Supreme Court

² Quotes from cases omit footnotes unless otherwise noted.

applied a multi-factor test in determining the validity of agency promulgations that were interpretive. In 1984, in Chevron U.S. A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984), the Supreme Court, considering a "legislative regulation" (issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision) articulated a standard that a regulation will be recognized as long as it is a permissible interpretation of the law.

The regulations in in this case were interpretive. They concerned, in part, whether employers and medical professionals in residency were required to pay taxes under the Federal Insurance Contributions Act (FICA) on the wages paid and received. The main issue in the case was the level of deference that the Court should give to interpretive regulations -- National Muffler or Chevron?

Mayo Foundation and the other plaintiffs offer residency programs to doctors who have graduated from medical school but seek additional instruction in a chosen specialty. Although the residents are required to take formal instruction, most of the learning is "hands-on" caring for patients which requires 50-80 hours per week. The hospitals pay stipends, and provide health and malpractice insurance. Mayo claimed that under the statute the medical residents were students exempt from FICA. The District Court agreed with Mayo; the Eighth Circuit reversed. The Supreme Court sustained the 8th Circuit, giving deference under Chevron.

After finding that the statute was ambiguous as to whether medical residents qualified as students, the Court stated:

In the typical case, such an ambiguity would lead us inexorably to Chevron step two, under which we may not disturb an agency rule unless it is "arbitrary or capricious in substance, or manifestly contrary to the statute." Household Credit Services, Inc. v. Pfenning, 541 U.S. 232, 242, 124 S. Ct. 1741, 158 L. Ed. 2d 450 (2004) (quoting United States v. Mead Corp., 533 U.S. 218, 227, 121 S. Ct. 2164, 150 L. Ed. 2d 292 (2001)). In this case, however, the parties disagree over the proper framework for evaluating an ambiguous provision of the Internal Revenue Code.

Mayo asks us to apply the multi-factor analysis we used to review a tax regulation in National Muffler, 440 U.S. 472, 99 S. Ct. 1304, 59 L. Ed. 2d 519. There we explained:

"A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute." *Id.*, at 477, 99 S. Ct. 1304, 59 L. Ed. 2d 519.

The Government, on the other hand, contends that the National Muffler standard has been superseded by Chevron. The sole question for the Court at step two under the Chevron analysis is "whether the agency's answer is based

on a permissible construction of the statute.” 467 U.S., at 843, 104 S. Ct. 2778, 81 L. Ed. 2d 694.

Since deciding Chevron, we have cited both National Muffler and Chevron in our review of Treasury Department regulations. See, e.g., United States v. Cleveland Indians Baseball Co., 532 U.S. 200, 219, 121 S. Ct. 1433, 149 L. Ed. 2d 401 (2001) (citing National Muffler); Cottage Savings Assn. v. Commissioner, 499 U.S. 554, 560-561, 111 S. Ct. 1503, 113 L. Ed. 2d 589 (1991) (same); United States v. Boyle, 469 U.S. 241, 246, n. 4, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985) (citing Chevron); see also Atlantic Mut. Ins. Co. v. Commissioner, 523 U.S. 382, 387, 389, 118 S. Ct. 1413, 140 L. Ed. 2d 542 (1998) (citing Chevron and Cottage Savings).

Although we have not thus far distinguished between National Muffler and Chevron, they call for different analyses of an ambiguous statute. Under National Muffler, for example, a court might view an agency's interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved. 440 U.S., at 477, 99 S. Ct. 1304, 59 L. Ed. 2d 519. The District Court in this case cited each of these factors in rejecting the Treasury Department's rule, noting in particular that the regulation had been promulgated after an adverse judicial decision. See 503 F. Supp. 2d, at 1176; see also Brief for Petitioners 41-44 (relying on the same considerations).

Under Chevron, in contrast, deference to an agency's interpretation of an ambiguous statute does not turn on such considerations. We have repeatedly held that “[a]gency inconsistency is not a basis for declining to analyze the agency's interpretation under the Chevron framework.” National Cable & Telecommunications Assn. v. Brand X Internet Services, 545 U.S. 967, 981, 125 S. Ct. 2688, 162 L. Ed. 2d 820 (2005); accord, Eurodif S. A., supra, at ___, 129 S. Ct. 878, 172 L. Ed. 2d 679. We have instructed that “neither antiquity nor contemporaneity with [a] statute is a condition of [a regulation's] validity.” Smiley v. Citibank (South Dakota), N. A., 517 U.S. 735, 740, 116 S. Ct. 1730, 135 L. Ed. 2d 25 (1996). And we have found it immaterial to our analysis that a “regulation was prompted by litigation.” *Id.*, at 741, 116 S. Ct. 1730, 135 L. Ed. 2d 25. Indeed, in United Dominion Industries, Inc. v. United States, 532 U.S. 822, 838, 121 S. Ct. 1934, 150 L. Ed. 2d 45 (2001), we expressly invited the Treasury Department to “amend its regulations” if troubled by the consequences of our resolution of the case.

The Court concluded that Chevron was the appropriate standard to apply to interpretive regulations promulgated by Treasury:

The principles underlying our decision in Chevron apply with full force in the tax context. Chevron recognized that “[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.” 467 U.S., at 843, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (internal quotation marks omitted). It acknowledged that the formulation of that policy might require “more than ordinary knowledge respecting the matters subjected to agency regulations.” *Id.*, at 844, 104 S. Ct. 2778, 81 L. Ed. 2d 694

(internal quotation marks omitted). Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. Cf. Bob Jones Univ. v. United States, 461 U.S. 574, 596, 103 S. Ct. 2017, 76 L. Ed. 2d 157 (1983) (“[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems”). We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to Chevron to the same extent as our review of other regulations.

As one of Mayo's *amici* points out, however, both the full-time employee rule and the rule at issue in National Muffler were promulgated pursuant to the Treasury Department's general authority under 26 U.S.C. § 7805(a) to “prescribe all needful rules and regulations for the enforcement” of the Internal Revenue Code. See Brief for Carlton M. Smith 4-7. In two decisions predating Chevron, this Court stated that “we owe the [Treasury Department's] interpretation less deference” when it is contained in a rule adopted under that “general authority” than when it is “issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision.” Rowan Cos. v. United States, 452 U.S. 247, 253, 101 S. Ct. 2288, 68 L. Ed. 2d 814 (1981); United States v. Vogel Fertilizer Co., 455 U.S. 16, 24, 102 S. Ct. 821, 70 L. Ed. 2d 792 (1982) (quoting Rowan).

Since Rowan and Vogel were decided, however, the administrative landscape has changed significantly. We have held that Chevron deference is appropriate “when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.” Mead, 533 U.S., at 226-227, 121 S. Ct. 2164, 150 L. Ed. 2d 292. Our inquiry in that regard does not turn on whether Congress's delegation of authority was general or specific. For example, in National Cable & Telecommunications Assn., *supra*, we held that the Federal Communications Commission was delegated “the authority to promulgate binding legal rules” entitled to Chevron deference under statutes that gave the Commission “the authority to ‘execute and enforce,’ ” and “to ‘prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions’ of,” the Communications Act of 1934. 545 U.S., at 980-981, 125 S. Ct. 2688, 162 L. Ed. 2d 820 (quoting 47 U.S.C. §§ 151, 201(b)). See also Sullivan v. Everhart, 494 U.S. 83, 87, 88-89, 110 S. Ct. 960, 108 L. Ed. 2d 72 (1990) (applying Chevron deference to rule promulgated pursuant to delegation of “general authority to ‘make rules and regulations and to establish procedures, not inconsistent with the provisions of this subchapter, which are necessary or appropriate to carry out such provisions’ ” (quoting 42 U.S.C. § 405(a) (1982 ed.))).

We believe Chevron and Mead, rather than National Muffler and Rowan, provide the appropriate framework for evaluating the full-time employee rule. The Department issued the full-time employee rule pursuant to the explicit authorization to “prescribe all needful rules and regulations for the enforcement” of the Internal Revenue Code. 26 U.S.C. § 7805(a). We have found such “express congressional authorizations to engage in the process of rulemaking” to

be “a very good indicator of delegation meriting Chevron treatment.” Mead, supra, at 229, 121 S. Ct. 2164, 150 L. Ed. 2d 292. The Department issued the full-time employee rule only after notice-and-comment procedures, 69 Fed. Reg. 76405, again a consideration identified in our precedents as a “significant” sign that a rule merits Chevron deference. Mead, supra, at 230-231, 121 S. Ct. 2164, 150 L. Ed. 2d 292; see, e.g., Long Island Care at Home, Ltd. v. Coke, 551 U.S. 158, 173-174, 127 S. Ct. 2339, 168 L. Ed. 2d 54 (2007).

We have explained that “the ultimate question is whether Congress would have intended, and expected, courts to treat [the regulation] as within, or outside, its delegation to the agency of 'gap-filling' authority.” Id., at 173, 127 S. Ct. 2339, 168 L. Ed. 2d 54 (emphasis deleted). In the Long Island Care case, we found that Chevron provided the appropriate standard of review “[w]here an agency rule sets forth important individual rights and duties, where the agency focuses fully and directly upon the issue, where the agency uses full notice-and-comment procedures to promulgate a rule, [and] where the resulting rule falls within the statutory grant of authority.” 551 U.S., at 173, 127 S. Ct. 2339, 168 L. Ed. 2d 54. These same considerations point to the same result here. This case falls squarely within the bounds of, and is properly analyzed under, Chevron and Mead.

COMMENT: The case is very important because it applied the Chevron standard sustaining a Treasury as long as the regulation is a permissible interpretation of the statute. Challenges to Treasury regulations in the transfer tax area will become more difficult.

B. Section 2036 Transfers With Retained Interests.

1. Estate of Van v. Commissioner, 101 T.C.M. 1077 (2011).

Van concerned the transfer of a residence by the taxpayer, who continued to live in the residence for the duration of her life without any agreement to pay rent. The retained interest of the taxpayer was found to be a retention of the possession or enjoyment of the property under Section 2036(a)(1).

The case was somewhat unusual because of the unique circumstances of how the taxpayer acquired the residence. She was a divorced mother of four when she moved from China to California in 1962. She began a relationship with a man, who in 1973 purchased a home to which the taxpayer moved, and in which she continuously resided, until her death in 2000. In 1988 she agreed to purchase the home from her friend for \$250,000. She supplied none of the consideration for the purchase. The entire downpayment, and all of the installment payments, were provided to her by one of her daughters, Norma, and Norma's husband. The final purchase price of the house wound up being \$230,000, because Mrs. Van's friend forgave \$20,000 of the debt.

Mrs. Van took title in 1989 and immediately conveyed it to herself and two grandchildren (children of her daughter Norma). In 1994 the two grandchildren conveyed title back to Mrs. Van and in 1997 Mrs. Van conveyed title to herself as trustee of her revocable trust. Then, in 1999, as trustee, Mrs. Van conveyed title to herself, her daughter Norma, and three grandchildren. The court stated that all of these transfers were gratuitous.

The estate claimed that the value of the home was not included in the decedent's estate because she did not own it at death. On audit, the Service raised Section 2036(a)(1) because of the retained enjoyment. The estate made two arguments to try to avoid the application of Section 2036:

The estate first argued that under California law, the decedent never had an interest in the property, because Norma and her husband were the real owners and the decedent was their agent. The court found that under California law the owner of legal title is presumed to be the owner of full beneficial title, and the presumption can only be revoked by clear and convincing evidence. The estate could not come up with a convincing reason of why title was in the decedent's name if Norma and her husband were the intended beneficial owners.

The estate's second argument was that the payment by Norma and her husband of the purchase price created a resulting trust. A resulting trust is created when the title holder was not intended to take the beneficial interest. The person who furnishes consideration for a purchase enjoys a natural presumption that the ostensible title holder acquired the title for the benefit of the one who supplied the funds. The court also had problems with this argument. First, it seemed apparent that all of the parties intended Mrs. Van to take title to the property when it was purchased. The facts indicated that Mrs. Van lived in the property continuously, never paying rent, until her death 27 years after she moved in. Moreover, a second presumption was at play: where the transaction is between a parent and a child, there is a presumption of gift. Again, the lack of any evidence or agreement among the parties as to Mrs. Van not being the intended holder of both the title and the beneficial interest led the court to conclude that Section 2036 applied.

2. Estate of Riese v. Commissioner, 101 T.C.M. 1269 (2011).

Mrs. Riese created a 3-year QPRT, survived the term, but continued to live in the residence for 6 months until her death. Although the plan was to draw a lease, and pay fair market rent, none of this was done prior to the decedent's death. The estate filed an estate tax return excluding the residence, claiming a Section 2053 deduction for rent that should have been paid by the decedent from the end of the QPRT term to the date of death, and also claiming rent for a period following the decedent's death. The Service disallowed these deductions, and included the full value of the home in the estate under Section 2036.

The Tax Court found that the decedent's continued occupancy of the property did not cause a Section 2036 inclusion. It allowed the deduction for rent to the date of death, but denied a deduction for rent following the date of death because there was no lease on which to base any continuing obligation. Important factors in this case were the understanding among the decedent, her daughter (Mrs. Grimes) and decedent's lawyer (Mr. Tucker), that a rental obligation existed and would have to be paid. The Court stated:

. . . decedent executed a QPRT agreement and rent was discussed on multiple occasions (e.g., when Mrs. Grimes explained the September 17, 1999, letter to decedent, during the February 7, 2000, phone call between Mr. Tucker and decedent, in the February 22, 2000, letter to decedent, and during subsequent conversations, etc.). Decedent agreed to pay rent and the trustees of the Property Trusts to which the residence transferred expected and intended to collect rent after the QPRT terminated. Furthermore, Mrs. Grimes' call to Mr. Tucker upon the QPRT's termination to find out how to determine fair market rent negates any possibility of an implied understanding that decedent would retain

an interest in the residence for life. While counsel's advice to determine rent by the end of the year was not the most prudent course of action, i.e., executing a lease and determining rent before the QPRT terminated would have been ideal, we accept the parties' good faith testimony that they intended to determine rent by the end of the year.

We find as a matter of fact that there was an agreement among the parties for decedent to pay fair market rent, the amount of which was to be determined and payments to begin by the end of 2003. See Diaz v. Commissioner, 58 T.C. 560, 565 (1972) (basing analysis upon evaluation of the entire record and credibility of witnesses). The Secretary had not issued any regulations or guidance as to how and when rent should be paid upon the termination of a QPRT. We believe that doing so by the end of the calendar year in which the QPRT expired would have been reasonable under the circumstances.

Unlike many cases involving the transfer of a personal residence where the decedent continued to live in the residence until death, see, e.g., Estate of Van v. Commissioner, T.C. Memo 2011-22, the existence of an implied agreement in this case is negated by the express agreement among the parties for the payment of rent. Many factors, e.g., the creation of the QPRT, the payment of gift tax upon the transfer of the residence to the QPRT, the several instances in which decedent agreed to pay rent, the fact that Mrs. Grimes called Mr. Tucker upon the QPRT's termination to find out how to determine the amount of rent to charge, and Mr. Tucker's corroborating testimony, all lead us to find that there was no agreement or understanding that decedent would retain an interest in the residence for life without paying rent.

We believe that Mrs. Grimes, on the advice of counsel, intended to and would have determined fair market rent by the end of 2003 and decedent would have paid rent. We believe further that Mr. Tucker would have made sure a lease was executed, rent was determined, and all appropriate changes were made to effect the change of ownership. Unfortunately, decedent died unexpectedly in October before any of this occurred.

On our examination of the entire record, we find that under the facts of this case decedent did not retain a life estate in the residence. There was no understanding, express or implied, at the time of transfer that decedent could occupy the residence rent free. Accordingly, the value of the residence was properly excluded from the gross estate and respondent's determination is not sustained on this issue.

C. Valuation Cases.

1. Estate of Mitchell v. Commissioner, 101 T.C.M. 1435 (2011).

Mitchell concerned the valuation of works of art and fractional interests in real property. The decedent's estate included a beachfront property in Santa Barbara and a sizeable ranch in the Santa Ynez valley in California. Both properties had been inherited from the decedent's father. As an adult, the decedent rarely visited either property, but had great affection for both and desired to keep both in the family. Six days before he died, he gave an undivided 5% interest in each property to trusts for his sons. He had also entered into leases for both properties with

third-party tenants. The leases were for initial 5-year terms, but gave the tenants the right to renew for three additional terms in the case of the beachfront property, and four additional terms in the case of the ranch.

The artwork included a Remington oil painting and a Russell watercolor. It was unclear whether the decedent knew of the existence of the art works; his father had crated the artwork at a general storage facility where they remained for over 30 years. The crates were opened after the decedent's death.

There was a great disparity between the value of these assets as disclosed on the Federal estate tax return, and as asserted in a notice of deficiency:

	<u>FET Value</u>	<u>IRS Value</u>
Beachfront Property		
- 95% Interest	\$5,881,450	\$12,918,578
- 5% Interest	\$241,600	\$435,153
Ranch Property		
- 95% Interest	\$2,570,000	\$10,950,371
- 5% Interest	\$123,750	\$432,251
Remington Oil	\$400,000	\$2,000,000
Russell Watercolor	\$300,000	\$2,600,000

The taxpayer's expert had valued the real properties under the income capitalization method, taking into account the rent payable under the leases, and assuming that the leases would be renewed by the tenants. The present value of the leases was then added to the present value of the reversionary interest. The calculation of the reversionary interest considered the fee value of the property under a comparable sales approach. The court accepted a calculation which assumed a 3.5% annual growth rate and a 9.5% annual discount rate for both properties. The court rejected the IRS "buyout" approach to value, which it characterized as novel and speculative. The court described the buyout approach as follows:

Respondent's experts stated that a leased-fee interest under the lease buyout method equals the real property's fee simple absolute value less the amount a landlord would have to pay to buy out a tenant (buyout amount). The buyout amount includes, among other things, a return of advance payments and deposits as well as the tenant's costs to terminate the lease and find another similar property to rent.

The Service argued that the income capitalization approach would be appropriate for commercial properties, but not for residences. Although the court found that the decedent rarely visited these properties, he had a desire to lease them and hold them for future family use. The Court concluded that the taxpayer's capitalization approach to value was most persuasive, and determined the values of the two beachfront and ranch properties as follows:

Beachfront Property

Lease Value	\$1,329,996
Reversion	<u>\$4,697,779</u>
Total	\$6,027,775

Rounded \$6,000,000

95% Interest	\$4,617,000	19% Discount
5% Interest	\$204,000	32% Discount

Ranch Property

Lease Value	\$150,713
Reversion	<u>\$3,200,000</u>
Total	\$3,350,713

Rounded \$3,370,000

95% Interest	\$2,080,975	19% Discount
5% Interest	\$101,100	32% Discount

An interesting aspect of the case is that the parties **stipulated** that the fractional discounts that would apply to the 95% and 5% interests.

The taxpayer did not fare as well with the art work, but still came out much better than the IRS assertions. The IRS had asked the Advisory Art Panel for its opinion of value for the two works. The Panel estimated a value between \$600,000 and \$800,000 for the Remington and between \$300,000 and \$1,000,000 for the Russell. The IRS staff appraiser did not believe that the Advisory Art Panel was sufficiently experienced in western art, and therefore assigned her own values to the works. The Court wound up assigning a \$1.2 million value to the Remington oil painting and a \$750,000 value to the Russell watercolor.

2. Estate of Gallagher v. Commissioner, 101 T.C.M. 1702 (2011).

The case involved the valuation of a 15% interest in an S company, PMG, that owned a number of newspapers and other publications. The decedent died on July 5, 2004, which was the valuation date (no alternate value election). The estate valued the 15% interest on the FET at \$34,946,000 and the IRS issued a notice of proposed adjustment valuing the interest at \$49,500,000. By the time the matter went to trial, both sides had procured a number of appraisals, with the taxpayer finally arguing in favor of a \$28,200,000 appraisal authored by its expert, Mr. May, and the Service arguing in favor of a \$40,863,000 appraisal authored by its expert, Mr. Thomson. In short, at trial the taxpayer argued for a value less than what was put forth on the return, while the Service argued for a value less than what it asserted in its notice of proposed adjustment.

As a preliminary matter, the Tax Court noted that the valuation of an asset on a tax return is an admission by the taxpayer when that valuation is inconsistent with a later position taken by the taxpayer. The admission is not conclusive and the trier of fact is entitled to determine, based

on all the evidence, what weight, if any, should be give to the admission. The Tax Court noted that the taxpayer could overcome the estate tax valuation (the "admission") by a preponderance of the evidence (more probably than not). The Court regarded the the lower IRS appraisal as a concession.

The Court ultimately found the value of the 15% interest to be \$32,601,640. There were a couple of interesting issues among the many that the Court discussed in arriving at its valuation.

First, there was a question as to whether Mr. Thomson could use financial data of the company for the a period that ended shortly before death, but that was not generally available (*i.e.*, published) until several months after death. The Court addressed this issue as follows:

Mr. Thomson bases his valuation analysis on data gathered from PMG's internally prepared financial statements ending June 27, 2004, and financial information for comparable public companies as of the quarter ending June 30, 2004. He considered that information to be more accurate than earlier data, despite the quarterly report's publication 1 or 2 months after the valuation date. In contrast, Mr. May's report relies upon financial information for comparable public companies ending March 28, 2004, the latest quarterly data available before the valuation date, and PMG's internally prepared financial statements ending May 30, 2004, the latest statements published before the valuation date. Mr. May declined to use the June 2004 financial statements, stating that a willing buyer and willing seller would be unaware of the information as of the valuation date, since the statements likely would not have been disclosed and published by such date.

We agree with Mr. Thomson that the June 2004 financial information should be used in valuing decedent's units. Petitioner argues that the June information was not publicly available as of the valuation date, preventing a willing buyer and seller from relying upon it in determining fair market value. That is not to say, however, that our hypothetical actors could not make inquiries of PMG or of the guideline companies (or of financial analysts), which would have elicited non-publicly available information as to end-of-June conditions. Moreover, we understand Mr. Thomson's testimony to be that the June 2004 financial information accurately depicts the market conditions on the valuation date, not that a willing buyer and seller would have relied upon the data. Importantly, petitioner has not alleged an intervening event between the valuation date and the publication of the June financial statements that would cause them to be incorrect. See Gross v. Commissioner, *supra*. Therefore, we shall rely on the June 30 and 27, 2004, financial information for comparable public companies and PMG, respectively.

Another issue involved whether the "guideline company" method could be employed where, as the taxpayer's expert asserted, there were no existing companies sufficiently similar to PMG to support the method. After reviewing the companies offered by Mr. Thomson in his guideline analysis for size, products and certain financial data, the Court concluded that the guideline approach was inappropriate.

A third issue involved whether, under the discounted cash flow method of valuation, PMG's earnings should be tax affected because it was an S company. The Court described tax affecting as the discounting of future corporate earnings on the basis of assumed future tax

burdens imposed on those earnings. As in other cases, the Tax Court refused to tax affect the earnings of an S company:

Mr. May tax affected PMG's earnings by assuming a 39-percent income tax rate in calculating the company's future cashflows, before discounting PMG's future earnings to their present value. He also assumed a 40-percent marginal tax rate in calculating the applicable discount rate. In contrast, Mr. Thomson disregarded shareholder-level taxes in projecting both the company's cashflows and computing the appropriate discount rate.

Mr. May failed to explain his reasons for tax affecting PMG's earnings and discount rate and for employing two different tax rates (39 percent and 40 percent) in doing so. Absent an argument for tax affecting PMG's projected earnings and discount rate, we decline to do so. As we stated in Gross v. Commissioner, T.C. Memo. 1999-254, the principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an S corporation. Mr. May has advanced no reason for ignoring such a benefit, and we will not impose an unjustified fictitious corporate tax rate burden on PMG's future earnings.

3. Estate of Giustina v. Commissioner, 101 T.C.M. 1676 (2011).

The estate of Natale Giustina included a 41.128% limited partner interest in a family partnership that owned timberland in Oregon. The estate reported the interest on the Form 706 at \$12,678,117; in its notice of deficiency the Service contended that the interest was worth \$35,710,000 and imposed an accuracy-related penalty under Code Section 6662 of \$2,541,501. By the time the case went to trial, the valuations of the respective parties had changed slightly: the taxpayer contended the interest was worth \$12,995,000 while the Service contended for a value of \$3,515,000. The Court found the value to be \$27,454,115 but found that the estate was not liable for the undervaluation penalty.

The company, if valued on a liquidation basis, would be much more valuable than if valued on the basis of continued operations. In valuing the interest, the court gave a 25% weight to the liquidation value of the partnership, even though the interest being valued was a limited partner interest that could not force liquidation. The court explained:

We believe that there was a 75-percent probability that the partnership would have continued its operations rather than liquidating its assets. The Giustina family had a long history of acquiring and retaining timberlands. We take this into account, but we also assume that the owner of the 41.128-percent limited partner interest is a hypothetical third party, see sec. 25.2512-1, Gift Tax Regs., who seeks the maximum economic advantage from the asset. As Reilly [taxpayer's expert] testified, the optimal strategy to maximize the value of the partnership would be to sell the timberland and "get \$143 million today." Selling the timberlands would generate about \$143 million; continuing to operate the partnership would generate only about \$52 million. Reilly opined that the value of the timberlands is irrelevant because a holder of Natale Giustina's interest could not unilaterally force the sale of the partnership's assets. It is true that the owner of a 41.128-percent limited partner interest could not alone cause the partnership to sell the timberlands. However, there are various ways in which a voting block of limited partners with a two-thirds interest in the partnership could

cause the sale. The members of such a voting block could replace the two general partners, who have the power to sell assets and make distributions. Alternatively, a two-thirds voting block could dissolve the partnership, an act that must be followed by the distribution of the partnership's assets. We are uncertain how many partners would share the view that the timberland should be sold. The uncertainty does not prevent us from estimating the probability of the sale:

The entire valuation process is a boundless subjective inquiry: To value an asset the court has to make guesses or assumptions about the future. These inquiries require speculation about the composition of management . . .

Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation", 50 Tax L. Rev. 415, 445 (1995). Some of these family members would perhaps prefer that the partnership remain in operation. But people also tend to prefer \$143 million to \$52 million, or, in this case, a share of \$143 million to a share of \$52 million. We believe that there is a 25-percent probability that a sufficient number of limited partners would cause the sale of the partnership's assets.

In excusing the undervaluation penalty, the Court stated:

. . . no penalty is imposed with respect to an underpayment if there was reasonable cause for the underpayment and the taxpayer acted in good faith. Sec. 6664(c)(1). Whether an underpayment of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Sec. 1.6664-4(b)(1), Income Tax Regs. In determining whether a taxpayer acted reasonably and in good faith with regard to the valuation of property, factors to be considered include: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the circumstances under which the appraisal was obtained; and (4) the appraiser's relationship to the taxpayer. *Id.* Although the IRS bears the burden of production under section 7491(c) that the section 6662 penalty is appropriate, the taxpayer bears the burden of proof in demonstrating reasonable cause. See Higbee v. Commissioner, 116 T.C. 438, 446-448 (2001).

The executor of the estate is the decedent's son, Larry Giustina. Larry Giustina hired a lawyer, Steven Lane, to prepare the estate-tax return. Lane hired Columbia Financial Advisors to appraise the 41.128-percent limited partner interest. Larry Giustina relied on the Columbia appraisal in filing the return.

The Columbia appraisal, like the Reilly report, valued the limited partner interest on the basis of capitalized cashflows, capitalized distributions, and the market values of other companies. Even though the Columbia appraisal did not incorporate the asset method, it was reasonable for the executor to rely on the Columbia appraisal. The partnership had been in operation for 15 years. It was reasonable to conclude that the partnership would continue to maintain its timberland assets without liquidating them.

The underpayment of tax on the estate's tax return resulted from its valuation of the 41.128-percent limited partner interest. The valuation was made in good

faith and with reasonable cause. The estate is not liable for the section 6662 penalty.

COMMENT: Assigning a 25% probability to a limited partner being able to join with others to effect a sale of the partnership assets, and a distribution, seems unrealistically high, especially given the Court's statement that it lacked certainty as to how many partners would share the view that the timberland should be sold. Perhaps this issue would be minimized, if not avoided altogether, if the general partner could only be removed for cause.

4. Linton v. U.S., 630 F.3d 1211 (9th Cir. 2011).

The Ninth Circuit has reversed the District Court's findings in Linton. Although the reversal is not a taxpayer victory – the Ninth Circuit found that the government was not entitled to summary judgment – the appellate court opinion contains important analysis on the application of the step transaction doctrine to strategies that involve the formation, funding and gifting of family-owned entities, such as family limited partnerships.

Linton is a “gift on formation” case in the line of Shepherd v. Commissioner, 283 F.3d at 1261, Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006), Holman v. Commissioner, T. C. Memo, 2008 Tax Court Lexis #12 (2008) and Gross v. Commissioner, T.C. Memo 2008-221; 2008 Tax Ct. Memo LEXIS 218 (2008). These cases generally arise because the taxpayer (1) cannot establish the proper order of formation of the entity, funding the entity, and gifts of entity interests, or (2) leaves so little time between these steps that these actions invite an attack under the step transaction doctrine. As a result, the Service argues that the taxpayer really gave away interests in the underlying assets rather than in the entity, such that there are no discounts available.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

summary judgment and the case was remanded for the District Court to make that determination.

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

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

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

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

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

The interdependence test asks “whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.” Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (10th Cir. 1991) (quotation marks omitted). Under this test, it may be “useful to

compare the transactions in question with those we might usually expect to occur in otherwise *bona fide* business settings." True, 190 F.3d at 1176.

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

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

5. Estate of Petter v. Commissioner, 653 F.3d 1012 (9th Cir. 2011).

The Ninth Circuit has affirmed the Tax Court's opinion in Petter, concerning the validity of a defined value clause. In Petter, the taxpayer created irrevocable trusts for each of her two children. The trusts were defective for income tax purposes. She then assigned LLC interests via defined value allocation clauses whereby the LLC interests were split between the trust and a donor advised fund. The assignment to one of the trusts read as follows:

Transferor:

1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be \$907,820, so that the amount of this gift should be \$ 453,910; and

1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.

The assignment to the other trust was identical, except for the identity of the charity. The Tax Court noted that the assignments contained a typographical error by its use of the word "minimum" instead of "maximum" when referring to the dollar amount that could pass free of gift tax. It dismissed this as a scrivener's error.

The gift documents also contained a provision which stated:

The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.

Both foundations also agreed to return property to the trusts if the value turned out to be overstated.

The taxpayer then sold LLC units to the trusts pursuant to defined value allocation provisions whereby the trusts agreed to purchase a fixed dollar amount of units and any value in excess of the fixed dollar amount would pass to the charities. The Tax Court held that the dollar formula clauses used to effect the additional transfers were not void as against public policy and that the charities' receipt of additional units was not subject to a condition precedent. The Service appealed.

The Ninth Circuit first discussed the meaning of a "condition precedent," characterizing it as a condition that must occur before a transfer to a charity becomes effective. The regulations at 25.2522(c)_3(c)(1)(i) deny a charitable deduction for transfers that are subject to precedent events in order to be effective. The Service argued that any transfer of units to the charity above the value initially disclosed on the taxpayer's gift tax return were subject to a condition precedent of an audit. The Court disagreed:

The dollar formula clauses of the gift documents assign to each of the two foundations the difference between 940 units and "the number of Units . . . that equals [\$453,910]." Thus, if X is the value of an LLC unit, these clauses assign to each foundation $940 - (453,910/X)$ units. Similarly, the two dollar formula clauses of the sale documents assign to one foundation—the Seattle Foundation—the difference between 8459 units and "the number of Units . . . that equals a value of \$4,085,190 as finally determined for federal gift tax purposes." Thus, each clause assigns to the Seattle Foundation $8459 - (4,085,190/X)$ units. Under the terms of all dollar formula clauses, the foundations receive a set number of LLC units; there are no contingencies that must be satisfied before the transfers to the foundations become effective.

The IRS, however, points out that the transfer agreements impose an obligation on the trusts to transfer excess units to the foundations if the value of Units the trusts receive by gift is finally determined for federal gift tax purposes to exceed \$453,910 or if the value of the Units the trusts receive by sale is finally determined to exceed \$4,085,190. In the IRS's view, these reallocation clauses—which were triggered once the IRS determined and the Taxpayer agreed that the LLC units had been undervalued—establish that "the gifts of the additional units to the foundations were dependent upon an IRS audit and a successful challenge of the value of the units as too low" because "[o]nly then do the foundations have a right to the additional units." We disagree. Although the reallocation clauses require the trusts to transfer excess units to the foundations if it is later determined that the units were undervalued, these clauses merely enforce the foundations' rights to receive a pre-defined number of units: the difference between a specified number of units and the number of units worth a specified

dollar amount. And that particular number of LLC units was the same when the units were first appraised as when the IRS conducted its audit because the fair market value of an LLC unit at a particular time never changes. Thus, the IRS's determination that the LLC units had a greater fair market value than what the Moss Adams appraisal said they had in no way grants the foundations rights to receive additional units; rather, it merely ensures that the foundations receive those units they were already entitled to receive. The number of LLC units the foundations were entitled to was capable of mathematical determination from the outset, once the fair market value was known.

Ultimately, the IRS argues that because the foundations would not have received the additional units but for the IRS audit, the additional transfer of units to the foundations was dependent upon a condition precedent. Adopting the IRS's "but for" test would revolutionize the meaning of a condition precedent. In one sense, the IRS is correct that but for its audit, the foundations would not have obtained additional LLC units, but that is because the IRS believed the estimated value was not the true fair market value. Either of the trusts or either of the foundations could also have challenged the Moss Adams valuation of the LLC units, although it was unlikely that they would have done so. But this practical reality does not mean that the foundations' rights to additional LLC units were contingent for their existence upon the IRS audit. Treasury Regulation § 25.2522(c)-3(b)(1) asks whether a transfer "is dependent upon . . . a precedent event in order that it might become effective," not whether a transfer is dependent upon the occurrence of an event so that the transferred assets actually change hands. An analogy to a simple contract illustrates this point. Consider a contract between A and B, in which A agrees to pay B \$1000 in exchange for B's services. If A enters into this contract knowing that he has no intention to pay and if B then performs his side of the bargain, B will receive the \$1000 only if he sues A in court. But for B's lawsuit, B would not receive the money he deserves. But B's filing of the lawsuit—though an event that must occur for B to be paid—is not a condition precedent to B's receiving the \$1000. That is so because B's entitlement to this sum is in no way dependent upon the filing of a lawsuit; A's duty to perform arose when B performed under the contract.

Citing I.R.C. § 2001(f)(2), the IRS further argues that a value as finally determined for gift tax purposes means the value shown on a taxpayer's return, unless the IRS conducts a timely audit and challenges that value. Because the Taxpayer used the term "as finally determined for federal gift tax purposes," the IRS claims that rather than transferring a particular number of units whose fair market value added up to the dollar amounts specified in the transfer agreements, the Taxpayer actually transferred a particular number of units whose pre-defined value—\$536.20 per unit, the value reported on the Taxpayer's gift tax return—added up to those dollar amounts. "And at that value, the foundations had rights to 1,773.91 and 93.47 units, and no more. The additional 4,503.82 and 237.04 units that the foundations subsequently were to receive were the result of the audit and the parties' agreement that the value of each unit was \$744.74."

But the Taxpayer's transfer agreements do not specify the value of an individual LLC unit. The gift documents assign to each of the two foundations the

difference between 940 units and "the number of Units . . . that equals [\$453,910]," while the sale documents assign to one foundation the difference between 8459 units and "the number of Units . . . that equals a value of \$4,085,190 as finally determined for federal gift tax purposes." Aside from the fact that only the dollar formula clause of the sale documents uses the phrase "as finally determined for federal gift tax purposes," a taxpayer who files a return cannot conjure up a value for federal gift tax purposes out of thin air; rather, she must use federal gift tax valuation principles. Under these principles, the value of an asset "as finally determined for federal gift tax purposes" is the fair market value of that asset. See Treas. Reg. § 25.2512-1 ("[I]f a gift is made in property, its value . . . is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."); cf. Succession of McCord v. Comm'r, 461 F.3d 614, 627 n.34 (5th Cir. 2006) ("There is no material difference between fair market value determined under Federal gift tax valuation principles and fair market value as finally determined for Federal gift tax purposes." (citation and internal quotation marks omitted)). Thus, the Taxpayer did not transfer to the foundations the number of units equal to a defined dollar amount divided by \$536.20; rather, she transferred the number of units equal to the defined dollar amount divided by the fair market value of a unit. The Moss Adams appraisal confirms this point; it states, on the first page, that its purpose "is to express an opinion of the fair market value of the [units]."

There are two additional problems with the government's reliance on I.R.C. § 2001(f)(2). First, although this section does state that "a value shall be treated as finally determined for purposes of [the gift tax chapter] . . . if . . . the value is shown on the return . . . and such value is not contested by the Secretary," id. § 2001(f)(2)(A), this definition applies "[f]or purposes of paragraph (1)," id. § 2001(f)(2). Paragraph (1), in turn, addresses the valuation of gifts in a particular circumstance: "if the time has expired . . . within which a tax may be assessed under [the gift tax chapter]." Id. § 2001(f)(1). In such circumstance, it makes sense to treat the value of a gift as the value reported on the taxpayer's return since, after all, the statute of limitations for assessing gift tax has passed. But I.R.C. § 2001(f)(2) does not purport to specify what is meant by a value "as finally determined for federal gift tax purposes" where the IRS may still assess tax. Second, I.R.C. § 2001(f)(2) also provides that "a value shall be treated as finally determined for purposes of [the gift tax chapter] if . . . the value is determined by a court." This language is broad enough to encompass the value of an LLC unit determined by a Washington court in an action by the foundations challenging the Moss Adams valuation as too low. See Oman, 422 P.2d at 493-94 (holding that the donee may enforce a completed gift). Accordingly, we reject the IRS's assertion that a value as finally determined for gift tax purposes is necessarily the value a taxpayer reports on her return.

The result we reach—that Treasury Regulation § 25.2522(c)-3(b)(1) does not bar the charitable deduction at issue in this case—is consistent with the Eighth Circuit's decision in Estate of Christiansen v. Comm'r, 586 F.3d 1061 (8th Cir. 2009),

The Service attempted to distinguish Christiansen, an estate tax case, from the facts here. The Ninth Circuit rebuffed this attempt:

The IRS offers three reasons to disregard Christiansen, but none are persuasive. First, the IRS argues that I.R.C. § 2518(a)—which provides that a qualified disclaimer relates back to the time of death by allowing the disclaimed amounts to pass as though the initial transfer had never occurred—ensured in Christiansen that "the disclaimed property passed to the foundation at the time of the decedent's death as opposed to being subject to a post-mortem condition precedent." As the IRS explains, "this 'relation-back' rationale is inapplicable in the instant case, which does not involve a qualified disclaimer." However, it is clear from reading Christiansen that the court's analysis focused on the word "transfer" in Treasury Regulation § 20.2055-2(b)(1), a regulation that closely mirrors the one applicable in this case. Though I.R.C. § 2518(a) buttressed the court's reasoning, it did not control the outcome. See Christiansen, 586 F.3d at 1062-63. Second, the IRS argues that the Eighth Circuit "relied on language in Treas. Reg. § 20.2055-2(e)(2)(vi)(a), an estate tax regulation that has no parallel in the gift tax regulations." We agree, but that regulation did not determine the outcome of the case; Treasury Regulation § 20.2055-2(b)(1)'s language did. See Christiansen, 586 F.3d at 1062 ("[Treasury Regulation § 20.2055-2(b)(1)] is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer. Rather, it speaks in terms of the existence of a transfer at the date of death."). Third, the IRS argues that Christiansen was wrongly decided because the court "overlooked the critical point that, but for the increase in the value of the estate 'as finally determined for federal estate tax purposes,' the foundation would not have had the right to any property beyond what it initially received." This is the same argument the IRS presses here, and we have already addressed it above.

The Ninth Circuit also rejected the argument that the defined value clause should be ignored because the gift tax charitable deduction is allowable only for amounts that the charities are assured of receiving, and here there arguably was no assurance. The Court stated:

Ultimately, the cases cited by the IRS stand for the unremarkable proposition that "[w]here the amount of a bequest to charity has not been determinable, the deduction properly has been denied." Estate of Sternberger, 348 U.S. at 199. But "[w]here the amount has been determinable, the deduction has, with equal propriety, been allowed." *Id.* Here, the Taxpayer's gifts to the foundations fall within the latter category. The foundations received a particular number of units: that number of units whose fair market value on the date of the transfers added up to a defined dollar amount. Because the fair market value of an LLC unit on a particular date is a constant, the foundations received gifts of a determinable amount. Therefore, Supreme Court precedent does not foreclose the Taxpayer's entitlement to a charitable deduction for the full value of her gifts.

6. Estate of Jorgensen v. Commissioner, 431 Fed. Appx. 544 (9th Cir. 2011).

The Ninth Circuit has affirmed the Tax Court decision in Jorgensen. Colonel and Mrs. Jorgensen had amassed several million dollars in marketable securities. Prior to his death, Colonel Jorgensen contributed some of his assets to a partnership known as JMA-I. Mrs. Jorgensen, although a contributor to the partnership, was not involved in discussions regarding its formation and was not involved in any of the decisions regarding its operation.

Correspondence between the attorney and the Jorgensens focused on the potential for discounting assets for estate tax purposes rather than other non-tax reasons.

After Colonel Jorgensen died, Mrs. Jorgensen funded a second partnership, known as JMA-II. The purpose of creating a second partnership was to isolate high-basis assets from low-basis assets, in order to facilitate a gift program to the Jorgensen's two adult children. The two children were the general partners of the partnerships. Mrs. Jorgensen had virtually no involvement in management or financial issues.

After Mrs. Jorgensen died, the IRS took issue with the discounts claimed in her estate for the two partnerships. The taxpayer claimed that there was a "significant non-tax reason" for the formation of both partnerships. The Tax Court considered the reasons advanced by the estate and rejected all of them, as follows:

1. Providing for Management Succession: The Tax Court held that JMA-I and JMA-II were passive investment vehicles. The general partners' activities with respect to the management of the partnerships did not rise to the level of active management. Citing Thompson v. Commissioner, 382 F.3d 367, 380 (3d Cir. 2004), the Tax Court found that the mere holding of an untraded portfolio of marketable securities weighs against the finding of a nontax benefit for a transfer of that portfolio to a family entity. Furthermore, the partnerships were not needed to help Ms. Jorgensen manage her assets because her revocable trust, which had her children as trustees, already served that function. Colonel Jorgensen had a similar plan in the trust he established at the same time as Ms. Jorgensen's. Ms. Jorgensen's trust was authorized to hold substantially all her assets and provided her with centralized management and control. Furthermore, the Jorgensen children were also her attorneys-in-fact and thus authorized to manage her assets under a durable power of attorney. The estate did not show how the limited partnerships accomplished the goal of managing Ms. Jorgensen's assets in a way that the trustees of her revocable trust or her attorneys-in-fact could not.
2. Financial Education of Family Members and Promotion of Family Unity: The Tax Court found that there was no evidence in the record that Colonel Jorgensen ever tried to teach his children anything about investing. Moreover, the Court observed that the children had differing spending habits (the son Gerald was a spendthrift; the daughter Jerry Lou was frugal). The partnership's requirement of pro-rata distributions, combined with the children's roles as general partners, seemed as likely to the Court to cause family disunity as unity. In short, the estate's reason seemed theoretical, not grounded in any factual situation.
3. Perpetuating a "Buy and Hold" Investment Philosophy and Encouraging Family Participation: The Court simply did not believe that the children were really attempting to perpetuate Colonel Jorgensen's practice of holding investments. The investment portfolio was diversified and was managed by third party advisors. In a footnote the Court distinguished Estate of Schutt v. Commissioner, T.C. Memo. 2005-126, on the basis that Schutt involved stock held by DuPont heirs that had been traditionally held by the family. Since Colonel Jorgensen did not involve his children in decision making while he was alive, and the grandchildren received only limited partner interests, the Tax Court could not see how the partnerships encouraged family participation.
4. Pooling of Assets: The Court observed that during Colonel Jorgensen's life he exercised complete management control over his assets and those of his wife. After he died the

Court could not find any evidence that Mrs. Jorgensen cared about the advantages of pooling assets. Moreover, whatever efficiencies that a partnership could offer in gift giving were not so significant as to make the funding of the partnerships a “*bona fide* sale.” The Jorgensens could have transferred securities to their children and grandchildren as gifts, and by linking the accounts for the children to their own, achieved a similar efficiency of management with their investment advisors.

5. Spendthrift concerns: The Tax Court found that it was unlikely that the Jorgensens were motivated to form the partnerships in order to address their son’s spendthrift habits. Were this so, the Tax Court observed, it would be unlikely that Gerald would have been made a general partner. The Court stated:

Gerald, despite being a general partner in both partnerships, believed until 1999 that the partnerships were like bank accounts and he could access money whenever he wanted. Yet he made no attempt to access the money until 1999, when he was told he could take a loan. He subsequently borrowed \$125,000 to purchase a home. No payments were made on the loan for 2 years, and at that time, only interest was paid. The loan was finally repaid when Jerry Lou and her husband suggested that it be repaid to make the partnership “look very legit.” At that point Gerald had received or was about to receive \$ 286,637 which we presume was related to the settlement of his mother's estate, more than enough to satisfy the \$ 125,000 loan. Gerald's ability to access funds in the form of a loan without making payment on the loan for 2 years suggests that curbing his spending was not a significant reason for the formation of the partnerships.

6. Providing for children and grandchildren equally: The Tax Court observed that Ms. Jorgensen could as easily provided for equality of distributions outside of partnership solution. Recall that in Mirowski equality of treatment was a significant non-tax reason for the partnership. Here the Tax Court distinguished Mirowski in a footnote, observing that Mirowski involved the management of patents, patent licensing agreements, and related litigation which could not be readily divided into equal shares, as opposed to a portfolio of marketable securities which could.

Winding up its discussion of the *bona-fide* sale exception, the Tax Court noted that there seemed to be little discussion of the reasons for the partnership other than tax savings, that the Jorgensens stood on “both sides” of the formation without any real input from their children or others, and that the partnerships were never operated as one would expect a legitimate business to be operated. Neither partnership maintained books and records, other than a checkbook that went unreconciled and monthly brokerage statements. The partnerships' return preparer used the partnerships' brokerage statements to prepare the partnership returns. There were no formal meetings between the partners, and no minutes were ever kept.

Having found that Ms. Jorgensen flunked the *bona fide* sale prong of the exception to the statute, the Tax Court then considered whether there was an impermissible retention under Section 2036(a)(1) or (a)(2). It concluded that there was an implied agreement under 2036(a)(1) for the retention of the enjoyment of the income from the transferred property. The Court observed that Ms. Jorgensen used partnership assets to make gifts, and after her death partnership assets were used to pay estate taxes.

In affirming this decision the Ninth Circuit's opinion was terse:

On appeal, the Estate does not contest the tax court's determination that § 2036(a) applies; that is, it acknowledges decedent retained some benefits in the transferred property (because she had written checks on partnership accounts to pay some personal expenses and make some family gifts), but argues that these amounts should be considered *de minimis* or that the application of the section should be limited to the actual amount accessed by decedent. These arguments are made for the first time to this court and run contrary to stipulations made by the Estate below.

In any event, these arguments are also without merit. We do not find it *de minimis* that decedent personally wrote over \$90,000 in checks on the accounts post-transfer, and the partnerships paid over \$200,000 of her personal estate taxes from partnership funds. See Strangi v. Comm'r, 417 F.3d 468, 477 (5th Cir. 2005) (post-death payment of funeral expenses and debts from partnership funds indicative of implicit agreement that transferor would retain enjoyment of property); see also Bigelow, 503 F.3d at 966 (noting payment of funeral expenses by partnership as supporting reasonable inference decedent had implied agreement she could access funds as needed).

Nor did the tax court clearly err by concluding there was an implied agreement decedent could have accessed any amount of the purportedly transferred assets to the extent she desired them. The actual amount of checks written for decedent's benefit does not undermine the court's finding that she could have accessed more, it was only used to buttress the court's conclusion that decedent had such access to the funds if needed.

Nor did the tax court clearly err by concluding decedent's transfer was not a *bona fide* sale for adequate and full consideration. Although not *per se* inadequate, transfers to family partnerships such as this are subject to heightened scrutiny, and, to be *bona fide*, must objectively demonstrate a legitimate and significant nontax reason for the transfers. Bigelow, 503 F.3d at 969. Here, the type of assets transferred (marketable securities) did not require significant or active management, there was some disregard of partnership formalities, and the nontax justifications are either weak or refuted by the record (including formation of a second family partnership to hold higher-basis assets for gift-giving purposes, purportedly for the same nontax justifications that the original partnership could have already served). See, e.g., Bigelow, 503 F.3d at 970-72; Strangi, 417 F.3d at 480-82. Thus, as the tax court found, the overriding objective purpose appeared to be a mere "recycling of value" into the partnership vehicle to permit discounted gift-giving and/or reduce the ultimate estate tax owed (by reducing the stated value of the securities due to a lack of control and marketability). See Estate of Thompson v. Comm'r, 382 F.3d 367, 378-81 (3d Cir. 2004).

7. Estate of Turner v. Commissioner, 102 T.C.M. 214 (2011).

Turner was a "bad facts" partnership which resulted in the underlying partnership property being includible in the decedent's estate under Code Section 2036.

Clyde Turner Sr. was married to Jewell Turner. They had four children, Clyde, Jr., Betty, Joyce and Janna. Joyce had predeceased her parents, leaving two sons, Rory and Riley. Rory dropped out of high school a couple of years after his mother's death, began abusing illegal drugs and wound up with a long arrest record. Nevertheless, he maintained a close relationship with his grandmother, Jewell.

Clyde Jr. had a domineering personality and did not get along well with his sisters or their husbands. Clyde had two sons, Marc and Travis. In approximately 1994 Marc began helping Clyde Sr. and Jewell with their finances and bookkeeping. In 2001 Clyde Sr. and Jewell asked Marc to meet with them to discuss their assets. In early 2002 Clyde Sr., Jewell, Marc and Travis met with attorneys from a firm that previously had done estate planning for work for Clyde Sr. Ultimately a limited liability partnership was formed ("Turner & Co.") of which Clyde Sr. and Jewell each owned a .5% GP interest and a 49.5% LP interest. Over a period of about 8 months Clyde and Jewell contributed about \$8,667,000 of their assets to the partnership. About 60% of the value of the partnership was dividend-paying stock in Regions Bank, but the stock represented less than 1% of the bank's outstanding shares. Clyde Sr. and Jewell had a sentimental connection with the stock and did not wish to see it sold. No interest in an operating business or in a regularly conducted real estate activity that required active management was contributed to the partnership. Clyde Sr. and Jewell kept about \$2,000,000 of personal assets outside of the partnership. These assets, together with their Social Security payments, generated about \$90,000 in income, which the Tax Court characterized as more than enough to pay their living expenses.

The original partnership agreement provided that when one general partner ceased to act, the other would act alone, and if both Clyde Sr. and Jewell ceased to act, then Marc and Travis (Clyde Jr.'s two sons) would become successor general partners. The FLP made payments to Marc and Travis in 2002, 2003 and 2004, which Clyde Sr. wanted to characterize as gifts from him. At the end of 2002 and beginning of 2003 Clyde Sr. and Jewell made gifts of LP interests to their children, and to Riley and Rory, the children of their deceased daughter Joyce. Rory's gift was made to a trust. Just before the first gifts were made, at the end of 2002, Betty and Janna, the two surviving daughters, insisted that the partnership agreement be amended to provide that following the last to die of their parents, the successor general partners would be Clyde Jr., Janna and Betty, each having one vote. Clyde Jr. could appoint his sons Marc and Travis, to serve in his place, but together they would still only have one vote. The amendment was signed.

The FLP engaged in two real speculative real estate ventures, each involving the purchase of land for less than \$400,000. In the first transaction, Turner & Co. borrowed funds to help finance the purchase. Clyde Sr. later paid the debt from personal funds. The partnership's general ledgers were adjusted over a year later to show this payment as a debt owed to Clyde Sr. In the second transaction Clyde Sr. wrote a personal check to fund the purchase and was paid back when the FLP obtained a bank loan. Distributions from the partnership were made only to Clyde Sr. in 2002, to Clyde Sr. and Jewell only in 2003, and to all of the partners in 2004. Clyde died in February, 2004, survived by Jewell. At the time of Clyde' death, the partnership was ultimately found to be worth \$9,580,520, and Clyde held a .5% GP interest and a 27.8% LP interest.

Clyde Sr.'s estate tax return valued the GP interest at \$30,744 and the 27.8% LP interest at \$1,578,240. The Service issued a notice of deficiency in which it included in Clyde Sr.'s estate one half of the net asset value of the partnership, and reduced Clyde's adjusted taxable gifts by the amounts his gifts of limited partnership interests to his children and grandchildren.

The Tax Court first considered whether the formation of the partnership met the adequate consideration/*bona fide* sale test. Meeting the adequate consideration prong of this test is usually not difficult where, as here, the partners receive partnership interests that are proportionate to the value of the partnership property they contribute. The decedent's estate met this test but ran into considerable difficulty with the *bona fide* sale prong of this test. The Tax Court began by noting that the *bona fide* sale prong requires the presence of a "legitimate and significant nontax reason" for forming the FLP. The estate gave three reasons:

1. To consolidate assets for management purposes and allow someone other than Clyde Sr. and Jewell or their children to maintain and manage the family's assets for future growth pursuant to more active and formal investment management strategy;
2. To facilitate resolution of family disputes through equal sharing of information; and
3. To protect the family assets and Jewell from Rory, and to protect Rory from himself.

The Tax Court then proceeded to debunk these reasons one by one. Regarding centralized management, it noted that nobody owned a significant amount of stock in an operating business; only passive assets were contributed to the partnership. The two real estate ventures, which the estate alleged showed an intent to start an active and profitable real estate development business, were characterized by the Court as real estate deals that "came Clyde Sr.'s way," and which were "channeled" through Turner & Co. The formation and operation of the partnership did not change the portfolio of marketable securities in any way. The Regions Bank stock continued to dominate the portfolio and the risk/return profile of the assets changed very little. Finally, Marc's involvement in the partnership did not offer significant management advantages since he had already been involved in his grandparents' finances before the FLP was formed. In short, they didn't need a FLP to involve Marc, or consolidate their assets or implement any formal investment strategy.

In discussing the issue of family discord, the Court first distinguished this case from Estate of Stone v. Commissioner, T.C. Memo 2003-309, where there was actual, bitter litigation that threatened a family-owned business. Here there was no family business nor even the threat of litigation. The Court stated:

The ill will among the Turner children was not about money, *per se*, and there is no evidence that the Turner children ever expressed a particular interest in managing their parents' assets. Instead, the bad feelings among the Turner children stemmed from the fact that Clyde Jr. had a domineering personality and had an unpleasant attitude toward his sisters and their husbands. Moreover, Clyde Jr.'s and his sons' involvement in Mt. Yonah caused Betty and Janna to resent their brother and to believe that their parents were treating them unfairly.

Given the source of the Turner family tension, we are not convinced that Clyde Sr.'s and Jewell's transfer of most of their wealth to a partnership managed by Clyde Jr.'s sons was intended to resolve family discord. Indeed, when Betty and Janna learned that Marc and Travis were managing Turner & Co., they demanded changes to the partnership agreement, including removal of Marc and Travis as the successor general partners. Petitioner's argument appears to be little more than an after-the-fact, hypothetical justification for the creation of Turner & Co.

The Court also dismissed the final justification for the partnership -- to protect Jewell from Rory and Rory from himself. The Court found no credible evidence that Jewell either wanted or needed protection from Rory, and that protecting Rory from himself did not require the formation of a partnership with Clyde and Jewell's assets.

Having debunked the taxpayer's justifications for the partnership, the Court then recited additional factors for why the *bona fide* prong could not be satisfied:

Several additional factors indicate that the transfers to Turner & Co. were not *bona fide* sales. First, Clyde Sr. stood on both sides of the transaction, and he created Turner & Co. without any meaningful bargaining or negotiation with Jewell or with any of the other anticipated limited partners; i.e., his children and grandchildren. See Estate of Harper v. Commissioner, T.C. Memo. 2002-121. Second, Clyde Sr. commingled personal and partnership funds when he used partnership funds to make personal gifts to Marc and Travis, to pay premiums on life insurance policies for the benefit of his children and grandchildren, and to pay legal fees relating to his and Jewell's estate planning. Third, Clyde Sr. and Jewell did not complete the transfer of assets to Turner & Co. for at least 8 months after formation of the partnership. See Estate of Hurford v. Commissioner, T.C. Memo. 2008-278; Estate of Bigelow v. Commissioner, T.C. Memo. 2005-65, affd. 503 F.3d 955 (9th Cir. 2007); Estate of Harper v. Commissioner, *supra*. [footnote omitted]

Having concluded that the decedent's estate flunked the adequate consideration/*bona fide* sale test, the Court then considered whether there was a retention under either 2036(a)(1) or 2036(a)(2) such that the transferred property is includible in the decedent's estate. It found a retention under both sections.

The factors that cause the taxpayer to flunk the *bona fide* sale prong of the statute are frequently the same factors that support inclusion under Section 2036(a)(1) on account of an implied agreement to retain income or the possession and enjoyment of the assets. The Tax Court addressed the Section 2036(a)(1) issues as follows:

We turn to the record and examine it for what it shows about Clyde Sr.'s possession and enjoyment of the assets he transferred to Turner & Co. We start with the partnership agreement. The partnership agreement expressly provides that the general partner is entitled to a "reasonable" management fee, and Clyde Sr. and/or Jewell chose to receive a management fee of \$2,000 per month without any apparent regard for the nature and scope of their actual management duties. There is nothing in the record to suggest that a \$2,000 management fee was reasonable. The record does not disclose what, if anything, Clyde Sr. and Jewell did to manage the partnership. In fact, some of the evidence suggests that Clyde Sr. and Jewell did not manage the partnership at all. The so-called management fee was paid under circumstances suggesting that no management services were actually provided. This is not indicative of a business or investment activity conducted for profit. Rather, it resembles an investment account from which withdrawals could be made at will. This impression is reinforced by a provision in the partnership agreement that gave Clyde Sr. the right, as general partner, to amend the partnership agreement at any time without the consent of the limited partners.

We turn now to an examination of the factors that tend to show an agreement to retain possession and enjoyment of the transferred assets. Nearly all of the facts point to an implied agreement. Clyde Sr. transferred most of his assets to Turner & Co. Nearly 60 percent of the value of all property that Clyde Sr. and Jewell contributed to Turner & Co. consisted of Regions Bank common stock. Because of his and Jewell's sentimental attachment to the Regions Bank stock, Turner & Co. did not sell the Regions Bank stock. Although he and Jewell retained sufficient assets outside of the partnership to meet their living expenses, they opted to receive management fees from Turner & Co. for few or no management services and took distributions from Turner & Co. at will. As discussed above, Clyde Sr. used Turner & Co. funds to make personal gifts to Marc and Travis, to pay life insurance premiums on policies held by Clyde Sr.'s Trust for the benefit of his children and grandchildren, and to pay legal fees related to his estate planning. He also commingled personal and partnership funds when he personally paid Turner & Co.'s debt to Habersham Bank, purchased the Lake Hartwell property on behalf of Turner & Co., and reimbursed Turner & Co. for its purchase of GMAC Notes. Clyde Sr. also received disproportionate distributions from Turner & Co.

Having found that the taxpayer retained possession and enjoyment of the assets under Code Section 2036(a)(1), the Court then considered whether the taxpayer also retained the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom under Code Section 2036(a)(2). It observed, citing United States v. Byrum, 408 U.S. 125, 92 S. Ct. 2382, 33 L.Ed. 238 (1972) that a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under Section 2036(a)(2). The Court did not discuss the concept of whether a general partner's fiduciary duties might block the imposition of Section 2036(a)(2). Rather, it first noted that for all intents and purposes, Clyde Sr. was the sole general partner of Turner & Co. In footnote 28 the Court observed:

Even if we were to treat Jewell as a coequal general partner of Turner & Co. we would reach the same conclusion because sec. 2036(a)(2) applies where the transferor's right to designate who shall possess or enjoy property and the income therefrom is held "alone or in conjunction with any person".

The Court continued in its opinion:

. . . the partnership agreement gave him broad authority not only to manage partnership property, but also to amend the partnership agreement at any time without the consent of the limited partners. As a general partner, Clyde Sr. had the sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay Federal and State tax liabilities) and to make distributions in kind. Moreover, Clyde Sr. had the authority to amend the partnership agreement at any time without the consent of the limited partners. Finally, even after the gifts of limited partnership interests to their children and grandchildren, Clyde Sr. and Jewell owned more than 50 percent of the limited partnership interests in Turner & Co. and could make any decision requiring a majority vote of the limited partners.

The Court concluded that the parties should look to the fair market value of the assets Clyde Sr. contributed to the partnership as of the date of his death in determining the amount includible in his estate. The gifts of limited partnership interests that Clyde reported on Forms 706 and 709 were disregarded for purposes of computing his adjusted taxable gifts.

The case concerned one other interesting issue. Clyde Sr. had established an irrevocable insurance trust with Crummey rights in his children and grandchildren. He paid premiums directly from his checking account, and there was no notice given to the beneficiaries of these "indirect" contributions to the trust. The Service argued that the decedent's adjusted taxable gifts had to be increased on account of these payments, because they were did not qualify for the present interest annual exclusion. In holding for the taxpayer on this issue, the Court stated:

In distinguishing present interests from future interests for Federal gift tax purposes, the test is not whether the beneficiary was likely to receive the present enjoyment of the property, but whether he or she had the legal right to demand it. As we explained in Estate of Cristofani v. Commissioner, supra at 83 (citing Crummey v. Commissioner, 397 F.2d 82, 88 (9th Cir. 1968), affg. in part and revg. in part T.C. Memo. 1966-144):

the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiaries, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment.

In Crummey v. Commissioner, supra at 82-83, the taxpayers established an irrevocable trust for the benefit of their children, some of whom were minors. The trust agreement provided that following a gift of property to the trust by the taxpayers or any other person, each beneficiary had the right to demand cash from the trust. Id. at 83. The trust agreement also provided that if a beneficiary were a minor, that beneficiary's guardian was authorized to make that a demand on behalf of the child. Id. The U.S. Court of Appeals for the Ninth Circuit acknowledged that it was extremely unlikely that any of the minor beneficiaries would make such a demand. Id. at 87. Indeed, the Court of Appeals noted that some, if not all, of the beneficiaries did not even know they had the right to demand money from the trust. Id. at 88. Nevertheless, the Court of Appeals held that where the trustee could not legally resist the demand, the gift was a gift of a present interest and the property was subject to the annual exclusion under section 2503(b).

The parties agree that Clyde Sr. made indirect gifts to the beneficiaries of Clyde Sr.'s Trust when he paid the premiums on life insurance policies for the benefit of his children and grandchildren. The parties disagree, however, on the nature of the gifts. Petitioner contends that the gifts were gifts of present interests (and therefore subject to the annual exclusion) because the beneficiaries had the absolute right and power to demand withdrawals of amounts transferred to Clyde Sr.'s Trust. Respondent contends that the gifts were gifts of future interests (and therefore not subject to the annual exclusion). Specifically, respondent argues the beneficiaries' withdrawal rights were illusory because Clyde Sr. did not deposit money with the trustees of Clyde Sr.'s Trust

but instead paid the life insurance premiums directly and because the beneficiaries did not receive notice of the transfers. Consequently, respondent argues that the beneficiaries had no meaningful opportunity to exercise the right of withdrawal.

The terms of Clyde Sr.'s Trust gave each of the beneficiaries the absolute right and power to demand withdrawals from the trust after each direct or indirect transfer to the trust. The fact that Clyde Sr. did not transfer money directly to Clyde Sr.'s Trust is therefore irrelevant. Likewise, the fact that some or even all of the beneficiaries may not have known they had the right to demand withdrawals from the trust does not affect their legal right to do so. See Crummey v. Commissioner, supra at 86-87; Estate of Cristofani v. Commissioner, supra at 80. We therefore conclude that the premium payments Clyde Sr. made as indirect gifts to Clyde Sr.'s Trust in 2000-2003 were gifts of present interests and are subject to the annual exclusion.

Respondent argues, in the alternative, that even if we conclude the premium payments were gifts of present interests, some of the gifts made in 2002 and 2003—specifically, the gifts made to Clyde Jr., Betty, Janna, Trey, and Rory—are still includable in Clyde Sr.'s taxable estate. This is so, respondent argues, because the transfers of limited partnership interests to Clyde Jr., Betty, Janna, Trey, and Rory in 2002 and 2003 used up their annual exclusions and any additional gifts to those beneficiaries during 2002 and 2003 are includable in Clyde Sr.'s estate. We disagree.

For the reasons discussed above, we have concluded that the value of property Clyde Sr. transferred to Turner & Co. is included in his gross estate under section 2036. Consequently, the gifts of limited partnership interests that the estate reported on Forms 706 and 709 must be disregarded for purposes of calculating Clyde Sr.'s adjusted taxable gifts. To do otherwise would result in the double inclusion of a significant part of the property transferred to Turner & Co. in Clyde Sr.'s estate. [footnote omitted]

D. Section 2041 and General Powers.

1. Estate of Chancellor v. Commissioner, 102 T.C.M. 70 (2011).

Chancellor considered whether a co-trustee-beneficiary's discretionary authority over principal distributions constituted a general power of appointment under Code Section 2041. The decedent was a co-trustee, with a bank, under her late husband's credit-shelter trust. The beneficiaries of the trust included the decedent and the descendants of her and her husband. The trust instrument conferred on the co-trustees the

right and power to invade the corpus of the trust and to use such part thereof and if necessary, all of it, for the necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures needed by . . . [Mr. Chancellor's] wife and the other beneficiaries of this trust taking into consideration the standard of living to which they are accustomed and any income available to them from other sources.

Mississippi law applied to the trust.

The Tax Court found that under Mississippi law the standard was ascertainable, despite the ability of the trustees to invade for "welfare" and "other appropriate expenditures needed . . .". After noting the ascertainable standard exception contained in the Code and in Treas. Reg. §20.2041-1(c)(2), the Court noted:

In his surreply brief respondent concedes that the will's use of the phrase "taking into consideration the standard of living to which * * * [the will beneficiaries] are accustomed" satisfies the first requirement, that the power of appointment be governed by an ascertainable standard.

The Tax Court could find no case in Mississippi that construed the term "welfare." It cited a case in which the Mississippi Supreme Court had endorsed the view that the word "comfort" in a trust document is intended to maintain the beneficiary's standard of living as it existed at the trust's creation. Gulf Natl. Bank v. Sturtevant, 511 So. 2d 936 (Miss. 1987). Gulf Natl. Bank, in turn, cited a 1953 First Circuit case, applying Massachusetts law, Blodget v. Delaney, 201 F.2d 589, which the Tax Court discussed at some length:

In Blodget v. Delaney, supra at 593, the Court of Appeals observed that "the words 'comfort and welfare' * * * do not have such sweeping subjective connotations" as the word "happiness". The Court of Appeals stated that in some circumstances "welfare" might cover more "elements of the subjective" than "comfort" but concluded that "it certainly is not as broad in its subjective sweep as 'happiness,' 'desire,' or 'use and benefit.'" Surely it cannot possibly be construed to cover whim or caprice, or even to cover an invasion of principal by the trustee to satisfy the life beneficiary's wish to make a gift." Id. The Court of Appeals concluded that under applicable Massachusetts law, taking into account the life beneficiary's circumstances and the trustee's duty to act in good faith for the best interests of both the life beneficiary and the remainder interest, the Massachusetts Supreme Court would equate the meaning of "welfare" as used in the will "not so much to the meaning of 'happiness,' 'desire' or 'use and benefit', as to 'maintenance' or 'support.'" That is to say, we think that court * * * would hold that 'comfort and welfare' * * * meant the physical comfort and state of physical well-being to which the life beneficiary had become accustomed". Id. at 594; see also In re Buell's Estate, 198 Misc. 358, 66 N.Y.S.2d 180 (1946) (interpreting "welfare" under New York law as providing for "physical comfort and well-being" in accordance with the beneficiary's accustomed standard of living).

We believe that the Mississippi Supreme Court would similarly construe the term "welfare" as used in Mr. Chancellor's will as part of the phrase "necessary * * * welfare * * * needed by * * * [Mr. Chancellor's] wife and the other beneficiaries of this trust taking into consideration the standard of living to which they are accustomed". In fact, taken *in toto*, with the seemingly overlapping qualifiers "necessary" and "needed" bookending the list of specified items which includes "welfare" and which is further qualified by express reference to the beneficiaries' accustomed standard of living, Mr. Chancellor's will makes at least as clear as the will considered in Blodget v. Delaney, supra at 593-594, that "welfare" was intended to refer to decedent's and the other beneficiaries' maintenance and support according to their accustomed standards of living. See Amoskeag Trust Co. v. Wentworth, 99 N.H. 346, 111 A.2d 198, 200 (N.H. 1955) (stating that a testatrix's "adoption of necessity and need as a criterion of the nature of the

payments she intended rules out those which might contribute to the beneficiary's happiness, contentment, and peace of mind regardless of his need for them and limits payments to those reasonably necessary in view of all the circumstances", taking into consideration "the manner and style to which he was accustomed to live at or about the time of the death of the testatrix" (citations omitted)).

The Tax Court similarly reasoned that invasions for "other appropriate expenditures needed" by the the beneficiaries was limited to maintenance and support:

For similar reasons, we do not believe that the phrase "other appropriate expenditures needed by * * * [Mr. Chancellor's] wife and the other beneficiaries of this trust taking into consideration the standard of living to which they are accustomed", preceded as it is by a list of "necessary" support-related purposes, was intended to permit decedent to invade trust corpus for other than support-related purposes as necessary to maintain her and the other beneficiaries' accustomed standard of living. We agree with petitioner that the Mississippi Supreme Court would most likely apply the rule of *ejusdem generis* to construe the words "other appropriate expenditures needed", etc. as referring to expenditures that are akin to or of like character with the expressly enumerated items that precede this phrase in the will; i.e., "maintenance, education, health care, sustenance, welfare"

As noted in the quoted material, the Court relied, in part, on a rule of construction, "*ejusdem generis*," to reach its conclusions that the trustees powers of invasion were limited to ascertainable standards relating to health, maintenance and support. The Latin term means "of the same kind," and is commonly applied when an instrument describes a general category as well as a list of specific items that may be included within the category. The application of the rule usually results in the general term being limited to the types enumerated in the specific list.

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In Chancellor the Service had argued that applying such a rule would render certain words meaningless. The Court disagreed:

Respondent suggests that applying the rule of *ejusdem generis* would effectively render the words "other appropriate expenditures" meaningless and thereby violate the maxim that effect should be given to each and every word and phrase of a document. See, e.g., Malone v. Malone, 379 So. 2d 926, 929 (Miss. 1980). But such concerns loom even larger under respondent's construction of the will. More particularly, if, as respondent seems to suggest, the power to invade corpus was ultimately intended to apply in all-encompassing fashion to any "appropriate expenditure", it would be pointless for Mr. Chancellor's will to have listed specified purposes ("necessary maintenance, education, health care, sustenance, welfare") that fall within the penumbra of "appropriate expenditures". Cf. Leinkauf & Strauss v. Barnes, 66 Miss. 207, 5 So. 402, 405 (Miss. 1889) (overruling an objection to the application of the rule of *ejusdem generis* in construing a statute, stating "it would be useless to specify certain things as to which the statute should apply, if it was intended that it should apply to all other things, whether *ejusdem generis*, or of a totally distinct character.").

Respondent observes that the will's power of appointment language lists "other appropriate expenditures" in the disjunctive from the other listed purposes, seeming thereby to suggest that "other appropriate expenditures" must mean

something apart from the other listed purposes. Although we do not view the will's use of the preposition "or" as controlling one way or another, we observe that in other circumstances the Mississippi Supreme Court, applying the rule of *ejusdem generis*, has construed "or" to mean "and". Anderson v. City of Hattiesburg, 90 So. 163, 164 (Miss. 1922) (applying the rule of *ejusdem generis* to construe a city ordinance against exhibiting "any obscene, indecent, or immoral picture" as if it read "obscene, indecent, and immoral.").

2. Reformation of Trust: PLR 201132017.

In this ruling, the Service permitted a state court ruling reforming a trust to correct a scrivener's error to be effective on a *nunc-pro-tunc* basis to avoid the decedent possessing a general power of appointment at death.

The issue apparently arose in a community property state, because the facts involved a Marital Trust, a By-Pass Trust and a Survivor's Trust. The document in question provided that after the death of the first spouse, the surviving spouse's debts, expenses and death taxes would be charged to the By-Pass Trust. After the first spouse died, the surviving spouse consulted a different attorney, who advised that the document should have provided that the debts, expenses and taxes would be charged to the Survivor's Trust. The surviving spouse and the drafting attorney submitted affidavits that the intent of the decedent and the surviving spouse was to minimize estate tax and maximize the use of the unified credit. The surviving spouse was the executor of the decedent's estate and the trustee of the trust. As trustee, the surviving spouse filed a petition in court to modify the trust on a nunc pro tunc basis. The argument in court was that the drafting attorney copied the language in the trust from paragraph 3.01, pertaining to debts, expenses and taxes being paid at the first decedent's death, to paragraph 4.01, pertaining to those charges being paid at the second decedent's death, without editing the language to refer to the Survivor's Trust. The spouse also pointed out that the language at it currently appeared created some internal inconsistencies in the document. The court granted the modification as an equitable reformation of trust under the common law and a state statute. In recognizing the effectiveness of the modification for tax purposes, the Service stated:

In this case, the documentation submitted by Surviving Spouse strongly indicates that Decedent and Surviving Spouse did not intend to have any control over the assets held in the By-Pass Trust, and that the provision in Section 4.01 of Trust to charge Surviving Spouse's debts, expenses and death taxes from the By-Pass Trust was the result of a scrivener's error. In reforming the By-Pass Trust, Court found that the modification of Trust was an equitable reformation of Trust under common law and State Statute 1.

Consequently, we conclude that the Court's Order on Date 4, modifying the trust instrument nunc pro tunc based on a scrivener's error is consistent with applicable State law that would be applied by the highest court of that state. Section 4.01 of Trust, as modified pursuant to the Court's Order, does not provide Surviving Spouse with a general power of appointment under § 2041(b) over the assets of the By-Pass Trust. Therefore, based on the facts submitted and the representations made, we conclude that the value of the assets in the By-Pass Trust will not be included in Surviving Spouse's gross estate under § 2041(a)(2) upon his death.

E. Graegin Loans: Estate of Duncan v. Commissioner, 102 T.C.M. 421 (2011).

Duncan involved a Graegin loan in an estate with significant oil and gas interests. Under the loan, the decedent's revocable trust borrowed funds from another family-related trust (the "Walter Trust") for a 15-year period. The two trusts had essentially the same beneficiaries and also had the same trustees. One of the co-trustees was the Northern Trust. In setting the interest rate, the co-trustees asked the Northern Trust's corporate banking department what the prevailing interest rate would be for a 15-year loan, no prepayment, and all interest and principal being due at the end of the term. The rate quoted was 6.7%, which the estate used for its Graegin loan. At the time of the loan, the prime rate was 8.25% and the long-term AFR was 5.02%. The estate deducted the full amount of the interest over the life of the loan as an "ordinary and necessary" administration expense under Code Section 2053.

The Service challenged the interest deduction on several grounds. One challenge questioned whether the debt was *bona fide* -- whether there were real economic consequences to the loan -- because the trustees and beneficiaries of the borrowing trust and the lending trust were the same. The Court rejected this argument on the basis that under state law the trusts were separate entities, and the repayment obligations of one trust could not be ignored by the other.

Another challenge was premised on Estate of Black v. Commissioner, 133 T.C. 340 (2009), in which an estate borrowed funds from a family limited partnership, which itself constituted the only significant asset of the decedent's estate. In Black the Tax Court found that the only conceivable means of repayment of the loan would be a sale of assets from the partnership, and on that basis held that the loan was not necessary. The Service argued that Black stood for the proposition that interest on a loan is not an "necessary" expense under Code Section 2053 where it is between related parties and the borrower could just as easily have sold assets to the lender to pay the tax. The Tax Court distinguished the ruling in Black:

The Estate claims it needed to borrow money because it could not have otherwise met its obligations without selling illiquid assets at reduced prices. The Estate estimated its Federal estate tax liability to be \$11.1 million but had liquid assets of only \$5.2 million at the time the loan was made.

Respondent does not contest that the Estate had insufficient liquid assets and that a forced sale of illiquid assets to a third party would have required a discount. Respondent instead argues that the 2001 Trust did not need to borrow money because it could have sold assets to the Walter Trust at full fair market value. Respondent argues that where the beneficiary of an estate was also the majority partner of a partnership owned by the estate, we found a loan from the estate to the partnership unnecessary because the estate could have redeemed its illiquid partnership interest in exchange for marketable securities held by the partnership. See Estate of Black v. Commissioner, 133 T.C. 340 (2009).

There, Mrs. Black's estate borrowed from the family limited partnership that it substantially owned. The income and distribution history of the partnership indicated that future distributions would be insufficient to allow the estate to repay the loan. Because the loan could not be repaid without selling stock owned by the partnership (and attributable to the estate's partnership interest), the Court held the loan was unnecessary. We also noted that because the estate's beneficiary was also the partnership's majority partner, he was on both sides of

the transaction and effectively paying interest to himself. As a result, those payments had no effect on his net worth aside from the net tax savings.

We find this is of no moment here. Respondent misinterprets our holding in Estate of Black. We did not hold that the loan was unnecessary because the estate could have sold stock. We held the loan was unnecessary because the estate would have had to sell the stock under any circumstance. The sale of the stock was inevitable, and the estate therefore could not have entered into the loan for the purpose of avoiding that sale.

Furthermore, respondent's conclusion is incorrect that the 2001 Trust could have sold assets to the Walter Trust at fair market value. If other prospective purchasers had insisted on a discount, Vincent Jr. and NTC (as trustees of the Walter Trust) would have been required to do the same. Under Illinois State law, Vincent Jr. and the NTC could not have directed the Walter Trust to purchase the 2001 Trust's illiquid assets at an unreduced price because they would have improperly shifted the value of the discount from the Walter Trust to the 2001 Trust.

The Service also argued that the 15-year term was excessive. In Estate of Gilman, 88 T.C.M. 627 (2004), the Tax Court had limited a Graegin loan term to 15.5 months because it found that the estate could pay the tax within that period. Here the Service noted that the oil and gas investments of the estate had generated sufficient cash flow after 3 years to allow the 2001 Trust to pay the tax in full. The Court distinguished between certitude, at the time of the loan, that cash will be available (Gilman) and uncertain projections of income that, with hindsight, turn out to be correct:

We did not, as respondent apparently suggests, second guess the Gilman estate's co-executors in Estate of Gilman. There, an estate owned stock of a holding company and acquired \$143 million in promissory notes in a subsequent tax-free reorganization of the holding company. To pay its Federal estate tax, the estate obtained a 10-year, \$38 million loan from a bank. Because the notes the estate held were due approximately 15.5 months later and there was no indication that the notes' obligors would fail to repay, there was no question that the estate could have fully paid its taxes and administration expenses from the repayment of the notes. We therefore held that the estate did not need to borrow funds past the date the notes were to be repaid and limited the estate's interest expense deduction accordingly.

Here, unlike the co-executors in Estate of Gilman, Vincent Jr. and NTC were not reasonably certain that the 2001 Trust would have enough money to fully pay the Estate's Federal estate tax and administration expenses within three years (the period to which respondent proposes to limit the Estate's interest expense deduction). To the contrary, Club Inc.'s accountant, Gregory Smith, credibly testified that the volatility in the price of oil and gas made future income difficult to predict. Although the Estate may have generated enough cash to repay the loan after three years, we will not use the benefit of hindsight to second guess Vincent Jr.'s and NTC's judgments when they were acting in the best interest of the Estate.

Finally, the Service argued that the interest rate of 6.7% was excessive, because it exceeded the long-term AFR. In rejecting this argument, the Court stated:

Respondent acknowledges that the interest rate here is less than the prime rate and that we have previously approved a loan based on the prime rate. See Estate of Graegin v. Commissioner, T.C. Memo. 1988-477. Respondent, however, seeks to distinguish this case by arguing that the interest rate in Estate of Graegin had an actual economic consequence to the estate because the corporate lender included shareholders outside the Graegin family. Respondent suggests that the co-trustees here should have used the long-term applicable Federal rate instead and that their selection of a higher interest rate has no economic consequence because the Walter Trust's interest income offsets the 2001 Trust's interest expense. Respondent argues that the loan's interest rate was not reasonable because there were no negotiations between the trusts.

We disagree that the co-trustees should have used the long-term applicable Federal rate because that rate does not represent the 2001 Trust's cost of borrowing. Interest rates are generally determined according to the debtor's rather than the creditor's characteristics. United States v. Camino Real Landscape Maint. Contractors, Inc., 818 F.2d 1503, 1506 (9th Cir. 1987). The long-term applicable Federal rate is thus inappropriate because it is based on the yield on Government obligations. See sec. 1274(d)(1)(C)(i) and (ii). It therefore reflects the Government's cost of borrowing, which is low because Government obligations are low-risk investments. See United States v. Camino Real Landscape Maint. Contractors, Inc., supra at 1506. Using the long-term applicable Federal rate consequently would have been unfair to the Walter Trust.

We reject respondent's argument that a higher interest rate is economically inconsequential simply because it is premised upon his treatment of the Walter Trust and the 2001 Trust as a single trust. Again, there is no basis in Federal tax law or State law for doing so.

We find perplexing respondent's argument that the interest rate was unreasonable since no negotiations had taken place. Vincent Jr. and NTC asked the Northern Trust Corporation's banking department for the market rate of interest. We do not understand why or how Vincent Jr. and NTC, as co-trustees of both trusts, would subsequently sit down and negotiate between themselves a different figure. Formal negotiations would have amounted to nothing more than playacting, and to impose such a requirement on the co-trustees would be absurd. Vincent Jr. and NTC made a good-faith effort to select an interest rate that was fair to both trusts. Once more, there is no reason to second guess their judgment.

F. Marital Deduction: PLR 201117005

This private letter ruling involved several interesting issues affecting the marital deduction. The taxpayer wished to create under his estate plan a QTIP trust with remainder to a foundation, and a charitable remainder unitrust with the foundation also holding the remainder interest.

The QTIP trust involved the allocation of assets between Fund A and Fund B. Fund A was designed to hold an interest in residential real estate in which the surviving spouse could reside rent free. Trust A was a net income trust, although it was not expected that the real estate would produce any income as long as the spouse resided there. If the real estate was sold, the trustees could invest the proceeds in replacement real estate, but also had discretion to transfer any funds not invested in real estate to Fund B. Fund B consisted of other assets, including an interest in an entity that held tangible personal property such as automobiles and an aircraft, of which spouse would have the rent-free use. Fund B provided that income would be determined under a state total return statute, as 4% of the assets of Fund B excluding the assets held in the entity. Under certain circumstances the unitrust amount could be reduced to 3%.

Under the CRUT the spouse would receive 20% of the charitable unitrust payment each year, and the remaining 80% of the unitrust amount would be payable, in the discretion of the trustees, to spouse and to the foundation, in such shares and proportions as the trustees determine, except that the trustees would be required to distribute enough to spouse to ensure that the distribution to her was not *de minimis*. In addition, if spouse remarried, nothing from the CRUT would be distributed to her except her 20% share and any additional amount to ensure that what she received was not *de minimis*.

The trustees could not be spouse, foundation, or any person who was related or subordinate to spouse, nor any other permissible recipient of distributions of income or principal during the term of the QTIP or CRUT or on the termination of either could serve as trustee. Only current trustees could appoint successor trustees and in the event of a vacancy a court would appoint an institutional trustee. The trust provided for some variation of mediation of any dispute or controversy between or among the beneficiaries and trustees and if the parties could not settle their differences by that procedure, for binding arbitration in accordance with a state statute.

Among the ruling issues the taxpayer requested were whether Fund A and Fund B both qualified for QTIP, whether the discretion of the trustees in paying the unitrust amount might render the CRUT a Section 678 trust or in any other way imperil the marital deduction, whether the decedent's estate would be able to deduct the full value of the CRUT as a marital/charitable deduction, and whether the mediation/arbitration provision affected the "passing" requirement for the marital and charitable deductions.

The Service ruled that Fund A and Fund B both qualified for the marital deduction under QTIP. As to the CRUT, the Service rules that there would be no power under the trust that would cause a trustee or beneficiary to be considered an owner of the trust property under Section 678. The Service also ruled that the mediation/arbitration provision would not prevent the CRUT from qualifying as a charitable remainder unitrust or prevent the property passing to the QTIP from qualifying as QTIP property, but noted that any final decision reached in voluntary binding arbitration or volunteer trial resolution "is subject to the scrutiny of the Service to determine if the decision is based on an enforceable right under state law properly interpreted."

The issue of how much of the CRUT could be deducted involved a computational conundrum under the statute. Normally one would compute the value of the charitable remainder and then look to the spouse's life estate to determine if it qualified for QTIP. Here, however, the trustee's discretion would allow for only a 20% marital deduction. What about the other 80% of the unitrust payment? Clearly it would pass to either the spouse or charity, but how to express this in a valuation mandated by the Code and the regulations? The Service acknowledged that the deduction should be complete, as follows:

Section 2056(b)(8)(B)(iii) provides that the term "qualified charitable remainder trust" means a charitable remainder annuity trust or charitable remainder unitrust described in § 664.

Section 20.2056(b)-8(a)(1) provides, in part, that if the surviving spouse of the decedent is the only noncharitable beneficiary of a charitable remainder unitrust described in § 664, § 2056(b)(1) does not apply to the interest in the trust that is transferred to the surviving spouse. Thus, the value of the unitrust interest passing to the spouse qualifies for a marital deduction under § 2056(b)(8) and the value of the remainder interest qualifies for a charitable deduction under § 2055.

In the legislative history to the Economic Recovery Tax Act of 1981, the House Ways and Means Committee stated:

If an individual transfers property outright to charity, no transfer taxes generally are imposed. Similarly, under the unlimited marital deduction provided in the committee bill, no tax generally will be imposed on an outright gift to the decedent's spouse. As a result, the committee finds no justification for imposing transfer taxes on a transfer split between a spouse and a qualifying charity. Accordingly, the bill provides a special rule for transfers of interests in the same property to a spouse and a qualifying charity.

Under the bill, if an individual creates a qualified charitable remainder annuity trust or a qualified charitable remainder unitrust, and the only noncharitable beneficiaries are donor and his spouse, the disallowance rule for terminable interests does not apply. Therefore, the individual will receive a charitable deduction (under secs. 2055 or 2522) for the amount of the remainder interest and a marital deduction (under secs. 2056 or 2523) for the value of the annuity or unitrust interest; no transfer tax will be imposed.

H.R. Rep. No. 97-201, at 162 (1981).

In the instant case, the entire value of the assets distributed to CRUT as of Taxpayer's date of death will be included in Taxpayer's estate. Assuming CRUT satisfies the requirements of § 664, the value of the charitable remainder interest will qualify for a charitable deduction under § 2055(e)(2)(A) because the remainder interest is in a charitable remainder unitrust described in § 664. Assuming CRUT satisfies the requirements of § 664, the value of Spouse's unitrust interest qualifies for a marital deduction under § 2056(b)(8). However, in this case, the value of Spouse's unitrust interest for purposes of determining the deduction available under § 2056(b)(8) is unclear as only a portion of the unitrust amount is required to be paid to Spouse under the instrument, with a larger portion of the unitrust amount payable to either Spouse or Foundation, as the trustees in their discretion may annually decide. In light of the legislative history noted above and based on the facts provided and representations made, we conclude that where Taxpayer establishes a testamentary charitable remainder unitrust for one measuring life in which the surviving spouse is the only noncharitable beneficiary, the estate tax marital deduction under § 2056(a) will

completely offset the value of the assets distributed to CRUT as of Taxpayer's date of death, after deducting the value of the remainder interest qualifying for a charitable deduction under § 2055(a).

G. Divorce: PLR 201116006.

This ruling involved a trust that was created by husband for wife's benefit, incident to a divorce. The trust was in partial settlement of the husband's support obligation to his wife, and was incorporated in the divorce judgment.

The trust provided that wife was entitled to the income for life, could receive principal in the discretion of an independent trustee, and could exercise a limited testamentary power of appointment in favor of her surviving issue. In default of exercise, the trust property passed to the wife's surviving issue, *per stirpes*. The wife had no power to alter, amend, revoke or terminate the trust or any right to remove, discharge or appoint the trustee of the trust. Wife died survived by a daughter. She never exercised the testatentary power of appointment. The issue was whether the trust was includible in the wife's gross estate.

The Service observed that the transfer of assets to the trust was pursuant to a judgment which dissolved the marriage. Therefore, the transfer of the assets to the trust was for full and adequate consideration under Code Section 2516, but only as to the value of the wife's life estate. What about the value of the remainder interest? The Service characterized this as a taxable gift, but the husband, not the wife, was the transferor for federal transfer tax purposes. The Service reasoned:

In this case, Spouse transferred cash property to Trust in partial satisfaction of his spousal support obligation. Accordingly, Decedent is not a transferor for purposes §§ 2036 and 2038. Under the terms of Trust, Decedent would receive all the net income of the trust during her lifetime. The independent trustee had the discretion to distribute principal to Decedent, or apply principal for her benefit, during her lifetime. Decedent possessed a testamentary limited power of appointment to appoint the trust assets to her surviving issue. The trust instrument did not grant Decedent any power to alter, amend, revoke, or terminate Trust or any right to remove, discharge, or appoint the trustee of Trust. Accordingly, based on the facts submitted and representations made, we conclude that the value of the Trust assets are not includible in Decedent's gross estate under §§ 2031, 2033, 2036, 2038, 2039, or 2041.

SELECTED ILLINOIS RECENT DEVELOPMENTS

P.A. 97-636: Amendment to Illinois Estate Tax.

Effective for decedents dying on or after January 1, 2012, Illinois again has increased the threshold amount before an estate tax is imposed.

The “State tax credit” under the statute now means, for persons dying after 2010:

. . . an amount equal to the full credit calculable under Section 2011 or 2604 of the Internal Revenue Code as the credit would have been computed and allowed under the Internal Revenue Code as in effect on December 31, 2001, without the reduction in the State Death Tax Credit as provided in Section 2011(b)(2) or the termination of the State Death Tax Credit as provided in Section 2011(f) as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, but recognizing the exclusion amount of only (i) \$2,000,000 for persons dying prior to January 1, 2012, (ii) \$3,500,000 for persons dying on or after January 1, 2012 and prior to January 1, 2013, and (iii) \$4,000,000 for persons dying on or after January 1, 2013, and with reduction to the adjusted taxable estate for any qualified terminable interest election as defined in subsection (b-1) of this Section.

The decoupling of the Illinois estate tax, and the lower applicable exclusion amount, produces two unusual issues when the estate is subject to the Illinois estate tax but less than the federal filing requirement.

1. **Illinois Alternate Value?** When an Illinois estate tax return is due, but there is no federal filing requirement, can the Illinois estate elect alternate value on the hypothetical federal return that accompanies the Illinois return? There has been no authoritative guidance on this issue but as a policy matter the Attorney General’s Office is permitting such an election. The rationale is that if the applicable exclusion amount were indeed \$3,500,000, as Illinois now assumes for 2012 decedents, an alternate value election would have been allowable for federal purposes and therefore is allowed for purposes of computing the Illinois tax. The election must be made on the hypothetical federal 706 that accompanies the Illinois return. The alternate value election, of course, has no effect for federal income tax purposes or for purposes of the Illinois income tax – it is only a calculation step in arriving at the correct amount of the Illinois tax.
2. **Effect of Double Deductions.** Illinois has no statutory provision similar to Code Section 642(g), which, with a limited exception for Code Section 691(b) deductions, prohibits an estate from claiming the same expenses an estate tax and income tax deductions. Assume that attorneys’ fees, executors’ fees and accountant’s fees are claimed as federal estate tax deductions on the hypothetical federal estate tax return that accompanies the Illinois return. These deductions are not actually claimed for federal estate tax purposes since there is no federal filing requirement. Since the

deductions have not been claimed on an actual federal estate tax return, there is no prohibition from claiming these as federal income tax deductions on the estate or trust's Form 1041. Inasmuch as the Illinois 1041 generally follows the federal form, the effect is to secure the fees as deductions for purposes of both the Illinois estate tax and the Illinois income tax.

Sanders v. Stasi, 351 Ill. Dec. 610, 951 N.E.2d 1274 (Fourth District, 2011).

Section 11(a) of the Illinois Trusts and Trustees Act (760 ILCS 5/1 et seq.) provides that a trustee must annually furnish an accounting to the income beneficiaries:

Every trustee at least annually shall furnish to the beneficiaries then entitled to receive or receiving the income from the trust estate, or if none, then those beneficiaries eligible to have the benefit of the income from the trust estate a current account showing the receipts, disbursements and inventory of the trust estate.

In Sanders, Otto Stasi died testate in 2000, establishing a trust which named his widow Carol as the trustee. The trust directed the following payments:

1. \$150 per week to Carol as trustee fees;
2. \$100 per week to Ruth Barnes for life; and
3. As much income as needed to defer Carol's payments of insurance, utilities and taxes with respect to her personal residence.

If any income remained, it would be paid 1/4 to Carol, 1/4 to Ruth Barnes, and 1/8 to each of four persons, one of whom was Lisa Sanders.

After ten years, Lisa asked for an accounting. She had never been paid any income. Carol refused to provide an accounting, on the basis that Lisa had no standing under the Trusts and Trustees Act to demand one. According to Carol, after the required payments, including the reimbursement for her insurance, utilities and taxes, there was never any excess income to be paid. Therefore Lisa could not be a person entitled to receive income under Otto's trust. In the trial court Carol presented tax returns that established the income of the trust, showing no excess income to distribute. The court granted Carol's motion for summary judgment. Lisa appealed.

The Fourth District reversed. Under the statute, the Fourth District found that Lisa was "entitled to receive" the income of the trust even if there was no income to distribute. In reaching its conclusion, the Court looked to an earlier appellate court case, Goodpasteur v. Fried, 183 Ill. App. 3d 491, 539 N.E.2d 207 (First District, 1989). Goodpasteur concerned the standing of a discretionary income beneficiary to demand an accounting. A discretionary income beneficiary was held to be one who was "eligible" to receive income, as distinguished from one who was "entitled" to receive income. The Goodpasteur Court characterized eligibility as "potentiality" rather than realization. In Sanders, the Fourth District concluded:

In this case, we conclude plaintiff was "entitled to receive" income from the trust within the meaning of the statute. Under Otto Stasi's will, plaintiff is to receive a share of any income generated in excess of the enumerated

distributions. Her entitlement to this income is not predicated upon any event and is not a mere potentiality.

The trustee has a duty to be transparent in the performance of her duties. See Wallace v. Malooly, 4 Ill. 2d 86, 95, 122 N.E.2d 275, 280 (1954) (" [T]he beneficiary is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust.") (quoting Restatement of Trusts § 173 cmt. C (1935)); see also State v. Taylor, 362 P.2d 247, 251 (Wash. 1961) (" 'If the cestui is to be able to hold the trustee to proper standards of care and honesty and procure for himself the benefits to which the trust instrument and the doctrines of equity entitle him, *he must know of what the trust property consists and how it is being managed.*' " (Emphasis in original.) (quoting George Gleason Bogert, Bogert Trusts & Trustees § 961, at 2 (2d ed. 1948))). Here, plaintiff is unable to enforce her entitlement if she does not receive an accounting of the trust's receipts, disbursements, and holdings. We interpret section 11(a) of the Act to entitle her to such an accounting.

Plaintiff is entitled to an accounting, and defendant is unable to carry her burden on summary judgment to establish she is entitled to a judgment as a matter of law. Summary judgment is inappropriate and the trial court's judgment must be reversed.

Scanlan v. Eisenberg, 2012 U.S. App. Lexis 1112 (7th Cir. 2011).

Scanlan was the beneficiary of six trusts created by her father and uncle. The trustees could distribute all or as much of the net income or principal, or both, of the trusts to Scanlan as the trustee deemed to be necessary for her support or in her best interests. No other person was eligible to receive any distributions from the trusts during Scanlan's lifetime, and Scanlan's children were contingent remaindermen.

The trusts had a combined net value of approximately \$800,000,000 and were invested heavily in General Growth Properties ("GGP") stock, a company that her family founded. In 2007 and 2008 the trustee of the trusts borrowed heavily against trust assets to purchase additional millions in GGP stock. When GGP declared bankruptcy in 2009, the trusts lost over \$200,000,000 in value. Scanlan, on behalf of herself and her children as contingent beneficiaries, sued the trustee, attorneys and others involved in the decision to retain and purchase additional GGP stock. The suit against the trustee alleged breach of its fiduciary duties of loyalty, prudence, and disclosure when it purchased the GGP stock in 2007 and 2008.

The District Court ruled that Scanlan lacked Article III standing and dismissed all of her claims with prejudice. Specifically, the District Court held that Scanlan lacked standing unless she could allege "facts showing a likelihood that the corpus of the trusts would ever be insufficient to pay all of her discretionary distributions to which [she] might become entitled during her lifetime." Scanlan appealed to the Seventh Circuit.

According to the Appellate Court, the lower court's standing inquiry, and more specifically, its injury-in-fact analysis, focused primarily on the current value of the trusts' assets. Since Scanlan did not allege any facts indicating that the value of the trusts' corpus would ever be insufficient to fund any potential "support" and "best interests" payments, the district court concluded that Scanlan did not suffer an injury in fact for purposes of Article III. In other words,

a discretionary beneficiary should not be able to complain about a \$200,000,000 loss as long as the loss does not impair the trustee's ability to make distributions for support and best interests.

The Appellate Court reversed. The following is an interesting albeit lengthy discussion of a discretionary beneficiary's standing under Article III:

That Scanlan must suffer an invasion of a legally protected interest is a principle of federal law. But the nature and extent of Scanlan's interest as a beneficiary of a discretionary trust, and therefore, whether that interest can form the basis of a federal suit, depend on the law that defines the rights of a discretionary beneficiary. FMC Corp. v. Boesky, 852 F.2d 981, 993 (7th Cir. 1988); see also Bochese v. Town of Ponce Inlet, 405 F.3d 964, 981 (11th Cir. 2005); Cantrell v. City of Long Beach, 241 F.3d 674, 684 (9th Cir. 2001). In this case, that is the law of Illinois. So we look to see whether according to Illinois law a discretionary trust beneficiary has the kind of stake that Article III requires.

So stated, this is an issue that has meager precedent. The Restatements (Third) of Trusts, Section 94, addresses who may bring a suit against a trustee for breach of trust, and therefore, provides some guidance on this topic. See In re Estate of Lieberman, 391 Ill. App. 3d 882, 909 N.E.2d 915, 922, 330 Ill. Dec. 893 (Ill. App. Ct. 2009). Section 94, which is entitled, "Standing to Enforce a Trust," provides:

A suit against a trustee of a private trust to enjoin or redress a breach of trust or otherwise to enforce the trust may be maintained only by a beneficiary or by a co-trustee, successor trustee, or other person acting on behalf of one or more beneficiaries.

The Restatements (Third) of Trusts, § 94(1).

Comment b to § 94 then explains who qualifies as a "beneficiary" with standing to bring suit to redress a breach of trust:

A suit to enforce a private trust ordinarily . . . may be maintained by any beneficiary whose rights are or may be adversely affected by the matter(s) at issue. The beneficiaries of a trust include any person who holds a beneficial, present or future, vested or contingent This includes a person who is eligible to receive a discretionary distribution

Id. § 94, cmt. b.

Clearly then, Comment b provides that a beneficiary of a discretionary trust whose rights are "adversely affected" has standing to enforce the trust. But Comment b poses, rather than answers, the question: What does it mean for a discretionary beneficiary's rights to be "adversely affected"? Again, the Appellees argue that Scanlan's rights as a discretionary beneficiary are not "adversely affected" until the Trustee fails to make a distribution in which she is entitled to under the terms of the Trusts. Only after that showing will Scanlan have standing, the Appellees claim. Such a rigid standard is not supported by

trust law authority, which indicates that a discretionary beneficiary's rights include something more than just an interest in potential distributions.

In Illinois, a beneficiary has an equitable interest in the trust property. Parkway Bank & Trust Co. v. Northern Trust Co., 213 Ill. App. 3d 444, 572 N.E.2d 1055, 1058, 157 Ill. Dec. 591 (Ill. App. Ct. 1991); Farkas v. Williams, 5 Ill. 2d 417, 125 N.E.2d 600, 605 (Ill. 1955) ("The declaration of trust immediately creates an equitable interest in the beneficiaries"); Gordon v. Gordon, 6 Ill. 2d 572, 129 N.E.2d 706, 708 (Ill. 1955); Norris v. Estate of Norris, 143 Ill. App. 3d 741, 493 N.E.2d 121, 126, 97 Ill. Dec. 639 (Ill. App. Ct. 1986). Jurisdictions examining the nature of a discretionary beneficiary's interest have found that, like an ordinary beneficiary, a discretionary beneficiary has an equitable interest in the trust property. See, e.g., Pritzker v. Pritzker, Case Nos. 02 CH 21426, 03 CH 7531, at 15-16 (Cir. Ct. of Cook Cty., Ch. Div. March 5, 2004) ("It is clear that beneficiaries of a discretionary trust have a present, existing property interest in the trust res."); In re Marriage of Jones, 812 P.2d 1152, 1157 (Colo. 1991) (citing 2 A. Scott on Trusts § 130, at 409 (4th ed. 1987)) (noting that a discretionary trust beneficiary has an equitable interest, but the beneficiary cannot force the trustee to pay income or principal unless the beneficiary could establish the trustee had engaged in fraud or an abuse of discretion); Pack v. Osborn, 2008 Ohio 5956, 2008 WL 4907545, at *3 (Ohio App. Ct. 2008) (determining the nature of the discretionary beneficiary's interest in the trust and concluding it was an equitable interest); Paulson v. Paulson, 2010 ND 100, 783 N.W.2d 262, 272 (stating that a discretionary beneficiary has an equitable interest in the trust assets); United States v. O'Shaughnessy, 517 N.W.2d 574, 577 (Minn. 1994) (citing Restatement (Second) of Trusts 199 (1959)) (commenting that a discretionary beneficiary has equitable remedies against a trustee for breach of trust).

Cases that establish a beneficiary's equitable interest in trust property, the Appellees argue, do not arise in contexts involving standing and instead merely recite general trust law principles. Yet we see no reason why canonical principles of trust law should not be employed when determining the nature and extent of a discretionary beneficiary's interest for purposes of an Article III standing analysis. Applying those principles, we conclude that Scanlan has an equitable interest in the corpus of the Trusts. And it is from that equitable interest that Scanlan acquires standing to enforce the Trusts.

Stemming from Scanlan's status as a beneficiary is a fiduciary relationship between her and the Trustee that gives rise to equitable remedies against the Trustee for breach of trust. A trustee owes a fiduciary duty to a trust's beneficiaries and is obligated to carry out the trust according to its terms and to act with the highest degree of fidelity and utmost good faith. In re Estate of Muppavarapu, 359 Ill. App. 3d 925, 836 N.E.2d 74, 77, 296 Ill. Dec. 659 (Ill. App. Ct. 2005); Paul H. Schwendener, Inc. v. Jupiter Elec. Co., Inc., 358 Ill. App. 3d 65, 829 N.E.2d 818, 828, 293 Ill. Dec. 893 (Ill. App. Ct. 2005); Giagnorio v. Emmett C. Torkelson Trust, 292 Ill. App. 3d 318, 686 N.E.2d 42, 46, 226 Ill. Dec. 693 (Ill. App. Ct. 1997); see also Restatement (Second) of Trusts § 2, cmt. b (1959); Restatement (Second) of Trusts § 170 (1959). The fiduciary obligation of loyalty flows from the relationship of the trustee and beneficiary, and the essence of that relationship is that the trustee is charged with equitable duties toward the

beneficiary. Home Federal Sav. & Loan Asso. v. Zarkin, 89 Ill. 2d 232, 432 N.E.2d 841, 845-46, 59 Ill. Dec. 897 (Ill. 1982); Restatement (Second) of Trusts § 164, cmt. h (1959); Matter of Reiman's Estate, 115 Ill. App. 3d 879, 450 N.E.2d 928, 71 Ill. Dec. 240 (1983) ("[A] trust involves not merely a discretionary authority, but a legal relationship whereby the trustee is under a fiduciary obligation to deal with property in accordance with the instructions of the trustor for the benefit of a third party . . ."). So by virtue of the fiduciary relationship between Scanlan and the Trustee, Scanlan acquires the right to bring an action for breach of fiduciary duty. See Parish v. Parish, 29 Ill. 2d 141, 193 N.E.2d 761, 766 (Ill. 1963); Burrows v. Palmer, 5 Ill. 2d 434, 125 N.E.2d 484, 486-87 (Ill. 1955); Restatement (Second) of Trusts § 199 (1959).

Our conclusion in this regard is further supported by trust law that recognizes a beneficiary's standing is not based on an absolute entitlement or a probability of receiving trust assets. The mere fact that a beneficiary may ultimately never receive trust assets does not prevent that beneficiary from bringing a claim. For example, a contingent beneficiary can bring an action against the trustee—even though his interest is remote and contingent—to protect his possible eventual interest, i.e., to protect and preserve the trust res. Barnhart v. Barnhart, 415 Ill. 303, 114 N.E.2d 378, 388 (Ill. 1953). In Illinois, therefore, "a trustee owes the same fiduciary duty to a contingent beneficiary as to one with a vested interest insofar as necessary for the protection of the contingent beneficiary's rights in the trust property." Burrows, 125 N.E.2d at 486-87; see also Shaw v. Weisz, 339 Ill. App. 630, 91 N.E.2d 81, 87 (Ill. App. Ct. 1950).

If a beneficiary who may never receive the trust's assets stands in a fiduciary relationship with the trustee, then so should a beneficiary of a discretionary trust. We see no reason why a beneficiary, simply by virtue of being the beneficiary of discretionary trust, should be denied the ordinary equitable rights that flow from the fiduciary duty that runs from a trustee to a beneficiary. Included in those rights is the right to bring an action for breach of trust.

Goodpasteur v. Fried offers further support. 183 Ill. App. 3d 491, 539 N.E.2d 207, 208, 131 Ill. Dec. 854 (Ill. App. Ct. 1989). In Goodpasteur, one of the beneficiaries of a discretionary trust sought an order requiring the trustee to provide an inventory of trust assets and an accounting of the trust's receipts and disbursements. *Id.* The appellate court rejected the trustees' argument that the discretionary beneficiary should not be able to bring his suit because his interest in the trust was an "expectancy" and the real party concerned was the remainderman. *Id.* at 210.

In reversing the circuit court, the appellate court reasoned:

Plaintiff is a named beneficiary of the trust. . . . It is conceivable that, at the death of the beneficiaries in plaintiff's class, no income or principal will be left to distribute to the [remainderman]. It is incongruous to argue that plaintiff should not be allowed to maintain this action because the [remainderman], which will enjoy the benefits of the trust only if funds are left at the death of plaintiff and beneficiaries in his class, is the party "really concerned." Such a statement implies that defendants have

already decided not to make any payments to plaintiff and the beneficiaries in his class.

We are of the opinion that plaintiff is a beneficiary eligible to have the benefit of income under the trust. As such, plaintiff is entitled to an account showing the receipts, disbursements and inventory of the trust estate. . . .

Id. at 210-11.

Again, no authority requires a discretionary beneficiary to first allege that the trust corpus is insufficient to fund a distribution when bringing a claim for breach of trust. That sort of inquiry has a damages flavor to it, which is a merits, not a standing, question. See Aurora Loan Servs. Inc. v. Craddieth, 442 F.3d 1018, 1024 (7th Cir. 2006) ("The point is not that to establish standing a plaintiff must establish that a right of his has been infringed; that would conflate the issue of standing with the merits of the suit. It is that he must have a colorable claim to such a right.").

The Appellees argue that Illinois trust law and Article III are not coextensive, and the mere fact that a discretionary beneficiary may have a right to sue under state law does not ensure standing. It is true that a standing inquiry does not necessarily end with the determination of a state right to sue. But the Supreme Court stated in Sprint Commc'n Co., L.P. v. APCC Services, Inc. that "history and tradition offer a meaningful guide to the types of cases that Article III empowers federal courts to consider" and that where parties have "long been permitted to bring" the type of suit at issue, it is "well nigh conclusive" that Article III standing exists. 554 U.S. 269, 274-75, 285, 128 S. Ct. 2531, 171 L. Ed. 2d 424 (2008). After carefully reviewing beneficiaries' rights, we determined that beneficiaries—including discretionary beneficiaries—have "long been permitted to bring" suits to redress a trustee's breach of trust.

Moreover, in FMC Corp. v. Boesky, we held that the actual or threatened injury required under Article III can be satisfied solely by virtue of an invasion of a recognized state-law right. 852 F.2d 981, 993 (7th Cir. 1988). In Boesky, FMC brought a claim for wrongful misappropriation and misuse of its confidential business information, which forced FMC to increase its cash distribution to its shareholders under a revised capitalization plan. Id. at 989-90. Finding that the distribution of FMC's assets to the owners of those assets was merely a movement of assets between owners, the district court found there was no injury for purposes of Article III. Id. We reversed the district court and held that the misappropriation of confidential information "constitutes a distinct and palpable injury that is legally cognizable under Article III's case and controversy requirement." Id. Basing our decision, in part, on Warth v. Seldin—which held that injury required by Article III may exist solely by virtue of statutes creating legal rights, the invasion of which creates standing—we concluded that "[t]he same must also be true of legal rights growing out of state law." Boesky, 852 F.2d at 993 (citing Warth v. Seldin, 422 U.S. 490, 498, 95 S. Ct. 2197, 45 L. Ed. 2d 343 (1975)). In fact, we pointed out that if this were not so, "federal courts sitting in diversity could not adjudicate some cases involving only state-law

breach-of-fiduciary claims . . . because some actions for breach of fiduciary duty do not require the plaintiff to show an injury." *Id.*

Here, Scanlan is the beneficiary of several discretionary Trusts, and under those Trusts, she is currently eligible to receive all of the Trusts' corpus. We established that Scanlan, as a beneficiary, is owed a fiduciary duty and that she has an interest in ensuring that the Trustee discharge its duties with fidelity and a certain degree of care. The Trustee and her lawyers, Scanlan claims, breached those fiduciary duties, causing the Trusts' corpus to lose approximately \$200 million. Under these circumstances, the Trustee's and Lawyers' dereliction of their fiduciary duties is a direct invasion of Scanlan's protected interest in the prudent and loyal administration of the Trusts. Scanlan has therefore suffered an injury sufficient to satisfy Article III's case and controversy requirement.

This holding is consistent with the objective of the standing doctrine. As the Supreme Court has explained, the purpose behind the standing doctrine is to ensure that plaintiffs have a "personal stake in the outcome" sufficient to "assure that concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult . . . questions." *Baker v. Carr*, 369 U.S. 186, 204, 82 S. Ct. 691, 7 L. Ed. 2d 663 (1962). The Court has also explained:

[T]he standing inquiry requires careful judicial examination of a complaint's allegations to ascertain whether the particular plaintiff is entitled to an adjudication of the particular claims asserted. Is the injury too abstract, or otherwise not appropriate, to be considered judicially cognizable? Is the line of causation between the illegal conduct and injury too attenuated? Is the prospect of obtaining relief from the injury as a result of a favorable ruling too speculative?

Allen, 468 U.S. at 752.

Scanlan has a "required stake" in her suit; she has a legally protected interest in Trusts' corpus and in the proper administration of that corpus. Her claims against her lawyers and the Trustee are brought to protect that interest and redress her injury by seeking to remove the Trustee, restore the Trusts' corpus, and disgorge attorneys' fees. Scanlan's injury, therefore is not "too abstract." Nor is the relief she seeks too speculative.

The Appellees argue that under some circumstances a discretionary beneficiary's present interest in the trust property—before a trustee has made a distribution—is too attenuated to be considered the beneficiary's property. The Appellees, therefore, urge us to conclude that Scanlan only has an interest in her potential distributions, rather than the Trusts' corpus. It is true that in some circumstances, e.g., for purposes of public aid eligibility and determining the bankruptcy estate, a discretionary beneficiary's interest in the trust assets is too remote to count as property. See, e.g., *Linser v. Office of Attorney Gen.*, 2003 ND 195, 672 N.W.2d 643, 646; *In re Britton*, 300 B.R. 155, 159 (Bankr. D. Conn. 2003); *In re Eley*, 331 B.R. 353, 358 (Bankr. S.D. Ohio 2005). Likewise, in some cases, creditors are prevented from attaching the assets of a discretionary trust and have no remedy against the trustee until the trustee distributes the property.

See, e.g., United States v. O'Shaughnessy, 517 N.W.2d 574, 577 (Minn. 1994); Harker v. Evatt, 140 Ohio St. 346, 44 N.E.2d 355, 357 (1942); Doksansky v. Norwest Bank Neb., N.A., 260 Neb. 100, 615 N.W.2d 104, 106-10 (Neb. 2000); In re Duncan's Will, 80 Misc. 2d 32, 362 N.Y.S.2d 788, 790 (Sur. 1974).

These rules, however, are the result of underlying principles and policy considerations involving restraints on involuntary alienation. Those concerns, which are not present here, are distinct from the equitable principles of trust law at work in this case; namely, a beneficiary's right to hold trustees accountable and ensure that they properly discharge their fiduciary duties when administering trust property. That in some contexts Scanlan's interest in the Trusts' assets may not rise to the level of a "property interest" does not negate the fact that she and the Trustee stand in a fiduciary relationship. The same can be said of her relationship with her attorneys.

We remain unpersuaded that our holding will lead to any beneficiary having standing whether or not its specific interest is affected. Only a beneficiary of a discretionary trust whose rights are "adversely affected" has standing to enforce a trust. In claims for breach of trust, the requirement that a beneficiary of a discretionary trust must plead facts indicating that the diminution in the trust assets had, or will ever have, a probable adverse impact on discretionary distributions is too demanding. Essentially that rule, which the Appellees ask us to adopt, would insulate trustees from suits for breach of trust. For instance, under that reasoning, a trustee could mismanage a trust with impunity, substantially reducing the assets over time, so long as there were enough assets left in the corpus to fund a future distribution. In fact, the larger the trust's corpus, the more likely that could happen. Take the Trusts in this case for example: with nearly \$1 billion in assets, it is hard to imagine that there would ever be a situation in which the corpus would be insufficient to fund Scanlan's "best interests" and "support" distributions. Surprisingly, the Appellees admit this. The Trustee, could, under the Appellees' reasoning, reduce the assets by 90%—to a paltry \$100 million—and still be sheltered from a breach of trust claim.

The Appellees' rule ignores the fiduciary relationship between a beneficiary and a trustee and is practicably unworkable because the question inevitably becomes: at what point is the trust's corpus diminished to such an extent that the trustee can no longer make a future distribution? The Appellees cannot answer this question. Nor can we. Scanlan's standing should not turn on whether her "best interests" and "support" needs, whatever they may be, will be met. The district court, therefore, erred to the extent it concluded that Scanlan lacked Article III standing because she did not suffer an injury in fact.