RECENT DEVELOPMENTS 2009:

SELECTED FEDERAL AND ILLINOIS CASES, RULINGS AND STATUTES

Chicago Estate Planning Council
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PART ONE

RECENT FEDERAL DEVELOPMENTS

1. ADMINISTRATIVE ISSUES.

A. *Inflation Adjustments.*

Rev. Proc. 2009-50, 2009-45 I.R.B. at 617 (November 9, 2009) sets forth the inflation-adjusted figures for exclusions, deductions and credits for 2009. In the estate and gift tax area these figures are the following:

- Annual Exclusion: Remains at $13,000
- Foreign Spouse Annual Exclusion: Increases to $134,000
- §2032A Aggregate Decrease: Remains at $1,000,000
- §6601(j) 2% Amount: Increases to $1,340,000

B. *2009-10 Priority Guidance Plan.*

On November 24, 2009, Treasury and the Internal Revenue Service announced their joint priority guidance plan for 2009-2010. The plan includes the following initiatives:

A. <u>Gifts, Estates and Trusts</u>

1. Regulations under §67 regarding miscellaneous itemized deductions of a trust or estate. Proposed regulations were published on July 27, 2007.
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 under §643 regarding uniform basis rules for trusts.
4. Guidance concerning adjustments to sample charitable trust forms under §664.
5. Revenue ruling regarding the consequences under various income, estate, gift, and generation-skipping transfer tax provisions of using a family owned company as a trustee of a trust. A proposed Rev. Rul. was published on August 4, 2008.
6. Guidance 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.
7. Guidance under §2036 regarding graduated grantor retained annuity trusts (GRATs). Proposed regulations were published on April 30, 2009.

8. Guidance providing procedures for filing and perfecting protective claims for refunds for amounts deductible under §2053.

9. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of administration expenses and claims against the estate.

10. Final regulations under §2053 regarding the extent to which post-death events may be considered in determining the deductible amount of a claim against the estate. Proposed regulations were published on April 23, 2007. Final Regulations were published on October 20, 2009 as TD 9468. See *infra* at page 55.

11. Limited Reexamination of Estate Tax Return Applicable to Certain §2053 Claims for Refunds. Notice 2009-84 was published October 16, 2009 in IRB 2009-44. See *infra* at page 62.

12. 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.

13. Guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership.

14. Final regulations under §7477 regarding declaratory judgment procedures relating to gift tax valuation issues. Final Regulations were published on September 8, 2009 as TD 9460.

15. Final regulations under §7520 updating the mortality based actuarial tables to reflect data compiled from the 2000 census. Temporary and Final Regulations were published May 4, 2009.

16. Guidance on whether a grantor's retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor's gross estate under §2042.

17. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

B. <u>Exempt Organizations</u>

1. Revenue procedure to provide terms for hosts of Cyber Assistant software (which is used to generate Forms 1023 eligible for a reduced user fee).

2. Proposed regulations under §§509 and 4943 regarding the new requirements for supporting organizations, as added by the Pension Protection Act of 2006. Proposed Regulations were published on September 24, 2009 in the Federal Register. Vol. 74, No. 184 at page 48672. See *infra* page 49.

3. Final regulations under §§509 and 4943 regarding the new requirements for supporting organizations, as added by the Pension Protection Act of 2006.

4. Announcement superseding Announcement 2006-93 to request a change in public charity classification. Announcement 2009-62 was published on August 17, 2009 in IRB 2009-33.

5. Notice under §4943, as amended by the Pension Protection Act of 2006, on excess business holdings rules.

6. Guidance under §4944 on program-related investments.

7. Final regulations under §§4965, 6011, and 6033 on excise taxes on prohibited tax shelter transactions and related disclosure requirements. Proposed regulations were published on August 20, 2007.

8. Proposed regulations regarding the new excise taxes on donor advised funds, as added by the Pension Protection Act of 2006.

9. Regulations under §6033 on group returns.

10. Proposed regulations to update regulations under §6104(c) relating to disclosures to state charity agencies for changes made by the Pension Protection Act of 2006.

11. Proposed regulations under §7611 relating to church tax inquiries and examinations. Proposed Regulations were published on August 5, 2009 FR as NPRM REG-112756-09.

12. Final regulations under §7611 relating to church tax inquiries and examinations. Proposed regulations were published on August 5, 2009.

2. VALUATION CASES.

A. Estate of Jorgensen v. Commissioner, T.C. Memo 2009-66; 2009 Tax Ct. Memo LEXIS 73 (March 26, 2009)

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 analysis 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.

COMMENT: The Service had alternately argued that the dual roles of the children, as co-trustees of Ms. Jorgensen's revocable trust (owner of interests in the two partnerships) and as co-general partners, caused the partnership assets to be included in the estate. The Court observed:

> Respondent makes an alternative argument related to the legal effect of Gerald's and Jerry Lou's dual roles as general partners of the partnerships and co trustees of Ms. Jorgensen's revocable trust. Ms. Jorgensen was the sole beneficiary of her revocable trust during her lifetime. Under the trust terms she had access to all trust income and corpus without restriction. Jerry Lou and Gerald, as co trustees, had the duty to administer the trust solely for their mother's benefit. Ms. Jorgensen, through her revocable trust, owned significant interests in JMA-I and JMA-II, whose general partners were Gerald and Jerry Lou.
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> Gerald and Jerry Lou were under a fiduciary obligation to administer the trust assets, including the JMA-I and JMA-II partnership interests, solely for Ms. Jorgensen's benefit; and as general partners of JMA-I and JMA-II, they had express authority to administer the partnership assets at their discretion. Under these circumstances, we also conclude that Ms. Jorgensen retained the use, benefit, and enjoyment of the assets she transferred to the partnerships.

In short, the Court seems to reason that the taxpayer impliedly retained the enjoyment of the transferred property by virtue of having named as general partners the same people who owed the taxpayer fiduciary obligations under the revocable trust. This suggests that one should plan to vest partnership decisions in someone who will not otherwise act in a fiduciary capacity (for example, agent under a power of attorney, or trustee) for the taxpayer.

B. ***Estate of Murphy v. United States*, 2009 U.S. Dist. LEXIS 94923 (W.D. Ark. 2009).**

In Murphy the District Court found that the decedent's formation of a partnership to hold certain "legacy" assets constituted a legitimate non-tax reason for the transfer, and therefore found that the formation was for full and adequate consideration. It is an excellent example of a "good facts" partnership.

Charles H. Murphy, Jr., was a second-generation businessman. As early as 1937 he and his family were involved in forming partnerships in conjunction with the growth of their business. By 1997 Mr. Murphy's "legacy" assets – those he had a keen interest in

preserving for his children and future generations – consisted of his interest in Murphy Oil, a publicly traded company, his interest in a publicly traded company owning farmland and timberland, and his interest in a bank. In addition to wishing to preserve these assets, Mr. Murphy was confronted with the reality that two of his four children did not apparently share his desire to perpetuate family assets; his two sons had dissipated assets that were given to them, because of their spending habits and in one case due to a divorce. Therefore, asset protection was here more than simply a theoretical reason for a partnership.

In 1997 Mr. Murphy decided to form a partnership to hold and preserve the "legacy" assets. He was then 77 years old and in good health. When the partnership formation was discussed, Mr. Murphy's two daughters, who shared his desire to perpetuate family assets, were involved. Moreover, one of the daughters was represented by counsel, and therefore the decedent did not stand on both sides of the transaction. The decedent eventually decided to transfer the "legacy" assets to a partnership which had an LLC as its general partner. Mr. Murphy owned 49% of the LLC and each of the two daughters owned 25.5%. The facts later recited that in a subsequent business decision the daughters disagreed with their father on a partnership matter, and their view prevailed. In short, Mr. Murphy's lack of control was real, not theoretical.

When the partnership was formed, Mr. Murphy invited all four children to make contributions in exchange for limited partner interests. The two daughters contributed assets; the two sons did not. Mr. Murphy contributed about $89 million of assets to the partnership, consisting mostly, but not exclusively, of the "legacy" assets. His contribution represented only about 41% of his net worth. The Court found that at the time of the partnership formation, the assets retained outside of the partnership – approximately $130 million – were sufficient to provide for his living expenses and to pay his estate taxes.

The Court noted that after its creation, the partnership engaged in business operations, purchased and sold assets, hired and managed employees, prepared (monthly) and disseminated (quarterly) financial statements to its partners, filed federal and state tax returns, and maintained its own bank account. The partners met from six to eight times a year to discuss partnership business. The partners respected the partnership as an entity separate and apart from themselves. Mr. Murphy did not commingle any of his personal assets with the assets of the partnership.

The partnership made two distributions during Mr. Murphy's life. The first was a pro rata cash distribution to cover the federal taxes attributable to the partnership's 1998 income. After this distribution, no other cash distributions were made. Rather, the partnership retained all income to repay loans incurred by it to purchase assets, including acreage that was sold by one of the company's whose stock was a "legacy" assets. The only other distribution by the partnership was made in December 2000. It was a distribution made to Mr. Murphy of shares of a company in order to allow it to convert from a "C" corporation to an "S" corporation. As a result of this distribution, Mr. Murphy's limited partner interest was reduced by 0.02875% and the other partners'

ownership percentages were increased in the aggregate by the same percentage. Each partner's capital account in the partnership was adjusted accordingly to reflect the change in ownership percentage.

After Mr. Murphy created the partnership, he engaged in another estate planning transaction that resulted in the transfer of substantial assets to a trust. As a result of this voluntary transfer, and partially as a result of the decline of his remaining assets, when Mr. Murphy died in 2002 his remaining assets were insufficient to fully pay his estate tax liabilities. His executors made up for the deficiency in part through a Graegin loan from the partnership in the amount of $11,040,000.

On audit the Service asserted a deficiency of some $41 million, disallowing discounts on the partnership assets, and challenging the deduction of the full interest on the Graegin note. The District Court found that the formation of the partnership ("MFLP") satisfied the full and adequate consideration test. Regarding *bona fide* sale, the Court stated:

> In this case, the MFLP was created for various purposes, among them to pool the family's Legacy Assets into one entity to be centrally managed in a manner that was consistent with Mr. Murphy's long-term business/investment philosophy. In order to accomplish this goal, Madison [a daughter] has taken an active role in the management of these Legacy Assets, serving on the Board of Directors of each company. The partnership has also purchased and is managing property (Epps Plantation and the Union Building) that is consistent with Mr. Murphy's philosophy of acquiring and maintaining the family's historical assets. This is a legitimate and significant non-tax purpose for creating the MFLP. See Estate of Schutt v. Comm'r, T.C. Memo 2005-126, 89 T.C.M. (CCH) 1353, 1367, 2005 WL 1244686 (2005); Estate of Mirowski v. Comm'r, T.C. Memo 2008-74, 95 T.C.M. (CCH) 1277, 1281, 2008 WL 795017 (2008); Estate of Stone v. Comm'r, T.C. Memo 2003-309, 86 T.C.M. (CCH) 551, 580, 2003 WL 22520101 (2003). Mr. Murphy also retained approximately $ 130 million outside the partnership. Thus, he was not dependant on distributions from the partnership in order to maintain his lifestyle. See Estate of Thompson v. Comm'r, 382 F.3d 367 (3rd Cir. 2004). He also did not treat the partnership's assets as his own and did not commingle his assets with those of the partnership. *Id.* During the formation of the MFLP, Mr. Murphy's two children, Madison and Martha, took an active role, with Martha being represented by her own attorney. Thus, Mr. Murphy was not effectively standing on both sides of the transaction. See Estate of Hillgren v. Comm'r, T.C. Memo 2004-46, 87 T.C.M. (CCH) 1008, 2004 WL 388988 (2004).

The IRS argues that the creation of the MFLP was not for a legitimate non-tax purpose because Mr. Murphy knew of the tax advantages associated with the partnership's creation. However, tax advantages do not "prevent a sale from being

'*bona fide*' if the transaction is otherwise real, actual and genuine." Estate of Kimbell, 371 F.3d at 264. It also argues that the creation of an entity that primarily owned Murphy Oil, Deltic and BancorpSouth stock is not a legitimate non-tax purpose because the stock was to be held long term and was not being actively managed. However, courts have held that entities that have a buy and hold investment strategy offer just as much justification as entities based upon a philosophy that focuses on active trading. Estate of Schutt, 89 T.C.M. at 1367. The Court also does not agree that the MFLP's assets, i.e., the Murphy Oil, Deltic, and BancorpSouth stock, were not actively managed. The evidence is clear that Madison took an active role in the management of Murphy Oil, Deltic and BancorpSouth, by serving on each company's Board of Directors. This active involvement enabled him to ensure the growth and continued success of the MFLP's assets. Thus, the Court finds that Mr. Murphy's transfer of assets to the MFLP was a *bona fide* sale.

The Court also found that the interest incurred on the Graegin note was fully deductible. The Service argued that the interest was not "necessarily" incurred under Section 2053, and therefore not deductible. It argued that the interest was unnecessary because, first, the need for the loan arose due to a voluntary estate planning transaction that Mr. Murphy entered into after the partnership was formed, and second, the estate could have obtained assets other than by a loan (i.e., the partnership could have sold asses and made a distribution). The Court rejected both arguments. As to the first argument, the Court found that the need for the borrowing resulted from an unforeseen decline in the value of the decedent's assets rather than a tax-motivated transfer. As to the second argument, the Court characterized the decision to borrow rather than to sell assets as one grounded in business judgment, which it would not second guess.

COMMENT: The Graegin loan issue in Murphy is interesting from a strategic standpoint. If an estate cannot borrow from a bank (something that seems inordinately difficult in these economic times) then the family partnership may be the only realistic possibility. Borrowing from the partnership on a Graegin basis appears to invite an argument from the Service that the interest in not necessarily incurred. Such a loan may also result in the sale of some of the very assets that the partnership was intended to preserve (in Murphy the partnership sold approximately $13,500,000 of "legacy" assets to fund the loan). On the other hand, if the partnership liquidates assets and makes a partial distribution to enable the estate to meet its tax obligations, the Service would be expected to argue that the distribution-to-pay-estate-tax is a "bad fact" implicating Section 2036. One possible solution is to borrow from the partnership but not on a Graegin basis. Interest would be deductible only as paid and the taxpayer would have to follow a cumbersome process for a protective refund claim.

C. ***Estate of Malkin*, T.C. Memo 2009-212; 2009 Tax Ct. Memo LEXIS 214.**

Malkin involved several issues, two of which concerned (1) application of Section 2036 to a partnership that consisted in part of "legacy" assets, and (2) whether an installment sale of partnership interests would be disregarded, resulting in gift treatment.

Mr. Malkin was the controlling shareholder of Delta & Pine Land Co. ("D&PL") He had 2 children, Jonathan and Melissa, and he hoped to be able to pass shares of his company to them but keep them from selling the shares. Toward that end, in the fall of 1998 he created a FLP ("MFLP") in which he was the sole general partner. He created two trusts, one for each of his children, which he funded with cash gifts of $500,000 each. The trusts also had $25,000 of cash, which nominally appeared to have been loaned to the trust by each child, although it appeared that this amount may have actually originated with the grantor. Malkin contributed shares of his company worth about $16.782 million to MFLP in exchange for his 1% GP and a 98.494% LP interest. Each trust contributed $25,000 for a .253% LP interest. The trusts then each purchased a 44.297 LP interest from Malkin on an installment basis, with the note being a SCIN.

The first payment on the installment note was due on August 31, 1999. The amounts due were not paid until March of 2000, and even then it appeared that the payments were made with moneys Malkin advanced to the trusts. The second payment on the installment notes was due on August 31, 2000. These payments were never made and Malkin died on November 22, 2000.

In 1999, after MFLP was funded with company stock, the partnership pledged most of the shares as collateral for Malkin's personal debt at Bank of America. A year later the pledge was renewed for Malkin's debt with another bank. Malkin guaranteed the partnership's pledge obligation and also promised to pay a guarantee fee of about .75% of the value of the pledge.

In 1999 Malkin was diagnosed with pancreatic cancer. Following this diagnosis, he created a second partnership ("CRFLP"), with himself and two new trusts for his children as partners. He funded the trust with interests he owned in four LLCs, and with other shares of his company. The remaining shares of his company were subject to a pledge agreement for his personal debt. These shares were contributed to the second partnership while remaining subject to the debt. He purportedly assigned partnership interests to the trusts as part of another sale transaction, but this occurred before the trust agreements were actually signed. No payments were ever made on the notes from this second sale transaction.

When Malkin died his probate estate was essentially insolvent. Virtually all of his assets were represented by his 1% GP interest in each partnership, his LP interest in each partnership (he retained about 10% in each partnership) and whatever rights he had with respect to payments under the installment notes.

The Service raised a number of issues on audit. The Service asserted that the DP&L stock was includible in Malkin's estate because of an implied agreement under Section 2036(a)(1) for his retention of the enjoyment of the transferred property. The Service pointed to the pledge of the partnership assets to collateralize Malkin's personal obligation as evidence of the implied agreement. With respect to the second partnership, the Service argued that the funding of the partnership was an indirect gift of

the underlying LLC assets rather than a transfer of partnership interests themselves.

In concluding that there was an implied agreement for the retention of the shares of decedent's company, the Court quoted the Service's summary of this issue:

> Decedent's relationship to his * * * [D&PL shares] never changed. He controlled them before and after the transfer to MFLP and CRFLP. The trusts * * * had no role in the affairs of the partnerships. Neither the trustees nor decedent's children objected to his use of the stock to obtain personal loans. Decedent's unrestricted use of * * * [the D&PL shares] suggests that there was an implied agreement that the * * * transferred [D&PL shares] would be available for decedent's use.

The Court then turned to whether the *bona fide* sale exception would prevent the statute from applying. The Court found that there was no legitimate non-tax reason for the partnerships:

> First, petitioners state that decedent created MFLP "to provide for his children." Although "[l]egitimate nontax purposes are often inextricably interwoven with testamentary objectives", Estate of Bongard v. Commissioner, 124 T.C. at 121, a "'good faith' transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form", Estate of Thompson v. Commissioner, 382 F.3d 367, 383 (3d Cir. 2004), affg. T.C. Memo. 2002-246.
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> Second, petitioners argue that the FLPs (in particular, MFLP) served a business purpose by preventing a sale of any D&PL stock. Yet only decedent transferred D&PL stock to the FLPs. The parties have stipulated that Jonathan Malkin owned at least 479,995 D&PL shares, which he pledged as collateral to secure his father's personal debt. Had decedent wanted to prevent the sale of any D&PL stock his family owned, he would have demanded (or at least requested) that his son contribute his own D&PL stock. He did not. Obviously, decedent did not need the FLPs to control his own D&PL stock; he already controlled it.
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> Third, petitioners argue that decedent created the FLPs to centralize management of the family's wealth--yet decedent contributed all (or almost all 13) the assets the FLPs held. Because there was no pooling of the family's assets in the FLPs, there was no pooled wealth to manage. *See* Estate of Strangi v. Commissioner, T.C. Memo. 2003-145 ("Decedent contributed more than 99 percent of the total property * * * and received back an interest the value of which derived almost exclusively from the assets he had just assigned."). The property the FLPs passively held, i.e.,

> the D&PL stock, was simply decedent's wealth. *See* Estate of Rosen v. Commissioner, T.C. Memo. 2006-115 ("[T]he 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." (*citing* Estate of Thompson v. Commissioner, supra at 380)).[footnotes omitted]

The Court then considered the contribution of the LLC interests to the second partnership. It characterized the sale of the CRFLP partnership interests to the second set of trusts as a “sham” transaction, and held that the transfer of the LLC interests to the partnership was an indirect gift of the interests themselves. The Court reasoned:

> Decedent made indirect gifts to his children when he transferred to CRFLP interests in the Malkin LLCs and subsequently transferred to his children's trusts limited partnership interests in CRFLP. The gifts were of the interests in the Malkin LLCs, not of the limited partnership interests.
>
> a. Indirect Gifts and Shepherd v. Commissioner
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> The facts here are analogous to those of Shepherd v. Commissioner, 115 T.C. 376 (2000), affd. 283 F.3d 1258 (11th Cir. 2002). In that case, a father (the taxpayer) and his two sons formed a partnership in which the father held a 50-percent partnership interest and each son held a 25-percent partnership interest. *Id.* at 380. On the same day the father signed the partnership agreement, he executed a deed purporting to transfer real property to the partnership. *Id.* at 379, 381. The next day, his sons signed the partnership agreement. *Id.* at 379. We held that, because State law did not recognize a "one-person partnership", the partnership was valid only after the sons signed the partnership agreement. *Id.* at 385. For that reason, the deed of land also was not effective until that second day. *Id.* Because the creation of the partnership preceded the effectiveness of the deed, the sons acquired interests in the real property by virtue of their status as partners of the partnership. *Id.* at 387. Because the taxpayer's contribution of the property was allocated to his and his sons' capital accounts according to their respective partnership shares, we held that the taxpayer's transfer of real property to the partnership was an indirect gift to each son of an undivided 25-percent interest in that real property. *Id.* at 389.
>
> The facts here are indistinguishable. On February 29, 2000, decedent and the trustees of the CRFLP trusts signed the CRFLP partnership agreement. That same day decedent (1) transferred his interests in the Malkin LLCs to CRFLP in return for all 100,000 partnership units, and (2) assigned 44,500 CRFLP limited partnership units to each CRFLP trust. On March 1, 2000, decedent established the CRFLP trusts. Because Mississippi State law does not recognize a one-person partnership, CRFLP was valid only after the formation of the trusts. *See* Miss. Code

Ann. sec. 79-14-101(10) (West Supp. 2008) ("'Limited partnership' * * * [means] a partnership formed by two * * * or more persons under the laws of this state".). Only after CRFLP was validly formed on March 1, 2000, could decedent transfer his interests in the Malkin LLCs to it. Thus, at the time of that transfer, the CRFLP trusts were already limited partners, and they acquired interests in the Malkin LLCs by virtue of their status as limited partners.

There is one difference between these cases and Shepherd. Petitioners argue that the CRFLP trusts purchased the limited partnership interests for their fair market value and thus that decedent made an indirect gift of neither limited partnership interests nor interests in the Malkin LLCs. We disagree with petitioners because we find that decedent's purported sale of limited partnership interests was a sham.

b. The Sham Sale of CRFLP Partnership Interests

On March 1, 2000, each CRFLP trust entered into a contract with decedent for the purchase of 44,500 CRFLP limited partnership units for $ 400,500. The terms of the contracts were similar; both called for a downpayment of approximately 10 percent and for a 9-year promissory note, at interest of 6.8 percent, for the balance. About a week after the signing of the contracts, decedent transferred $ 40,525 to each CRFLP trust. Two days after those transfers, each trust transferred $ 40,500 to decedent as the 10-percent downpayment for the CRFLP limited partnership units. The CRFLP trusts never paid any interest on the promissory notes; decedent died before the first payment became due, and the estate never made any demand.

Decedent's purported sale of CRFLP limited partnership interests was a sham. At the time decedent and the trusts executed the contracts, decedent was terminally ill. Decedent provided all the money for the 10-percent downpayments; in effect, the notes constituted the only consideration the trusts gave decedent. Both children, however, could have paid a $ 40,500 downpayment: Petitioners offer evidence that, as of December 31, 1999, Melissa Malkin had a net worth of more than $ 2,300,000, and Jonathan Malkin testified he was worth more than $ 22 million. Petitioners do not explain how decedent's actions comported with an arm's-length sale. Moreover, petitioners offer no evidence, beyond the self-serving testimony of decedent's children, that decedent expected the trusts (or his children) to pay the promissory notes. Given that decedent gave his children the money to pay the interest on the MFLP SCINs, we find their testimony as to the CRFLP promissory notes unconvincing. Petitioners offer no explanation for decedent's actions other than his generosity and a donative intent. Those are motivations for a gift, however, not a sale.

> Petitioners also do not explain the estate's failure to demand payment on the promissory notes. Jonathan Malkin testified that, although he expected his trust to pay the interest and did not expect himself to pay it, he had "sufficient business knowledge" to know that "if the interest isn't paid, the transaction doesn't hold." We agree. [footnotes omitted]

COMMENT: Although Malkin also concerned “legacy” assets, unlike Murphy, the decedent acted as the sole general partner, personally benefitted from a pledge of partnership assets, and left his estate virtually insolvent after the funding of the partnerships. These facts are bad enough by themselves, but become even worse against the backdrop of the sloppy administration of the legal relationships. If Murphy stands as an example of how legacy assets might be preserved via a family limited partnership, Malkin surely stands as an example of what not to do.

D. ***Estate of Miller, T.C. Memo 2009-119 (2009).***

Mrs. Miller died on May 28, 2003. Her husband had predeceased her. For the 26 years between his retirement as an architect and his death, Mrs. Miller’s husband engaged primarily in research and investing in securities. He adhered to a methodology of investing called “charting,” which requires one to analyze stocks based on the daily high and low of trading values. Mr. Miller kept handwritten records of these high and low values. He taught one of his four children – Virgil G. Miller – to chart stocks in this manner.

When Mr. Miller died his estate claimed a QTIP marital deduction for property that passed to a trust for Mrs. Miller that qualified for QTIP. Despite the requirement that the trust pay all of its income to Mrs. Miller annually, the trust accumulated income and never made any distributions to Mrs. Miller.

In November of 2001, after Mr. Miller’s death and when Mrs. Miller was 86 years old, a FLP was created by filing appropriate papers with the Indiana Secretary of State. The GP of the FLP was the son Virgil, and the LPs were Mrs. Miller (through her revocable living trust), and her four children. The partnership agreement was not signed until some time after February 8, 2002, and certificates representing partnership interests were not issued until late March, 2002. The stated purpose of the partnership centered on investment activity.

Certificates representing limited partnership interests were issued in March, 2002, indicating that Mrs. Miller, through her living trust, owned a 92% LP interest, that Virgil owned a 1% GP interest and a 1% LP interest, and that Mrs. Miller’s other three children each owned a 2% LP interest. The court believed that when the partnership was formed Mrs. Miller was in general good health, subject to conditions and ailments common to older persons.

The first contribution to the partnership was made in April, 2002. 100% of the assets of the FLP were contributed by Mrs. Miller, totaling about $4,000,000. Therefore, Mrs. Miller's contribution constituted a gift to her children since they contributed nothing for their 2% interests. The contributed assets comprised about 77% of Mrs. Miller's net worth. Shortly after the contribution, the FLP transferred assets back to Mrs. Miller's securities accounts in order to satisfy margin debt that existed on these accounts at the time of the funding of the partnership.

Although the FLP was not funded until April of 2002, the GP authorized the appraisal of the FLP for gift tax purposes using a valuation date of December 31, 2001. The appraiser valued the FLP on the basis of assets Virgil told him *would be* contributed to the FLP. The appraiser assigned a 35% discount.

Virgil, the GP, continued his father's practice of "charting" stocks and claimed to work 40 hours a week on behalf of the partnership, although his trading activity was not very great.

About a year after the initial funding, Mrs. Miller fell and suffered a broken hip. During her hospitalization she also suffered from heart problems. When it became apparent that her illness was serious and perhaps life threatening, additional funds were transferred to the partnership on her behalf. She died about 2 weeks after the second set of transfers.

Mrs. Miller's estate tax return claimed substantial discounts for the partnership interests. Due in part to the second set of transfers, Mrs. Miller's assets outside the partnership were insufficient to pay the estate tax liability, and there was a distribution from the partnership to the partners to enable her estate to make these payments. The estate tax return also disclosed the existence of the QTIP trust created by the decedent's husband, but did not include it in the decedent's estate.

On audit, the Service disallowed the discounts and assessed additional tax on the basis that (1) the QTIP property was a taxable asset, and (2) the partnership property was includible in the decedent's estate under Section 2036. The Service argued that the "bad facts" supporting the application of Section 2036 were the following:

(1) The partnership's lack of a functioning business operation;

(2) The delay in making contributions to the partnership after the partnership was formed and the partnership agreement was signed;

(3) The type of assets transferred;

(4) The decedent's age;

(5) That decedent stood on both sides of the transaction;

(6) Decedent's failure to retain sufficient assets outside of the partnership; and

(7) The stated reason for the partnership's formation.

The taxpayer first argued that the QTIP property should not be includible in the decedent's estate because she enjoyed no benefit from the trust and she "refuted" the trust during her lifetime. The Tax Court noted that the husband's estate elected QTIP treatment for the trust and that there was no evidence presented that Mrs. Miller ever income was irrelevant to the question of whether she was entitled to it. The Tax Court found that the assets of the QTIP were includible in the decedent's estate.

Regarding the partnership issues, the Tax Court concluded that the first set of transfers to the partnership met the bona-fide sale test, but that the second set (the ones done shortly before death) did not. As to the first set of transfers, the Court found that the decedent had a legitimate and substantial non-tax business reason for forming the partnership. Citing Estate of Mirowski v. Commissioner, T.C. Memo 2008-74 and Estate of Schutt v. Commissioner, T.C. Memo. 2005-126, the Court noted that the decedent established and funded the partnership to ensure that her assets would continue to be managed according to her late husband's investment philosophy. The Court found that Virgil, the general partner, actively managed the property, charted stocks on a daily basis, and communicated with his siblings about partnership matters. The Court also found that Mrs. Miller retained sufficient assets outside of the partnership to pay her living expenses. The Court was not troubled by the partnership's payment of the margin account balances; it noted that it was stocks that caused the margin debt and it was stocks that were used to pay it.

The Tax Court believed that the 2003 transfers represented a different issue. Here the assets were contributed shortly before Mrs. Miller's death, for no apparent reason other than to obtain a discount. Mrs. Miller was in poor health, and the transfers did not leave her estate with enough funds to pay her estate tax. The transfers in 2003 were not motivated by the desire to perpetuate the "charting" investment philosophy of her late husband; had that been the case, the funds could have been transferred the year before with the other assets. In short, the Tax Court believed that the 2003 transfers lacked a legitimate and substantial non-tax business reason and therefore the *bona-fide* sale portion of the consideration furnished test could not be met.

E. ***Keller v. United States, 2009-2 U.S. Tax Cas. (CCH) P60,579 (S.D. Tex., 2009).***

Mr. Williams died in 1999. Shortly after his death, his widow, Mrs. Williams, began to discuss various financial strategies with the family's long-time financial advisors, Keller & Company. Keller & Company recommended the creation of various family limited partnerships to hold the family's substantial real estate, mineral and financial holdings. In its findings of fact, the Court stated:

It is clear to the Court that the primary purpose of these partnerships was to consolidate and protect family assets for management purposes and to make it easier for these assets to pass from generation to generation. Any estate tax savings that resulted from these partnerships were, in the Court's view, merely incidental. It is, therefore, clear to the Court that the primary purpose of these partnerships was not federal estate tax avoidance, and the actions taken to form these partnerships were not done so to create a disguise gift or sham transaction as those terms are used in estate taxation.

The discussions between Mrs. Williams and her advisors intensified during the summer of 1999, at which time several meetings were held to discuss an Investment partnership. These meetings typically occurred at Mrs. Williams' home and were attended by Mrs. Williams and her advisors from Keller & Company. Occasionally, the group met in the offices of the Keller's accounting firm. The meetings that occurred at the firm's offices (also the Williamses' family offices) were also attended by an associate of one of the Keller's, an accountant. Mrs. Williams' health was declining during this period, but not failing. She was legally blind, but was credibly described as cogent and able to see well enough to read with some difficulty and to sign her name. She was further credibly described by the Kellers as being sharp enough to discuss the details of her plans for the partnership in detail.

Plans were formulated for the creation and funding of an investment partnership to hold approximately $250 million in bonds. After a meeting in September, 1999, Mrs. Williams' attorney was engaged to prepare the partnership documents. Various drafts, edits and redrafts of the partnership agreement went back and forth between the attorney and the advisors, but were not discussed with Mrs. Williams until January, 2000, when she was presented with what the Court termed a "nearly-final" draft.

The plan also called for the creation and funding of a limited liability company, which would act as the general partner of the partnership. The documents for the general partner were also drafted, circulated and revised during the period from September, 1999 to January, 2000.

After the January, 2000 presentation of the partnership documents to Mrs. Williams, several more changes were made, by her request. The attorney and advisors continued to work on the documents through the spring of 2000. In March of 2000 Mrs. Williams was diagnosed with cancer but the doctors did not believe her death was imminent. On May 9, 2000 final papers for the partnership and the general partner were transmitted to one of Mrs. Willams' advisors, who took them to her hospital room. He spent two hours explaining the documents and the changes, and then she signed the papers for the formation of the partnership and the incorporation of the general partner. In this transaction Mrs. Williams was initially the only person whose signature was necessary. The partnership documents included a subscription agreement by which Mrs. Williams agreed to contribute her percentage interest in the total capital of the partnership, but the partnership agreement itself contained blanks on Schedule A for the partners' contributions. The Schedule for the partnership was left blank, according to

the testimony of one of the advisors, because the bonds that were intended to fund the partnership would have to be valued, including accrued interest to the date of funding.

On May 10, 2000, a check was prepared for the funding of the corporate general partner. This check required the signature of Mrs. Williams. On May 11 the incorporation papers for the corporate general partner were filed with the Secretary of State, and the certificate of limited partnership was also filed. Mrs. Williams died on May 15, 2000, before the partnership could be funded, before Mrs. Williams could sign the $300,000 check to fund the corporate general partner, and before tax ID numbers were received for the partnership and the corporation. After Mrs. Williams' death, all the advisors, believing that the partnership had not been formed, ceased to work on the project. In February, 2001, a check for approximately $147,000,000 was tendered to the U.S. Treasury along with an extension request for the filing of the Form 706 for Mrs. Williams' estate.

On May 17, 2001, one of the advisors attended an estate planning seminar and learned of Church v. United States. No. SA-97-CA-0774-OG, 2000 U.S. Dist. LEXIS 714, 2000 WL 206374 (W.D. Tex. Jan. 18, 2000), which held that a family limited partnership had been validly created under Texas law even though not funded as of the decedent's death. After the seminar, the Church case was discussed among the advisors and the Williams family, the family was advised that they should quickly move forward with all of the formalities that had been left undone a year earlier and seek the advice of a tax litigator regarding what effect such efforts might have on the estate tax burden on Mrs. Williams' estate. Mrs. Williams' advisors sprang into action and resumed their efforts with respect to formally establishing the investment partnership. These efforts included the formal recorded transfer of the bonds to the partnership. When the estate filed its Federal Estate Tax Return in August, 2001, it claimed no valuation discounts for the partnership. However, with a view toward preserving the estate's liquidity, the estate borrowed $114 million from the partnership, apparently on a Graegin note, and deducted the interest. The estate later filed a claim for refund, requesting a refund of approximately $40 million due in part to the partnership discounts. The Service disallowed the refund, citing Section 2036, and the taxpayer sued in District Court.

Regarding the formation of the partnership, the Court entered the following conclusions of law:

> 1. Well-established principles of Texas law provide that the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership. Church v. United States, No. SA-97-CA-0774-OG, 2000 U.S. Dist. LEXIS 714, 2000 WL 206374, at *7 (W.D. Tex. Jan. 18, 2000); Biggs v. First Nat'l Bank of Lubbock, 808 S.W. 2d 232, 237 (Tex. App.--El Paso 1991, *writ denied*); King v. Evans, 791 S.W.2d 531, 532 (Tex. App. -- San Antonio 1990, writ denied); Logan v. Logan, 138 Tex. 40, 156 S.W. 2d 507, 512 (Tex. 1941).

2. This is the case whether or not legal or record title to the property has yet been transferred. Church, 2000 U.S. Dist. LEXIS 714, 2000 WL 206374 at 7 (citing Logan, 156 S.W. 2d at 512)); see also Biggs, 808 S.W. 2d at 237 ("Under well-established partnership principles, ownership of property intended to be a partnership asset is not determined by legal title."). Specifically, the failure to affect an internal change to the Vanguard accounts prior to Mrs. Williams' passing was not necessary to make the Community Property Bonds property of the Partnership. Mrs. Williams' advisors' failure to finalize the Partnership documentation immediately following Mrs. Williams' death also does nothing to alter the legal effect of her intent that the Community Property Bonds be transferred to the Partnership. See Succession of McCord v. Commissioner, 461 F.3d 614, 626 (5th Cir. 2006); Estate of Smith v. United States, 198 F.3d 515, 521 (5th Cir. 1999).

3. Moreover, Mrs. Williams was obligated to fund the general partner and assign her stock to Ann Harithas, Michael Anderson, and Steve Anderson. See TEX. BUS. & COM. CODE ANN. § 8.113; Neyland v. Brammer, 73 S.W. 2d 884, 888 (Tex. Civ. App.--Galveston 1993); see also Cardwell v. Sicola-Cardwell, 978 S.W. 2d 722, 726 (Tex. Civ. App.--Austin 1998) "[C]ontractual obligations generally survive the death of a party and bind his estate if the contract is capable of being performed by the estate representatives.").

4. Because Plaintiffs have established that Mrs. Williams intended to transfer the Community Property Bonds to the Partnership at the time she signed the Partnership Agreement, and that the Partnership was a valid Texas limited partnership before Mrs. Williams' death, the assets are considered partnership property before her passing, and Mrs. Williams' estate may be able to obtain a refund for taxes paid. *See* I.R.C. §§ 2033, 7701(a)(2).

The Service argued that Sections 2036 and 2038 should apply to cause the underlying assets of the partnership to be includible in the decedent's estate, rather than the value of the partnership interests themselves. The Court's entire discussion [footnores omitted] of these points, and its conclusions of law, are:

19. Neither Section applies, however, if the transfer is a "*bona fide* sale for an adequate and full consideration in money or money's worth." Strangi v. Commissioner, 417 F.3d 468, 478 (5th Cir. 2005); Kimbell v. United States, 371 F.3d 257, 261 (5th Cir. 2004). The determination as to whether a transfer is a *bona fide* sale is an entirely objective inquiry. Kimbell, 371 F.3d at 263-64.

20. A "*bona fide* sale" is a sale that, rather than being a disguised gift or sham transaction, is one made in good faith. Kimbell, 371 F.3d at 263

(citing Wheeler v. United States, 116 F.3d 749, 767 (5th Cir. 1997) and 26 C.F.R. §§ 20.2036-1(a) & 20.2043-1(a)). However, if the transaction is motivated solely by potential tax advantage and without a business purpose, the transaction is ignored for tax purposes. Kimbell, 371 F.3d at 264. That the transferor retains sufficient assets outside of the partnership to meet his personal needs supports the conclusion that the transfer was affected through a *bona fide* sale. *Id.* at 267. The fact that family members might only make *de minimus* contribution to the partnership does not, in and of itself, require a court to conclude that the transaction was a sham or disguised gift. *Id.* at 268.

21. Mrs. Williams' transfer of the Community Property Bonds to the Partnership was a *bona fide* sale. First, the lengthy discussions that went into creating the Partnership Agreement, which Mrs. Williams signed, provide sufficient objective evidence that the Partnership transaction was "real, actual, genuine, and not feigned." Kimbell, 371 F.3d at 263. Second, the primary purpose underlying the Partnership's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This was accomplished by creating an entity that, by altering the legal relationship between Mrs. Williams and her heirs, could facilitate the administration of significant family assets. In other words, the creation and funding of the Partnership was undertaken for a legitimate business purpose and not the mere "recycling" of wealth. Finally, the fact that Mrs. Williams had a significant collection of assets outside of the Partnership--well over $ 100 million--further supports the conclusion that the transfer was made pursuant to a *bona fide* sale.

22. Courts are to consider a variety of factors when determining whether a transfer is for full and adequate consideration, such as: "(1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts." *Id.* at 266.

23. Mrs. Williams' transfer was made for full and adequate consideration. First, the "Subscription and Acceptance by Limited Partner" portion of the Partnership Agreement provides that the percentage interests of the partners are proportionate to their respective contributions. The Agreement also sets forth the capital accounts in which the contributions of a partner are credited to the respective capital account of the partner. Finally, the Partnership agreement provides that, upon liquidation, the partners are to receive their capital accounts in accordance with their percentage interests.

24. Although the Government relies on Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005), the facts of Strangi are distinguishable from those present here. In Strangi, the Fifth Circuit upheld the tax court's ruling that because the decedent retained enjoyment of the assets transferred to a partnership, the property was properly included in the taxable estate under Section 2036(a). The Strangi court concluded that an implied agreement existed between Strangi and his son-and-law (who possessed power of attorney) that Strangi would retain possession or enjoyment of the property. The circumstantial evidence that led the *Strangi* court to conclude that an implied agreement was in place does not exist here. In *Strangi*, the Court pointed to the fact that *Strangi* transferred almost his entire accumulated wealth to the partnership, relied on partnership funds to satisfy his various post-transfer financial needs, and continued to live at the residence that comprised a portion of the partnership's corpus. Here, Mrs. Williams withheld significant funds in which to comfortably live the remainder of her life and thus had no need to rely on the Partnership's assets. Accordingly, the Court cannot conclude that she retained possession or enjoyment of the Community Property Bonds at issue. The Strangi court also found that the decedent's transfer of assets lacked a substantial non-tax purpose and thus could not be considered a bona-fide sale. As noted above, that is not the case here.

25. Accordingly Sections 2036(a) and 2038(a) do not apply to the transfer of any assets to the Partnership.

COMMENT: Many cases find that the taxpayer standing on both sides of the transaction is evidence of an implied agreement for retention of the transferred property. Here Mrs. Williams was the only person to whom the advisors looked for the structure and completion of the transaction. Instead of finding this a negative, the Texas District Court found two positives:

- First, in applying the *bona fide* sale test, the Court found that these lengthy discussions were evidence that the transaction was “real, actual, genuine, and not feigned."

- Second, because only her signature was required on the papers, when she signed she became subject to a binding commitment to subscribe to the partnership.

The result in Keller – discounts when the partnership was not even funded until a year after the person died – is extraordinary and perhaps should stand as a useful reminder of what can be achieved when facts can be presented in the most favorable light.

F. ***Black v. Commissioner*, 133 T.C. No. 15, 2009 U.S. Tax Ct. LEXIS 35.**

Black involved another buy-and-hold investment strategy with "legacy" assets. Mr. Black was a long-time employee, officer and director of an insurance company that was founded in 1927. His family eventually wound up, as a group, being the second largest shareholder of the company. In 1993 Mr. Black decided to form a family limited partnership, to which shares of the insurance company owned by him, his son, and trusts for his two grandsons would be contributed. The principal non-tax reasons for forming the partnership concerned preserving the family assets from being sold to fund living expenses or to pay creditors.

(1) Mr. Black was concerned over the pressure his son might face to sell insurance company shares. Mr. Black believed that his daughter-in-law was a "lazy" person and feared that if she and his son should divorce an award of property to her might have to be satisfied with company shares. In addition, the daughter-in-law's parents had financial difficulties and Mr. Black feared that the in-laws would persuade the son to sell shares in order to provide financial assistance.

(2) Mr. Black had established trusts for his two grandsons. The corpus of each trust was subject to withdrawal by the grandson ½ at age 25 and the balance at age 30. By 1993 the grandsons were both in their 20s. Neither had ever held a job and Mr. Black was concerned that the grandchildren would withdraw their shares and sell them to fund living expenses, or perhaps would make unwise financial decisions.

When the partnership was formed, Mr. Black left sufficient sources of income outside of the partnership to amply provide for his living expenses. He predeceased his wife, but she died only a few months after him. Mr. Black's estate plan provided for a QTIP marital trust for Mrs. Black, to be funded with a pecuniary amount using date of funding values. Since she died so soon after his death, the QTIP was not funded when she died. Her executor included it in her estate at the pecuniary value and assumed that it would be funded with partnership interests valued as of the date of her death.

When the wife died, there also were significant estate taxes due. The wife's estate attempted to borrow funds from commercial or investment banks, pledging the insurance company stock as collateral. None of the prospective lenders wished to take a partnership interest as collateral, unless the insurance company stock was subject to possible sale if its price dropped below certain levels. The estate did not wish to agree to this, because there was some discord within the family of the largest shareholder and it was feared that this discord could affect the stock value.

Lacking a commercial lender, Mrs. Black's estate turned to the FLP and arranged for a Graegin loan. The FLP was able to raise cash by selling some of its insurance company stock, and it used the cash proceeds for the Graegin loan that called for a balloon payment of all principal and interest due in four years. The note prohibited pre-payment. Mrs. Black's estate deducted the full amount of the interest due under the arrangement..

The Service challenged the discounted values of the FLP in both the estates of Mr. and Mrs. Black under the adequate consideration/*bona fide* sale exception to Section 2036, argued that the amount of FLP interests necessary to fund the pecuniary QTIP should be valued as of Mr. Black's death, rather than Mrs. Black's death, and sought to deny the lump-sum interest deduction for the Graegin loan because the interest was not "necessarily" incurred. Calculating the funding as of Mr. Black's death would, in effect, treat the QTIP as if it were a fractional gift, since the trust would then reflect, as of Mrs. Black's subsequent death, a portion of the significant appreciation in the insurance company stock that occurred in the short period between the two deaths.

Regarding the 2036 issue, the Service believed that because the partnership was not an operating business, the Court should find that there was no significant non-tax reason for the entity. The Court found that a family limited partnership that does not conduct an active trade or business may nonetheless be formed for a legitimate and significant nontax reason. Here, the decedent's concern regarding the preservation of the insurance company stock was both legitimate and significant. The Court also found that the partnership provided benefits that could not otherwise be realized. For example, the Service argued that the FLP provided no greater protection for the son's inheritance in a potential divorce proceeding than the state-law characterization of inherited property as non-marital. However, the Court pointed out that non-marital property, if owned by the son, could be sold to satisfy an award of marital property to the wife, if other liquid assets were insufficient. Putting the shares in a partnership would prevent their sale.

Regarding the funding of the QTIP trust, the Court agreed with Mrs. Black's estate that the QTIP trust should be valued as of the date of Mrs. Black's death:

> Had Mrs. Black lived long enough to allow for the funding of her marital trust, then, as required by the terms of the revocable trust, that funding would have been accomplished with a class B limited partnership interest in Black LP the size of which would have been determined with reference to its fair market value on the date of distribution from the revocable trust to the marital trust. There is no reason to apply a different rule to a deemed distribution of that interest to the marital trust. The issue is what date, after Mr. Black's death, to choose. Because the marital trust was to terminate upon Mrs. Black's death, that is the last possible date on which it could have been funded. We agree with petitioner that to pick that date, which is the date closest to what would have been the actual date of the distribution to the marital trust had Mrs. Black survived, as the deemed date of funding is logical and reasonable.

Finally, the Court disallowed the deduction for the balloon amount of interest on the Graegin loan because the balloon payment of interest was not necessarily incurred:

We find that the $ 71 million loan from Black LP to Mrs. Black's estate and the revocable trust, and the borrowers' payment of interest thereon, was unnecessary. Therefore the interest is not deductible. *See* sec. 20.2053-3(a), Estate Tax Regs.

The only significant asset in Mrs. Black's estate was the Black LP partnership interest to be transferred from the revocable trust to the marital trust. Between 1994 and 2001, Black LP's total income was less than $ 28 million, and its total distributions to partners were less than $ 26 million. Even assuming equivalent income and distributions to partners between February 25, 2003, the date of the loan, and November 30, 2007, the purported due date for repayment of the loan, timely repayment by the borrowers of the $ 71 million loan principal out of partnership distributions (derived almost entirely from dividends on Black LP's Erie stock) was, on the date of the loan, inconceivable. Thus, the borrowers knew (or should have known) that, on the loan date, payment of the promissory note, according to its terms, could not occur without resort to Black LP's Erie stock attributable to the borrowers' class B limited partnership interests in Black LP.

Petitioner argues that the borrowers had no right under the partnership agreement to require a distribution to them of assets (i.e., Erie stock) either as part of a pro rata distribution to partners or in partial redemption of their partnership interests. But the partnership agreement provided for the modification thereof, and a modification permitting either a pro rata distribution of Erie stock to the partners or a partial redemption of the borrowers' partnership interests would not have violated petitioner's fiduciary duties, as managing partner, to any of the partners.

Assuming additional sales or pro rata distributions of Erie stock would have been considered undesirable, the only feasible means of repaying the loan by the purported due date of November 30, 2007, would have been for Black LP to make an actual or deemed distribution of Erie stock to the borrowers in partial redemption of their interests in the partnership and for the borrowers to make an actual or deemed return of the stock to Black LP in discharge of the promissory note. That transaction, had it, in fact, occurred, would have demonstrated that the loan was unnecessary because the parties thereto would have been in exactly the same position as they would have been had Black LP used Erie stock to redeem part of the partnership interests of the estate and revocable trust, and, in 2003, to pay the debts of the estate, had they sold that Erie stock (e.g., by means of a secondary offering identical, except for the identity of the seller, to the one that actually occurred). The only distinction between the loan scenario and the partial redemption scenario is that the former gave rise to an immediate estate tax deduction for interest in excess of $ 20 million, offset by a substantially smaller income tax expense (because of the

passthrough of interest income) to the Black LP partners. That the loan scenario, like the partial redemption scenario, required a sale of Erie stock to discharge the debts of Mrs. Black's estate, *i.e.*, that Erie stock was available and actually used for that purpose, negates petitioner's contention that the loan was needed to solve a "liquidity dilemma". The loan structure, in effect, constituted an indirect use of Erie stock to pay the debts of Mrs. Black's estate and accomplished nothing more than a direct use of that stock for the same purpose would have accomplished, except for the substantial estate tax savings. Those circumstances distinguish these cases from the cases on which petitioner relies in which loans from a related, family-owned corporation to the estate were found to be necessary to avoid a forced sale of illiquid assets, *see* Estate of Todd v. Commissioner, 57 T.C. 288 (1971); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477, or to enable the estate to retain the lender's stock for future appreciation, McKee v. Commissioner, T.C. Memo. 1996-362. In none of those cases was there a sale of either the stock or assets of the lender to pay debts of the estate borrower, as occurred in these cases. Moreover, as respondent points out, the principal beneficiary of the estate, petitioner, was also the majority partner in Black LP. Thus, he was on both sides of the transaction, in effect paying interest to himself. As a result, those payments effected no change in his net worth, except for the net tax savings.

COMMENT: Black is a useful reminder that simply arranging for Graegin-like terms will not be sufficient to achieve an up-front deduction of all the interest incurred when funds are borrowed to pay estate tax. In a FLP context, the loan itself may be unnecessary (and therefore no interest would be deductible) when as a practical matter the estate could never repay the loan without a distribution from the partnership.

From the number of recent cases involving Graegin loans it appears that the technique has gained widespread popularity, and may be a factor in selecting an estate for audit. If the taxpayer wishes to minimize audit risk by avoiding the Graegin situation, interest could be deducted by a series of claims for refund – admittedly a cumbersome process, but one that should wind up in approximately the same position. Of course, the danger with a claim for refund is that the Service can raise any issue on the return to offset the refund, even if the statute of limitations has run. Also, deducting interest on a periodic basis would offer no advantage if, as in Black, the loan itself was unnecessary to begin with.

G. ***Pierre v. Commissioner, 133 T.C. No. 2 (2009), 2009 U.S. Tax Ct. LEXIS 21.***

Pierre considered the effect of the check-the-box regulations on the federal gift tax. On July 13, 2000, the taxpayer organized a single-member limited liability company under New York law, called the Pierre Family LLC ("Pierre LLC"). All of the formalities regarding the creation of the LLC were respected and there was no question as to

whether or not Pierre LLC was validly formed under New York law. The taxpayer did not elect to treat Pierre LLC as a corporation for Federal tax purposes by filing a Form 8832, Entity Classification Election, and therefore filed no corporate return for Pierre LLC. Since the taxpayer was the sole member of Pierre LLC, under the federal tax regulations the entity was disregarded "for federal tax purposes."

On July 24, 2000, the taxpayer created two irrevocable grantor trusts, one for her son, and the other for her granddaughter. On September 15, 2000, the taxpayer transferred $ 4.25 million in cash and marketable securities to Pierre LLC. Twelve days later, on September 27, 2000, the taxpayer transferred her entire interest in Pierre LLC to the trusts. She first gave a 9.5-percent membership interest in Pierre LLC to each of the trusts to use a portion of her then-available gift tax credit amount and her GST exemption. She then sold each of the trusts a 40.5-percent membership interest in exchange for a secured promissory note. The LLC interests were subject to substantial discounts for purposes of the gift and the installment sale. On the audit of the taxpayer's gift tax return, the Commissioner disallowed any discount for the LLC interests, and assessed tax on the basis of the full value of the underlying assets, less the value of the installment notes that the taxpayer had received from the sale to the grantor trusts.

In a full Tax Court opinion, a majority of the Tax Court held that the check-the-box regulations could not be interpreted so as to ignore the state-law characteristics of the entity for federal gift tax purposes. Judge Wells, writing for the majority, began his analysis with a review of the historical method of valuing gifts, and the interplay between federal and state law. The opinion noted that a fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights. The majority observed:

> Pursuant to New York law petitioner did not have a property interest in the underlying assets of Pierre LLC, which is recognized under New York law as an entity separate and apart from its members. N.Y. Ltd. Liab. Co. Law sec. 601. Accordingly, there was no State law "legal interest or right" in those assets for Federal law to designate as taxable, and Federal law could not create a property right in those assets. Consequently, pursuant to the historical Federal gift tax valuation regime, petitioner's gift tax liability is determined by the value of the transferred interests in Pierre LLC, not by a hypothetical transfer of the underlying assets of Pierre LLC.

The majority opinion then considered whether the check-the-box regulations altered this historical approach to transfer tax value. Treas. Reg. § 7701-3(b) states that unless the entity elects otherwise, if it has a single owner it will be disregarded as separate from its owner. The regulations under Section 7701 by their terms apply for "federal tax purposes" without any further limiting language; however, the regulations are replete with the word "classification" when describing their effect.

The majority distinguished between the “classification” of an entity under the check-the-box regulations from the determination of the gift tax value of a gift of an entity interest:

> There is no question that the phrase "for federal tax purposes" was intended to cover the classification of an entity for Federal tax purposes, as the check-the-box regulations were designed to avoid many difficult problems largely associated with the classification of an entity as either a partnership or a corporation; *i.e.*, whether it should be taxed as a pass-through entity or as a separately taxed entity. Simplification of Entity Classification Rules, 61 Fed. Reg. 21989-21990 (May 13, 1996). The question before us now is whether the check-the-box regulations require us to disregard a single-member LLC, validly formed under State law, in deciding how to value and tax a donor's transfer of an ownership interest in the LLC under the Federal gift tax regime described above.
>
> * * * * * * * * * * *
>
> The multistep process of determining the nature and amount of a gift and the resulting gift tax under the Federal gift tax provisions described above, *i.e.*, (1) the determination under State law of the property interest that the donor transferred, (2) the determination of the fair market value of the transferred property interest and the amount of the transfer to be taxed, and (3) the calculation of the Federal gift tax due on the transfer, is longstanding and well established. Neither the check-the-box regulations nor the cases cited by respondent support or compel a conclusion that the existence of an entity validly formed under applicable State law must be ignored in determining how the transfer of a property interest in that entity is taxed under Federal gift tax provisions.
>
> While we accept that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes, *i.e.*, as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond classifying the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (*i.e.*, how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (*i.e.,* whether an LLC should be taxed as a separate entity or disregarded

> so that the tax on its operations is borne by its owner). To conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court. See sec. 7701. [footnotes omitted].

The majority noted that in chapter 14 of the Code Congress has enacted a valuation method that departs from the traditional "willing seller/willing buyer" regime. By contrast, however, Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. The majority concluded:

> In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.

Nine judges, including Judge Cohen, who wrote a concurring opinion, agreed with Judge Wells. Five judges dissented from the decision, and two (Judges Halpern and Kroupa) wrote dissenting opinions.

COMMENT: Thoughtful planning should avoid the issue in Pierre. Prior to the gift or sale, a third person could contribute cash or property to the partnership. The contribution would terminate the treatment of the LLC as a disregarded entity.

H. Linton v. United States, __ F. Supp. ___ (W.D. Wash., 2009), 2009 WL 1913255.

Linton is another "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.

One of the interesting facts of this case concerned the self-executing nature of the trusts and the assignments. The trusts indicated that at the time of the signing of the agreement the grantors had assigned FLP interests to the trusts, receipt of which the trustee acknowledged. The assignments indicated that the trusts were dated on the same date of the assignments.

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

In Linton the District Court found that the step transaction applied under all three iterations of the doctrine. In so finding, the Court seemed to misapply at least two of the iterations, and since this part of its opinion may be *dicta* it is hoped that its opinion is an aberration that will not have any future value to the Service. Nevertheless, one can expect to see these arguments raised in audits.

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. Whether or not the Court correctly or logically applied the test here is probably irrelevant to the fact that if the proper sequence of formation, funding and gifting is observed, with a reasonable "cure" period between funding the LLC and

making the gifts, there should never be a "binding commitment" to make a later gift just because a taxpayer forms a partnership. There simply is no legal relationship whereby one step requires another.

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

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

Finally, the 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.

COMMENT: At the 2010 Miami Institute, Jeffrey Pennell likened the step transaction doctrine to a version of the so-called "smell test." He believes that it is pointless to analyze the reasoning of the Court in Linton, because when a transaction "stinks" a Court will find some potential justification for applying the doctrine. Nevertheless, because one can expect these arguments to be raised in future audits, one should be familiar with the problems inherent in the Court's opinion.

I. ***Estate of Litchfield v. Commissioner, Tax Court Memo 2009-21 (January 29, 2009).***

Litchfield concerned the discount for built-in capital gains. The estate included minority interests in two closely held companies. One company – LRC – was formed in 1921 to invest primarily in Iowa farmland. The other company – LSC – invested primarily in marketable securities. LRC had been a "C" corporation for many years but on January 1, 2000 converted to an S corporation. The decedent died on April 17,

2001, well before the expiration of the 10-year period during which sales of property held when the S conversion took place would be subject to corporate income tax.

The Court noted that as of the estate tax valuation date, LRC's $33,174,196 net asset value included $28,762,306 in built-in capital gains, which represented 86.7% of LRC's total net asset value. The built-in gains included $19,789,772, which related to farmland and real property LRC owned and $8,972,534 related to marketable securities LRC owned. As of the valuation date, LSC's $52,824,413 net asset value included $38,984,799 in built-in capital gains, which represented 73.8% of LSC's total net asset value. LSC had always been a C corporation.

With some minor adjustments for the discount for lack of marketability, the Court found the taxpayer's expert evidence more persuasive than the government's. The following represents the discounts claimed by the taxpayer, asserted by the Service on audit, and finally allowed by the Court:

LRC	Taxpayer	IRS	Court
Built-in Gains	17.4%	2%	17.4%
Lack of Control	14.8%	10%	14.8%
Lack of Marketability	36%	18%	25%

LSC	Taxpayer	IRS	Court
Built-in Gains	23.6%	8%	23.6%
Lack of Control	11.9%	5%	11.9%
Lack of Marketability	29.7%	10%	20%

The case is noteworthy for its allowance of a built-in gains discount for an S corporation. In footnote 10 to the opinion, the Court indicated that in this case the discount for both the S company and the C company would not be on a dollar-for-dollar basis:

> In Estate of Jelke v. Commissioner, 507 F.3d at 1331, the U.S. Court of Appeals for the Eleventh Circuit held that -- using the net asset method to value closely held C corporation stock and regardless of whether a sale or liquidation of corporate investment assets was contemplated as of the valuation date -- an assumption, as a matter of law, was appropriate that all corporate investment nonoperating assets would be liquidated on the

> valuation date and therefore that a built-in capital gains tax discount equal to 100 percent of the built-in capital gains taxes that would be due on a sale of the appreciated assets should be allowed. To the same effect see the opinion of the United States Court of Appeals for the Fifth Circuit in Estate of Dunn v. Commissioner, supra at 352-353.
>
> Herein, the estate's expert does not assume that LRC's and LSC's appreciated, nonoperating assets would be sold on the valuation date, and the estate does not ask us to apply a full dollar-for-dollar valuation discount for estimated built-in capital gains taxes. Therefore, we need not decide herein whether such an approach would be appropriate in another case where that argument is made.

Since the appraiser's assumption was that the assets would not be sold on the valuation date, the issue of built-in gains for the S corporation became somewhat more complicated. The decedent died in year 2 of the 10-year period for built-in gains. Although the estate's appraiser did not assume that the assets of the S company would all be sold on the valuation date, he did assume that all would be sold by the end of the remaining 8 year period. In footnote 11 to the opinion, the Court stated:

> Under the estate's expert's turnover estimates for LRC (which we find credible and reasonable on the facts) LRC's assets owned on the valuation date are treated as sold during the period in which LRC will still owe corporate-level taxes on the sale of assets and therefore a built-in capital gains tax discount for LRC is appropriate. The facts herein are unique and not all S corporations will be allowed a built-in capital gains tax discount. See Dallas v. Commissioner, T.C. Memo 2006-212.
>
> Regarding LSC, the estate's expert's calculation of the built-in capital gains tax discount assumed a sale of assets in year 8 for ease of explanation. If the estate's expert had made his capital gains tax calculation using a sale of 12.5 percent of LSC assets in each of years 1 through 8 after the valuation date, his calculation would have been more consistent with his projection of asset turnover (i.e., 12.5 percent of assets sold in each year resulting in a final asset sale in year 8) and also would have resulted in a slightly increased built-in capital gains tax discount. We find no significant flaw in the estate's expert's simplification.

COMMENT: Dallas v. Commissioner, cited by the Court in footnote 11, was not a built-in gains case. Dallas considered, among other issues, whether the earnings of an S corporation should be tax affected in determining the fair market value of the stock. In Dallas the taxpayer's expert assumed that a hypothetical buyer would not continue the S status of the company and therefore adjusted earnings by an assumed income tax rate. The Tax Court in Dallas held that there was insufficient evidence to assume that hypothetical buyers and sellers would tax affect earnings and ignored this computation in arriving at the value of the S stock.

J. *Stone v. United States, 2009 U.S. App. LEXIS 6347 (9th Cir. 2009).*

The Ninth Circuit has affirmed the District Court's decision in Stone, regarding the appropriate discount for a fractional interest in 19 paintings. The taxpayer had claimed a 44% discount for fractional interest. The appraiser could find no market for fractional interests in art, and analogized the discounts in this case to discounts for fractional interests in real estate and partnerships investing in real estate. The District Court found the analogy unpersuasive, allowed a discount of 2% for costs of selling, $50,000 for legal expenses in enforcing a hypothetical seller's right of partition, and directed the parties to confer to work out an agreement for the decrease in value that might be occasioned for the time it would take to sell the art. Stone v. United States, 2007 U.S. Dist. LEXIS 58611. The parties were unable to reach agreement, and the District Court subsequently determined that the over-all discount allowed to the taxpayer was 5%. Stone v. United States, 2007 U.S. Dist. LEXIS 38332 (N.D. Cal., May 25, 2007). The taxpayer appealed.

The taxpayer argued that that the trial court's refusal to accept its expert's real estate and limited partnership data "treated the lack of . . . data [regarding real-world sales of fractional interests in art] as a barrier to valuation" in violation of Bank of California, Nat'l Ass'n v. Commissioner, 133 F.2d 428 (9th Cir. 1943), and its progeny. The Ninth Circuit disagreed, stating that those cases:

> . . . hold only that the absence of a real-world market for a given asset does not make that asset valueless for estate-tax purposes, and that a district court must "assum[e] a hypothetical market" in which the asset could be sold so that it can be valued. Shackleford v. United States, 262 F.3d 1028, 1033 (9th Cir. 2001). The district court did not conclude that the Estate's fractional interest could not be valued or that it was valueless; rather, the district court envisioned a hypothetical market, as our precedents require, and determined a hypothetical fair-market value that reflected a discount. Bank of California and Shackleford's "hypothetical market" rule did not require the district court to accept [the estate's expert's] real-estate and limited-partnership data as sufficient to meet the Estate's burden of proving a discount -- let alone a discount greater than 5%.

3. ANNUAL EXCLUSION.

Price v. Commissioner, T.C. Memo 2010-2; 2010 Tax Ct. Memo LEXIS 2; 99 T.C.M. (CCH) 1005.

Price concerned whether a taxpayer could claim an annual exclusion for gifts of partnership interests. The taxpayers, husband and wife, organized a family limited partnership in which each of them, through their revocable living trusts, owned a 49.5%

limited partner interest. The general partner, a Nebraska corporation, owned a 1% interest. The sole shareholders of the corporation were the husband and wife, again through their revocable trusts.

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

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

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

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

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

1997	None
1998	$ 7,212
1999	$ 343,800
2000	$ 100,500
2001	None
2002	$ 76,824

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

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

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

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

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

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

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

2. The taxpayers next argued that the ability of a limited partner to purchase interests under the partnership agreement, and eventually own enough interests to liquidate the partnership, rendered the transfers present interests. The Court rejected this because it found that the donees were not limited partners, but only assignees, and therefore had no rights other than income rights. Moreover, the Court rejected the idea that a present interest could be founded on future conduct.

3. The taxpayers argued that the ability of a donee to sell the interest to the general partner rendered the gift a present interest. The Court looked behind the general partner and found one of the taxpayers, who engineered the entire series of transactions. It found that the mere ability of a donor to reacquire a gift could not render the gift one of a present interest; otherwise every gift would be so.

4. The taxpayers argued that the Schedules K-1 distributed to the donees enhanced their finances and made them more creditworthy. The Court found no convincing evidence of this, and held that this benefit, even if it existed, was at best highly contingent and speculative and did not constitute a source of substantial economic benefit, particularly in the light of the restrictions on alienation contained in the partnership agreement.

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

The income flow from the long-term real estate leases was sufficient to show that the partnership generated income at or near the time of the gifts, so the first prong of the three-part test was satisfied. However, the taxpayers were unable to establish either of the other two conditions cited by the Court. The partnership agreement provided that income distributions were in the discretion of the general partner, and

therefore the taxpayers could not show that income would flow steadily, or that the income flow could be readily ascertained. The Court observed that the actual distributions did not establish a "steady" income flow because no distributions were made in 1997 and 2001. Furthermore, testimony that the partnership was likely to make annual distributions to permit the partners to cover their income tax liabilities was not sufficient to establish that the donees had any present interest; these distributions were at the discretion of the general partner.

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

4. DEFINED VALUE CLAUSES.

A. ***Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009).**

The Eighth Circuit has affirmed the Tax Court's decision in Christiansen. The Service appealed the taxpayer's use of a defined value clause in a disclaimer. The decedent's only child, Christine, disclaimed the estate above a stated dollar amount. The disclaimed property would pass 75% to a charitable lead trust and 25% to the family foundation (which held the lead interest in the CLT). The Tax Court had found the disclaimer to be ineffective with respect to the transfer to the CLT because the disclaimant had not also disclaimed her remainder interest in the CLT. The Tax Court, however, had held that the disclaimer was effective with respect to the transfer directly to the foundation.

The Service had argued two points before the Tax Court regarding the defined value clause. First, it argued that disclaiming a portion of the estate above a certain amount "as finally determined for federal estate tax purposes" resulted in an extraneous event (namely, an audit) determining the ultimate amount of a charitable deduction. It believed that this condition violated the Treasury Regulations. Second, the Service argued that the defined value clause should be invalidated on policy grounds because it discouraged the enforcement of the federal tax laws. The Service's argument was that if an adjustment to value on audit did not result in additional revenue (due to an increased charitable deduction), there would be no incentive for the Service to perform its duties.

The appeal to the Eighth Circuit was limited to both of the defined value issues that the Service had argued before the Tax Court. The Appellate Court affirmed on both issues. First, the Court pointed out that the reference to values as "finally determined" for federal estate tax purposes was not an event that arose post-death so as to defeat a

charitable bequest; rather, the "transfer" occurred as of death and the only uncertain event was valuation, itself a time-of-death factor. In fact, the Court pointed out, the Service's own Treasury Regulations recognize the need to rely on final values:

> Regarding the first argument, we are unable to accept the Commissioner's interpretation of Treasury Regulation § 20.2055-2(b)(1). The regulation 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. See Treas. Reg. § 20.2055-2(b)(1) ("If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."); see also 26 U.S.C. § 2518(a) (providing that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred); S.D. Codified Laws § 29A-2-801 (b) (same). Here, all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation. The foundation's right to receive twenty-five percent of those amounts in excess of $ 6.35 million was certain.
>
> In pressing his current argument, the Commissioner fails to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death. The Commissioner cites several cases in which courts disallowed deductions because future contingent events might have defeated a transfer or a charitable contribution. See <u>Comm'r v. Sternberger's Estate</u>, 348 U.S. 187, 199, 75 S. Ct. 229, 99 L. Ed. 246, 1955-1 C.B. 450 (1955) (deduction disallowed where bequest to charity was dependent upon testator's daughter dying without descendants); <u>Henslee v. Union Planters</u>, 335 U.S. 595, 600, 69 S. Ct. 290, 93 L. Ed. 259, 1949-1 C.B. 223 (1949) (deduction disallowed where a bequest to charity was the remainder of trust and where the trust's primary beneficiary had the right to invade the trust corpus, therefore making not only the value of the bequest contingent, but making the existence of the charitable bequest non-ascertainable); <u>Bookwalter v. Lamar</u>, 323 F.2d 664, 669-70 (8th Cir. 1963) (marital deduction disallowed where surviving spouse's continued survival was a condition upon disposition of the estate, thus creating "a 'terminable interest' within the meaning of § 2056 of the 1954 [Internal Revenue] Code."). In each cited case, however, the actual contingencies under scrutiny were outside the legal or accounting process of determining a date-of-death value for the estate or an asset. None of these cases stand for the proposition that deductions are to be disallowed if valuations

involve lengthy or disputed appraisal efforts or if the Commissioner's actions in challenging a return result in determination of an adjusted value. As stated by the Tax Court below:

That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future.

In fact, in a different subsection of the regulation, the agency itself recognizes that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" for purposes of qualifying as a guaranteed annuity interest. Treas. Reg. § 20.2055-2(e)(2)(vi)(a). In doing so, the agency expressly uses the above-quoted language to distinguish fixed determinable amounts from fluctuating formulas that depend upon future conditions for their determination. The regulation provides:

An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the decedent's spouse, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed in terms of a fraction or a percentage of the net fair market value, as finally determined for Federal estate tax purposes, of the residue of the estate on the appropriate valuation date, or it may be expressed in terms of a fraction or percentage of the cost of living index on the appropriate valuation date.

Id. (Emphasis added). It seems clear, then, that references to value "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in the present case was the calculation of value to be placed on a right to receive twenty-five percent of the estate in excess of $ 6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the disclaimer was a "qualified disclaimer." 26 U.S.C. § 2518(a). We find no support for the Commissioner's assertion that his challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

As to the second argument, the Court agreed that its decision might result in a lesser incentive to audit, but found that the policy of the Service was to enforce the tax laws, not maximize revenue:

> First, we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws. *See* 26 U.S.C. § 7801 (a)(1) ("[T]he administration and enforcement of [the Tax Code] shall be performed by or under the supervision of the Secretary of the Treasury."); *Id.* § 7803(a)(2) ("The Commissioner shall have such duties and powers as the Secretary may prescribe, including the power to (A) administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party . . . .").
>
> Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations. See 26 U.S.C. § 2055(a)(2); Sternberger's Estate, 348 U.S. at 190 n.3 ("The purpose of the deduction is to encourage gifts to the named uses."). Allowing fixed-dollar-amount partial disclaimers supports this broad policy.
>
> Third, and importantly, even if we were to find a general congressional intent regarding a need to maximize the incentive-to-audit, no corresponding rule of construction would be necessary in the present context to promote accurate reporting of estate values. The Commissioner premises his policy argument on the assumption that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In the present context, however, there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations. *See*, *e.g.*, S.D. Codified Laws § 29A-3-703(a) ("A personal representative is a fiduciary . . . ."); *Id.* § 55-9-5 (providing that the attorney general is the representative of beneficiaries of charitable foundations and has a duty to enforce their rights in court actions); 18 U.S.C. 1001 et seq. (criminalizing various acts of fraud and knowing misrepresentations); Ward v. Lange, 1996 SD 113, 553 N.W.2d 246, 250 (S.D. 1996) ("[T]he fiduciary has a 'duty to act primarily for the

> benefit' of the other.") (quoting High Plains Genetics Research, Inc. v. J K Mill-Iron Ranch, 535 N.W.2d 839, 842 (S.D. 1995)).
>
> In addition, with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate's value. Such beneficiaries, therefore, have an interest in serving a watchdog function. Further, in this case Hamilton was not only the primary beneficiary who made the contested partial disclaimer, she was the executor of the estate and a board member for the foundation. Because she owed a fiduciary obligation to both the estate and the foundation, any self-dealing in this instance would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self dealing. See Ward, 553 N.W.2d at 250; S.D. Codified Laws § 55-9-8 ("The trustee of a trust described in § 55-9-7 shall not engage in any act of self-dealing which would give rise to any liability for the tax imposed by section 4941 (a) of the Internal Revenue Code."); *Id.* § 55-9-7 (defining trusts to include private foundations). In general, and on the specific facts of the present case, then, there are sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner, thereby undercutting the Commissioner's policy-based argument.

B. ***Estate of Petter v. Commissioner*, T.C. Memo 2009-280; 2009 Tax Ct. Memo LEXIS 285.**

Shortly after the Eighth Circuit decided Christiansen, Judge Holmes, who wrote the *en banc* decision for the Tax Court in Christiansen, released his opinion in Estate of Petter v. Commissioner, T.C. Memo 2009-280; 2009 Tax Ct. Memo LEXIS 285. 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.

In rejecting the Service's Proctor argument, the Court stated:

> To reach a reasonable conclusion in this case, we start with two maxims of gift-tax law: A gift is valued as of the time it is completed, and later events are off limits. Ithaca Trust Co. v. United States, 279 U.S. 151, 155, 49 S. Ct. 291, 73 L. Ed. 647, 67 Ct. Cl. 714, 1929-1 C.B. 313 (1929). And gift tax is computed at the value of what the donor gives, not what the donee receives. *Id.*
>
> The Fifth Circuit held in McCord that what the taxpayer had given was a certain amount of property; and that the appraisal and subsequent translation of dollar values (what the donor gave each donee) into fractional interests in the gift (what the donees got) was a later event that a court should not consider. 461 F.3d at 627. In Christiansen, we also found that the later audit did not change what the donor had given, but instead triggered final allocation of the shares that the donees received. 130 T.C. at 15. The distinction is between a donor who gives away a fixed set of rights with uncertain value -- that's Christiansen -- and a donor who tries to take property back -- that's Procter. The Christiansen formula was sufficiently different from the Procter formula that we held it did not raise the same policy problems.

A shorthand for this distinction is that savings clauses are void, but formula clauses are fine. But figuring out what kind of clause is involved in this case depends on understanding just what it was that Anne was giving away. She claims that she gave stock to her children equal in value to her unified credit and gave all the rest to charity. The Commissioner claims that she actually gave a particular number of shares to her children and should be taxed on the basis of their now-agreed value.

Recital C of the gift transfer documents specifies that Anne wanted to transfer "940 Class T [or Class D] Membership Units" in the aggregate; she would not transfer more or fewer regardless of the appraisal value. The gift documents specify that the trusts will take "the number of Units described in Recital C above that equals one-half the * * * applicable exclusion amount allowed by Code Section 2010(c)." The sale documents are more succinct, stating the trusts would take "the number of Units described in Recital C above that equals a value of $ 4,085,190." The plain language of the documents shows that Anne was giving gifts of an ascertainable dollar value of stock; she did not give a specific number of shares or a specific percentage interest in the PFLLC. Much as in Christiansen, the number of shares given to the trusts was set by an appraisal occurring after the date of the gift. This makes the Petter gift more like a Christiansen formula clause than a Procter savings clause.

IV. Public Policy Again

Because this formula clause is not sufficiently similar to that in Procter, we must first ask whether to apply policy arguments at all. As we noted in Christiansen, there is a general public policy in favor of encouraging gifts to charities. *See* United States v. Benedict, 338 U.S. 692, 696-97, 70 S. Ct. 472, 94 L. Ed. 478, 115 Ct. Cl. 839, 1950-1 C.B. 70 (1950). And the facts in this case show charities sticking up for their interests, and not just passively helping a putative donor reduce her tax bill. The foundations here conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests. Perhaps the most important of these was their successful insistence on becoming substituted members in the PFLLC with the same voting rights as all the other members. By ensuring that they became substituted members, rather than mere assignees, the charities made sure that the PFLLC managers owed them fiduciary duties. In McCord, the taxpayers built into the partnership agreement restrictions on charitable interests in the partnership (i.e., limited voting rights and the right of other partners to buy out the charitable interests at any time). 120 T.C. at 362-63. In contrast, Anne's gift made the charities equal members in the PFLLC, giving the charities power to protect their interests through suits for breach of the operating agreement or breach of a manager's fiduciary duties, as well as

through the right to vote on questions such as amending the operating agreement and adding new members. These features leave us confident that this gift was made in good faith and in keeping with Congress's overall policy of encouraging gifts to charities.

As in Christiansen, we find that this gift is not as susceptible to abuse as the Commissioner would have us believe. Although, unlike Christiansen, there is no executor to act as a fiduciary, the terms of this gift made the PFLLC managers themselves fiduciaries for the foundations, meaning that they could effectively police the trusts for shady dealing such as purposely low-ball appraisals leading to misallocated gifts. *See* Wash. Rev. Code Ann. secs. 25.05.165(1), 25.05.170 (West 2005). The directors of the Seattle Foundation and the Kitsap Community Foundation owed fiduciary duties to their organizations to make sure that the appraisal was acceptable before signing off on the gift -- they also had a duty to bring a lawsuit if they later found that the appraisal was wrong. See *Id.* sec. 24.03.127 (West 1986).

We could envision a situation in which a charity would hesitate to sue a living donor, and thus risk losing future donations or the donor's goodwill. However, gifts are irrevocable once completed, and the charities' cause of action most likely would have been against the trusts, rather than against Anne, since the trusts held the additional shares to which the charities laid claim.

The Commissioner himself could revoke the foundations' 501(c)(3) exemptions if he found they were acting in cahoots with a tax-dodging donor. *See, e.g.*, sec. 503(b). And Washington's attorney general is also charged with enforcing charities' rights. *See* Wash. Rev. Code Ann. secs. 11.110.010, 11.110.120 (West 2006). We simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax. We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits. *See* Tellier, 383 U.S. at 694.

Applying the Supreme Court's admonition to the second and third policy concerns in Procter, we find a similar lack of "severe and immediate" threat to public policy. We do not fear that we are passing on a moot case; because of the potential sources of enforcement, we have little doubt that a judgment adjusting the value of each unit will actually trigger a reallocation of the number of units between the trusts and the foundation under the formula clause. So we are not issuing a merely declaratory judgment. [footnotes omitted].

The taxpayer pointed out, and the Court noted, that formula clauses have been accepted within the Code for a variety of other purposes.

The Court also had to consider the effect of the formula clause on the timing of the deduction. The Service argued that the gift could not be taken when made because the amount was not then known. Again the Court rejected this argument:

> . . . Anne made a gift for which, at the time of transfer, the beneficiaries could be named but the measure of their enrichment could not yet be ascertained. The Commissioner is comfortable with this ambiguity when considering whether the gift is completed or not, and states that tax treatment should not change simply because a donee's identity becomes known at a date later than the date of the transfer. By analogy, we see no reason a donor's tax treatment should change based on the later discovery of the true measure of enrichment by each of two named parties, one of whom is a charity. In the end, we find it relevant only that the shares were transferred out of Anne's name and into the names of the intended beneficiaries, even though the initial allocation of a particular number of shares between those beneficiaries later turned out to be incorrect and needed to be fixed.

5. TAXATION OF LIFE INSURANCE CONTRACTS.

The Service issued two revenue rulings in 20009 regarding the income tax consequence of the surrender or transfer by sale of life insurance policies. Portions of the revenue rulings have been subject to widespread criticism.

In **Rev. Rul. 2009-13**, 2009-1 C.B. 1029, the Service posed three situations. In situation 1 A, the owner and insured of a policy, surrenders the policy to the insurance company for the cash value of the policy, $78,000. A’s total premiums were $64,000 and the ruling indicates he had never received a prior distribution nor borrowed any funds from the policy. The ruling states that on surrender, A realized income of $14,000, the difference between his investment in the policy and the proceeds on surrender. See § 72(e), which deals with amounts received under an annuity, endowment or life insurance contract. The entire amount is treated as ordinary income. There is nothing surprising nor controversial about this holding.

In situation 2, A sells the same contract to B, who is unrelated to A and is a person who would suffer no economic loss on A’s death. B pays A $80,000 for the contract. The Service begins it analysis by asserting that §72(e) does not apply to the sale of a life insurance contract to a third person. Relying mainly on a 1934 case, Century Wood Preserving Co. v. Commissioner, 59 F2d 967 (3rd Cir.), the Service asserts that in this situation a life insurance contract has aspects of insurance as well as investment, and therefore the taxpayer’s nominal basis of $64,000 must be reduced by the value of the annual life insurance protection earned and used by the taxpayer. The ruling does not describe how this annual protection is calculated but stipulates this amount to be $10,000. Therefore, on sale the taxpayer realized a gain of $26,000

($80,000 less $54,000). A portion of this gain is ordinary income and a portion of the gain is capital in nature. To separate the portions of the gain the Service applies a doctrine called the "substitute for ordinary income" judicial doctrine, which, so it claims, causes the taxpayer to report as ordinary income the amount of gain that would have been ordinary had the policy been surrendered. Since the taxpayer would have realized $14,000 on surrender of the policy, the Service concludes that of the $26,000 of gain, $14,000 is ordinary and $12,000 is capital.

In situation 3 the policy is a 15-year term policy with a level premium and no cash surrender value. The monthly premium was $500 and through June 15 of the year in issue and the taxpayer had paid an aggregate of $45,000 in premiums. A sells the policy to B, an unrelated third party who would suffer no economic loss on A's death, for $20,000. According to the Service, since the policy was a term policy, it is presumed that, absent proof to the contrary, the monthly cost of the insurance protection was equal to the monthly premium paid. Moreover, the absence of inside build-up of value rendered the "substitute for ordinary income" doctrine inapplicable. Since A sold the policy in the middle of a month, he had $250 of "basis" which had not been recovered, and therefore his gain on the sale was $19,750, all of which was treated as capital gain.

Rev. Rul. 2009-13 states that its holding with respect to situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009.

Rev. Rul. 2009-14, 2009-1 C.B. 1031, also analyzed three situations, all of which focused on the tax consequences to the purchaser of a life insurance contract. In situation 1, B purchased a life insurance contract from A, who was the insured and a U.S. citizen. The ruling states that the contract was issued by a U.S. domestic company, that B is unrelated to A, and that B had no insurable interest in A's life, except for the purchase of the contract.. B purchased the policy with a view to profit. The policy, a level-premium fifteen-year term life insurance contract without cash surrender value, was issued on January 1, 2001, and B purchased the policy from A on June 15, 2008. The monthly premium for the policy was $500, so on the date of purchase there was $250 of unearned premium. B paid $20,000 for the policy, and subsequently paid $9,000 in premiums. On A's death on December 31, 2009, B received $100,000 in proceeds. Since no exception to the transfer for value rule applied to the transaction, the Service ruled that under § 101(a)(2) B could only exclude from income the amount of the actual value of the consideration paid for the transfer. B realized income of $71,000 ($100,000 less basis of $29,000),

Regarding the character of the gain, the ruling states that neither §61(a) nor § 72(e) specifies whether taxable amounts of death benefits received by a transferee for value of a life insurance contract by reason of the death of the insured are treated as ordinary income or capital gain. Although the Service concludes that the policy constitutes a capital asset in B's hands, it concludes that neither the surrender of a life insurance or annuity contract, nor the receipt of a death benefit from the issuer under the terms of the contract, produces a capital gain. Therefore the $71,000 of income is treated as ordinary income.

Situation 2 is the same as situation 1, except that A did not die, and B sold the contract to C, a person unrelated to both A and B, for $30,000. The ruling concludes that B's basis in the contract is the sum of what he paid ($20,000) plus additional premiums which he is allowed to capitalize ($9,000), or a total of $29,000. B is not required to reduce his basis for the cost of insurance charges because he derived no benefit from the annual insurance protection (he was unrelated to the insured and would suffer no economic loss by the insured's death). B's gain was $1,000, and is treated as long-term capital gain.

Situation 3 is the same as situation 1, except that here B is a foreign corporation that is not engaged in a trade or business within the United States, including the trade or business of purchasing or taking assignments of life insurance contracts. The Service ruled that B realizes $71,000 of ordinary income, which is considered U.S. source income, taxable to B under Code Section 881(a).

6. MARITAL DEDUCTION

***Estate of McCoy v. Commissioner*, T.C. Memo 2009-61, 2009 Tax Ct. Memo Lexis 61 (Filed March 19, 2009).**

McCoy concerned the proper amount of the marital deduction when the decedent's estate planning documents were unclear as to how estate taxes should be charged. The decedent's will distributed his personal effects by specific bequest and provided that the "residue" of his estate would pass to his living trust to be disposed of thereunder.

The decedent's living trust contained several references to the residue of the trust estate that made it uncertain whether taxes were to be charged to the recipients of cash legacies. Paragraph 5 of the trust first directed that the trustee shall pay from the "residue of the trust estate prior to any distributions provided for herein" all debts, expenses of administration, and estate taxes. Paragraph 6A of the trust then directed that "after all payments are made pursuant to paragraph 5 above" the trustee would distribute specific bequests to the decedent's children, grandchildren and spouse. Finally, paragraph 6B directed the trustee to retain the "rest, residue and remainder of the trust estate" in a trust qualifying for the marital deduction.

The executor took the position on the estate tax return that the will and trust directed the source of payment (*i.e.*, the trust property before any distributions to the beneficiaries) but did not direct how taxes would be charged among the beneficiaries. The trust was governed by Utah law, which by statute and case law directed that unless the will or trust specifically and clearly directed otherwise, equitable apportionment of taxes would apply. Under equitable apportionment, only dispositions that generate the estate tax liability contribute toward it. Therefore the estate tax return apportioned the taxes to the taxable bequests. On audit the Service asserted that because Paragraph 5

directed taxes to be paid from the "residue," and the residue was, essentially, the marital deduction disposition, all taxes should be charged to the marital trust. This increased taxes by $412,330.

The Tax Court observed that it was impossible to determine what the settlor of the trust meant by the term "residue." The "residue" could mean the probate residue (that is, the amount the trustee received from the executor), or the trust estate after the payment of the Paragraph 5 obligations and the Paragraph 6A gifts. The Utah Supreme Court, in In re Estate of Hufffaker, 641 P.2d 120 (1982), had held that there is a strong policy favoring equitable apportionment, and a direction to the contrary "must be expressed in terms that are specific, clear, and not susceptible of reasonable contrary interpretation." Accordingly, in light of the ambiguity and Huffaker, the Tax Court found that equitable apportionment must apply.

7. CHARITABLE ISSUES.

A. Type III Organizations.

Proposed Regulations have been issued for Type III supporting organizations in the Federal Register, Vol. 74, No. 184 (September 24, 2009).

Background

The Pension Protection Act took aim at so-called "Type III" supporting organizations ("SO"), which are organizations that under Treas. Reg. 1.509(a)-4(f)(2) are operated "in connection with" one or more publicly supported organizations. A Type III SO historically required the least nexus with the organizations it supported. Many SOs were charitable trusts, and in some cases taxpayers were able to engage in business transactions with the supporting organizations, provided that there was no violation of the "excess benefit" rules of Code Section 4958. The Service became concerned about the potential for abuse in these transactions, especially where the SO was subject to little direct oversight by the organization(s) it supported.

In order to qualify as an SO under the regulations, a Type III charitable organization had to meet, among others, two tests, a "responsiveness" test and an "integral part" test. In the case of organizations that were formed as charitable trusts, prior to PPA the responsiveness test was met if the organization was a charitable trust under state law, the supported organization was named in the charitable trust's governing instrument, and the supported organization had the ability to enforce the terms of the trust under state law. There is no requirement that the trustees or directors of the SO be elected by or controlled by the organization(s) supported by the SO.

The integral part test was met if the charitable organization maintained a significant involvement in the operation of one or more publicly supported organizations and such publicly supported organizations were in turn dependent on the SO for the type of

support it provided. The integral part test could be met in two different ways, called the "but for" test and the "attentiveness" test. The "but for" test involved the activities of the SO. The organization could qualify under this prong of the test where the SO performed activities that carried out the purposes or performed the functions of the publicly supported organization and "but for" the involvement of the SO the publicly supported organization would have to perform these activities itself.

The attentiveness test required the SO to make payments that were of such a magnitude as to assure the "attentiveness" of the supported organization to the operations of the SO. The regulations required that the SO pay substantially all of its income (by revenue ruling at least 85%) to for the use of one or more publicly supported organizations, provide enough support to one or more publicly supported organizations to insure the attentiveness of such organizations to the operations of the supporting organization, and pay a substantial amount of the total support of the supporting organization to the supported organizations that met the attentiveness requirement.

The PPA made five changes to these general rules:

(1) It removed the alternative test for charitable trusts as a means of meeting the responsiveness test;

(2) It required the Secretary of the Treasury to set a new payout requirement for organizations that are not functionally integrated (generally, those organizations that met the integral part test by satisfying the attentiveness test under the existing regulations) to ensure that such organizations pay a ''significant amount'' to their supported organizations;

(3) It provided that a Type III supporting organization must annually provide to each of its supported organizations such information as the Secretary may require to ensure that the supporting organization is responsive to the needs or demands of its supported organization(s);

(4) It prohibited a Type III supporting organization from supporting any supported organization not organized in the United States; and

(5) It prohibited a Type I or Type III supporting organization from accepting a gift or contribution from a person who, together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type I or Type III supporting organization.

Proposed Regulations

The proposed regulations provide that an organization cannot qualify as an SO if it accepts any gift or contribution from a person (other than a Section 509(a)(1), (2) or (4)

organization) who directly or indirectly controls the organization that the SO supports. Family members and 35-percent controlled entities are considered when determining direct or indirect control. Prop. Reg. § 1.509(a)-4(f)(5).

Every Type III supporting organization must: satisfy a notification requirement set forth under Prop. Reg. § 1.509(a)–4(i)(2), in addition to meeting the responsiveness and integral part tests. The proposed regulations require that each taxable year, a Type III supporting organization must provide to each of its supported organizations: (A) a written notice addressed to a principal officer of the supported organization identifying the supporting organization and describing the amount and type of support it provided to the supported organization in the past year; (B) a copy of the supporting organization's most recently filed Form 990; and (C) a copy of the supporting organization's governing documents, including any amendments. Copies of governing documents need only be provided once, and all of the documents may be provided by electronic media. Since satisfying the notification requirement is a condition of qualifying as a Type III organization, the organization should retain proof of delivery of these documents. The documents must be postmarked or electronically delivered by the last day of the 5th month after the close of the organization's taxable year.

A Type III supporting organization can meet the responsiveness test in one of three ways. The first two describe parent-subsidiary and brother-sister arrangements for related boards and generally do not apply to charitable trusts, in which the trustees of are typically unrelated to the board of the supported organization. The third test allows an organization to qualify if the officers, directors or trustees of the supporting organization "maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization. Under the Proposed Regulations, with respect to any of these tests the governing body of the supported organization must have a significant voice in the investment policies of the SO, the timing of grants, the manner of making grants, the selection of recipients by the SO, and in otherwise direction the use of the income or assets of the SO. Prop. Reg. § 1.509(a)-4(i)(3)(iii). Two examples are given, one in which representatives of a charitable trust meet quarterly with an officer of a university that the trust supports. The university's projected needs are discussed, together with the ways in which the university would like to use the income and how the university would like the trust to invest its assets. In addition, there is regular communication regarding investments and plans for distributions from the trust. This describes a "close and continuous" relationship. The other example describes a situation where the charitable trust distributes the required documentation and makes annual cash distributions to each of three charities it supports, but otherwise does not meet or communicate with the organizations. Here the trust does not meet the responsiveness test. The Proposed Regulations permit SOs that were in existence before November 20, 1970, to take into account additional facts and circumstances, such as a historic and continuing relationship, in complying with the responsiveness test.

The integral part test was modified for all Type III organizations. PPA amended the Code to distinguish between Type III organizations that are "functionally integrated" and

those that are not. A "functionally integrated" Type III supporting organization is one that is not required to make payments to the organizations it supports, because either it is the parent of each of its supported organizations, or it directly furthers the exempt purposes of the supported organization by performing the activities of, or carrying out the functions of, the publicly supported organization that, but for the involvement of the SO, the supported organization would have to perform or carry out itself. Holding title and managing exempt-use property are activities that directly further the exempt purposes of the supported organization, but fundraising, investing and managing non-exempt-use property, and making grant are not, except in limited circumstances dealing with support of governmental entities. Prop. Reg. 1.509(a)-4(ii), (iii)

Non-functionally integrated Type III organizations are those that meet the integral part test through payments rather than activities. In the Proposed Regulations a non-functionally integrated organization must (1) satisfy a distribution requirement generally equal to 5% of the fair market value of non-exempt-use assets, and (2) satisfy an attentiveness requirement. The distribution requirement is based on the value of the organization's assets in the prior taxable year, and must be distributed by the last day of its current taxable year. For the first taxable year that the SO is treated as non-functionally integrated, its required distribution amount is zero. While the distribution requirements draw on the principles of Section 4942, governing private foundations, they are not the same. No set asides are allowed, although the Proposed Regulations seek comment on whether set asides are necessary and consistent with Congressional intent. Also, the Proposed Regulations reverse the carryover distribution rule of Section 4942 by allowing the SO to treat excess distributions from prior years to be considered first, in a future year, rather than actual distributions in that year. There is a reasonable cause exception to the distribution requirement but it is narrow, pertaining to incorrect valuations, ministerial errors or unforeseen events. Finally, the proposed regulations contain rules regarding what assets are excluded from the computation of the annual distribution requirement, including exempt-use assets, pledges, trusts created and funded by third parties, certain future interests and amounts due but not yet paid from estates.

The Proposed Regulations modify the attentiveness requirement in existing Treas. Reg. § 1.509(a)–4(i)(3)(iii) to provide that an organization must distribute one-third or more of its annual distributable amount to one or more supported organizations that are attentive to the supporting organization and with respect to which the supporting organization meets the responsiveness test under Prop. Reg. § 1.509(a)–4(i)(3).

The Proposed Regulations provide that to demonstrate that a supported organization is attentive, a supporting organization must either: (1) provide 10 percent or more of the supported organization's total support; (2) provide support that is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization; or (3) provide an amount of support that based on all the facts and circumstances is a sufficient part of a supported organization's total support. If the SO makes payments to or for the use of a particular department or school of a university, hospital or church, the total support of the department or school is substituted

for the total support of the organization. A supported organization will not be considered attentive if it holds amount contributed in a donor advised fund. Prop. Reg. § 1.509(a)-4(iii)(C).

The proposed regulations will apply to all taxable years beginning after the date that they are published in the Federal Register as final or temporary regulations.

B. *Transfer Tax Deductions When Charity is Not 501(c)(3).*

PLR 200901023 considered whether gifts to a charitable trust that had not qualified as a tax-exempt entity under Section 501(c)(3) would qualify for the gift tax deduction under Section 2522 and the estate tax deduction under Section 2055. The charitable trust was formed to foster and develop the arts by sponsoring public exhibits of the artistic works of an artist who worked in the United States and a foreign country. The trust would exhibit works anywhere, but principally in the United States and in the foreign country. The trust did not intend to apply for tax-exempt recognition under 501(c)(3). For income tax purposes the trust would be governed by Section 4947(a)(1) as a wholly charitable trust.

Both Section 2522 and Section 2055 deny a deduction to an organization described under Section 508(d)(2) or Section 4948(c)(4). Section 508(d)(2) refers to two types of organizations:

- A private foundation or a trust described in Section 4947(a)(1) that fails to meet the requirements of Section 508(e), relating to the governing instrument requirements for the penalty tax provisions of Section 4942-4945; and
- Any organization in a period when it is not treated as an organization described in Section 501(c)(3) by reason of Section 508(a). Section 508(a) provides that an organization that does not timely apply for tax-exempt recognition shall not be treated as a Section 501(c)(3) organization.

In this case, the charitable trust contained the governing instrument requirements of Section 508(e), so the first point was satisfied. As to the second point, Section 4947(a)(1) and Treas. Reg. §1.508-2(b)(1)(viii) create an exception for a wholly charitable trust. A 4947(a)(1) trust is not required to file for tax-exempt recognition under Section 501(c)(3), and therefore the provisions denying a deduction to an organization that fails to make a timely application do not apply to it.

8. GENERAL INCOME TAX ISSUES.

A. *Income Tax Issues on Vesting of Remainder Interest.*

PLR 200901008 concerned the income tax consequences to the purchaser of a remainder interest when the remainder vests. Under the facts of the ruling, the limited partnerships holding real property sold the property to Buyer 1 and Buyer 2. Buyer 1 purchased a 50-year estate for years and Buyer 2 purchased the remainder. Seller,

Buyer 1 and Buyer 2 were unrelated parties. The questions raised were whether Buyer 2's holding period began on the date of purchase (it did) and whether when the lead interest terminated, Buyer 2 would recognize any income, gain or loss on account of the remainder interest becoming possessory (he would not). The Service ruled that the passage of time would have no effect under Sections 61, 1001 and 1222.

B. *Effect of GST Division on ESBIT.*

Letter Ruling 200913002 concerned the division of a trust that was exempt from the generation-skipping tax into two separate trusts. The division of GST-exempt trusts has been the subject of many letter rulings and is generally approved as a modification of the trust as long as the modification does not shift a beneficial interest in the trust to a beneficiary who is in a younger generation than the persons who held the beneficial interest before the modification, and does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

The interesting twist in this case concerned a modification to ensure that the trust would continue to qualify as an ESBT. The trustees first went to court in order to release their right to make distributions to certain governmental entities under Section 170(c) of the Code. An ESBT election cannot be made if such an entity is a potential current beneficiary.

The trustees obtained court approval for the release of their right to make distributions to the Section 170(c) organizations and subsequently made the ESBT election. Following the release, the beneficiaries of the trust were certain descendants of the settlor, and their spouses. After the election was made, one of the beneficiaries married a resident alien. Under Treas. Reg. §1.1361-1(m)(1)(ii)(D) if a nonresident alien is a "potential current beneficiary" of an ESBT the S company will be treated as having an ineligible shareholder and its S corporation election will terminate. The trustees were fearful that the alien might someday become a non-resident, thereby terminating the S election.

In order to safeguard the S status, the trustees proposed to divide the trust into two Trusts, Trust A and Trust B. Trust A would hold the S company stock and Trust B would hold the other assets. The beneficiaries of the trusts would be the same, but Trust A would provide that no distributions could be made to nonresident alien beneficiaries as long as nonresident aliens are not permissible current beneficiaries of an ESBT or as long as Trust A holds S company stock.

The Service ruled that the proposed division would not cause the new trusts to lose their exemption from the generation-skipping tax, and that Trust A would be eligible as an ESBT.

C. *Disclosure of Statistical Compilations of Anonymous Tax Return Information Under Section 7216*

In Notice 2009–13, 2008 - 6 I.R.B. 447 (February 9, 2009), the Service issued interim guidance regarding disclosure of statistical compilations of anonymous tax return information. The interim guidance provides that tax return preparers may use and disclose, without taxpayer consent, statistical compilations of tax return information to support the tax return preparer's tax return preparation business, but any disclosure of a statistical compilation must be in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. To further ensure anonymity, this interim guidance prohibits the disclosure of statistical compilations with cells containing data from fewer than twenty-five tax returns. Finally, the sale or exchange for value of all or any part of an anonymous statistical compilation is prohibited except if the sale occurs in conjunction with the transfer of assets made pursuant to the sale or other disposition of the tax return preparer's tax return preparation business. The interim guidance continues to prohibit disclosure of anonymous statistical compilations of average refund, credit, or rebate amounts, or a part thereof, for purposes of advertising or marketing.

9. SECTION 2053 DEDUCTIONS

Final Regulations. The Service has published final regulations regarding the estate tax deductions for claims, taxes and expenses of administration. 2009 - 44 I.R.B. at 570. The final regulations depart significantly in several respects from the proposed regulations that were first published in 2007.

The most significant impact of the final regulations is that they reverse a trend that had been emerging in the circuits regarding valuation of claims. Three circuit courts had held that post-death events could not be considered in valuing claims. See O'Neal v. United States, 258 F 3rd 1265 (11th Cir. 2001), McMorris v. Commissioner, 243 F 3rd 1254 (10th Cir. 2001), and Estate of Smith v. Commissioner 198 F 3rd 515 (5th Cir. 1999).

The final regulations provide that with limited exceptions, only amounts actually paid as of the date of filing the federal estate tax return may be deducted. Because the estate tax statute of limitations (§ 6511) cannot be voluntarily extended by agreement, the new rules will create significant problems when there is a contested or unmatured claim in an estate that cannot be determined within the limitations period. This problem will have to be addressed by the taxpayer filing a protective claim for refund.

The final regulations also grant relief to situations wherein a claim or expense that would have been deductible if paid would (because not actually deductible) reduce a marital or charitable deduction. In these cases as long as the executor files a protective claim for refund neither the charitable nor the marital deduction need be reduced until the claim is paid or meets one of the three exceptions to the rule that only paid claims are deductible (see below).

General Requirements of § 20.2053-1

Section 2053(a) allows a deduction for four separate categories of expenses: funeral expenses, administration expenses, claims against the estate, and unpaid mortgages or other indebtedness in respect of property included in the gross estate. The final regulations affect all four categories, not just claims. Treas. Reg. § 20.2053-1(b) has been extensively rewritten after subpart (1). Subpart (2) of that Regulation imposes a *bona fide* requirement as follows:

> (2) *Bona fide* Requirement. (i) In general. Amounts allowed as deductions under section 2053(a) and (b) must be expenses and claims that are *bona fide* in nature. No deduction is permissible to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest) except to the extent the deduction is for a claim that would be allowable as a deduction under section 2055 as a charitable bequest.

Family Claims

Subpart (2) goes on to discuss when a family claim may be considered *bona fide*. The final regulations eliminate the rebuttable presumption contained in the proposed regulations that a claim held by a family member is invalid. Instead, the final regulations recite the following nonexclusive list of factors indicative of the *bona fide* nature of a claim or expense involving a family member:

(A) The transaction underlying the claim or expense occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent;

(B) The nature of the claim or expense in not related to an expectation or claim of inheritance;

(C) The claim or expense originates pursuant to an agreement between the decedent and the family member, related entity, or beneficiary, and the agreement is substantiated with contemporaneous evidence;

(D) Performance by the claimant is pursuant to the terms of an agreement between the decedent and the family member, related entity, or beneficiary and the performance and the agreement can be substantiated.

(E) All amounts paid in satisfaction or settlement of a claim or expense are reported by each party for Federal income and employment tax purposes, to the extent appropriate, in a

manner that is consistent with the reported nature of the claim or expense.

For these purposes "family members" include the spouse of the decedent, the grandparents, parents, siblings, and lineal descendants of the decedent or of the decedent's spouse, and the spouse and lineal descendants of any such grandparent, parent, and sibling. Treas. Reg. § 20.2053-1(b)(iii)(A). Note that the spouses of lineal descendants are not included in this definition.

A "related entity" is an entity in which the decedent, either directly or indirectly, had a beneficial ownership interest at the time of the decedent's death or at any time during the three-year period ending on the decedent's date of death. There are exceptions for interests in publicly owned companies, and closely-held companies if the combined beneficial interest of the decedent and the decedent's family (either direct or indirect) is less than 30% of all beneficial ownership (including voting and non-voting stock, capital and/or profits interests). However, any entity in which the decedent had a managing interest (for example, as the general partner of a partnership) shall be considered a related entity.

Court Orders, Consent Decrees and Settlements

Subpart (3) of Treas. Reg. § 20.2053-1(b) sets forth different standards for deduction depending on whether the expense is approved in a court decree, is the subject of a consent decree, or represents a settlement. The final regulations treat these categories as follows:

Court Decree: If the court of competent jurisdiction over the administration of the estate reviews and approves expenditures for funeral expenses, administration expenses, claims against the estate, or unpaid mortgages as allowable estate expenditures under local law, the executor may rely on the final judicial decision in that matter to determine the amount deductible for estate tax purposes if the following conditions are satisfied:

(A) The expenditures are otherwise deductible under section 2053 and the corresponding regulations;

(B) The court actually passes upon the facts on which deductibility depends and on the merits of the claim (which will be presumed in all cases of active and genuine contest); and

(C) The expenditures have been paid by the estate or will be paid; subject to any applicable limitations contained in Section 20.2053-1 of the regulations.

Consent Decree: An executor may rely on a local court decree rendered by consent to establish the amount deductible under section 2053 under the following conditions:

(A) A court decree is not required under applicable law to determine the amount or allowability of the claim or expense;

(B) The consent resolves a *bona fide* issue in a genuine contest; and

(C) The expenditures have been paid by the estate or will be paid; subject to any applicable limitations contained in Section 20.2053-1 of the regulations.

Settlements: An executor may rely on a settlement to establish the amount deductible under section 2053 for amounts paid if the following conditions are satisfied:

(A) A court decree is not required under applicable law to determine the amount or allowability of the claim or expense;

(B) The settlement resolves a *bona fide* issue in a genuine contest;

(C) The settlement is the product of arm's length negotiations by parties having adverse interests with respect to the claim;

(D) The expenditures have been paid by the estate or will be paid; subject to any applicable limitations contained in Section 20.2053-1 of the regulations.

The requirement of the proposed regulations that the settlement be within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement has been deleted from the final regulations. The deletion resulted from a principle that if the settlement satisfies the criteria for deductiblility (*bona fide* issue in an active and genuine contest, etc.), the Service should not be involved in second-guessing the settlement.

The final regulations account for situations where the cost and delay of litigation would negate the benefit of even a favorable outcome. The final regulations state: "A deduction will not be denied for a settlement amount paid by an estate if the estate can establish that the cost of defending or contesting the claim or expense, or the delay associated with litigating the claim or expense, would impose a higher burden on the estate than the payment of the amount paid to settle the claim or expense." Treas. Reg. § 20.2053-1(b)(3)(iv). Since the statute requires the claim to be enforceable in order to be deductible, payment of an unenforceable claim on the basis of cost of litigation would be nondeductible.

Treas. Reg. § 20.2053-4 has been substantially rewritten to now provide that a deduction for claims against the estate are limited to amounts for legitimate and *bona fide* claims that:

(A) Represent personal obligations of the decedent existing at the time of the decedent's death;

(B) Are enforceable against the decedent's estate at the time of payment; and

(C) Are actually paid by the estate in satisfaction of the claim or meet the requirements for being ascertainable.

A claim that is unmatured on the date of death may be deducted if it later matures and is paid, but no deduction can be taken on the return for an unpaid amount of an unmatured claim. Similarly, no deduction can be taken on the return for a contested claim, unless a portion of the claim falls into the exception for estimated claims. The executor should file a protective claim for refund for claims that cannot be deducted on the return but that may later be deductible.

A special rule governs recurring payments. If an obligation involving a recurring obligation is an enforceable and certain claim, and are not subject to a contingency, the amount of the claim will be deemed "ascertainable" for purposes of the rule for deducting ascertainable amounts (see below). For purposes of this rule, "recurring payments" exclude payments made in connection with a mortgage or indebtedness governed by Treas. Reg. 20.2053-7. If, on the other hand, the decedent's obligation is subject to a contingency, the deduction is limited to amounts actually paid by the estate in satisfaction of the claim. A recurring obligation can be deducted through the purchase of a commercial annuity from an unrelated dealer in an arm's length transaction. Where the obligation to make a recurring payment is contingent on the death or remarriage of the claimant, and the claim otherwise satisfies the requirements for deduction as a recurring payment, the claim will be deemed "ascertainable" in an amount measured by actuarial principles. The regulations illustrate the recurring payment obligation in the context of payments under a divorce decree. Where the decedent or his estate is obligated to make payments to his former spouse, which cease on the former spouse's death or remarriage, the estate may deduct the amount of the claim measured according to actuarial principles. Treas. Reg. § 20.2053-4(d)(7), Example 8.

There are also special rules for claims enforceable against multiple parties. See Treas. Reg. § 20.2053-4(d)(3). If the decedent or the decedent's estate is one of two or more parties against whom the claim is being asserted, the estate may only deduct the portion of the total claim due from and paid by the estate, reduced by the total of any reimbursement received from another party, insurance or otherwise. If the estate could have collected from a third party, but fails to do so, it must reduce its claim by the amount it could have, but failed to collect.

Subsection (d)(1) of Treas. Reg. 20.2053-1 states that in order to take into account events after a decedent's death in determining the amount deductible under section 2053 and the regulations, the deduction of any claim or expense described in subsection (a) "is limited to the total amount actually paid in settlement or satisfaction of that item (subject to any applicable limitations contained in this section)." However, this general prohibition is subject to the following exceptions:

1. **Ascertainable Claims.** A deduction will be allowed for a claim or expense that otherwise satisfies all applicable requirements, even though it is not yet paid, provided that the amount to be paid is ascertainable with reasonable certainty and will be paid. These expenses will most commonly include attorneys' fees and executors' commissions. The regulations state that if the claim or expense is contested or contingent, then the claim or expense cannot be ascertained with reasonable certainty. The final regulations eliminate the provision of the proposed regulations that imposed a duty on the executor to amend a return in order to report amounts that were claimed as deductions but were not actually paid or paid in full. This provision was eliminated from a concern that a duty to amend could not be enforced after the expiration of the period of limitations for assessment. The Service will consider post-death events in connection with an "ascertainable" claim and if it believes that the requirements for deductibility cannot be met, it will disallow the claim. In cases where the claim or expense is not allowed (or allowable) because unpaid, the executor may file a protective claim for refund in order to preserve the benefit of the deduction when paid. (see discussion above).

2. ***Claims and Counterclaims in Related Matters.*** If a claim that is asserted against the estate is "integrally related" to an asset of the gross estate (whether claim, cause of action or other property interest) then the value of the claim can be deducted on the return even if it is not "reasonably ascertainable" as of filing the return. The claim must otherwise satisfy the applicable requirements for deductibility set forth in Treas. Reg. 20.2053-1, must represent a personal obligation of the decedent existing at the time of the decedent's death, must be enforceable against the decedent's estate, and must be subject to adjustment for post-death events. The amount of the deduction is limited to the value of the related asset includible in the estate, and the estate must meet two additional requirements: (1) the value of the claim must be determined by a qualified appraisal of a qualified appraiser under the requirements of § 170, and (2) the aggregate value of the related assets includible in the gross estate must exceed 10% of the value of the gross estate. Again, a claim under this category is subject to post-death events. If the claim is paid during the period of limitations, or meets the requirement for an ascertainable claim, the claimed deduction is subject to adjustment to reflect, and may not exceed, the amount paid or the amount meeting the requirements of an ascertainable claim (i.e., the amount is ascertainable with reasonable certainty and will be paid). If during the period of limitations a claim that was deducted on the Form 706 remains unpaid and is not deductible under the "ascertainable" exception, the claimed deduction is subject to adjustment to reflect, and may not exceed, the current valuation of the claim. A current valuation must include post-death events. Any

amount of a potential claim in excess of deductible amounts is subject to the protective claim for refund provisions.

3. ***$500,000 Exception.*** The third exception to the general rule that only claims that are paid are deductible involves claims that in the aggregate do not exceed $500,000. This exception was added to the final regulations as a result of comments that the protective claim procedures of the proposed regulations would result in increased administrative costs and delays in the administration of estates because filing a protective claim effectively would keep the period of limitations open to the extent of the amount of the claim for refund. Under the final regulations, the "full value" of each claim must be considered in full when determining whether the aggregate threshold of $500,000 is exceeded. The "full value" is defined in the regulations to mean the unpaid amount of the claim that is not deductible after the applications of § 20.2053-1 (relating to court orders, consent decrees, settlements and ascertainable amounts) and § 20.2053-4(b) (relating to claims and counterclaims). The final regulations give an example of thee $200,000 claims. Since the value of all three would exceed the $500,000 threshold, only two of the claims can be deducted under this exception (provided the claims meet the other standards for deduction under Section 2053). The third claim cannot be deducted in whole or in part under this exception. This exception also requires that each claim will be valued in a qualified appraisal by a qualified appraiser as provided in § 170. Finally, a claim under this exception is subject to the same potential post-death adjustments as claims under the "claim/counterclaim" exception.

Except as provided in the above three exceptions, no estate tax deduction may be taken for a claim while it remains a potential or unmatured claim. Claims that later mature may be deducted in connection with a timely filed claim for refund, and a protective claim can be filed. Moreover, no deduction may be taken for a claim against an estate to the extent that the estate is contesting the decedent's liability.

If the estate is one of two or more parties against whom a claim is being asserted, the estate may only deduct the portion of the total claim due from and paid by the estate, reduced by the total of any reimbursement received from another party, insurance, or otherwise. The claim will also be reduced by the contribution or other amount that the estate could have collected from another party or an insurer but declines or fails to collect to attempt. The regulations appear to intend that an estate can claim a deduction when it fails to pursue reimbursement if it establishes that the burden of collecting would have outweighed the benefit from those efforts, by cross referencing the portion of the regulations dealing with reimbursements (§ 20.2053-1(d)(3)).

The Final Regulations are effective for estates of decedents dying on or after October 20, 2009.

Notice 2009-84, 2009 – 44 I.R.B. at 592 (November 2, 2009). In conjunction with the publication of final regulations under Section 2053, the Service also published a notice in which it announced limited exceptions to its ability to re-examine an estate tax return in connection with claims for refunds filed under the new Section 2053 regulations. In general, a taxpayer's claim for refund enables the Service to examine the entire return on which the claim is based in order to determine whether an overpayment exists. In effect, the protective claim for refund procedure could keep the period of limitations on assessments open to the extent of the amount of the claim for refund and thereby impede the goal of achieving finality in the administration of a decedent's estate. In the Notice, the Service states:

> Accordingly, if the period of limitations on assessment has expired and the Service is notified that a timely-filed protective claim for refund of tax based on a deduction under Section 2053 has ripened and is ready for consideration, the Service generally will refrain from exercising its authority to examine each item on the Form 706 to determine if there is an overpayment of tax for purposes of section 6402. Instead, when such a timely-filed claim for refund ripens after the expiration of the period of limitations on assessment, the Service will limit its examination of the Form 706 to the evidence relating to the deduction under section 2053 that was the subject of the protective claim.
>
> To the extent that the Service determines the deduction under section 2053 is allowable, the Service will recompute the estate tax liability of the estate (and the marital and charitable deductions, and all other amounts determined as part of that process) by allowing the deduction.

PART TWO

RECENT FEDERAL NON-DEVELOPMENTS

1. 2010 ISSUES.

A. *Confusion regarding 2010 actions.*

Section 501 of EGTRRA provided that there would be no estate tax or generation skipping tax for persons dying, or transfers taking place in, 2010. Note, however, that EGTRRA did not repeal chapter 11 or chapter 13 of the Code; it simply provided that those chapters would not apply.

Section 2022(a), added by EGTRRA, reads as follows with respect to the estate tax:

> (a) In General**.** Except as provided in subsection (b) [relating to Qualified Domestic Trusts], this chapter shall not apply to the estates of decedents dying after December 31, 2009.

Section 2664, also added by EGTRRA, reads as follows with respect to the generation-skipping tax:

> This chapter shall not apply to generation-skipping transfers after December 31, 2009.

The absence of the estate tax will raise difficult issues for documents that are formula driven, which concerns virtually all married couples, many generation-skipping transfers for the both the married and unmarried, and some provisions required by divorce decrees. In these documents, gifts are often described by reference to a formula amount that relates to what can pass free of the estate tax, or what may be equal to a GST exemption amount. With no estate tax and no generation-skipping tax in effect, these documents will surely produce unanticipated and in many cases unwelcome results.

Complicating this situation is the anticipation that Congress may, or may not, change these rules, and if it does, the changes may, or may not, have retroactive application. Prudent estate planning attorneys will review their client lists and contact those clients who, due to illness or advanced age, may die in 2010. But what do we advise these clients to do?

It seems that the best general plan when the spouse is the primary beneficiary of the estate is to pass the entire residuary estate to a QTIP trust. A QTIP trust will qualify for both the general basis increase and the spousal basis increase. If estate tax is enacted retroactively one should be able to make a QTIP election to avoid estate tax. If there is no retroactive enactment, then the trust should avoid estate tax in the surviving spouse's estate. The significant disadvantage of the QTIP approach is that income is

mandatorily payable to the spouse, which can increase the surviving spouse's estate. However, a prudent trustee could manage income flow through investment policy. It is generally believed that a Clayton-type QTIP will not be recognized for purposes of the spousal basis increase.

Some practitioners favor the idea of a "quick fix" to estate planning documents, by means of a trust amendment or codicil, which defines the tax terms as if the decedent had died on December 31, 2009. Some states (Virginia, for example) are drafting legislation to this effect. While this approach may avoid a trust construction action, it may not be what the client desires. One must remember that many, perhaps most, estate planning formula documents are products of the tax laws (for example, giving $3,500,000 to a Family Trust and the balance to a marital disposition is the product of tax planning, not the natural choice of a client who has the freedom to give away property in any manner without estate or generation-skipping tax being implicated). Without a tax structure, formulas built on the tax laws will no longer make sense in most situations. The global "fix it" is just not going to work very well, and there seems to be no good alternative to considering each potentially affected situation on an individual basis.

Given the fact that "repeal" will sunset in 2011, and perhaps sooner if Congress acts, the vast majority of clients' estate plans will be unaffected because they will not die this year. Therefore, a "sit tight" strategy for most clients will probably be followed.

B. *Gift Tax.*

The federal gift tax remains in existence in 2010 although the rate on gifts is reduced to 35%. For taxpayers who contemplate making taxable gifts in any event 2010 is a good year to do so. For those who are concerned about whether the rate may retroactively be imposed at 45%, consideration can be given to making a net gift. Also, gifts by means of defined value formula allocation clauses should be considered.

Another gift strategy is to create a lifetime QTIP trust with provisions for a gift over in the event of a spouse's disclaimer. The QTIP trust would give the taxpayers time to decide whether to make the QTIP election to avoid tax (for example, if 45% rates are imposed retroactively), or for the spouse disclaim and have a gift over at the lower rates.

Due to the uncertainty of certain GST issues (see below), it may be wise to delay gifts to trusts where inclusion ratios will be important. This may be a near impossible task in many situations. Clients frequently make annual exclusion gifts on a near "automatic" basis without annual consultation from attorneys. Gifts to 2503(c) and Crummey minors trusts and gifts to life insurance trusts to pay premiums are obvious examples. Clients may wish to make loans, rather than contributions, to insurance trusts until there is further clarification of the some of the GST issues.

C. *Generation-Skipping Issues.*

The one-year hiatus in the estate and generation-skipping taxes has raised a number of questions that mainly revolve around transfers to trusts. For example, if a person dies in 2010 and transfers property to a trust that is expected to eventually make distributions that under Chapter 13 would be considered "skip persons," how will the trust be treated after 2010? Certainly there is no GST tax in 2010 as a result of the death of the decedent. But if the provisions of Chapter 13 do not apply in 2010, can there be a "transferor" for GST purposes? Section 2652(a)(1)(A) defines "transferor" as the decedent in the case of property "subject to the tax imposed by chapter 11, ..." With no transferor, generation assignments become meaningless. Also, if the provisions of chapter 13 do not apply, it would be impossible to apply GST exemption to the trust on a current basis. A similar concern is a transfer in 2010 to a "skip" trust (in which all the beneficiaries are skip persons). There would be no GST tax in 2010 but what happens in 2011 and beyond? Will distributions from the trust attract tax? The trust would seem to have an inclusion ratio of 1 and it would seem that the "move down" rule could not apply since there was no GST tax imposed to begin with.

Moreover, the language of Code § 2664 itself seems contradictory. It says that chapter 13 will not apply to generation-skipping transfers after 2010. This implies that in 2010 there is something that is called a "generation-skipping transfer." If the Code provisions, which define that a GST transfer is to begin with, do not apply, then it is difficult to see what would constitute such a transfer.

There are no clear answers to the questions raised by these issues. Those planning GST transfers are contemplating outright transfers, and possibly not to trusts or custodians (which are treated as trust equivalents). One suggestion is to transfer gifts to an LLC for donees to allow for the management of property without the involvement of a trust that might have an inclusion ratio.

2. *Sunset Issues.*

Perhaps more troubling is that the sunset provisions of EGTRRA raise a number of questions as to whether actions occurring in 2001-2010 will simply be ignored come 2011, possibly upsetting inclusion ratios for GST and affecting basis issues.

Section 901(a) of EGTRRA states:

> IN GENERAL. All provisions of, and amendments made by, this Act shall not apply – (1) to taxable, plan or limitation years beginning after December 31, 2010, or (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010.

Section 901(b) states:

> APPLICATION OF CERTAIN LAWS. The Internal Revenue Code of 1986 . . . shall be applied and administered to years, estates, gifts and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

Does this mean that we must assume, come 2011, that various advantages enacted by EGTRRA must then be disregarded? For example, a decedent who died in 2009 may have allocated $3,500,000 of GST exemption to a by-pass trust. In 2011, when the GST exemption amount is $1,340,000, will the inclusion ratio of this trust have to be adjusted from 0 to something between 0 and 1 in order to give effect to the sunset provision? EGTRRA enacted a number of beneficial GST issues, including automatic allocation rules and qualified severance rules. Will these no longer be available and if they must be disregarded, what is the effect on existing trusts.

Likewise, if a person dies in 2010 with carryover basis, in 2011 will the assets of the estate now take on as a basis the FMV as of the date of death? This concern has prompted some advisors to counsel putting off sales of estate assets until these issues are clarified.

PART THREE

SELECTED ILLINOIS DEVELOPMENTS

1. LEGISLATION.

A. *Convenience Bank Accounts.*

P.A. 96-0123 established the Banking Convenience Account for Depositors Act. The Act is intended to allow persons to establish joint accounts by which third parties can make deposits and withdrawals for their benefit without establishing ownership rights in the third parties.

Under the Act, a banking organization may permit a "depositor" to establish a "convenience account," which essentially is an account that permits a third party (the "convenience depositor," hereinafter referred to for clarity's sake as the "third party") to make deposits to the account for the benefit of the person who established the account. The Act permits the banking institution to pay or deliver funds to either the depositor, or the third party, "for the convenience of the depositor."

Deposits to the convenience account do not affect title to any deposit (which remains with the original depositor as a matter of local law) and the depositor is not considered to have made a gift to the third party when the account is established or when additional funds are contributed to the account. Deposits to a convenience account made by any third party, and any accruals thereon, are deemed to have been made by the depositor. When the depositor dies, the third party does not have and does not acquire any survivorship rights in the convenience account.

Unless and until it has received written directions from the depositor to the contrary, the banking institution may pay amounts from the account to either the depositor or the third party, and the delivery of funds by the institution discharges it.

When the depositor dies, the banking institution is further protected if it pays to the third party prior to its receipt of written notice of the depositor's death. Once the bank has notice of the depositor's death, as long as it has not been served with a restraining order, injunction or other appropriate process from a court of competent jurisdiction prohibiting payment, it is fully discharged by turning over the convenience account to the executor, administrator or other qualified representative of the depositor's estate.

The Act is effective as of January 1, 2010, but by its terms is repealed 5 years after its effective date.

B. *Virtual Representation and Total Return Trusts.*

Public Act 96-0479 has made some significant modifications to the virtual representation provisions of the Illinois Trusts and Trustees Act, and has also liberalized the procedure for converting to a total return trust.

Virtual Representation

Prior to the Act, agreements pursuant to the virtual representation statute required (a) all "primary beneficiaries" of a trust to be adult and not incapacitated, and (b) unanimous agreement among all such beneficiaries and the trustee. The Act defined a "primary beneficiary" as a beneficiary either currently entitled to or eligible to receive any portion of the trust income or principal, or assuming the non-exercise of a power of appointment, those who would receive, or be entitled to withdraw, all or a portion of the principal of the trust, if the beneficiary survived to the final date of distribution with respect to the beneficiary's share. The changes to the Act keep this definition of "primary beneficiary" with slight modifications to the language.

Many trusts could not enter into virtual representation agreements because not all primary beneficiaries were adults or could be ascertained. This would be especially true for long-term generation-skipping trusts with spray trust provisions among descendants. The amendments to the virtual representation statute address these concerns by permitting certain beneficiaries to be bound by others with identical interests, and also by permitting "presumptive remainder beneficiaries" to bind contingent beneficiaries.

Under Section 16.1(a)(1) of the statute, a minor, disabled person, unborn person, or a person whose identity or location is unknown and not reasonably ascertainable may be represented and bound by another individual having a substantially identical interest with respect to the particular question or dispute to the extent there is no conflict of interest between the representative and the person represented, and as long as there is no court-appointed guardian already representing that person. If the court has appointed a guardian to represent the interests of the person in question, then the actions of the guardian will represent and bind the person for purposes of the statute.

Section 16.1(a)(2) of the statute deals with virtual representation by the "primary beneficiaries." Whereas under the former statute all primary beneficiaries had to be adults and not incapacitated, under the amendment a primary beneficiary can be represented by another beneficiary acting under the "substantially identical interest" provisions of subsection (a)(1). The actions of the primary beneficiaries or their respective representatives will represent and bind all other persons who have a successor, contingent, future or other interest in the trust, and who would become primary beneficiaries only by reason of surviving a primary beneficiary.

Section 16.1(a)(3) of the statute adds a new provision for "presumptive remainder beneficiaries," which are defined to mean all beneficiaries who on the date of determination and assuming nonexercise of all powers of appointment, either:

1. Would be eligible to receive a distribution of income or principal if the trust terminated on that date; or

2. Would be eligible to receive a distribution of income or principal if the interests of all beneficiaries currently eligible to receive income or principal from the trust ended without causing the trust to terminate.

Under the amendment a presumptive remainder beneficiary also can be represented by another beneficiary acting under the "substantially identical interest" provisions of subsection (a)(1). If all presumptive remainder beneficiaries are adults and not disabled, or have representatives under subsection (a)(1) who are adults and not disabled, the actions of the presumptive remainder beneficiaries or their respective representatives will represent and bind all other persons who have a successor, contingent, or other future interest in the trust. The new provisions for presumptive remainder beneficiaries will be useful for agreements that are intended to bind remainder persons without affecting the interests of the current beneficiaries.

Section 16.1(b) expressly makes the virtual representation rules of 16.1(a) applicable to enable conversions to total return trusts by agreement (see below).

Section 16.1(c) clarifies an issue in the statute concerning charitable trusts. The statute now provides that if a charity is not specifically named or otherwise represented, the Illinois Attorney General may represent, bind and act on behalf of the charitable interest with respect to any particular question or dispute, including without limitation the conversion to a total return trust or a non-judicial settlement agreement. The amendment states that subsection (c) shall be construed as declarative of existing law and not as a new enactment, and that nothing in the new statute shall be construed as limiting or affecting the Attorney General's authority to file an action or take other steps to enforce or protect the general public interest of a charitable trust, regardless of whether a specific charity is named.

Section 16.1(d) deals with "nonjudicial settlement agreements." Under the statute before its amendment, the primary beneficiaries and the trustee could enter into "any written agreement, including, without limitation, an agreement construing any provision of the trust or an agreement regarding any duty, power, responsibility, or action of the trustee." The agreement, however, could not accelerate the termination of a trust, in whole or in part.

The scope of the "agreement" is now explained much more fully, and includes, under certain circumstances, the termination of a trust. The agreement must be entered into by "interested persons" or their respective representatives determined after giving effect to the preceding provisions of Section 16.1. The "interested persons" are the trustee and all other persons and parties in interest whose consent or joinder would be required in order to achieve a binding settlement were the settlement to be approved by the

court. Further, a nonjudicial settlement agreement is valid only to the extent that its terms and conditions could be properly approved under applicable law by a court of competent jurisdiction. A trustee may (but is not required to) obtain and rely upon an opinion of counsel on any matter relevant to Section 16.1, including (1) whether an agreement could be approved by a court, and (2) whether there is no conflict of interest between a representative and the person represented with respect to a particular question or dispute. An interested person may request a court to approve any part or all of a nonjudicial settlement agreement, as long as the petition for approval is filed before or within 60 days after the effective date of the agreement.

The statute sets forth the following matters as a non-exclusive list of what a nonjudicial settlement agreement may cover:

1. Interpretation or construction of the terms of the trust;
2. Approval of a trustee's report or accounting;
3. Exercise or nonexercise of any power by a trustee;
4. The grant to a trustee of any necessary or desirable administrative power;
5. Questions relating to property or an interest in property held by the trust;
6. Resignation or appointment of a trustee;
7. Determination of a trustee's compensation;
8. Transfer of a trust's principal place of administration;
9. Liability or indemnification of a trustee for an action relating to the trust;
10. Resolution of disputes or issues related to administration, investment, distribution or other matters;
11. Modification of terms of the trust pertaining to administration of the trust; and
12. Termination of the trust, provided that court approval of such termination must be obtained in accordance with subsection (d)(5) [requiring any petition for approval to be filed before or within 60 days of the effective date of the agreement], and the court must conclude continuance of the trust is not necessary to achieve any material purpose of the trust; and upon such termination the court may order the trust property distributed as agreed by the parties to the agreement or otherwise as the court determines equitable consistent with the purposes of the trust.

A nonjudicial settlement agreement entered into in accordance with Section 16.1 is final and binding on the trustee and all beneficiaries of the trust, both current and future, as if ordered by a court of competent jurisdiction over all parties in interest.

The changes to Section 16.1 are effective as of January 1, 2010 and on and after the effective date will apply to all existing and future trusts, judicial proceedings, or agreements entered into in accordance therewith on or after the effective date.

<u>Conversions to Total Return Trusts</u>

The Act amends the procedure under Section 5/5.3(b) by which a conversion to total return trust may be made by agreement. Before the amendment, conversion by agreement required the consent of the trustee and all "primary beneficiaries" of the trust under the virtual representation statute if the statute otherwise applied (i.e., if the "agreement" under the virtual representation statute was permitted). The amendment to the total return statute expands the circumstances under which an agreement can be entered into. Section 5.3(b) now provides as follows:

> (b) Conversion by agreement. Conversion to a total return trust may be made by agreement between a trustee and (i) all primary beneficiaries, either individually or by their respective representatives in accordance with subsection 16.1(a)(2) of this Act, or (ii) all beneficiaries currently eligible to receive income or principal from the trust and all beneficiaries who are presumptive remaindermen, either individually or by their respective representatives in accordance with subsection 16.1(a)(3) of this Act. The agreement may include any actions a court could properly order under subsection (g) of this Section; however, any distribution percentage determined by the agreement may not be less than 3% nor greater than 5%.

The changes to the total return trust statute are effective January 1, 2010.

C. *Illinois QTIP and Marital Deduction Savings Provision.*

P.A. 96-0789 permits a state-only QTIP election for estates of decedents dying after December 31, 2005 and on or before December 31, 2009. The election may be separate from any QTIP election available for federal estate tax purposes. Because the exclusion allowed by the Illinois estate tax matched the federal applicable exclusion until 2009, as a practical matter the new QTOP provision will be effective only for decedents dying in 2009. For decedents dying after December 31, 2009, the Illinois estate tax continues to be the credit for state death tax allowable under the Internal Revenue Code. Unless Congress reinstates the state death tax credit (unlikely at least for 2010), Illinois will have to enact a "patch" to the existing arrangement if it does not wish to see its estate tax eliminated in 2010. Perhaps a "patch" would also extend the state-only QTIP election.

The state-only election allows an estate to take advantage of the full $3,500,000 federal exclusion without incurring Illinois estate tax, as long as $1,500,000 of the federal exclusion amount is elected as a state QTIP. For planning purposes, the client's will or trust might create a net income family trust for the surviving spouse in the amount of $3,500,000 that would qualify for federal QTIP treatment if necessary; the executor or trustee could then make the state only election for $1,500,000 of the family trust. Another approach would be a 3-trust arrangement, whereby the estate plan creates a $2,000,000 family trust, a $1,500,000 trust that satisfies QTIP but for which a state-only

election would be made, and a marital trust for the balance of the client's property. Yet a third approach would be to limit the by-pass trust to the smallest amount necessary to reduce combined federal and state taxes to zero and allocating the balance to a QTIP trust. The executor or trustee could then decide to make a partial QTIP election, in which case the non-elected portion of the trust could "flip" to the by-pass trust. See Treas. Reg. §20.2056(b)-7(d)(3), §20.2056(b)-7(h)(Example 6), and Clayton v. Commissioner, 976 F.2d 1486 (5th Cir., 1992). Note that neither the surviving spouse nor any beneficiary of the trust should make the election, since the effect of the election by an interested person might be considered a gift.

The statute provides that for purposes of the Illinois estate tax, the inclusion of the QTIP property in the gross estate of a surviving spouse is the same as under Section 2044 of the Internal Revenue Code, which means that Illinois intends to capture the deferred tax on the survivor's death. If an Illinois surviving spouse takes advantage of the state-only QTIP and then establishes residence in another state that has no death tax (such as Florida or California), it appears that Illinois will never collect the forgone tax, except to the extent the QTIP trust remains in existence and contains Illinois situs property.

Of more lasting duration is a second change to the statute, which imposes a "productive property" requirement on any QTIP trust that qualifies for the federal or Illinois marital deduction. This will be useful in situations where the client wishes to make an election over part of a by-pass trust in order to avoid what would otherwise be an Illinois estate tax.

Prior to the amendment, it was feared that the absence of a productive property clause would preclude a marital deduction for an income interest in a trust. Treas. Reg. § 20.2056(b)-f(4), dealing with the "right to income," provides in relevant part as follows:

> Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. . . . For example, a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. [emphasis added]

A well-drafted marital deduction trust ordinarily will include a provision allowing the spouse to direct the trustee to make assets productive. The problem arises when a trust that was not intended to qualify for the marital deduction – such as a net income family trust – becomes the subject of a partial QTIP election in order to avoid death tax in a decoupled estate.

To remedy this problem the new provision states:

In the case of any trust for which a State or federal qualified terminable interest property election is made, the trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse.

P.A. 96-0789 became effective on September 9, 2009.

B. Cases.

1. **<u>In re Estate of Feinberg</u>**, ___ Ill. 2d ___, ___ N.E. 2d ____ (Opinion filed September 24, 2009), appeal from 383 Ill. App. 3d 992, 891 N.E.2d 549 (First District, 2008).

Max Feinberg died in 1986. His widow, Erla Feinberg, died in 2003. When Max died he created marital and residuary trusts, the beneficiaries of which were his two children (Michael and Leila), and five grandchildren.

Max's trust instrument contained the following provision, which the parties, and the Appellate Court, referred to as the "Jewish Clause" but which the Supreme Court referred to as the "beneficiary restriction clause":

> A descendant of mine other than a child of mine who marries outside the Jewish faith (unless the spouse of such descendant has converted or converts within one year of the marriage to the Jewish faith) and his or her descendants shall be deemed to be deceased for all purposes of this instrument as of the date of such marriage.

At the time of Erla's death, all five grandchildren had married, but only one of the five grandchildren had married within the Jewish faith.

Max's estate plan created a QTIP marital deduction trust called "Trust A" and a by-pass trust called "Trust B." Max's trust provided that on Erla's death any part of Trust A not distributed pursuant to the preceding provisions would be added to Trust B. The provisions for Trust B provided, in relevant part, as follows:

> 3.3 During the life of my spouse, the following shall apply to Trust B:

* * * * * * *

> (c) The principal of Trust B shall be distributed to or in trust for any one or more of my descendants in the manner and proportions as my spouse may appoint during my spouse's lifetime or may appoint by will making specific reference to this power.

Erla signed a document on July 23, 1997, that purportedly exercised the power. She did so at a time when at least one grandchild was married, although the Supreme Court's opinion does not indicate whether the married grandchild had married within the Jewish faith. Erla's exercise of the power stated in relevant part as follows:

> Under the power give me under Paragraph 3.3 (c) in Section III of the MAX FEINBERG TRUST . . . I . . . make the following appointment:
>
> Upon my death the trustee shall pay from the principal of Trust B (Trust B as defined in Section III, paragraph 3.1) to each of my two children and to each of my five grandchildren the sum of Two Hundred Fifty Thousand Dollars ($250,000) such sum hereinafter referred to as the APPOINTMENT. My two children are [here she names each child]. My grandchildren are: [here she names each of the 5 grandchildren]. If either of my children are deceased then the sum that would have been paid to that child (the APPOINTMENT) shall be distributed in equal amounts to the children of that child. If any of my grandchildren are deemed deceased then the APPOINTMENT shall be paid equally to the parents of that grandchild.

The Supreme Court noted that the record suggested that Erla's gifts under the power of appointment depleted Max's trusts so that there would be no trust assets remaining subject to Max's original plan. The depletion, in all likelihood, was the combined result of estate taxes attributable to Trust A, and litigation expenses.

After Erla died, Michelle, one of the grandchildren who had not married within the Jewish faith, became involved in litigation with her father Michael, and her aunt Leila and her aunt's husband. Several actions were consolidated and Michelle's father eventually moved to dismiss Michelle's complaint. Michael argued that by marrying outside of the Jewish faith Michelle could not take under the appointment, and therefore had no legal right to bring an action for an injury based on her rights as an alleged beneficiary.

The trial court held the Jewish Clause to be unenforceable as a violation of Illinois public policy. Michael appealed, and the First District, in a 2-1 decision, affirmed.

On appeal the Supreme Court reversed, and held that four of the five grandchildren, by marrying outside the faith, failed to qualify as beneficiaries under the estate plan. The Court framed the issue as follows:

> Thus, the question we must answer is whether the holder of a power of appointment over the assets of a trust may, without violating the public policy of the state of Illinois, direct that the assets be distributed at the time of her death to then-living descendants of the settlor, deeming deceased any descendant who has married outside the settlor's religious tradition. In effect, we are not called upon to consider the validity of Max's estate plan as a whole, which would have continued to hold the assets in trust for the benefit of the grandchildren only so long as they complied with the restriction. Rather, we must assess Max's beneficiary restriction clause in conjunction with Erla's directions for distribution.

The Court examined the public policy issues regarding testation and found that the Probate Act, the Trust and Trustees Act, the Statute Concerning Perpetuities and the Rule in Shelly's Case Abolishment Act expressed a broad public policy protecting the ability of an individual to distribute his property, even after his death, as he chooses, with minimal restrictions under state law. It also found that in this case there was no restraint on the ability of a grandchild to marry, in effect treating Erla's exercise of the power of appointment as the functional equivalent of a testator deciding to write someone out of his will because he did not approve of the person's marriage. The court reasoned that Erla's exercise established a "condition precedent" (i.e., a condition the person would have to meet to take at the moment of Erla's death) rather than a "condition subsequent."

The record did not indicate whether the grandchildren knew of the restriction when they married. However, the grandchildren were not heirs-at-law of the Feinbergs, and since the grandchildren had no vested interest in the property, they had no entitlement of notice. The Court concluded:

> Thus, this is not a case in which a donee, like the nephew in the illustration [Restatement Third of Trusts, Section 29, Comment j], will retain benefits under a trust only so long as he continues to comply with the wishes of a deceased donor. As such, there is no "dead hand" control or attempt to control the future conduct of the potential beneficiaries. Whatever the effect of Max's original trust provision might have been, Erla did not impose a condition intended to control future decisions of their grandchildren regarding marriage or the practice of Judaism; rather, she made a bequest to reward, at the time of her death, those grandchildren whose lives most closely embraced the values she and Max cherished.

COMMENT: The only discussion of what Erla might have meant by the term "deemed deceased" in the exercise of the power of appointment is the following conclusion by the Court:

> In keeping with Max's original plan, if any grandchild was deemed deceased under the beneficiary restriction clause, Erla directed that his or her share be paid to Michael or Leila.

Nothing in Erla's power of appointment indicates what she meant by the term "deemed deceased." The power of appointment is odder still for dealing with a grandchild who is "deemed" deceased but remaining absolutely silent on the treatment of a grandchild who was actually deceased. At least one grandchild was married by 1997. The record did not state how many were married in 1997 or whether any of them who were married at that time had married outside of the Jewish faith. Given the fact that Erla specifically stated that she had five grandchildren living in 1997, the reference to "deemed deceased" in the appointment document would seem to have warranted a closer determination of who exactly was married at that point and whether Erla in fact meant to invoke the beneficiary restriction clause of Max's original plan.

Also, it seems interesting that Erla exercised a "lifetime" power by directing a disposition that had no lifetime effect but which took effect at death. Would not this be a testamentary exercise that had to be effected under the terms of the document by a will? Finally, if this was indeed a "lifetime" exercise over Trust B, is it altogether clear that the exercise took effect over Trust A? In the power of appointment, the exercise over Trust B refers to "Trust B as defined in Section III, paragraph 3.1" of Max's trust. Section III, paragraph 3.1 is the clause that separates the trust estate into Trust A and Trust B. The reference to paragraph 3.1 concerns Trust B before any subsequent merger of Trust A into it.

2. In re Estate of Ellis, ___ Ill. 2d ___, ___ N.E. 2d ____ (Opinion filed October 29, 2009), appeal from 381 Ill. App. 3d 427; 887 N.E.2d 467 (First District, 2008).

Grace executed a will in 1964 which left her multi-million dollar estate to her elderly parents, with contingent remainder to her "descendants" and the Shriners Hospital for Crippled Children. In 1999, approximately 4 years prior to her death, Grace executed a new will, in which she left her entire estate to James G. Bauman, the pastor of the Lutheran Church she attended. The 1999 will also named Bauman as executor. Grace had never married and had no children.

After Grace died in 2003, Bauman petitioned the probate court for admission of the 1999 will to probate and for letters testamentary as independent executor. The court

granted the petition and named Bauman as executor. Bauman gave notice to Grace's two living cousins, and 12 other more remote relations. The two cousins initially sued but later settled with the estate.

In 2006, nearly three years after the will was admitted to probate, Shriners first became aware of the existence of the 1964 will and its interest under it. Shriners initiated a will contest, alleging in three counts lack of mental capacity, undue influence and tortious interference with an expectancy. The tortious interference claim also concerned inter-vivos issues, including allegations that Bauman used a power of attorney to transfer assets to himself. Bauman, the executor, moved to dismiss under Section 2-615 of the Civil Practice Act as an action barred by the statute of limitations.

Section 8-1 of the Probate Act requires a person to contest a will within 6 months after its admission to probate. In Ruffing v. Glissendorf, 41 Il. 2d 412, 415, 243 N.E.2d 236, 240 (1968), the Illinois Supreme Court held that Section 8-1 is a jurisdictional requirement that cannot be tolled by allegations of fraudulent concealment or other impropriety. The probate court granted the motion to dismiss. Shriners appealed the decision but abandoned the mental capacity and undue influence arguments in the course of the appeal, focusing solely on the count for tortious interference. It argued that the bar of Section 8-1 does not apply to a tortious interference claim.

The First District affirmed the trial court's dismissal of the complaint. In affirming the trial court, the First District rejected Shriners' argument that Section 8-1 cannot bar a tortious interference claim because it only refers explicitly to will contests. The Court stated:

> . . . , here, allowing Shriners to proceed on its allegations that Bauman tortiously interfered with an inheritance expectancy, by abusing his position as Ellis' trusted advisor and "[u]nduly influencing [her] to execute a new will on August 9, 1999, which named him as executor and sole beneficiary, thereby overcoming Grace's long term desire to leave her estate to [Shriners]," would permit the grounds for a will contest to be litigated years after the will was admitted to probate and became immune from contest. Allowing Shriners to proceed on its untimely allegations would be contrary to the legislature's intent.

Shriners appealed and the Supreme Court reversed. The Supreme Court distinguished a will contest from a claim for tortious interference:

> Shriners contends that the appellate court's application of section 8–1 of the Probate Act of 1975 to tort claim for intentional interference with expectancy of inheritance contradicts the clear and unambiguous language of the statute and confuses the tort with a will contest. We agree. Under the plain language of section 8–1, the six month statutory limitation period applies to a "petition *** to contest the validity of the will." 755 ILCS 5/8–1 (West 2006). A tort action for intentional interference with inheritance is distinct from a petition to contest the validity of a will, in

> several important respects. The single issue in a will contest is whether the writing produced is the will of the testator. Mount v. Dusing, 414 Ill. 361, 365 (1953); Hall v. Eaton, 259 Ill. App. 3d 319, 321 (1994). Any ground which, if proved, would invalidate the will, including undue influence, incapacity, fraud, or revocation, may state a cause of action. Hall, 259 Ill. App. 3d at 321. The object of a will contest proceeding is not to secure a personal judgment against an individual defendant but is a quasi *in rem* proceeding to set aside a will. In re Estate of Spaits, 104 Ill. 2d 431, 435-36 (1984); Nupnau v. Hink, 33 Ill. 2d 285, 288 (1965). See also Merrick v. Continental Illinois National Bank & Trust Co. of Chicago, 10 Ill. App. 3d 104, 114 (1973) ("An action to set aside a will is against the will itself and not the beneficiaries").
>
> By contrast, in a tort claim for intentional interference with inheritance, "[o]ne who by fraud, duress or other tortious means intentionally prevents another from receiving from a third person an inheritance or gift that he would otherwise have received is subject to liability to the other for loss of the inheritance or gift." Restatement (Second) of Torts §774B (1979). The "widely recognized tort" does not contest the validity of the will; it is a personal action directed at an individual tortfeasor. See Marshall v. Marshall, 547 U.S. 293, 312, 164 L. Ed. 2d 480, 498, 126 S. Ct. 1735, 1748 (2006) (the tort claim "seeks an *in personam* judgment against [the defendant], not the probate or annulment of a will"). Although some of the evidence may overlap with a will contest proceeding, a plaintiff filing a tort claim must establish the following distinct elements: (1) the existence of an expectancy; (2) defendant's intentional interference with the expectancy; (3) conduct that is tortious in itself, such as fraud, duress, or undue influence; (4) a reasonable certainty that the expectancy would have been realized but for the interference; and (5) damages. See In re Estate of Roeseler, 287 Ill. App. 3d 1003, 1021 (1997); In re Estate of Knowlson, 204 Ill. App. 3d 454, 457 (1990); Nemeth v. Banhalmi, 99 Ill. App. 3d 493, 499 (1981); Restatement (Second) of Torts §774B (1979). The remedy for a tortious interference action is not the setting aside of the will, but a judgment against the individual defendant, and, where the defendant has himself received the benefit of the legacy, a constructive trust, an equitable lien, or "a simple monetary judgment to the extent of the benefits thus tortuously acquired." Restatement (Second) of Torts §774B(e) (1979). Thus, a tort claim for intentional interference with an expectancy is not a "petition *** to contest the validity of the will" under the plain statutory language of section 8–1.

The Supreme Court noted that in a prior case, where the plaintiff had an opportunity to bring a will contest but chose not to, the plaintiff was later foreclosed from bringing a tortious interference claim. Robinson v. First State Bank of Monticello, 97 Ill. 2d 174. This case was different, however:

> The concern articulated in Robinson about the "practical effect" of allowing the plaintiffs to maintain the tort action must be read in the context of the facts of that case. Unlike Shriners, the plaintiffs in Robinson could have obtained complete relief had they filed a timely will contest. Instead, they settled with the estate and agreed not to file any further claims arising from the will and codicil. In the instant case, we cannot say that a will contest was "available" to Shriners, nor that a successful will contest would have furnished the relief sought by Shriners in its tort action. The parties agree that Shriners was unaware of its bequest in the 1964 will until more than two years after the 1999 will had been admitted to probate. Our holding in Robinson was limited to not recognizing the tort action where plaintiffs have an opportunity to contest a probated will but choose not to do so, and subsequently enter into an agreement to take no further court action. Unlike the plaintiffs in Robinson, Shriners did not choose to forgo an opportunity to contest the probated will. It never had that opportunity. Once the 1999 will was admitted to probate, and the six-month jurisdictional period had passed with no will contest having been filed, the validity of the will was established for all purposes. Robinson, 97 Ill. 2d at 182-83.

Not only did Shriner's not have an opportunity to bring the will contest, but a will contest, even if brought, would not have disposed of all of Shriners' claims, since some of its claims were based on *inter-vivos* transfers of property.