CURRENT DEVELOPMENTS IN ESTATE AND GIFT TAX AUDITS AND LITIGATION

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Presented by:

Keri D. Brown
Baker Botts L.L.P.
910 Louisiana Street
Houston, Texas 77002
keri.brown@bakerbotts.com

Materials by:

John W. Porter
Baker Botts L.L.P.
910 Louisiana Street
Houston, Texas 77002
john.porter@bakerbotts.com

KERI D. BROWN
Baker Botts L.L.P.
Houston, Texas
keri.brown@bakerbotts.com

Keri Brown serves as a trusted advisor to some of the nation's most prominent individuals on complex federal estate, gift and income tax litigation and controversy matters, including disputes and litigation with the Department of Justice and the Internal Revenue Service. She counsels high net worth individuals and families in a variety of courts, including in the United States Tax Court, United States District Courts, and United States Courts of Appeals. She also represents taxpayers in federal tax audits and administrative appeals and represents fiduciaries and beneficiaries of trusts and estates in state courts with respect to administration and fiduciary duty issues. Published cases in which Keri served as one of the taxpayer's counsel include *Estate of Murphy*, *Steinberg*, *Estate of Petter*, *Hendrix*, and *Estate of Christiansen*. In addition to her tax and fiduciary practice, Keri serves as the global partner-in-charge of Corporate Social Responsibility at Baker Botts.

Published cases in which Keri served as one of the taxpayer's counsel include:

- Steinberg – Tax Court rejected IRS challenge to gift tax value offset for donees' assumption of potential estate tax under I.R.C. § 2035 ("net, net gift") (*Steinberg v. Comm'r*, 141 T.C. 258 (2013))

- Estate of Anne Y. Petter – successful defense of taxpayer in case of first impression involving gift/sale of LLC units to family and charity using a dollar value formula based on values as "finally determined for federal gift tax purposes." (*Petter v. Comm'r*, 98 T.C.M. (CCH) 534 (2009)), *aff'd*, 653 F.3d 1012 (9th Cir. 2011))

- Hendrix – successful defense of taxpayer in case regarding the tax effect of a gift of corporate stock made by way of a dollar-based defined value formula (*Hendrix v. Comm'r*, T.C. Memo 2011-133 (June 15, 2011))

- Estate of Helen Christiansen – successful Eighth Circuit affirmance of Tax Court decision in case of first impression regarding tax effect of partial disclaimer of limited partnership interest to charity made by way of formula based on values "as finally determined for estate tax purposes." (*Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009))

- Estate of Charles H. Murphy, Jr. – successful $42 million estate tax refund suit involving numerous valuation issues and IRS attempt to ignore limited partnership under I.R.C. § 2036. (*Estate of Murphy v. United States*, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009))

Keri is Chambers-ranked, a Fellow of the American College of Trust and Estate Counsel and is board certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization. She is an American Bar Association's RPTE Section council member. She is the 2022 recipient of the Texas Bar Foundation's Terry Lee Grantham Memorial Award, recognizing her pro bono service. She was recognized as a "Woman Who Means Business" in 2021 and a "40 Under 40" in 2018 by the *Houston Business Journal* for her significant business accomplishments, as well as her commitment to community service, received a resolution in her honor from the State Bar of Texas in 2020, and was named the State Bar of Texas's Pro Bono Coordinator of the Year in 2018.

TABLE OF CONTENTS

Page

I. OVERVIEW 1

II. BASIC VALUATION PRINCIPLES 1

III. FAMILY LIMITED PARTNERSHIP ISSUES — Dealing with the IRS's Arguments Regarding Family Limited Partnerships 1
- A. I.R.C. § 2703 Argument 2
  - 1. I.R.C. § 2703 Cannot Be Used to Completely Ignore the Existence of a Partnership Validly Created and Existing Under State Law 2
  - 2. I.R.C. § 2703 Can Affect the Value of the Interest Transferred 2
- B. The Indirect Gift/Gift on Formation Argument 4
  - 1. A Gift Does Not Occur Where the Creation of the Partnership Was a Bona Fide Arm's-Length Transaction That Was Free from Donative Intent 5
  - 2. A Partner Cannot Make a Gift to Herself 5
- C. Disregarded Entities/Step Transaction 9
- D. I.R.C. § 2036(a) 11
- E. Significant § 2036 Cases 11
  - 1. *Estate of Cohen v. Comm'r* 11
  - 2. *Estate of Murphy v. United States* 13
  - 3. *Estate of Black v. Comm'r* 14
  - 4. *Estate of Turner v. Comm'r* 15
  - 5. *Estate of Kelly v. Comm'r* 17
  - 6. *Estate of Beyer v. Comm'r* 18
  - 7. *Estate of Powell v. Comm'r* 19
  - 8. *Estate of Moore v. Comm'r* 20
  - 9. Drafting for § 2036(a)(2) 23

IV. FORMULA TRANSFERS 25
- A. Value Adjustment Clauses 26
- B. Value Definition Clauses 27
- C. Recent Decisions Favor the Use of Formula Clauses 27
  - 1. *McCord* – Value in Excess of a Defined Amount Goes to Charity (2006) 27
  - 2. *Christiansen* – Value in Excess of a Defined Amount as Finally Determined Is Disclaimed to Charity (2008/2009) 30
  - 3. *Petter* – Value Adjustment Clause Based on Values as Finally Determined with Lifetime Transfer to Charity (2009/2011) 33
  - 4. *Hendrix* – *McCord*-Like Transaction in the Tax Court Again (2011) 34
  - 5. *Wandry* – Value Adjustment Clause Based on Values as Finally Determined, and No Third Party (2012) 36
  - 6. *Nelson* – Formula language matters 38
- D. Potential Donees of the "Excess Amount" Under a Formula Clause 40
  - 1. Public Charity/Donor Advised Fund 40
  - 2. Private Foundation 41
  - 3. Lifetime QTIP Trusts 41
  - 4. Grantor Retained Annuity Trusts 41
- E. Gift Tax Reporting 42
- F. Income Tax Issues 42

V. GROSS ESTATE/CHARITABLE DEDUCTION MISMATCH 43
A. *Dieringer v. Comm'r* 43
1. Facts 43
2. Arguments by the IRS and the Estate 44
3. Holding and Rationale of the Ninth Circuit 45
B. *Ahmanson Foundation v. United States* 45
C. *Provident National Bank v. United States* 46

VI. SECTION 2519 47
A. *Estate of Kite v. Comm'r,* T.C. Memo. 2013-43 (Feb. 7, 2013) 47
1. The Private Annuity Agreements 48
2. Section 2519 48
B. *Estate of Anenberg v. Comm'r*, 162 T.C. No. 9 (May 20, 2024) 48

VII. ISSUES REGARDING GRAT AUDITS 50

VIII. Valuation Effect of Life Insurance Funded Redemption Agreements 51
A. *Connelly v. United States*, 602 U.S. ___ (June 6, 2024) 51

IX. NET/NET GIFTS 52
A. *Steinberg* I 52
B. *Steinberg* II 53

X. VARIOUS VALUATION ADJUSTMENTS 55
A. Unrealized Capital Gains 55
B. Undivided Interests in Real Estate 58
C. Tiered Discounts 58
D. Tax Affecting Cash Flows of Flow Through Entities 59

XI. PROMISSORY NOTES 61
A. THE SECTION 7872 SAFE HARBOR 61
1. Application of § 7872 61
2. *Frazee* Court Determines Exclusivity of § 7872 63
3. *Estate of True* Emphasizes Extent of § 7872's Applicability 63
B. BONA FIDE LOAN OR GIFT? 64
1. Overview 64
2. Key to Analysis: Expectation of Repayment 64
3. Loan to Related Party to Invest in New Venture - Anticipated Success at Venture Is Sufficient for True Debt to Exist 65
4. In Determining Whether Transfer Is Loan or Gift, Courts Do Not Apply Factors Formulaically 65
5. Willing Third-Party Lender Unnecessary 66
C. Refinancing a Note at the AFR 66

XII. SPLIT DOLLAR LIFE INSURANCE 66
A. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 66
B. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016) (gift tax), T.C. Memo. 2021-60 (estate tax) 67
1. Gift Tax Case Holding 68
2. Estate Tax Case Holdings 68

C. *Levine v. Commissioner*, 158 T.C. No. 2 (February 28, 2022) 69

XIII. ADEQUATE DISCLOSURE TO START THE GIFT TAX STATUTE OF LIMITATIONS 69
A. Prior Law 70
B. The Taxpayer Relief Act of 1997 70
1. The Statutes 70
2. The Treasury Regulations 71
3. Adequate Disclosure Requirements in Treas. Reg. § 301.6501(c)-1(e) 71
4. Adequate Disclosure Requirements in Treas. Reg. § 301.6501(c)-1(f) 72
C. Preamble to the Final Regulations 74
D. Case and Other Sources 75
1. Treas. Reg. § 301.6501(c)-1(f) 75
2. Cases related to I.R.C. § 6501(e)(1), omission of items of income 77

XIV. PRIVILEGES IN THE ESTATE PLANNING CONTEXT 77
A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level – Anticipate Your Potential Audience 77
B. Understand the IRS's Broad Subpoena Power 78
C. Understand and Preserve All Privileges 78
1. The Attorney-Client Privilege 79
2. The Attorney Work Product Privilege 80
3. The Tax Practitioner's Privilege 81
4. The Physician-Patient Privilege 82
D. Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client's Best Interest to Do So 82

XV. AVOIDING VALUATION PENALTIES 82

XVI. WHERE ARE WE NOW AND WHERE ARE WE HEADED? 83

EXHIBIT A 85

I. OVERVIEW

The determination of the fair market value of an interest in property which is being transferred, either by gift or at death, is the foundation upon which our federal estate and gift tax system is built. The United States Supreme Court has often held that succession taxes, inheritance taxes and estate taxes are constitutional levies by the federal government only if they are applied in a manner that merely is an excise tax at the transfer of property at death. *See*, *e.g.*, *Knowlton v. Moore*, 178 U.S. 41 (1900); *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921). Therefore, only that property which is transferred as a result of a taxpayer's death or by gift during the taxpayer's life can be subjected to taxation under the federal estate and gift tax system. The tax cannot be a "wealth tax" or "property tax" on the intrinsic value of an asset to the decedent or donor at the time the transfer occurs; rather, it must be a tax on the value of the asset transferred. *See* I.R.C. §§ 2033, 2035-38, 2040(c), 2044 and 2501.

II. BASIC VALUATION PRINCIPLES

In determining the value of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). After that determination is made, federal tax law takes over to determine how such rights and interests will be taxed. *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Comm'r*, 309 U.S. 78 (1940); *Estate of Nowell v. Comm'r*, 77 T.C.M. (CCH) 1239 (1999) (Cohen, C.J.). The valuation of property for transfer tax purposes is based upon the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Regs. §§ 20.2031-1(b) and 25.2512-1. "The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is a not personalized one which envisions a particular buyer and seller." *LeFrak v. Comm'r*, 66 T.C.M. (CCH) 1297, 1299 (1993). "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case." Treas. Reg. § 20.2031-1(b).

Because of this test, there are two primary components of federal estate and gift tax valuation: (1) understanding the state law rights being transferred from the hypothetical willing seller to the hypothetical willing buyer, and (2) determining the fair market value of the transferred rights.

III. FAMILY LIMITED PARTNERSHIP ISSUES — Dealing with the IRS's Arguments Regarding Family Limited Partnerships

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity be completely disregarded for estate and gift tax purposes under various theories, whether or not that entity was validly created and existing under state law. *See*, *e.g.*, PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997); PLR 9735003 (May 8, 1997); PLR 9730004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997); and PLR 9723009 (February 24, 1997). Since those pronouncements were issued, a number of these arguments have been decided by the courts.

A. I.R.C. § 2703 Argument

Sec. 2703. Certain Rights and Restrictions Disregarded

> (a) GENERAL RULE—For purposes of this subtitle, the value of *any property* shall be determined without regard to—
>
> (1) any option, agreement, or other right to acquire or use *the property* at a price less than the fair market value of *the property* (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use *such property*.
>
> (b) EXCEPTIONS—Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

I.R.C. § 2703 (emphasis added).

1. I.R.C. § 2703 Cannot Be Used to Completely Ignore the Existence of a Partnership Validly Created and Existing Under State Law

In each of the National Office pronouncements, the Service took the position that § 2703 allows the IRS to disregard the existence of a partnership under the theory that the partnership agreement is a "restriction on the right to sell or use" the property of the partnership which can be ignored under § 2703 unless it meets the safe harbor provisions of § 2703(b). The IRS has lost that argument in every case it pursued the argument. *See, e.g., Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part on other grounds*, 293 F.3d 279 (5th Cir. 2002); *Church v. United States*, 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion,* 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinion available at 88 A.F.T.R.2d 2001-5352 (5th Cir. 2001).

2. I.R.C. § 2703 Can Affect the Value of the Interest Transferred

In *Estate of Blount v. Commissioner,* T.C. Memo. 2004-116 (May 12, 2004), the Tax Court addressed the question of whether the redemption price in a modified buy-sell agreement controlled the value of a decedent's closely-held stock for federal estate tax purposes. The decedent ("D") and his brother-in-law each owned 50% of the outstanding shares of stock in a construction company. In 1981, D, his brother-in-law, and the company entered into an agreement that restricted transfers of the company stock during both the shareholder's lifetimes and at death. The agreement required the company to buy a deceased stockholder's stock at an established price. Unless redetermined by the parties to the agreement, the purchase price would be equal to book value. In 1992, the company created an ESOP. The ESOP later became a third minority shareholder. After the redemption of the brother-in-law's shares following his death in January 1996, D's shares constituted a controlling 83.2% interest in the company.

In 1996 (without obtaining the ESOP's consent), D and the company modified the agreement, changing the price and terms under which the company would redeem D's shares at death, but leaving unchanged the provisions requiring the consent of other shareholders for lifetime transfers. The modified price was substantially below the price that would have been payable pursuant to the unmodified agreement. D died, and the company redeemed his shares pursuant to the modified agreement. D's estate reported the value of the shares held by D at death as equal to the price as set forth in the modified agreement.

The Court found that the restrictions in the modified buy-sell agreement were not binding on D during his lifetime because D, as the controlling shareholder, had the unilateral ability to amend the agreement. Therefore, under pre- § 2703 law, the agreement was disregarded for purposes of valuing the stock. In addition, the Court concluded that the agreement was subject to § 2703 because the modification significantly altered the rights of the parties with respect to the stock. The agreement did not fall within § 2703(b) because the estate failed to show that the modified agreement was comparable to similar arrangements entered into by persons in an arm's length transaction. The only evidence offered by the estate on the issue was testimony and the expert report of the estate's valuation expert, who testified that the terms of the modified agreement were comparable to similar arrangements entered into at arm's length because the price provided for in the agreement for D's shares was fair market value. The Court rejected this testimony, noting that the expert "did not present evidence of other buy-sell agreements or similar arrangements . . . actually entered into by persons at arm's length. Nor did he attempt to establish that the method decedent used to arrive at his $4 million price was similar to the method employed by unrelated parties acting at arm's length." Thus, the Court held that the modified agreement was disregarded under § 2703 in valuing D's stock.

In *Holman v. Commissioner*, 130 T.C. 12 (2008), the IRS argued that a right of first refusal contained in the partnership agreement should be ignored under § 2703. The right of first refusal permitted the Partnership (and if not exercised, the partners) to purchase an interest transferred to a "non-permitted transferee" at fair market value (*i.e.*, after considering applicable lack of control and lack of marketability discounts). Applying the three part test of § 2703(b), the Tax Court determined that the right of first refusal and related transfer restrictions were not part of bona fide business arrangement. The Court noted that § 2703 contains no definition of the phrase "bona fide business arrangement." The Court stated that the provisions "do not serve bona fide business purposes because from its formation through the date of the 2001 gift, the Partnership carried on little activity other than holding shares of Dell stock." Despite undisputed testimony from the taxpayers that one of the primary purposes of the buy-sell provisions was to prevent transfers of interests outside of the family and to preserve the assets contributed to the Partnership, the Court held that § 2703(b)(1) had not been satisfied because the purposes of the Partnership (in the Court's view) did not include the operation of a closely held business.

The Court also found that the buy-sell provisions did not satisfy the "device" test of § 2703(b)(2). The Court found that the buy-sell provision would permit the Partnership to redeem the interests of an impermissible transferee for less than the proportionate share of the Partnership's net asset value, and the values of the remaining partners' interests in the Partnership would increase because of that redemption. Because the partners benefiting from any redemption would include one or more of the taxpayers' children, the Court found the transfer restrictions to be a device to transfer units in the Partnership to natural objects of the taxpayer's bounty for less than adequate consideration.

The 8th Circuit affirmed the decision of the Tax Court in a 2-to-1 decision. *Holman v. Comm'r*, 601 F.3d 763 (8th Cir. 2010). The majority applied a clear error standard of review and not a de novo standard. With respect to the § 2703 analysis, the majority determined that the buy/sell agreement did not satisfy the bona fide business arrangement test of § 2703(a) because the predominant purpose for the

restrictions included in the partnership agreement was "estate planning, tax reduction, wealth transference, protection against dissipation by children, and education for the children." With respect to the willing buyer/willing seller test, the majority concluded that when the Tax Court calculated the discount for lack of marketability, it considered what a rational economic actor would deem appropriate and did not ascribe personal or non-economic motivations to a hypothetical purchaser.

The dissenting judge opined that the Holmans had satisfied the three required elements under § 2703(b). The dissent reasoned that the Holmans' goals of maintaining family control over the partnership, including the rights to participate as a partner and receive income, and protecting assets from outside creditors, were included as legitimate purposes in the legislative history of § 2703(b)(1). The dissent also noted that the Tax Court did not properly apply the willing buyer and the willing seller test in determining the lack of marketability discount for the partnership interests because it assumed that the hypothetical buyers already owned Holman limited partnership interests, in violation of the Tax Court's holding in *Estate of Jung v. Commissioner*, 101 T.C. 412, 438 (1993). The dissent noted that the "Tax Court's analysis is essentially based on the idea that a mere rational economic actor in the existing market would pay less than rational actors who already hold Holman limited partnership interests. Courts commit legal error where, as here, they substitute hypothetical buyers for 'particular possible purchases' based on 'imaginary scenarios as to who a purchaser might be.'" *Id*. at 34, citing *Estate of Simplot v. Comm'r*, 249 F.3d 1191, 1195 (9th Cir. 2001).

In *Kress v. United States*, 372 F.Supp.3d 731 (E.D. Wisc. 2019), the court applied § 2703 a provision in an S corporation's bylaws which restricted transfer of shares to nonfamily members. The court opined that § 2703(a) applied unless the plaintiff could satisfy the safe harbor provisions under § 2703(b). The court determined that the restriction was a bona fide business arrangement, contrasting the entity from the Holman partnership by noting that the company was "unmistakably an operating business . . . and there is no dispute that the Family Transfer Restriction was incorporated into the [bylaws] to ensure that the Kress family retains control of the company, to minimize the risk of disruption by a dissident shareholder, to ensure confidentiality of GBP's affairs, and to assure that all sales of GBP minority stock are too qualified subchapter S shareholders." The court also found that § 2703(b)(2) did not apply in a gift tax situation due to the use of the term "decedent's." The court found, however, that the plaintiff had failed to satisfy § 2703(b)(3) by showing that the restriction is comparable to similar arrangements entered into by persons in an arm's-length negotiation because they failed to submit specific evidence showing that the "right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's-length transaction" as required by the statute." Ignoring this provision only minimally impacted the lack of marketability discount, however, as the court applied a 3% downward adjustment.

B. The Indirect Gift/Gift on Formation Argument

The IRS's argument that a gift occurs when a partnership is created is based on the notion that if the value of the partnership interest received by a partner is less than the value of the assets contributed by the partner (under the fair market value definition of Treas. Reg. § 20.2031-1(b)), a gift has been made because someone must have received a gratuitous transfer of the difference. In support of this argument, the IRS commonly relies on *Commissioner v. Wemyss*, 324 U.S. 303 (1945), in which the Supreme Court stated that "[The gift tax statute by] taxing as gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate." 324 U.S. at 307-308.

1. A Gift Does Not Occur Where the Creation of the Partnership Was a Bona Fide Arm's-Length Transaction That Was Free from Donative Intent

The "ordinary course of business" provision under Treas. Reg. § 25.2512-8 deems a transaction to be for "adequate and full consideration" under § 2512(b), even if the purported transferor receives less consideration than a hypothetical willing seller would receive. A transfer is deemed to be for adequate and full consideration, and not subject to tax, if made "in the ordinary course of business (a transaction which is bona fide, at arm's-length, and free from donative intent)." Treas. Reg. § 25.2512-8. The creation of a mechanism to ensure family ownership and control of a family enterprise has long been held by the Tax Court to constitute a bona fide and valid business purpose. *See Estate of Bischoff v. Comm'r*, 69 T.C. 32, 39-41 (1977); *Estate of Reynolds v. Comm'r*, 55 T.C. 172, 194 (1970), *acq*., 1971-2 C.B. 1; *Estate of Littick v. Comm'r*, 31 T.C. 181, 187 (1958), *acq. in result*, 1984-2 C.B. 1; *Estate of Harrison*, 52 T.C.M. (CCH) at 1309.

2. A Partner Cannot Make a Gift to Herself

The IRS's claim that a gift on formation of the Partnership occurred also suffers from another fatal flaw – a partner cannot not make a gift to herself. Assume that at formation, Mrs. Jones owned a 90% partnership interest in the partnership, and other family members own the rest. The partnership is pro rata and each family member received an interest in the partnership equal to the value of the assets contributed. The IRS would argue that because the value of Mrs. Jones' interest in the partnership was worth less than the assets she contributed, she has made a gift equal to the difference between the value of the assets received and the value of the assets transferred. If a gift was made by Mrs. Jones, she was the recipient of 90% of that gift. *See Kincaid v. United States*, 682 F.2d 1220, 1225 (5th Cir. 1982) (noting that the taxpayer could not make a gift to herself when she transferred her ranch to a newly formed corporation that she and her two sons owned all of the voting stock, the Court held that she had made a gift to each of her sons of one-third of the total gift amount); *Estate of Hitchon v. Comm'r*, 45 T.C. 96 (1965) (father's transfer of stock to a family corporation for no consideration constituted gift by father of one-quarter interest to each of three shareholder sons).

On the other hand, in *Shepherd v. Commissioner*, a father and his two sons created a partnership and the father, at creation, transferred all of the assets to the partnership, and the sons made no individual capital contribution, the Tax Court held that the father had made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 376 (2000). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. In language which should give some level of comfort to creators of pro rata partnerships, the Tax Court stated that "obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of the contribution, thus entitling him to recoup the same amount upon liquidation of the partnership." *Id.* at 389. The Court also held, however, that the transfer should be treated as separate transfers of 25% to each son, and applied undivided interest discounts in determining the value of the gifts.

In *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), decedent formed a family limited partnership with his children and transferred assets to the partnership in return for a 99% limited partnership interest. The IRS argued that the decedent had made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Tax Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital account, the taxpayer had not made a gift at the time of the

contribution. Although the *Strangi* court rejected the IRS's gift on formation argument, it appeared to do so because the Tax Court did not believe that the decedent gave up control of his assets. As the Court stated, "in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a miniscule proportion of the value that would be 'lost' on the conveyance of his assets for the partnership in exchange for a partnership interest." *Estate of Strangi*, 115 T.C. at 490.

The Tax Court dealt the IRS's gift on formation a significant blow in *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001). In that case, Mr. Jones formed a family limited partnership with his son and transferred assets including real property in exchange for a 95.5389% limited partnership interest. He also formed a family limited partnership with his four daughters and transferred real property to it in exchange for an 88.178% limited partnership interest. The son contributed real property in exchange for general and limited partnership interests in the first partnership, and the daughters contributed real property in exchange for general and limited partnership interests in the second partnership. All of the contributions were properly reflected in the capital accounts of the contributing partners. The IRS argued that Mr. Jones made taxable gifts upon contributing his property to the partnerships. "Using the value reported by decedent on his gift tax return, the IRS argues that, if decedent gave up property worth $17,615,857 and received back limited partnership interests worth only $6,675,156, decedent made taxable gifts upon the formation of the partnerships equal to the difference in value." *Id*. at 127.

The Tax Court held that the contributions of property were similar to the contributions in *Strangi* and distinguishable from the gifts in *Shepherd*. "Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts." *Id.* at 128. Thus, even though Mr. Jones contributed most of the assets to the partnerships and received noncontrolling limited partnership interests in return, the Court held that he did not make a taxable gift on the formation of the partnerships because his contributions were properly reflected in his capital accounts when the entity was created and the value of the other partners' interests was not enhanced by his contributions.

In *Senda v. Commissioner*, T.C. Memo. 2004-160 (July 12, 2004), husband and wife ("H and W") signed a partnership agreement on April 1, 1998, and the certificate of limited partnership was issued on June 3, 1998. On December 28, 1998, H and W contributed approximately $1.8 million worth of MCI WorldCom stock to a partnership, and their children purportedly transferred oral accounts receivable for their partnership interests (which were .10% limited partnership interests). The accounts receivable were never reduced to writing, had no terms for repayment, and had not been paid as of the time of trial. On that same day, H and W sent a facsimile to their accountant to inform him of the transfer of stock and (except for charges) to ask what percentage of the limited partnership interest they should transfer to their children. Later that day, H gave each child a 29.94657% LP interest, and W gave each child a .0434% LP interest. The court noted that "the certificates of ownership reflecting these transfers were not prepared and signed until several years thereafter."

A second partnership was created in 1999 in a similar manner. However, the facsimile to the accountant regarding what percentage interest in the second partnership should be given to the children was sent two days after the purported gifts of the partnership interests.

The IRS argued, and the Tax Court agreed, that the transfers of stock to the partnerships and the gifts of limited partnership interests to the children should be as gifts of the underlying stock (without

discounts) rather than as gifts of discounted limited partnership interest. Relying on *Shepherd*, the Court concluded that there were no records or other reliable evidence that the parents contributed the stock to the partnerships before they made the gifts of partnership interests to the children. Although the parents argued that their capital accounts were increased by the amount of their contributions of stock to the partnership before the gifts were made, the Court found no evidence that the contributions were ever reflected in the parents' capital accounts.

The Eighth Circuit affirmed the Tax Court's decision, holding that the transfers of stock to the partnerships were indirect gifts of stock to the children because the taxpayers did not present reliable evidence that they contributed the stock to the partnerships before they transferred the interests to the children. The Court held that the Tax Court did not clearly err when it reached its conclusion as the evidence demonstrated that (1) the husband, as general partner, did not maintain any books and records for the partnerships, and (2) there was considerable delay in preparing the tax returns and the certificates of ownership after the transfers. The Court further noted that letters from the tax advisors were inconclusive in proving that the taxpayers transferred the stock before transferring the partnership interests. *See Senda v. Comm'r*, 433 F.3d 1044 (8th Cir. 2006).

In *Holman v. Commissioner*, 130 T.C. 170 (2008), the Tax Court rejected the IRS's indirect gift theory with respect to gifts of limited partnership interests made shortly after the partnership was formed and funded. On November 2, 1999, the taxpayers and a trust created for the benefit of their children formed a limited partnership and transferred Dell stock to it. Each of the contributing partners received an interest in the Partnership equal to the number of Dell shares contributed. Six days after the Partnership was formed and funded, the taxpayers gave limited partnership interests to a custodianship account and to a trust for the benefit of their children. In 2000, 2001, and 2002, the taxpayers made additional gifts of limited partnership interests.

With respect to the November 8, 1999, transfers, the IRS argued that (1) the taxpayers had made an indirect gift of Dell stock and not of the partnership units, and (2) the formation, funding and gifts of partnership units were steps in an integrated donative transaction and that once the intermediate steps are collapsed, the taxpayers' gifts are of Dell stock "in the form of partnership units." The IRS did not make the same arguments with respect to the 2000-2002 gifts.

The Tax Court rejected the IRS's indirect gift argument, noting that the Partnership was formed and funded before any gifts of partnership interests were made. The Court noted that unlike the transactions in *Senda* and *Shepherd*, the taxpayer had satisfied its burden to show that they "did not first transfer LP units to [the trustee] and then transfer Dell shares to the Partnership, nor did they simultaneously transfer Dell shares to the Partnership and LP units to [the trustee]." *Holman*, 130 T.C. at 186.

The Court also rejected the IRS's argument that the formation and funding of the Partnership should be treated as occurring simultaneously with the 1999 gifts of limited partnership units because the events were interdependent and the separation and time between the first two steps (formation and funding) and the third (the gift) serve no purpose other than to avoid making an indirect gift under Treas. Reg. § 25.2511-1(h). The Court noted that the IRS did not ask it to consider either the 2000 gift (made approximately 2 months after the formation of the Partnership) or the 2001 gift (made approximately 15 months after the formation of the Partnership) to be indirect gifts of Dell shares. The Court further noted that the passage of time between the funding of the Partnership and the transfer of interests in the Partnership was "indicative of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another." The Court noted that "petitioners bore a real economic risk of a change in value of the

Partnership for the six days that separated the transfer of Dell shares to the Partnership account and the date of the 1999 gift." The Court thus held that the 1999 gift should be treated in the same way as the IRS conceded the 2000 and 2001 gifts should be treated – as gifts of partnership units.

In *Gross v. Commissioner*, 96 T.C.M. (CCH) 187 (2008), the Tax Court again rejected the IRS's indirect gift theory regarding gifts of partnership interests made 11 days after the partnership was formed and funded. As in *Holman*, the Tax Court opined that the taxpayer did not make an indirect gift of the securities transferred to the partnership to her daughters. Rejecting the IRS's substance over form argument, the Tax Court noted that "all of the contributions were reflected in [the donor's] capital account, and the value of her daughters' capital accounts was not enhanced because of her contributions. After she contributed the [securities] to the partnership, she made gifts of interests in the partnership to her daughters." Rejecting the IRS's step transaction doctrine argument, the Tax Court noted that the donor bore a real economic risk of a change in value in the 11 days that had passed between the transfer of the securities to the partnership and the donor's gifts of interests in the partnership. The Tax Court noted, however, that "[w]e caution, however, in terms similar to those as we used in *Holman v. Commissioner*, 130 T.C. 170, 191, n.7 (2008): 'The real economic risk of a change in value arises from the nature of the [securities] as heavily traded, relatively volatile common stock. We might view the impact of a 6-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond.'"

In *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009), the district court held in summary judgment proceedings that the taxpayers' transfer of property to an LLC on the same day that gifts of LLC interests were made to a trust for their children resulted in indirect gifts of the underlying assets.

Linton involved the initial creation of an LLC in late 2002. On January 22, 2003, (1) Mr. Linton gave 50% of his interest in the LLC to his wife, (2) Mr. Linton signed documents transferring assets, including undeveloped real property, cash and municipal bonds to the LLC, and (3) Mr. and Mrs. Linton created trusts for each of their four children. The trust agreements stated that the agreements were entered into effective upon contribution of property to the trusts and stating that "at the time of the signing of this Agreement, the Grantors have transferred percentage interests in" the LLC to the trustee. The same day, Mr. and Mrs. Linton also signed gift assignments collectively assigning 90% of the LLC interests to the trusts. The taxpayers' gift tax returns reported gifts of approximately $725,000 each (after discounts). The IRS asserted that no discounts should be allowed and that the gifts by each were approximately $1.5 million.

The court's analysis focused on Treas. Reg. § 25.2511-1(h)(1), which applies the indirect gift approach for contributions to a corporation. The court concluded that "the distinguishing factor for gift tax purposes is whether the donating partner's contribution of property was apportioned among the other partners or was attributed only to the donor's own capital account." If the contribution is apportioned directly among the other partners' capital accounts, the contribution is treated as an indirect gift to the other partners.

Analyzing the factual scenarios present in *Shepherd*, *Jones*, and *Senda*, the court held that "because the trusts were created, and gifts of LLC interests were made to the Trusts . . . either before or simultaneously with the contribution of property to" the LLC, "the case is analogous to both *Shepherd* and *Senda*, and that the Lintons transfer of real estate, cash and securities enhance the LLC interests held by the children's Trusts, thereby constituting indirect gifts to Trusts of pro rata shares of the assets conveyed to the LLC." The court also found that the step transaction doctrine applied to ignore the valuation discounts. Distinguishing *Holman* and *Gross* from the facts in *Linton*, the court noted that the

donors did not delay the gifts for some period of time after funding of the LLC and there was no data concerning the fluctuations and the prices of the various securities on a daily basis during the period in question. Thus, the court held that the plaintiffs could not show "the volatility necessary to establish a real economic risk associated with" any delay that may have existed.

The Ninth Circuit reversed the district court's decision, holding that material issues of facts existed as to the sequence of the transactions in which the gifts were made. *Linton v. U.S.*, 630 F.3d 1211 (2011). The court noted that the attorney had erroneously dated the documents January 22, 2003, when the intent, according to the Lintons' accountant, was to date the documents January 31, 2003. Because the court could not determine at what point the couple had placed the gifts of the LLC interests "beyond retrieval" or otherwise objectively manifested an intent to make the gifts effective, it found there were material issues of fact as to when the gifts were complete under Washington law. In addition, the court found that the IRS was not entitled to summary judgment regarding the step transaction doctrine because the series of transactions made by the Lintons did not satisfy any of the three step-transaction tests.

Heckerman v. United States, 2009 WL 2240326 (W.D. Wash. 2009), is another gift tax case decided in the same federal district court (but by a different judge) as *Linton*. The court, granting the Government's motion for summary judgment, held that contributions of cash to an LLC and gifts of interests in the LLC on the same day should be treated as indirect gifts and as violative of the step transaction doctrine to eliminate valuation discounts for gift tax purposes.

On January 11, 2002, Mr. and Mrs. Heckerman transferred mutual funds (principally cash) to an LLC and on the same day transferred 49.60% interests in the LLC to trusts created for the benefit of their children. The documents assigning LLC interests and admitting the trusts as members of the LLC stated that the interests were signed "effective January 11, 2002." The gift tax returns attached an appraisal of the LLC interests based on a 58% discount. The IRS, however, asserted that the transfer of cash constituted an indirect gift to the trusts and, alternatively, that the step transaction doctrine applied to eliminate the valuation discounts.

Applying the same analysis as the court did in *Linton*, the court held that the facts were very similar to those of *Senda* and *Linton*, in that the transfer of assets to the LLC and gifts of interests in the LLC were made on the same day and the taxpayers could not prove which happened first. With respect to the step transaction doctrine, the court again distinguished *Holman* and *Gross* on the basis that there was no delay between the date of funding and the date of the gifts and that the nature of the gifts (cash) was such that the taxpayers could not establish that there was any real economic risk that the LLC units would change value between the time of the funding and the gifts of LLC units. Finding that the "end result test" (which is based on whether a "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result") was satisfied because the donors "clearly had a subjective intent to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of 'pre-arranged parts of a single transaction.'" The court also held that the "interdependence test" of the step transaction doctrine had been satisfied because "it is clear from the record that but for the anticipated discount in calculating gift taxes, based on a low market appeal of Family LLC's structure, Plaintiffs would not have transferred the cash into Investments LLC."

C. Disregarded Entities/Step Transaction

In *Pierre v. Commissioner*, 133 T.C. 24 (2009), the Tax Court addressed the question of whether interests in a single member limited liability company (treated as a disregarded entity under § 7701)

should be treated for gift tax purposes as transfers of proportionate shares of the underlying assets owned by the LLC or as transfers of interests in the LLC.

In *Pierre*, the LLC was organized on July 13, 2000. The taxpayer did not elect to treat the LLC as a corporation for federal tax purposes, and therefore the entity by default was treated as owned by the taxpayer "for federal tax purposes." On September 15, 2000, the taxpayer transferred $4.5 million in cash and marketable securities to the LLC. Twelve days later, the taxpayer transferred her entire interest in the LLC to two trusts, one created for the benefit of her son and the other created for the benefit of her daughter. The transfers consisted of a gift of a 9.5% interest and a sale of a 40.5% interest to each trust.

The IRS argued that because the taxpayer elected to treat the LLC as a disregarded entity for federal tax purposes under the § 7701 check-the-box regulations, the gift tax should be based upon the value of a proportionate share of the LLC's underlying assets. The taxpayer argued that state law, and not federal law, determined the nature of the interests transferred. Under applicable state law, a member has no interest in LLC property and the transfers of interests were properly valued as interests in the LLC (and subject to valuation discounts for lack of marketability and control).

The Majority decision of the Tax Court (authored by Judge Wells and joined by Judges Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison) analyzed the historical gift tax valuation regime and held that the check-the-box regulations do not explicitly alter "the long-established federal gift tax valuation regime." The Majority noted that Congress has enacted provisions of the Internal Revenue Code (*e.g.*, Chapter 14) that disregard valid state law restrictions in valuing transfers. In those cases, however, Congress expressly provided exceptions to address perceived valuation abuses. In the absence of explicit Congressional action and in light of the mandate in § 7701(a) that the check-the-box provisions apply only where the application is not "manifestly incompatible with the intent" of the Internal Revenue Code, the Majority held that Congress did not intend to eliminate entity related discounts for single member LLC's in the gift tax context.

Judge Cohen, joined by eight other judges (including all of the judges that joined in the Majority opinion except Judge Morrison), authored a concurring opinion noting that the Majority opinion does not involve the issue of deference to the Commissioner's interpretation of a statute and its regulations because § 7701(a) precludes the application of the statute where its terms are "manifestly incompatible with the intent" of the Internal Revenue Code. The concurrence noted that "[w]e have never accorded deference to the Commissioner's litigating position, as contrasted to (1) contemporaneous expressions of intent when the regulations were adopted, and (2) consistent administrative interpretations before the litigation."

Judge Halpern dissented, arguing that the plain language of the § 7701(a) regulations requires a single entity LLC to be disregarded for *all* tax purposes, including federal gift tax purposes. Judge Halpern's dissent was joined by Judges Kroupa and Holmes. In addition, Judge Kroupa authored a separate dissenting opinion noting that the check-the-box regulations do not just apply for "federal *income* tax purposes." (emphasis in original). Judge Kroupa's dissent was joined by Judges Colvin, Halpern, Gale, Holmes and Paris.

On May 13, 2010, the Tax Court issued its second opinion in *Pierre v. Commissioner*, T.C. Memo. 2010-106 (May 13, 2010). The Tax Court held that the step transaction doctrine applied to collapse the 9.5% gift and the 40.5% sale, which were made at approximately the same time, to each separate trust for valuation purposes. The Tax Court treated the transfers as an aggregate transfer of a 50% interest in the LLC to each trust. The Tax Court identified four reasons for concluding that the gift and sale were "integrated steps of a single transaction." The four reasons were (1) the transactions

happened the same day; (2) no time elapsed other than "the time it took for documents to be signed"; (3) the taxpayer "intended to transfer her entire interest in [the LLC] without paying gift tax"; and (4) each trust's capital account in the LLC's journal and ledger were recorded with the notation "to reflect gift transfer by Suzanne Pierre to Jay Despretz Trust and K. Despretz Trust" rather than distinguishing the gift and sale transaction. The Tax Court thus found that "nothing of tax independent significance occurred in the moments between the gift transactions and the sale transactions" and that the transactions "were planned as a single transaction and that multiple steps were used solely for tax purposes."

The effect of the Tax Court's ruling on valuation, however, was not substantial. The taxpayer had argued for a 10% lack of control discount and a 30% lack of marketability discount. The Tax Court, relying on trial testimony from the taxpayer's expert, found that the lack of control discount should be reduced to 8%. Surprisingly, the Government submitted no expert testimony to support its valuation position.

D. I.R.C. § 2036(a)

The primary area in which the IRS has experienced success in connection with its challenges to family limited partnerships involved situations where the taxpayers failed to respect the integrity of the entity. In these cases, the Tax Court has used § 2036(a) to bring the value of the assets of the partnership back into the decedent's estate as a retained life interest. Section 2036(a) provides as follows:

> (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> > (1) the possession or enjoyment of, or the right to the income from, the property, or
> >
> > (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

E. Significant § 2036 Cases

1. *Estate of Cohen v. Comm'r*

The § 2036(a)(2) position taken by the Tax Court in *Strangi* is contrary to the position taken by the Tax Court in *Estate of Cohen v. Commissioner*, 79 T.C. 1015 (1982). In *Cohen*, the decedent was a co-trustee of a Massachusetts business trust. The trust agreement gave the decedent and his co-trustees broad management powers with respect to the property of the trust, including the discretionary power to determine whether to declare dividends on common shares of the business trust. The IRS argued that the dividend power possessed by the decedent and his co-trustees gave them the "right" to designate the persons who enjoy trust income. *Id.* at 1023.

The Court began its discussion by analyzing *Byrum*, noting that the *Byrum* court:

> [R]ejected the contention that this de facto power to affect dividend policy was "tantamount to the right to designate the persons who shall enjoy trust income" (408 U.S. at 144), emphasizing the fiduciary obligations imposed upon both majority shareholders and corporate directors under the applicable local law. In view of these fiduciary constraints, Byrum's theoretical power in respect of dividends was not an "ascertainable and legally enforceable" right (408 U.S. at 136-37), and thus was not a "right" within the meaning of section 2036(a)(2).

Id. at 1023-24.

The *Cohen* Court emphasized the similarities between the Massachusetts business trust and the corporation in *Byrum*, and stated that "the very fact that we are concerned here with the declaration of ***dividends*** on ***shares*** representing interests in the entity bolsters the corporate analogy, and thus the relevance of *Byrum*." *Id.* at 1025 (emphasis in original). The Court further opined that:

> In *Byrum*, the critical impediments to the transformation of the power to affect dividend policy into a right to designate enjoyment were the fiduciary obligations imposed by local law on *Byrum* as a controlling shareholder and on the corporate directors he could elect. Therefore, the issue here must turn upon the construction of this trust agreement under Massachusetts law. ***If the agreement may be said to give the trustees unlimited discretion in this respect, so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would constitute a "right" under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such "right" exists.***

Id. (emphasis added).

The Court determined that a fair reading of the trust agreement would permit the omission of the dividend (or a reduction in amount) "only if the determination to eliminate or reduce the dividend were made in good faith and in the exercise of a bona fide business judgment." *Id.* at 1026. The Court further found that while "it was within the discretion of the trustees to prefer a business opportunity over a larger dividend, . . . there is no implication that the trustees could simply forego dividends without justification." *Id.* at 1026. Thus, the Court held that:

> In view of the perceived limitations on the dividend power in the trust agreement in question, and the apparent willingness of the Massachusetts courts to hold business trustees to a fair standard of conduct, we conclude that the decedent and his sons did not have the power to withhold dividends arbitrarily. Thus, they did not have an "ascertainable and legally enforceable" *right* to shift income between the classes of shareholders, and the dividend power does not require inclusion of either the common or preferred shares in the decedent's estate under section 2036(a)(2). We think *Byrum* is controlling.

Id. at 1027.

2. *Estate of Murphy v. United States*

In *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009), the Federal District Court for the Western District of Arkansas addressed a refund claim involving the IRS's attempt to apply § 2036 to the assets contributed by the decedent to a family limited partnership.

Charles H. Murphy, Jr. had been involved for over 50 years in the oil and gas, banking, and timber businesses. He created Murphy Oil Company, which spun off Deltic Land & Timber Co. He also owned substantial interests in two banking enterprises and other assets.

In 1997, after several years of planning, he formed a partnership to centralize management of core family assets and protect against dissipation of those assets. He transferred his interests in Murphy Oil Company, Deltic Land & Timber Co., and First United Bancshares, Inc. (which later became Bancorp South) to the partnership and the limited liability company that was the general partner. Two of his four children also contributed stock of these companies to the limited liability company. Mr. Murphy contributed assets worth approximately $90 million; he retained assets worth approximately $130 million outside of the partnership. Mr. Murphy acquired a 96.75% limited partnership interest and a 49% interest in the LLC general partner. His two children each acquired a 25.5% interest in the LLC. He gave away a 1% limited partnership interest to a university as a charitable gift.

The creation of the partnership was a part of Mr. Murphy's process of turning over management of family assets to the next generation. Two of his children shared his business/investment philosophy and were actively involved with the management of the partnership, its employees and its assets. Mr. Murphy's youngest son continued serving on the board of directors of the three corporations comprising the family's core assets. The partnership purchased 16,000 acres of farmland and timberland and made significant capital improvements to them. This property was purchased from Deltic Timber, and had comprised some of the Murphy family's early landholdings.

The partnership made only two distributions during Mr. Murphy's life. The first was a pro rata distribution in the first year to cover the partners' federal income taxes attributable to partnership income. The second distribution was a distribution of stock in a small company that was necessary to allow the company to convert to an S Corporation. This second distribution reduced Mr. Murphy's percentage interest in the partnership and his capital account.

Mr. Murphy made annual exclusion gifts of partnership interests to his children, their spouses and his grandchildren. At the time of his death, he owned a 95.25365% limited partnership interest and a 49% interest in the LLC. The assets of the partnership grew to $131.5 million at the time of his death. Mr. Murphy's estate reported the value of his 95.25% limited partnership interest at $74 million, based upon a combined 41% discount for lack of control and lack of marketability.

Between the time Mr. Murphy funded the partnership and his death, assets held by Mr. Murphy outside of the partnership had declined substantially in value. The estate needed additional liquidity to pay estate taxes. The estate borrowed $11 million from the partnership under a nine-year "Graegin" note which was secured by a 14.36% limited partnership interest.

After an audit, the IRS issued a notice of deficiency seeking additional taxes of $34 million plus interest. The IRS alleged that the estate undervalued various assets, and subsequently alleged that the partnership assets were includable in Mr. Murphy's estate under § 2036. The IRS also denied the deduction for the interest on the loan used to pay estate taxes. In response to the notice of deficiency,

the estate borrowed approximately $41 million from family trusts to pay the additional tax and interest, and filed a claim for refund. When the claim for refund was denied, the estate filed suit in the federal district court.

In its Findings of Fact and Conclusions of Law issued October 2, 2009, the court held that § 2036 did not apply to the partnership because the creation of the partnership qualified for the bona fide sale for adequate and full consideration exception under § 2036. The court found that the purpose of the partnership included pooling 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. The court noted that Mr. Murphy's youngest son was actively involved in the management of the partnership's assets, and the partnership purchased and managed property consistent with the goal of acquiring and maintaining the family's historical assets. The court also noted that Mr. Murphy retained $130 million of assets outside of the partnership, he did not treat the partnership assets as his own and did not commingle assets of his own with the partnership's assets. Finally, the court noted that the children who were involved with the partnership took an active role in its formation, and Mr. Murphy's daughter was represented by her own attorney.

3. *Estate of Black v. Comm'r*

In *Estate of Black v. Commissioner*, 133 T.C. 15 (2009), the Tax Court held that the value of property contributed to a family limited partnership by Samuel P. Black, Jr. ("Mr. Black") was not includable in his gross estate under § 2036 because the "bona fide sale for adequate consideration" exception was met.

Mr. Black and members of his family were the second largest shareholders of stock in Erie Indemnity Company. Mr. Black had previously made gifts of his Erie stock to his son and to two trusts set up for the benefit of his grandsons. In 1993, Mr. Black, his son, and the two trusts contributed their Erie stock to Black Limited Partnership ("Black LP"), a family limited partnership, in exchange for partnership interests in proportion to the fair market value of their respective contributions. The principal reasons for creating Black LP included: (i) perpetuating Mr. Black's buy-and-hold investment philosophy with respect to the Erie stock; (ii) placing the family's Erie stock under greater investment controls; (iii) allowing the Black family to maintain a seat on the board of directors and giving the family potential "swing vote" powers; and (iv) protection against future creditors and failed marriages. Of the Erie stock contributed to the partnership, Mr. Black contributed almost $69 million, his son contributed over $11 million, and the trusts for his grandchildren contributed almost $1 million.

Mr. Black died in December of 2001 and his wife died five months later. The IRS argued that § 2036 applied to the transfer of Erie stock by Mr. Black to Black LP, causing a pro rata portion of the underlying assets to be included in Mr. Black's gross estate.

In analyzing the IRS's argument, the Tax Court focused on the "bona fide sale for adequate consideration" exception to § 2036. As in *Schutt*, the Court examined the exception under the "legitimate and significant non-tax reason" standard. Also, the Court used the Third Circuit's requirement in *Thompson* and *Turner* for the need for some potential benefit to the transferor other than estate tax benefits. The Court found that the reasons for the creation of the partnership were substantially similar to those of *Schutt*, and that the partnership was formed for legitimate and significant nontax purposes.

Next, the Court examined the "adequate consideration" leg of the exception, under the four factor test used in *Schutt*:

> (1) The participants in the entity at the issue received interests proportionate to the value of the property each contributed to the entity; (2) the respective contributed assets were properly credited to transferors' capital accounts; (3) distributions required negative adjustments to distributee capital accounts; and (4) there was a legitimate and significant nontax reason for the formation of the entity.

Id. The factors were met in this case, but the Court went further and addressed the concerns expressed by the Third Circuit in *Thompson* that the value of the interests received in the partnership is often less than the value of the assets contributed, especially when the partnership does not operate a "legitimate business." The Court reasoned that the operation of a legitimate business is not required as long as the partnership has a legitimate and significant nontax purpose and obtaining a valuation discount is not the sole benefit of the partnership. Because this was found this to be true under the "bona fide" leg of the statutory test, the Court held that the transfer was made for adequate and full consideration. Therefore, the fair market value of Mr. Black's interest in Black LP, rather than the value of the underlying assets, was includable in his gross estate.

4. *Estate of Turner v. Comm'r*

In *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (Aug. 30, 2011), the Tax Court held that the value of property contributed to a family limited partnership by Clyde W. Turner, Sr. ("Mr. Turner") was includable in his estate under both §§ 2036(a)(1) and (a)(2).

Before his death, Mr. Turner had operated a lumber company with his brothers and used income generated by the company to acquire additional assets, principally stock of Regions Bank. Mr. Turner's father was the first depositor of Regions Bank and several family members had served on his board of directors. Mr. Turner also inherited some Regions Bank stock from his father, and he sold few, if any, shares over the years. By the time of his death, the stock had appreciated greatly in value, had paid dividends for years, and was the cornerstone of his wealth. Mr. Turner had other investments, including real estate. While he did not follow any particular investment strategy, he strongly believed in Regions Bank stock as a long-term investment.

In 2001, Mr. Turner recognized that his family investments were "really in a scrambled situation" and asked one of his grandsons to make a recommendation regarding asset management. In 2002, the family retained an estate planner who created the "Turner & Co. Limited Liability Partnership" (the "Partnership"). The Partnership was formed on April 15, 2002. It was funded with cash, Regions Bank stock, other stocks, CDs and various investment accounts. Sixty percent of the assets consisted of Regions Bank stock. At the time he formed the Partnership, Mr. Turner was in good health. He retained $2 million of assets outside of the Partnership.

During 2002 and 2003, Mr. Turner and his wife gave limited partnership interests to their three children and grandchildren. Mr. Turner died on February 4, 2004, after a brief illness. At his death, Mr. Turner owned a .5% general partner interest (the only general partner interest) and a 27.8% limited partner interest. The Internal Revenue Service argued that § 2036 applied to all of the assets transferred to the Partnership by Mr. Turner.

The Court first focused on whether Mr. Turner's transfer of assets to the Partnership satisfied the bona fide sale for full and adequate consideration exception. Noting that the partnership agreement was modeled on a standard form, the Court stated that some of the purposes listed in the partnership agreement did not apply to the Turner family. The Estate argued that Mr. Turner had several nontax reasons for creating the Partnership not listed in the partnership agreement. Those reasons were (1) consolidation of assets for management purposes; (2) facilitation of resolution of family disputes; (3) protecting family assets from one of the grandchildren and protecting that child from himself.

The Court rejected each of the proffered nontax reasons. First, the Court noted that although consolidation of assets can be a legitimate nontax purpose, the assets transferred to the Partnership were passive investments that did not require active management. The Court further noted that Mr. Turner did not have a distinct investment philosophy that he hoped to perpetuate and his daughter already had significant management responsibility with respect to the assets. Second, the Court rejected the Partnership as a tool to resolve family disputes, stating that the ill will among Mr. Turner's children was not about money and could not be solved by the Partnership. Third, the Court noted that although asset protection could be a legitimate nontax purpose, it did not apply in this case. Although one of the grandchildren had significant drug problems, previous transfers to that grandchild had been voluntarily made and nothing in the record indicated that the grandchild was a threat to the assets. The Court further observed that since Mr. Turner held $2 million outside of the Partnership, exposure to the grandchild continued despite the creation of the Partnership.

The Court identified several additional factors that led the Court to conclude that the transfers to the Partnership were not "bona fide." First, the Court stated that Mr. Turner was on "both sides of the transaction" and created the Partnership without any meaningful bargaining or negotiating with his wife (an original partner) or with any of the other anticipated limited partners. Second, Mr. Turner apparently commingled personal and partnership funds when he used partnership funds to make personal gifts, to pay premiums on life insurance policies for the benefit of his children and grandchildren, and to pay legal fees relating to estate planning. Third, the Court noted that Mr. Turner did not complete the transfer of assets to the Partnership for at least eight months after the Partnership was formed.

The Court also found that Mr. Turner retained possession and enjoyment of the assets transferred to the Partnership under § 2036(a)(1). The findings of the Court included the following: (1) Mr. Turner received excessive management fees of $2,000 per month given the Court's observation that he did not manage partnership assets at all; (2) Mr. Turner transferred most of his assets to the Partnership; (3) Mr. Turner used partnership funds to make personal gifts, to pay life insurance premiums, and pay legal fees associated with his estate planning; and (4) Mr. Turner commingled personal and partnership funds when he personally paid a partnership debt, purchased property on behalf of the Partnership, and reimbursed the Partnership for its purchase of certain notes without documentation.

The Court also found that § 2036(a)(2) applied because Mr. Turner, as general partner, had the sole and absolute discretion to make pro rata distributions of partnership income and to make distributions in kind. In addition, Mr. Turner had the authority to amend the partnership agreement at any time without consent of other limited partners.

In *Turner II* (*Estate of Turner v. Comm'r*, 138 T.C. 306 (March 29, 2012)), the court addressed the estate's motion for reconsideration regarding (1) the § 2036 issue, and (2) whether the marital deduction operated to exclude from the taxable estate the value of the partnership assets attributable to the assets included in the estate under § 2036. The court affirmed its § 2036 holding. As to the second point, the estate argued that there should be no estate tax deficiency because the formula marital

deduction clause in Mr. Turner's will allowed the estate to claim an increase in the estate tax marital deduction.

As to the marital deduction issue, the court acknowledged that applying § 2036 in the context of a family limited partnership raises two potential marital deduction issues on the death of the first spouse. First, potential mismatch between the date of death value of the ***partnership assets*** included in the gross estate under § 2036 and the fair market value of ***partnership interests*** used to fund the marital bequest.[1] The court concluded that this mismatch problem did not exist because the IRS increased the marital deduction by calculating it on the basis of the value of the assets transferred in exchange for the partnership interests that were owned by the decedent at death and used to fund the marital deduction bequest.

The second marital deduction mismatch issue that can arise is when lifetime gifts are made of partnership interests to someone other than a spouse, and the date of death value of the assets attributable to those partnership interests is included in the transferor's gross estate under § 2036. The estate asserted that the formula marital deduction should be recalculated based on the date of death value of the assets attributable to the partnership interests given away during Mr. Turner's life. The estate posited that § 2036 creates a legal fiction for purposes of the gross estate, and for consistency purposes, the marital deduction should be increased to reflect that legal fiction. The estate also argued that it would be inconsistent to conclude that the decedent retained a right to possess or enjoy the assets contributed to the family limited partnership, while at the same time ignoring the value of those assets included in the gross estate under § 2036 in calculating the marital deduction.

The court rejected the estate's arguments, stating that the estate tax marital deduction is based on a property interest that passes to or for the benefit of a surviving spouse, not the limited partnership interests that were given to family members (other than the surviving spouse) nor the underlying assets passed to or for the benefit of the surviving spouse. The court thus held that the estate could not deduct the value of either the gifted partnership interests or the underlying assets.

The court noted that the policy behind the marital deduction is one of deferral of tax rather than elimination of tax. Marital deduction property that is owned by the surviving spouse at death is not subject to estate tax. In regard to the assets attributable to the partnership interest that Mr. Turner gave to other family members, his surviving spouse did not have beneficial ownership. The court opined that allowing a marital deduction for the value of the gifted partnership interests or the value of the underlying assets would result in assets leaving the marital unit without tax at the first spouse's death or upon a transfer by gift or at the death of the surviving spouse.

5. *Estate of Kelly v. Comm'r*

In *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 (March 19, 2012), the Tax Court (Judge Foley) held that § 2036 does not require estate tax inclusion of operating quarries and other real property and assets contributed to a partnership during a guardianship proceeding. *Kelly* involved the creation of a partnership under a court order allowing the decedent's guardianship estate to contribute operating quarries and other assets to limited partnerships. The general partner of the partnerships was a corporation owned entirely by the decedent. The primary reasons proffered for the creation of the entities were to (1) ensure the equal distribution of the decedent's estate, thereby avoiding litigation after

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[1] This issue was raised by the IRS in *Estate of Black* and *Estate of Shurtz*. However, since § 2036 did not apply in those cases, the court did not reach the issue.

the decedent's death, (2) provide effective management, and (3) address potential liability concerns. The plan provided for the management of the assets (many of which required active management). Ms. Kelly retained $1.1 million out of the partnerships, and no distributions from the partnerships were used to pay any of her living expenses. The court found that the reasons for creating the partnership were legitimate and significant non-tax reasons, and the bona fide sale for full and adequate consideration exception applied.

Ms. Kelly also made gifts of limited partnership interests prior to her death. The IRS argued that the parties had an implied agreement that the decedent would continue to enjoy the income from the partnerships and that the partnerships' assets attributable to those gifted interests were includable in the gross estate under § 2036(a)(1). The IRS also argued that the language in the petition to the guardianship court for authority to implement the plan, which provided that the decedent would own all of the outstanding stock of the corporate general partner and that the management fee received would ensure that the ward would be provided with adequate income to cover her probable expenses for support, care and maintenance for her lifetime, was evidence of a retained right. The court rejected this argument, noting that the parties respected the entities, the decedent retained sufficient assets for living expenses, the management fee paid to the corporation was not used to pay living expenses, the fiduciary duties limited the fee to reasonable management fees, and the management fee paid to the company were in fact reasonable.

6. *Estate of Beyer v. Comm'r*

In *Estate of Beyer v. Commissioner,* T.C. Memo. 2016-183 (September 29, 2016), the Tax Court held that assets transferred to a limited partnership should be included in the decedent's estate under § 2306.

Edward Beyer, the retired CFO of Abbott, had accumulated approximately 800,000 shares of Abbott stock over his career. Mr. Beyer transferred his Abbott stock and other assets, held in a grantor trust ("the Living Trust"), to a family limited partnership (EGBLP). He subsequently sold his 99% limited partner interest out of the Living Trust to trusts for the benefit of his two nephews and a niece. The general partner interest was held in a management trust. One of Mr. Beyer's nephews held a power of attorney to act as general partner and direct all of Mr. Beyer's investments.

The IRS argued that the assets transferred were includable in his estate under § 2036(a).

In assessing whether the transfer was a bona fide sale for full and adequate consideration, the court noted that the Estate must show that the transfer was for a "legitimate and significant nontax reason." Furthermore, "The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. A significant purpose must be an actual motivation, not a theoretical justification."

The court noted that the partnership agreement contained a list of 28 boilerplate purposes that Mr. Beyer wanted to accomplish by forming EGBLP. However, none of Mr. Beyer's [testified to] desires were on the list.

The parties agreed that one reason for creating EGBLP was to keep the Abbott stock in a single block on a long-term basis. The court opined that this desire could have been accomplished by amending the grantor trust. The court further noted that the partnership agreement did not require the stock to be held as a single block and, in fact, the nephew's power of attorney allowed him to sell Abbot stock.

The parties also agreed that EGBLP was created for "continuity of management," to allow Mr. Beyer's nephew to manage the assets long term. Again, the court opined that an amendment to the Living Trust would accomplish this result.

The court ultimately determined that the Mr. Beyer's transfer of assets to EGBLP was not a bona fide sale for an adequate and full consideration in money or money's worth within the meaning of § 2036(a).

With respect to retained rights, the IRS argued that Mr. Beyer did not maintain sufficient assets outside of the partnership to pay his anticipated obligations, including gift and estate tax that would be anticipated. Based on his anticipated obligations, the court agreed.

The court noted that after Mr. Beyer sold the 99% limited partnership interest and the Living Trust was no longer a partner, the partnership distributed $659,660 to the Living Trust to pay his gift tax liability. The court also noted that after Mr. Beyer's death, $9,945,000 was transferred to the Living Trust to pay Mr. Beyer's estate tax. The court further noted that the Living Trust agreement obligated the Living Trust to pay any death taxes due after Mr. Beyer died.

Thus, the court determined that § 2036(a) applied to the assets of the partnership.

7. *Estate of Powell v. Comm'r*

In the *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), the Tax Court held that § 2036(a)(2) (via § 2035) operated to include in a decedent's estate assets that the decedent's son had transferred to a limited partnership seven days before the decedent's death under a power of attorney.

The decedent's son, using a power of attorney, contributed $10 million of cash and marketable securities to a limited partnership in return for a 99% limited partnership interest. The decedent's two sons also contributed notes in return for a 1% general partner interest. The same day, the son transferred the decedent's 99% limited partnership interest to a charitable lead annuity trust, with the remainder passing at the decedent's death to her two sons. The value of the interest was based on a 25% combined discount for lack of control and lack of marketability. The decedent died seven days later.

The IRS claimed that the assets contributed to the partnership were includible in the decedent's estate under §§ 2036(a)(1), 2036(a)(2), 2038, and under § 2035(a) (transfer of property within three years of death that otherwise would have been included in the estate under §§ 2036-2038 or 2042), even if the transfer to the CLAT was valid. Interestingly, the taxpayer did not challenge the IRS's application of § 2036(a)(2), or assert that the bona fide sale for full and adequate consideration exception to § 2036 applied. The taxpayer simply argued that §§ 2036 and 2038 could not apply because the decedent did not own any interest in the partnership at her death (despite the fact that the interest had been transferred within 3 years of her death).

The majority and concurring opinions both agreed that § 2036(a)(2) applied. The majority opinion was based on the holdings (1) that the decedent, in conjunction with all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the general partner and as her agent, could control the amount and timing of distributions from the partnership.

Because § 2036(a)(2) applied, the court did not address §§ 2036(a)(1) or 2038.

Although not raised by either party, the majority opinion also addressed how §§ 2036 and 2038 operate in conjunction with § 2043 to "avoid" double inclusion. The consideration received in return for

the contribution to the partnership (*i.e.*, the 99% interest) is subtracted under § 2043 from the amount included in the gross estate under § 2036.

In effect, the value of the discount is included under §§ 2036/2043 (*i.e.*, the value of the assets contributed to the partnership under § 2036 less the value of the 99% interest considering lack of control and marketability discounts received in return under § 2043). In addition, the 99% interest is included in the gross estate (if the gift is not authorized under the power of attorney) or is included in adjusted taxable gifts if the gift is recognized.

But that analysis avoids double inclusion ***only*** if the assets have not appreciated before death (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, the majority opinion acknowledges that a "duplicative transfer tax" would apply because the date of death asset value included in the gross estate under § 2036 is offset only by the date of contribution value of the partnership interest. The date of death value of the limited partnership interest would also be included under § 2033, so all of the post-contribution appreciation of the assets would be included under § 2036 and the discounted post-contribution appreciation would also be included under § 2033. Under this analysis, more value may be included in the gross estate than if the decedent had never contributed assets to the partnership.

The majority opinion addressing the double inclusion analysis was joined by only 8 judges (one of whom was Judge Halpern, who is a Senior Judge). A concurring opinion that rejected the double inclusion analysis was joined by 7 judges, and 2 judges concurred in the majority opinion in result only.

8. *Estate of Moore v. Comm'r*

In *Estate of Moore v. Comm'r*, T.C. Memo. 2020-40, the Tax Court held that § 2036 operated to include in a decedent's estate assets that the decedent had transferred to a limited partnership approximately four months before his death after he had been admitted to hospice care.

In late 2004, while the decedent was negotiating the sale of his successful family farming business, his health failed, resulting in his hospitalization. On December 15, 2004, the decedent was discharged to hospice, after his doctors described his condition as "critical" and estimated his life expectancy at six months.

As he was in the discharge process, the decedent started to work on his estate plan with the help of a veteran estate planning attorney that he previously consulted for basic documents. On December 20, 2004, the decedent created a foundation, five trusts, and a family limited partnership (the "Moore FLP"). He transferred an 80% interest in the family farming business to the Moore FLP.

On February 4, 2005, the decedent sold his business for $16.5 million, and the proceeds were split between the living trust and the Moore FLP based on their 20% and 80% interests in the company. Proceeds from the sale were used for the decedent's benefit, including by (a) his living trust and Moore FLP paying $200,000 that the decedent owed to his estate planning attorney and (b) the Moore FLP making (i) $500,000 "advances" to each of the decedent's four children, (ii) a $500,000 gift to the decedent's grandson, and (iii) a $2 million non-pro rata distribution to the living trust. The Tax Court determined that none of the advances, nor the $2 million distribution, was a loan by Moore FLP.

On March 7, 2005, the living trust sold its 95% Moore FLP limited partnership interest to an intentionally defective grantor trust (the "Irrevocable Trust") for $5.3 million based on the partnership's

net asset value, less a 53% discount. The Irrevocable Trust paid the purchase price using a $500,000 gift from the Living Trust and promissory notes.

In late-March 2005, the decedent died. The estate reported the 2005 gift to the Irrevocable Trust on a gift tax return for that year. The estate tax return reported the following assets (a) beneficial interest in the Management Trust (valued at $0.54 million) and (ii) notes receivable from the Irrevocable Trust (valued at $4.8 million). The decedent's estate also claimed as deductions (x) a debt owed by the Living Trust to the Moore FLP of $2 million (related to the non-pro rata distribution), (y) a charitable deduction of $4.8 million, and (z) estate administration expenses of $475,000 for attorney's fees paid to the decedent's estate planning attorney.

The Commissioner asserted that the assets of the partnership or, alternatively, the 95% partnership interest transferred, were included in the decedent's estate under § 2036. The Commissioner also challenged each deduction claimed by the decedent's estate.

The Tax Court agreed that the assets transferred to Moore FLP were included in the estate under § 2036. Addressing the bona fide sale test, the Tax Court noted that the inquiry into whether a transfer is bona fide focuses on motives. When looking at motive, the Tax Court acknowledged that it does not apply a uniform test. *See id.* at *30 n.14. Rather, it analyzes some combination of the transfer's (a) significant and legitimate nontax purpose and (b) genuine arm's-length nature.

The Tax Court rejected the estate's position that the following purposes: (1) to bring together "dysfunctional" family members to help manage the decedent's business; and (2) to protect against liabilities, creditors, and bad marriages, satisfied the bona fide sale test. As to the first purpose, the Tax Court explained that "there was no business to run" since the decedent sold the farming business within days of the formation and funding of the Moore FLP. *Id.* *32-33. Further, an investment advisor managed the liquid assets that remained in Moore FLP after the sale, with there being no evidence that the family took any interest in their management. The Tax Court was also skeptical of the desire for creditor protection because (a) the decedent's children were "unable to name any possible creditors and were unaware of any threats of possible litigation" and (b) the Moore FLP "held a significant amount of capital for any creditor to pull from." *Id.* *33-34. Instead, the Tax Court identified the decedent' poor health, statements, and unilateral actions, as well as the overall testamentary nature of the estate plan, as factors showing the absence of a bona fide sale.

The Tax Court also held that an implied agreement existed under which the decedent retained possession or enjoyment over the assets contributed to Moore FLP because the decedent (i) continued to live on and operate the farm after its contribution to and sale by the Moore FLP, (ii) using non-pro rata distributions from the Moore FLP to pay personal expenses and make gifts to his children and grandchildren, (iii) making all decisions related to Moore FLP assets, and (iv) making statements that his planning goal was to minimize taxes and retain control over his property.

The Tax Court also revisited the consideration offset under § 2043 addressed in *Estate of Powell*. Building on that decision, the court designed the formula below for determining the appropriate inclusion amount and provided four hypothetical demonstrative examples of its application.

Remaining Consideration $_{DOD}$[†]
Section 2035-38 Property $_{DOD}$
(Received Consideration $_{TD}$)

Net Inclusion Amount

DOD = Date of Death TD = Transfer Date

Example 1 (Constant Value): A decedent contributes land valued at $1,000 to a partnership in exchange for interests worth $500. The transfer is subject to sections 2035-2038. There were no changes in value between the contribution date and the date of death. As a result, the inclusion amount equals $1,000 ($500 + $1,000 - $500).

Example 2 (Inflating Value): Same facts as Example 1, except that the date of death values of the land and partnership interests have doubled between the contribution date and the date of death. As a result, the inclusion amount equals $2,500 ($1,000 + $2,000 - $500).

Example 3 (Declining Value): Same facts as Example 1, except that the date of death values of the land and partnership interests have halved between the contribution date and the date of death. As a result, the inclusion amount equals $250 ($250 + $500 - $500).

Example 3 (Discounting; Simple): Similar facts as Example 1, except that the decedent receives limited partnership interests subject to a 25% discount in exchange for the contribution of land with a value of $1,000. Post-discount, the limited partnership interests received by the decedent have a value of $750 on the contribution date. There was no change in the value between the contribution date and the date of death. As a result, the inclusion amount equals $1,000 ($750 + $1,000 - $750).

Example 4 (Discounting; Complex): Same facts as Example 3, except that the partnership sells the land for $1,000 and distributes $400 to the decedent. There are no other changes to the value of the partnership between the contribution date and the date of death. As a result, the inclusion amount equals $700 ($450 + $1,000 - $750), plus the $400 distribution under section 2033.

In sum, the § 2043 analysis results in some amount of double inclusion if the partnership assets increase in value between funding and death, and a lower value if the assets decrease in value during the same period. The Tax Court left the parties to handle the computation of the net inclusion amount.

A final issue related to the § 2036 finding involves the estate's claim for an additional charitable deduction under § 2055 for amounts that would pass to charity by operation of a formula clause. The Irrevocable Trust required its trustee to "distribute [to the living trust] an amount equal to the value of any asset of this trust which is includible in my gross estate for federal tax purposes." *Id.* *8-12.

[†] Because this variable is "not limited by tracing rules," whatever is left of the original consideration is included, as are any proceeds from subsequent transfers that are included within the gross estate under § 2033; but, property that leaves the estate between the transfer that is subject to §§ 2036 through 2038 and the decedent's death is not generally included in the gross estate. *Id.* *45-46.

Likewise, the living trust contained a formula charitable residuary bequest in favor of a charitable lead annuity trust (the "CLAT") for amounts passing to it from the Irrevocable Trust.

The Tax Court identified two problems with the position taken by the estate. First, the court's § 2036 holding never triggered the operative language of Irrevocable Trust's formula clause because the clause applied only to "any asset of ***this trust***," included in the estate (it was the assets of the Moore FLP included under § 2036). Second, this deemed transfer from the irrevocable trust to the living trust to the CLAT was too contingent to permit a charitable deduction under § 2055 because it was dependent on a successful audit by the Commissioner.

9. Drafting for § 2036(a)(2)

a. Distribution provisions consistent with *Cohen/Byrum* analysis

"**Operating Distributions**

1.01 No Other Distributions Except as provided in this Article, the Partnership shall make no distributions of cash or other property to any Partner until its liquidation as provided in Section _____.

1.02 Distributable Cash Distributable Cash includes only that cash held by the Partnership at the end of a Fiscal Year after reasonable reserves of cash have been set aside by the Partnership Management, subject to the duties imposed by Section ____, for working capital and other cash requirements, including current and reasonably projected expenses, current and reasonably projected investment opportunities, and reasonably anticipated contingencies. For purposes of this Section, any of the Partnership Assets that are contributed to the Partnership by the Partners, any borrowed funds, and any cash generated upon the sale of any of the Partnership Assets, including Partnership Assets that are purchased with borrowed funds and including the cash attributable to appreciation in value, shall be considered as necessary for investment purposes.

1.03 Operating Distributions

(a) From time to time during each Fiscal Year, the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute any part or all of the Distributable Cash proportionately to each of the Partners based on their Percentage Interests.

(b) During the course of a Fiscal Year, in lieu of making any determinations or distributions under Sections 1.02 and 1.03(a), the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute cash or other Partnership Assets proportionately to the Partners based on their Percentage Interests; provided that the total amount of distributions under this Section 1.03(b) in any Fiscal Year may not exceed five percent (5%) of the fair market value of the Partnership Assets (net of liabilities) as of the beginning of that Fiscal Year.

(c) No distributions under Section 1.03(a) or 1.03(b) shall have the effect of changing any of the Percentage Interests.

1.04 Income Tax Distributions Regardless of the amount of Distributable Cash and in addition to any distributions under Section 1.03, the Partnership may distribute during the

course of each Fiscal Year an amount of cash that would be sufficient for each Partner to pay the Partner's federal and state income taxes attributable to profit and loss allocations by the Partnership at the highest marginal income tax rate, including quarterly estimated tax payments. Any distributions under this Section 1.04 shall be made proportionately to the Partners based upon their Percentage Interests, by distributing the smallest total amount necessary for each Partner to pay such tax."

b. Liquidation/amendment provisions to address *Powell*

To avoid the §2036(a)(2) holding in *Powell*, it is important for the senior family member to have no right, directly or indirectly, to vote on liquidating the entity. In this example, the general partner is a limited liability company owned solely by parties other than the senior family member (i.e. children).

"**Winding Up and Termination**

(1) Winding Up. No Partner may cause the winding up of the Partnership except as provided in this Section. The Partnership shall not be wound up until the first to occur of:

a. the death of the first to die of any individual General Partners;

b. the unanimous, written consent of the General Partners;

c. a decree by a court requiring the winding up or dissolution of the Partnership, rendered under the Act or other law;

d. December 31, ____, unless within ninety days after such date all remaining Partners agree in writing to continue the business of the Partnership; or

e. an event of withdrawal of a General Partner, as the term "event of withdrawal" is defined [under local law], unless:

(i) there remains at least one General Partner and the remaining General Partner or General Partners wish to carry on the business of the Partnership; provided that if the event requiring a winding up was the death of a General Partner, any substituted General Partner admitted to the Partnership as provided in Section ____ shall not have the right to participate in the determination of whether the Partnership's business should be carried on; or

(ii) if there remains no General Partner within ninety days after the event of withdrawal of the last remaining General Partner, the Limited Partners agree in writing to continue the business of the Partnership by a majority vote based on their Percentage Interests and agree to the appointment of one or more new General Partners to be effective as of the event of withdrawal; provided in each case that the agreement of a former General Partner who is admitted to the Partnership as a Limited Partner upon withdrawal as provided in Section ____ shall not be required with respect to any Partnership Interest owned by that

former General Partner if the event requiring a winding up was that former General Partner's withdrawal, further provided that the agreement of a substituted General Partner admitted to the Partnership as provided in Section ____ shall not be required with respect to any Partnership Interest owned by that substituted General Partner if the event requiring a winding up was the death of the antecedent General Partner, and further provided that all of the remaining Partners shall bear proportionately the dilution of their Partnership Interests caused by the admission of any General Partner under this Section _____.

(2) Modification, Termination, and Waiver. This Agreement may be modified, terminated, or waived only by written agreement of all of the General Partners; provided that no modification or amendment that both adversely and disproportionately affects any Limited Partner shall be effective unless it is approved in writing by that Limited Partner."

IV. FORMULA TRANSFERS

In planning involving the transfer of hard-to-value assets such as interests in closely held entities, job one is to engage a qualified and experienced appraiser to determine the value of the asset transferred. Some clients, however, do not desire to run the risk of the IRS attempting to take a contrary valuation position in an attempt to impose additional gift or estate tax. For this reason, formula clauses have been used by careful practitioners for years to remove valuation uncertainty from transactions.

In the typical valuation case, the taxpayer simply argues that the value determined by the appraiser is correct. With a formula clause, the taxpayer possesses additional arguments to avoid the imposition of transfer tax. Formula clauses are designed to limit the transferor's gift exposure by either adjusting the value of the interest transferred to the extent a different value is "finally determined for gift tax purposes" (a "value adjustment clause") or specifying the dollar value of the interest transferred (a "defined value clause").

Because a formula clause may negate an IRS attempt to impose additional transfer tax, the IRS has challenged their use under a variety of theories. The IRS asserts that formula adjustment clauses are against public policy because they are a condition subsequent to the transaction that render any audit or litigation regarding value meaningless. The IRS claims that the clauses waste both the IRS's and the court's time, because once a determination is made that the value of the transferred property is higher than the taxpayer believed, the clause kicks in to adjust the transaction so that no gift tax is owed. Taxpayers assert that such clauses provide the taxpayer with certainty as to the tax they owe in a given transaction, and are designed with the very admirable goal of avoiding valuation disputes with the IRS.

Given the numerous types of formula clauses routinely sanctioned by the Treasury, the IRS's position seems disingenuous. These clauses include:

- Formula marital deduction clauses (Rev. Proc. 64-19, 1964-1 C.B. 682)
- Formula GST transfers (Treas. Regs. §§ 26.2632-1(b)(2)(11), 26.2632-1(d)(1))
- Split-interest charitable trusts (Treas. Reg. § 1.644-2(a)(1)(iii); Rev. Rul. 72-395, 1972-2 C.B. 340; Treas. Reg. § 20.2055-2(e)(2)(vi)(a))

- Formula transfers to a GRAT (Treas. Reg. § 25.2702-3(b)(1)(ii)(B))

In each example, the formulaic adjustment would be made ***only*** if the value of the transferred property is determined to be different than the originally reported value.

Over the years, several value adjustment clauses have been tested in the courts, with the results historically favoring the IRS's position that the transfer tax consequences of the transfer should be determined without regard to the clause. But recent decisions in *McCord, Hendrix*, *Christiansen*, *Petter*, and *Wandry* provide the taxpayer with substantial reason to be optimistic about the use of formula clauses and provide needed guidance to practitioners in their use and implementation.

A. Value Adjustment Clauses

There are generally two types of value adjustment clauses. The first type of clause provides that if it is finally determined for transfer tax purposes that the value of the property transferred exceeds a specified dollar amount (*e.g*., by agreement with the IRS or by a court decision), the size of the transferred interest is reduced so that the value of the property transferred equals the specified dollar amount. The second type of clause, rather than adjusting the size of the transferred interest, requires the transferee to give additional consideration to the transferor equal to the difference between the value of the interest as finally determined for transfer tax purposes and the specified dollar amount.

The validity of value adjustment clauses was first addressed in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the taxpayer transferred property and provided in the transfer document that if it were determined by a final judgment of a court of last resort that any part of the transfer was subject to gift tax, the property subject to gift tax would be deemed excluded from the transfer and would remain the transferor's property. The Fourth Circuit Court of Appeals held that the provision did not eliminate the taxable gift because it imposed a condition subsequent that violated public policy. The court determined that the provision would be "trifling with the judicial process," *id.* at 827, and would inhibit tax collection since attempts to enforce the tax would defeat the gift. Moreover, the court held that giving effect to the provision would obstruct justice because courts would have to pass on a tax issue that became moot once the decision was rendered.

In *Ward v. Commissioner*, 87 T.C. 78 (1986), the Tax Court held that a gift of shares of stock of a closely-held corporation which the donor reserved the right to revoke the gift to the extent the value of each share was "finally determined for Federal gift tax purposes . . ." to exceed $2,000 would be disregarded for purposes of determining the amount of the gift. The Tax Court opined that the transaction was a gift subject to a power of revocation exercisable upon the occurrence of an event beyond the control of the donor. Because the donor had no control over the possible revocation of the gift, the court determined that the donor parted with all dominion and control over the transferred property and that there was a completed gift of the entire property. Moreover, the Tax Court also determined that the clause violated public policy under the analysis set forth in *Procter*. The Tax Court also ignored valuation adjustment clauses in *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (1986), and *Estate of McLendon v. Commissioner*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

The only pre-*McCord* decision upholding the validity of a formula transfer was the Tenth Circuit's decision in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), which involved the sale of stock pursuant to a value (or purchase price) adjustment clause. In *King*, the taxpayer sold stock to trusts for his children for $1.25 per share, a price the taxpayer believed to be equal to its then fair market value. The sales agreements provided that "if the fair market value . . . as of the date of . . . [the

agreement] is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the . . . manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." 545 F.2d at 703-04. The IRS took the position that the shares were worth more than $1.25 per share, and that the price adjustment clause was ineffective. The Tenth Circuit rejected the IRS's argument, holding that the taxpayer had not made a taxable gift. The court distinguished the case from *Procter* since the sole purpose of the *Procter* clause was to rescind the transaction in the event it was determined to be a taxable gift. The *King* court stated that

> Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not affect the nature of the transaction.

Id. at 705. The Tenth Circuit found that the *King* clause had a proper purpose; that is, "an attempt to avoid valuation disputes with the Internal Revenue Service agents by removing incentive to pursue such questions is not contrary to public policy in the absence of a showing of abuse."

B. Value Definition Clauses

Although value definition clauses have the same dispute avoidance goal as value adjustment clauses, they operate very differently. Rather than adjusting the value of a gift after an adverse determination, a value definition clause seeks to specify the value of the transferred interests at the time of the transfer. For example, if a transferor desires to give a $1 million interest in an entity to a child, the transfer document would specify that the transferor assigns to his child that number of shares having a fair market value of $1 million on the date of the gift. Until recently, the IRS has not focused on value definition clauses in the same manner that it focused on adjustment clauses. But in FSA 200122011 (issued in connection with the *McCord* audit), the IRS took the position that value definition clauses are also void against public policy under the same theories as set forth in *Procter*, *Ward*, and their progeny.

C. Recent Decisions Favor the Use of Formula Clauses

1. *McCord* – Value in Excess of a Defined Amount Goes to Charity (2006)

The application of *Procter* and *Ward* to value definition clauses was directly at issue in *McCord v. Commissioner*, 120 T.C. 358 (2003). In *McCord*, the taxpayers made a gift of their 82% limited partnership interests to a group consisting of their sons, generation-skipping trusts for the benefit of each son's family line, and two charities. The gift was made using a value definition clause in which the taxpayers specified that their sons and the trusts, collectively, had the right to receive that portion of the transferred interests having a fair market value of $6.9 million with the remainder of the interests passing to the charities. The taxpayers left it up to the dunes to determine what portion of the 82% interest passed to the sons and the trusts (*i.e.*, what portion of the interest had a fair market value of $6.9 million), and what portion passed to the charities. After the gift was made and after an appraisal was obtained, the donees entered into an arm's length agreement as to the percentage interest each received in a document entitled "Confirmation Agreement." The partnership redeemed the charities' interests approximately seven months after the gifts.

The IRS argued that the value of the partnership interests transferred by the McCords was substantially greater than that set forth in the gift tax return. Relying on *Procter*, the IRS also asserted that the defined value clause should be ignored. As to the value definition clause, the taxpayers countered that the clause should be respected, asserting that the gift tax is based upon the state law property rights transferred (*see United States v. Bess*, 357 U.S. 51 (1958)), and that the rights transferred to the sons and the trusts under the assignment agreement were the right to receive, collectively, interests in the partnership having a fair market value of $6.9 million. Thus, the value of the gift to the sons and the trusts was equal to $6.9 million.

The taxpayers also argued that clauses similar to the defined value clauses used to transfer the 82% interest are commonly used in other areas and have been approved by the IRS. Using such clauses, a donor can define the amount of a transfer that is subject to tax and ensure that the remainder is either entitled to a deduction from such tax or is not subject to such tax. *See*, *e.g*., Rev. Proc. 64-19, 1964-1 C.B. 682 (defined value formula for funding the marital deduction). *See also* Treas. Reg. § 25.2518-3(c) (defined value formula for pecuniary disclaimer). Similarly, the Treasury Regulations specifically sanction using formula allocations of GST exemption to ensure that a generation-skipping transfer is exempt from GST tax or that a generation-skipping trust has an inclusion ratio of zero. *See* Treas. Regs. §§ 26.2632-1(b)(2), 26.2632-1(d)(1). Likewise, the regulations permit the use of formula clauses in determining the amount passing to charity under a charitable trust. Treas. Reg. § 1.664-2(a)(1)(iii) (percentage of initial fair market value as finally determined for federal tax purposes), 1.664-3(a)(1)(iii) (adjustments in annuity amounts if incorrect determination of fair market value has been made); *see also* Rev. Rul. 72-392, 1972-2 C.B. 573, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71. The IRS has even recognized the validity of a value definition clause in its pronouncements. T.A.M. 8611004 (Nov. 15, 1985).

The taxpayer also distinguished *Procter* and its progeny because the cases involved formula clauses that attempted to adjust the terms of a gift *after the gift was made*. In those cases, assets were purported to be transferred in such a way that, if it was determined by the IRS or the court that a portion of the transfer would be subject to gift tax, the transaction was adjusted after-the-fact such that those portions were no longer subject to gift tax. *See, e.g., Procter*, 142 F.2d at 827; *Ward*, 87 T.C. at 114. Contrasting the case with *Procter*, the value of the interests transferred under the *McCord* defined value clause to the sons and the trusts were readily determinable, and were not subject to change. The sons and the trusts were entitled, collectively, to the first $6.9 million of transferred interests. The value of the transfer to the sons and the trusts was unaffected by any determination by the court or by the IRS. The taxpayers were simply trying to determine and establish with certainty, through the use of a formula clause specifying the dollar value of the interest in the partnership passing to each donee, the amount of gift tax that would result from the transfers. The taxpayers argued that the property rights transferred by the taxpayers to the sons and the trusts – the right to receive assignee interests in the partnership with a fair market value of $6.9 million – were clearly set forth in the assignment agreement and should be given effect for purposes of calculating the taxpayers' gift tax. *See Morgan v. Comm'r*, 309 U.S. 78, 80-81 (1940).

A majority of the Tax Court found that the charity received a specific partnership interest equal to 5.1208888%, which was the amount that the charities received collectively in the confirmation agreement signed between all of the donees (but not Mr. and Mrs. McCord) several months after the partnership interests were transferred. *McCord v. Comm'r*, 120 T.C. 358 (2003). The Tax Court opined that the formula clause was not self-effectuating, and it was thus necessary to look to the confirmation agreement to determine the percentage interest that each donee received.

The majority thus concluded that the donor was entitled to a charitable deduction equal to $594,743. This amount was higher than the dollar figure the charities received when their interests were redeemed six months after the assignment.

Judges Laro and Vasquez dissented, finding that under the IRS's common law arguments they would have allowed a deduction for only the amount actually received by the charity in the redemption. Judges Chiechi and Foley concurred in part and dissented in part. They rejected the majority's interpretation of the assignment agreement under Texas law. Both also found, in separate concurring opinions, that the assignment agreement should govern the property rights transferred to the donees and that under Texas property law, the value of the gift to the taxable donees was $6,910,933 — the amount specified in the assignment agreement.

The Fifth Circuit reversed the Tax Court's Majority opinion. *See Succession of Charles T. McCord, Jr., et al. v. Comm'r*, 461 F.3d 614 (5th Cir. 2006). The Fifth Circuit emphasized that the fair market value of the interests transferred must be determined on the date of the gift. The Fifth Circuit noted that

> The Majority's key legal error was its confecting sua sponte its own methodology for determining the taxable or deductible values of each donee's gift valuing for tax purposes here. This core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation Agreement's intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

Id. at pp. 9-10 (citing *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929); *Estate of McMorris v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001); *Estate of Smith v. Commissioner*, 198 F.3d 515, 522 (5th Cir. 1999)). Thus, the Fifth Circuit focused on the values of the interests transferred by Mr. and Mrs. McCord as stated in the Assignment Agreement, and not the percentage interests reflected in the donee's Confirmation Agreement that was executed several months after the gifts.

The court noted that the charities retained outside counsel to assist with the transaction, the charities independently analyzed the taxpayer's appraisal and found the methodology appropriate and the value reasonable, and that none of the Tax Court judges found any evidence of an understanding between the taxpayers and the charities that the donee was expected to or had agreed to accept a percentage interest in the partnership with a value less than the full value they were entitled to receive under the assignment agreement. As we will see in later cases, these facts can play an important role in sustaining the viability of a formula transfer.

2. *Christiansen* – Value in Excess of a Defined Amount as Finally Determined Is Disclaimed to Charity (2008/2009)

The application of *Procter* to a defined value formula disclaimer was at issue in the *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008). In *Christiansen*, the decedent's Will left her entire estate to her daughter. The Will further provided that any disclaimed assets would pass 75% to a charitable lead annuity trust (the "CLAT") and 25% to a private foundation (the "Foundation").

Mrs. Christiansen's estate tax return reflected assets having a fair market value of $6.51 million. The principal assets of the Estate were 99% limited partnership interests in two limited partnerships involved principally in the farming and ranching business. Within nine months of Mrs. Christiansen's death, her daughter executed a formula disclaimer, disclaiming a fractional share of the estate exceeding $6.35 million. The formula disclaimer provided, in pertinent part, as follows:

> Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001.

Id. at 5. The formula clause went on to define fair market value "as such value is finally determined for federal estate tax purposes." *Id.*

During the estate tax audit, the IRS asserted that the fair market value of the Estate's assets should be substantially increased. The IRS argued that the assets of both partnerships should be included in Mrs. Christiansen's Estate under § 2036 or, alternatively, that the fair market value of each 99% interest should be increased greatly. Approximately six weeks before trial, the Estate and the IRS reached an agreement whereby (1) the IRS conceded its § 2036 argument, and (2) the parties agreed that the value of the partnership interests should be based on discounts from pro rata net asset value of 37% and 34%, respectively. This agreement increased the size of the gross estate from $6.51 million to approximately $9.6 million.

The settlement caused an additional $3.1 million of value to pass to the CLAT and the Foundation as a result of the disclaimer If those transfers qualified for the estate tax charitable deduction, there would be no additional estate tax. A majority of Tax Court held that the disclaimer was not a qualified disclaimer as to the 75% portion that passed to the CLAT[2]. The majority opined that the disclaimed property did not meet the requirements of § 2518 because Mrs. Christiansen's daughter retained her contingent remainder interest in the CLAT. As to the 25% passing to the Foundation, there was no question that the disclaimer satisfied § 2518. However, the IRS challenged the formula disclaimer on two theories. First, the IRS argued that any increased amount passing to the Foundation was contingent on a condition subsequent. Second, the IRS argued that the formula clause based on values "as finally determined for federal estate tax purposes" was void as contrary to public policy based on *Procter*.

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[2] Judge Swift and Judge Kroupa (the trial judge) dissented from this portion of the opinion. Both opined that the disclaimer was qualified under § 2518.

The Tax Court's decision with respect to the effect of the formula class was unanimous. With respect to the IRS's argument that the transfer pursuant to the formula was contingent on subsequent events and thus violated Treas. Reg. § 20.2055-2(b)(1), the Tax Court noted that the first problem with the argument was that the transfer of property to the Foundation was not a "testamentary charitable contribution." The Tax Court noted that the transfer was the result of a disclaimer which is governed by Treas. Reg. § 20.2055-2(c), and relates back to the decedent's death as if it had been a part of the decedent's Will. The IRS also argued that the increased bequest to the Foundation was contingent because it depended upon the IRS examining the estate tax return and challenging the reported fair market value of the Estate's assets. The Tax Court disagreed, stating

> The regulations speaks of the contingency of 'a transfer' of property passing to charity. The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen's death (other than the execution of the disclaimer) – it remains 25% of the total estate in excess of $6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of [being] dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the day Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future. Our Court is routinely called upon to decide the fair market value of property donated to charity – for gift, income, or estate tax purposes.

Id. at 15-16.

The IRS also argued that the disclaimer's formula clause was void on public policy grounds because it would discourage the IRS from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction. The Tax Court rejected the IRS's public policy argument, noting that "we are hard-pressed to find any fundamental public policy against making gifts to charity – if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving." *Id*. at 16-17. Rejecting the IRS's reliance upon *Procter* and its progeny, the Tax Court noted that

> This case is not *Procter*. The contested phrase would not undue a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation. If the fair market value of the estate's assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.

Id. at 17.

The Tax Court further noted that the Foundation's directors as well as executors of a decedent's estate owe fiduciary duties that are enforceable both by the IRS and by the state Attorney General. Thus, the Tax Court found that *Procter* and its progeny did not apply to the formula disclaimer, and that the transfer to the Foundation qualified for the charitable deduction.

The Eighth Circuit affirmed the Tax Court's decision. *Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009). With respect to the Commissioner's argument that the gift to charity was contingent, the Eighth Circuit opined that

> 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.
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> 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.

With respect to the Commissioner's argument that the formula clause violated public policy because it might reduce the Commissioner's incentive to audit, the Eighth Circuit first noted "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." In addition, the Eighth Circuit found "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. [Citations omitted.] Allowing fixed-dollar-amount partial disclaimers supports this broad policy."

Finally, the Eighth Circuit noted that "there are countless other mechanisms in place to ensure that fiduciaries 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." The Eighth Circuit also noted that the contingent

beneficiaries taking the disclaimed property have an interest in ensuring that the executor does not underreport the estate's values and have an interest in serving a watchdog function. Accordingly, the Eighth Circuit noted that the executor owed a fiduciary obligation to both the estate and the foundation and that any self-dealing would be a clear violation of the general state-law fiduciary obligation to put the interest of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self dealing.

3. *Petter* – Value Adjustment Clause Based on Values as Finally Determined with Lifetime Transfer to Charity (2009/2011)

In *Estate of Petter v. Commissioner*, 98 T.C.M. (CCH) 534 (2009), the taxpayer made a lifetime defined-value transfer of units of the Petter Family L.L.C. worth a specific value to trusts for her two children, with the excess portion over that specified value passing to charities, and with the division of the units to be based on values as finally determined for tax purposes. The gift documents required the trusts to transfer any excess units to the charities if the value of the units initially received was finally determined for tax purposes to exceed the defined-value amount. Similarly, the charities agreed to return any excess if the reverse were true.

The IRS argued that the value was higher than reported. Ultimately, the parties settled on a somewhat higher valuation. Thus, the only issues before the Tax Court were whether the defined-value clauses would work as intended by the taxpayer and whether the taxpayer was entitled to a charitable deduction based upon the value of the units passing to charity under the formula.

The Tax Court rejected the public policy arguments raised by the IRS under *Procter*. The Tax Court rejected the mootness argument, determining that any increase in value would result in an increased charitable deduction. The Tax Court pointed out that an adjustment to the value of the units "will actually trigger a reallocation of the number of units between the trust and the foundation under the formula clause. So, we are not issuing a merely declaratory judgment." The Tax Court also stated that "[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."

In response to the IRS's assertion that regulatory formula transfers cited by the taxpayer did not support the defined-value transaction at issue in *Petter*, the Tax Court stated as follows:

> The Commissioner argues that the validity of these other types of formula clauses tells us nothing about the validity of the formula clauses at issue here. He says: 'The absence of an authorization of the formula clause under the instant situation is intentional, as the use of formula clauses in this situation is contrary to public policy, and frustrates enforcement of the internal revenue laws.' He seems to be saying that Congress and the Treasury know how to allow such gifts, and their failure to explicitly allow formula clauses under the Code and regulations governing gift tax means that they have implicitly banned them. But the Commissioner does not point us to any Code section or regulation generally prohibiting formula clauses in gift transfers, or denying charitable deductions for donors who use these formula clauses in transfers to charities. The Commissioner also fails to address the argument that Anne is actually making; the mere existence of these allowed formula clauses, which would tend to discourage audit and affect litigation outcomes the same

> way as Anne's formula clause, belies the Commissioner's assertion that there is some well-established public policy against the formula transfer Anne used.

The Tax Court thus upheld the defined-value structure. In its opinion, the Tax Court drew something of a bright line between *Procter*-style savings clauses, on the one hand, and formula clauses like *Petter*, *Christiansen*, and *McCord*, on the other hand. The Tax Court noted that 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*. . . . A shorthand for this distinction is that savings clauses are void, but formula clauses are fine."

The Ninth Circuit affirmed the Tax Court's decision. *Estate of Petter v. Comm'r*, 598 F.3d 1191 (9th Cir. 2011). The Ninth Circuit rejected the IRS's argument that the adjustment future of the formula clause makes the "additional charitable gifts subject to the occurrence of a condition precedent." Noting that "a condition precedent is one that must occur before a transfer to charity 'become[s] effective,'" the court held that Mrs. Petter's transfers became effective immediately upon her execution of the transfer documents and delivery of the units. The only possible open question was the value of the units transferred, not the transfers themselves. The court further opined that while the reallocation clauses in the transfer agreements required the trusts to transfer excess units to the foundations if it was later determined that the units were undervalued, "these clauses merely enforce the foundations' rights to receive a pre-defined number of units: the difference between a specified number of units and the number of units worth a specified dollar amount. The court stated that the IRS's determination that the LLC units had a greater fair market value than what the Moss Adams appraisal said they had in no way grants the foundations' rights to receive additional units; rather, it merely ensures that the foundations receive those units they were already entitled to receive. The number of LLC units the foundations were entitled to was capable of mathematical determination from the outset, once the fair market value was known."

4. *Hendrix – McCord*-Like Transaction in the Tax Court Again (2011)

The issue in *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (June 15, 2011), was whether a defined value formula clause contained in an assignment agreement determined the fair market value of the stock in the John H. Hendrix Corp. ("JHC") that Mr. and Mrs. Hendrix transferred on December 31, 1999, to family trusts and to a charitable foundation. The Tax Court determined that the formula clauses were reached at arm's length and that they are not void as contrary to public policy.

The Hendrix's principal asset was the stock of JHC. On December 31, 1999, the Hendrixes, the trustees of trusts created for the benefit of their daughters, and the Greater Houston Community Foundation (the "Foundation") executed an assignment agreement that irrevocably assigned 287,619.64 shares of each of Mr. and Mrs. Hendrix's JHC nonvoting stock to the trusts and to the Foundation. Mr. and Mrs. Hendrix utilized a formula that assigned (1) shares having a fair market value as of the effective date equal to $10,519,136.12 to GST trusts for the initial benefit their two daughters, and (2) any remaining portion of the assigned shares to the Foundation for the benefit of donor advised funds that the Hendrixes had established. The assignment agreements, similar to those used in *McCord*, defined fair market value in the same manner as defined under the gift tax Treasury Regulations. The assignment agreements also required the trusts to proportionately pay any gift taxes imposed as a result of the transfer. The trustees signed promissory notes obligating the trustees to pay $9,090,000 to each petitioner.

On the same day, a second set of assignment agreements were executed containing the same terms as the first set of assignment agreements, except that Mr. and Mrs. Hendrix each irrevocably transferred 115,622.21 shares of the JHC nonvoting stock to his or her corresponding "issue" trust and to the Foundation, and the fair market value of the stock transferred to the issue trusts was set at $4,213,710.10. The second set of assignment agreements directed the trustees to deliver to each petitioner a note in the amount of $3,641,233.

The assignment agreements provided Mr. and Mrs. Hendrix with no right or responsibility for allocating the shares among the transferees on a per share basis. The allocation was left to the transferees. Taxpayers had an appraisal prepared and after the transfer, their counsel sent the appraisal to the Foundation and its counsel. The Foundation, consistent with its policy regarding receipt of hard–to–value assets, retained another independent appraisal firm to review the appraisal. The Foundation's appraiser concluded that the appraisal was "reasonable and fair." One month later, the Foundation and the trustees entered into confirmation agreements that allocated the JHC shares amongst the recipients according to the fair market value of $36.56 per share listed in the appraisal. Mr. and Mrs. Hendrix were not parties to the confirmation agreements.

The Tax Court noted that the case was appealable to the Fifth Circuit, and that it was obliged to follow *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g.*, 120 T.C. 358 (2003). The Tax Court held that *Succession of McCord* was dispositive of the case except to the extent that Respondent argued that (1) the formula clauses were not the result of an arm's length transaction or (2) the formula clause was void as contrary to public policy.

The Tax Court began its arm's length transaction analysis by noting that "generally, a taxpayer may structure a transaction in a manner that minimizes or avoids taxes by any means the laws allow." The Tax Court noted that it may disregard the form of a transaction in favor of its substance whenever collusion, an understanding, a side deal, or other indicia that the transaction was not at arm's length exists. The Tax Court also noted that the disregard of a transaction for lack of substance cannot be based on mere suspicion and speculation arising from the fact that a taxpayer engaged in estate planning.

The Tax Court rejected Respondent's argument that the formula clause was not at arm's length because Mr. and Mrs. Hendrix and their daughters (or their trusts) were close and lacked adverse interests, the daughters benefitted from the petitioners' estate plan, and the clauses were not thoroughly negotiated. The Tax Court held that the mere fact that Mr. and Mrs. Hendrix and their daughters were close and that the petitioners' estate plan was beneficial to them does not necessarily mean the formula clauses failed to be reached at arm's length. The Tax Court also opined that a finding of negotiation or adverse interests is not an essential element of an arm's length transaction. The Tax Court noted, however, that there was nothing in the record to persuade the Tax Court that either the formula clauses were not subject to negotiation or that the petitioners and the daughters' trusts lacked adverse interests.

The Tax Court also declined to accept Respondent's request to find collusion between the Hendrixes and the Foundation. The Tax Court found that the creation of the donor advised fund at the Foundation did not diverge from their usual course of donation and that the Foundation had accepted various potential risks incident to its receipt of the gifts, including a loss of the Foundation's tax-exempt status if it failed to exercise due diligence as to the gifts. The Tax Court also noted that the Foundation, which manages nearly $270 million of assets, exercised its bargaining power when its counsel insisted on certain provisions being added to the assignment agreements. The Tax Court found it important that the Foundation was represented by independent counsel and the Foundation hired an independent appraiser to review the petitioners' appraisal. Finally, the Tax Court noted that the Foundation had

fiduciary obligations under state and federal law to ensure that it received the number of shares it was entitled to receive under the formula clauses.

The Tax Court also rejected Respondent's *Procter*-based public policy argument, noting that the formula clauses do not immediately and severely frustrate any national or state policy. To the contrary, the "fundamental public policy here is one of encouraging gifts to charity, and the formula clauses support that policy."

The Tax Court found the Hendrix transaction to be distinguishable from *Procter* and its progeny because the formula clauses imposed no condition subsequent that would defeat the transfer. The Tax Court concluded the formula clauses furthered the fundamental public policy of encouraging gifts to charity, citing *Estate of Christiansen v. Commissioner*, 130 T.C.-1 (2008). The Tax Court found no legitimate reason to distinguish the formula clauses in the *Hendrix* transfers from the disclaimer in *Christiansen*, and declined to do so.

5. ***Wandry*** – Value Adjustment Clause Based on Values as Finally Determined, and No Third Party (2012)

In *Estate of Wandry v. Commissioner*, T.C. Memo. 2012-88 (March 26, 2012), the Tax Court upheld a dollar value formula transfer clause transferring LLC units. What is unique about this case is that it did not involve a charity or any other tax-free entity.

On January 1, 2004, the taxpayers decided to give LLC units in amounts equal to their (1) $1 million gift tax exemption, to be divided equally among each of their four children, and (2) $11,000 annual exclusion to each of their four children and five grandchildren. Following the advice of their counsel, they made gifts of LLC units under a formula specifying that the LLC units for federal gift tax purposes equaled each of the specific dollar amounts. The transfer documents provided as follows:

I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service

> ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

After obtaining an independent appraisal, the LLC's accountant adjusted the capital accounts to reflect the transfers. The taxpayers filed gift tax returns reporting each gift on a percentage basis. However, the dollar value of each gift corresponded to the value of the interest each taxpayer desired to transfer, and the percentage interests were based on the value of a 1% interest reflected in the appraisal attached to their gift tax return.

After an IRS audit, the parties agreed to a higher value for the units transferred. The IRS claimed additional gift tax was due. The IRS asserted that the value of the gifts should be equal to the percentages listed in the gift tax returns multiplied by the stipulated value of a 1% interest. The taxpayer argued that the dollar value formula controlled and required a reallocation of units, which did not change the value of the units transferred to the children and grandchildren.

a. The Tax Return Position Was Not an Admission that Percentage Interests Were Transferred

Relying on *Knight v. Commissioner*, 115 T.C. 506 (2000), the IRS argued that the gift descriptions contained in the gift tax returns were binding admissions that the taxpayers had transferred fixed percentage interests. The court disagreed, noting that in *Knight*, the taxpayers disregarded the formula by arguing that the gifts were actually worth less than the dollar value included in the transfer documents. The court contrasted *Knight* with the fact that the *Wandry* taxpayers believed that they had made dollar value gifts equal to the specified dollar amounts, noting "[a]t all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units." The court further noted that the gift tax returns and the schedules attached to them reported gifts of dollar amounts. The court found that the description of the dollar value transfers and the appraisal report attached to the gift tax returns demonstrated petitioners' consistent intent that dollar value gifts were intended.

The IRS also argued that the capital accounts controlled the nature of the gifts and the capital accounts reflected gifts of fixed percentage interests. The court rejected this argument, opining that the "facts and circumstances determine Norseman's capital accounts, not the other way around." The court pointed out that the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect prior years.

b. The Formula Clause Was Not a Void Savings Clause

The IRS next argued that the formula contained an improper savings clause in violation of the public policy principles espoused in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). Relying on its analysis in *Estate of Petter*, the Tax Court drew a distinction between a "savings clause" (*Procter*) and a "formula clause" (*Petter*), noting that

> A savings clause is void because it creates a donor that tries 'to take property back.' On the other hand, a 'formula clause' is valid because it merely transfer a 'fixed set of rights with uncertain value.' The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*].

The court opined that it was inconsequential that the adjustment clause reallocated membership units among the taxpayers and the donees, rather than to a charitable organization, because the reallocation did not alter the transfer. As a result of the transfer, each donee was entitled to a predefined percentage interest in the LLC expressed through a formula. The transfer documents did not allow the taxpayer to take back units; rather, the transfer documents provided for the allocation of the units among the donees and the taxpayers.

The court's public policy analysis went on to address the specific public policy concerns raised in *Procter*. The court first stated that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. The court also noted that there are mechanisms outside of IRS audits to ensure accurate valuation reporting. As it stated in *Petter*, a judgment in the gift tax case regarding value will reallocate units among the donors and donees. Therefore, the court is not ruling on a moot case or issuing merely a declaratory judgment.

Finally, the court addressed the absence of a charity in the formula transfer. The court noted that while the charitable aspect of the formula clause contributed to the court's decision in *Petter*, it was not determinative. Accordingly, the court stated that the lack of charitable component in a formula clause does not result in a "severe and immediate" public policy concern as required by *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966).

On November 13, 2012, the IRS announced that it did not acquiesce in the *Wandry* decision.

6. *Nelson* – Formula language matters

In *Nelson v. Commissioner*, T.C. Memo. 2020-81, the Tax Court determined that interests in a partnership transferred pursuant to a formula clause were of fixed percentage interests and not dollar amounts based on values as finally determined for gift tax purposes. This case illustrates that the language used in the formula clause is critical.

Mrs. Nelson made two transfers of limited partnership interests to a trust created for the benefit of next generation family members. The first transfer was a gift on December 31, 2008. The transfer document provided that

> [Mrs. Nelson] desires to make a gift and assign to * * * [the trust] her right, title and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * * as determined

> by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

The second transfer was a sale on January 2, 2009. The language employed was similar:

> [Mrs. Nelson] desires to sell and assign to * * * [the trust] her right, title and interest in a limited partner interest having a fair market value of TWENTY MILLION SAND AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * * as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment.

Neither the gift or sale document employed clauses defining fair market value or subjecting the limited partner interests to reallocation if the value as finally determined for gift tax purpose was different than the appraised value of the limited partnership interests.

Mr. and Mrs. Nelson filed gift tax returns splitting gifts. As required by the transfer documents, an appraiser had determined the value of the limited partnership interests, which the Commissioner challenged on audit. The Tax Court actually determined a value that was different than the values determined by the Taxpayers and the Commissioner's appraisals.

The Taxpayers argued that no additional gift could occur regardless of any revaluation because the formula clauses were similar to clauses upheld by the courts in *McCord*, *Petter* and *Wandry*. As a part of their argument, they cited evidence of intent, which included settlement discussions with IRS Appeals and subsequent adjustments they made to the ownership of interest based on those settlement discussions (which was never finalized in a binding settlement). The Tax Court disagreed.

The Tax Court's analysis began with the transfer documents and noted that the parties' subsequent actions were irrelevant. The court noted that the transferred interests were expressed in the transfer documents as "an interest having a fair market value of a specific amount as determined by an appraiser within a fixed period." The court further noted that "[t]he clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." *Id.* *20. The court thus opined that

> By urging us to interpret the operative terms in the transfer instrument as transferring dollar values of the limited partner interests on the bases of fair market value as later determined for Federal gift and estate tax purposes, petitioners ask us, in effect, to ignore "qualified appraiser * * * within *** [a fixed period]" and replace it with "for federal gift and estate tax purposes" While they may have intended this, they did not write this. They are bound to what they wrote at the time.

On November 5, 2021, the Fifth Circuit Court of Appeals affirmed the Tax Court's decision. *Nelson v. Commissioner*, No. 20-61068 (November 3, 2021). The court reaffirmed the well-known transfer tax principle that "the nature of the transfer is ascertained by looking at the transfer document and its language, rather than subsequent events," *citing McCord* and *Petter*. Focusing on the language used in the transfer agreement, the court opined that the "specific qualification added by the Nelsons separates their agreement from the formula clauses considered in other cases." The court noted that "most formula-clause cases featured transfer instruments that defined the interests transferred as the fair market value as determined for federal-gift or estate tax purposes," while those that did not "defined fair

market value through a reference to the "'willing-buyer/willing seller' test" in the Treasury regulations. The court specified that in this case, the transfer agreement specifically qualified fair market value by reference to the appraiser, rather than a final determination or to gift tax principles. The court concluded that the Nelson's reading "does not comport with the plain meaning of the language used" in the agreement.

The court further opined that the transfer documents in every other formula-clause case contained crucial language that the Nelsons' instruments did not: "specific language describing what should happen to any additional shares that were transferred should the valuation be successfully challenged." The court noted that the formula clause cases in general do not reopen a transaction since donor has so parted with dominion and control so as to leave in him no power to change its disposition, whether for his own benefit or the benefit of another,'" and the gift could be determined at the time of the transfer since the number of units transferred is capable of mathematical determination from the time of the gift.

D. Potential Donees of the "Excess Amount" Under a Formula Clause

For a formula clause to be successful, the amount in excess of the defined value must pass to a person or entity that will not result in the imposition of transfer taxes. *McCord*, *Hendrix*, *Petter* and *Christiansen* all involved transfers of the excess amount to charity. However, some clients are not charitably inclined, yet they still desire some level of certainty with respect to their transfer.

Wandry involved the transfer of a specified dollar amount of assets, with any "overage" being retained by the transferor. Planners have also utilized QTIP trusts and GRATS as recipients of the non-taxable portion of the transfer.

1. Public Charity/Donor Advised Fund

As noted above, public charities were involved in each of the transactions at issue in *McCord*, *Hendrix*, and *Petter*. Preference of the independent charity in each of those cases were important attributes in the courts' decisions.

Parties to the transaction must be aware that the charity has independent obligations to the state's attorney general and to the Internal Revenue Service that provide the charity with the obligation and incentive to "audit" the transaction.

Public charities are subject to private inurement rules and excess benefit rules. Section 501(c)(3) requires that a public charity ensure that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual . . . ." I.R.C. § 501(c)(3). The transferor should expect the charity to be on the lookout for private inurement, both with respect to the initial transaction as well as the operation of the entity in the event that the charity holds its interest long term. The IRS has the ability to sanction a charity violating the private inurement rules by (1) revoking its tax-exempt status or (2) imposing intermediate sanctions. Treas. Regs. § 1.501(c)(3)-1(c)(2).

The intermediate sanctions provisions authorize the IRS to impose a 10% penalty on the charity's managers who authorized an excess benefit transaction and an escalating series of penalties against disqualified persons receiving the excess benefit. An excess benefit transaction is one involving an economic benefit passing from the charity to a disqualified person in excess of any consideration received by the charity. The taxes under the intermediate sanctions rules are draconian, with a first-tier tax of 25% being imposed on the disqualified person receiving the prohibited benefit, a second tier tax

of 200% being imposed on a disqualified person when an excess benefit transaction is not corrected within a specified period, and a tax of 10% of the excess benefit imposed on the organization's managers who agreed to the transaction. Each of these taxes is subject to abatement under § 4962 if reasonable cause and the absence of willful neglect can be shown and corrective action is taken within 90 days of the notice of deficiency. The transferor, the transferor's family, the entity, and any other party involved in the transaction may be considered disqualified persons for purposes of imposition of intermediate sanctions.

The transactions in *McCord*, *Hendrix*, and *Petter* all involved donor advised funds of a public charity. The donor advised fund has the same private inurement and excess benefit issues discussed above. The primary benefit to the donor advised fund is the ability for the family to retain some level of control over the charitable purpose of the assets transferred to the charity through the recommendation of potential charitable donees.

2. Private Foundation

The private foundation is a permissible charitable transferee of an interest under a formula clause, and was one of the recipients of interests in the *Christiansen* case. The private foundation rules prohibiting self-dealing (I.R.C. § 4941), excess business holdings (I.R.C. § 4943), jeopardizing investments (I.R.C. § 4944), and taxable expenditures (I.R.C. § 4945), provide substantial barriers to using the private foundation as a donee under a formula clause.

3. Lifetime QTIP Trusts

Because the transfer of assets to a QTIP trust is exempt from gift tax, many planners have coupled a defined value transfer to taxable transferees with a gift of the value above the specific dollar amount to a QTIP trust. Testamentary formula transfers to QTIP trusts have been used for decades, and the theory underlying the courts' decisions in *McCord*, *Hendrix*, *Petter*, and *Christiansen* should apply equally to a transfer to a QTIP trust as it does to a charity. But if (1) the trustee of any trust receiving the defined value portion of the transfer (such as an IDGT) is the same as the trustee of the QTIP trust, or (2) the remainder beneficiaries of the QTIP trust are the same persons as those receiving the defined value portion, the IRS may question whether a party with the incentive (and the fiduciary obligation) to enforce the terms of the formula transfer really exists. The obvious response is the QTIP trustees have an independent fiduciary obligation to all beneficiaries of the trust to ensure the proper valuation of the interests being transferred. In other words, the trustees of the QTIP have an obligation to protect the interests of the trust similar to the charity's obligation to protect its interests. *See*, *e.g.*, *Estate of Duncan v. Comm'r*, T.C. Memo. 2011-255 (Oct. 31, 2011). To avoid this argument, planners should consider (1) having different trustees of any trust receiving the defined value portion and the QTIP, and (2) having remainder beneficiaries of the QTIP who are different from the recipients of the defined value portion of the transfer.

4. Grantor Retained Annuity Trusts

Another commonly used technique is to have the "non-taxable" portion of the transaction pass to a grantor retained annuity trust. One of the benefits of the GRAT is the formula provisions are substantially similar to those contained and blessed by the Treasury in the Regulations contained under § 2702. The IRS may make arguments similar to those outlined above with respect to lifetime QTIP transfers. As with lifetime QTIPs, the parties might consider (1) having different trustees of any trust receiving the defined value portion and the GRAT, and (2) having remainder beneficiaries of the GRAT who are different from the recipients of the defined value portion of the transfer.

E. Gift Tax Reporting

When using a formula adjustment clause based on values as finally determined for gift tax purposes, a gift tax return for the calendar year of the transaction should be filed. My preference is to lay out the formula provisions in detail, as well as attaching copies of the appraisal and the transaction documents as exhibits to the return. Attaching all of this information fully discloses the transaction to the IRS and begins the statute of limitations running on the determination of final gift tax values. If the formula clause is based on gift tax values as finally determined, it would seem that filing the gift tax return is required to achieve "finality" on gift tax values.

If transfers are not reported on the gift tax return, the IRS will argue that the statute of limitations has not started to run and the IRS may raise the valuation at issue at any time during the transferor's lifetime or upon death. Even where the taxpayer asserts that no gift occurred as the result of a sale transaction, the Treasury Regulations provide that adequate disclosure is required to start the gift tax statute of limitations running. Regulations provide that a non-gift transfer will be adequately disclosed on a gift tax return if the following information is provided:

> (i) a description of the transferred property and any consideration received by the transferor;
>
> (ii) the identify of, and relationship between, the transferor and each transferee;
>
> (iii) if the property is transferred in trust, the trust tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instruments; and
>
> (iv) a statement describing any position taken that is contrary to any proposed, temporary or final Treasury Regulations or Revenue Rulings published at the time of the transfer.

Treas. Regs. § 301.6501(c)-1(f)(2)(i)-(v). The Treasury Regulations also require an explanation regarding why the transfer is not a transfer by gift. Treas. Regs. § 301.6501(c)-1(f)(4).

The transaction should be reported consistently with the formula to avoid the argument faced by the taxpayers in *Knight v. Commissioner*, 115 T.C. 506 (2000) (IRS successfully argued that the gift descriptions contained in the gift tax returns were binding admissions that the taxpayers had transferred fixed percentage interests instead of interests pursuant to a formula). That is why I prefer to see the formula reflected in the gift tax return schedules, with an explanation of how the percentage interest allocated was derived (*i.e.*, based on the attached appraisal), and with copies of the appraisal and the transaction documents attached.

F. Income Tax Issues

If the charity receives an interest in the entity pursuant to the formula, the value of the interest transferred to charity should be deductible for income tax purposes (subject to percentage limitations and reduction rules).

For transactions based on values "as finally determined," there will be an initial allocation of units based upon either an appraisal or agreement. If the value is "finally determined" to be different

from the initial allocation (as was the case in *Petter*), the parties will need to reallocate income and expense items retroactive to the date of the initial transfer. Likewise, it may be necessary to file amended returns to account for the fact that the parties were entitled to the proportionate interest finally determined at the time of the initial transfer. That is because all income items and deduction items would be retroactive to the date of the initial transfer.

Because the three-year statute of limitations would apply, the parties to the transaction (particularly the taxable donees and the entity) should consider filing protective claims for refund before the expiration of the three-year statute of limitations to preserve the right to amend income tax returns in the event that it is determined that the interest received by the taxable transferee is less than what was initially anticipated. In addition, the transferor should consider filing a protective claim for refund in the event that the charity receives a gift greater than the amount anticipated to be received in the initial allocation preserve the ability to obtain a larger income tax charitable deduction than was initially anticipated for the year of transfer.

Because the *McCord*-type transaction is not based on values as finally determined, any change in value of the asset transferred by a court does not affect the allocation of the units. Thus, no amended income tax returns will need to be filed by the recipients of the transferred interests.

V. GROSS ESTATE/CHARITABLE DEDUCTION MISMATCH

A. *Dieringer v. Comm'r*

In *Dieringer*, the Ninth Circuit affirmed a Tax Court decision upholding an estate tax deficiency because the executor overstated the charitable deduction. [3] The estate's charitable deduction was based on the value of stock bequeathed to a charity under the will. However, because a significant portion of that stock was redeemed at a discount to the estate tax value of the stock, assets of a lesser value actually funded the charitable bequest. Leaning on the Ninth Circuit's holding in *Ahmanson Foundation,* which underscored "the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity," the Ninth Circuit determined that a gross estate/charitable deduction valuation mismatch occurred and upheld the Tax Court's deficiency determination and accuracy-related penalties. *See Ahmanson Foundation v. United* States, 674 F.2d 761, 772 (9th Cir. 1981).

1. Facts

The facts of *Dieringer* are critical to understanding the holdings. The decedent, Victoria Dieringer, had provided in her will for all assets to pass to a trust, which trust provided for some minor gifts to her children, several contributions to charities, and the residuary of her estate (which included voting and non-voting shares in Dieringer Properties, Inc. ("DPI")) to pass to the Dieringer Family Foundation.

[3] *Estate of Dieringer v. Comm'r*, 146 T.C. 117, 133-34 (2016) ("We do not believe that Congress intended to allow as great a charitable contribution deduction where persons divert a decedent's charitable contribution, ultimately reducing the value of the property transferred to a charitable organization. This conclusion comports until the principle that if a trustee is empowered to divert the property ** to a use or purpose which would have reduced it, to the extent if in subject to such a power, not deductible had it been directly so bequeathed, *** the deduction will be limited to that portion, of any, of the property, or fund which is exempt from the expertise of the power. Sec. 20.2055-2(b)(1). Estate Tax Regs.")

Prior to her death, the board of DPI had discussed the purchase of stock from Mrs. Dieringer, with which she was in agreement, but no pre-death redemptions of stock were made.

After Mrs. Dieringer's death, the board converted the corporation to an S corporation and redeemed the shares passing to the foundation. The DPI stock was purchased out of the trust in exchange for two promissory notes, each bearing interest, based on a 6-year-old appraisal before the shares could be transferred to the foundation.[4] The parties agreed to obtain a new appraisal and that the note would be adjusted based on the value determined pursuant to that appraisal. The executor (who was a son of decedent and a shareholder, director, and president of DPI) instructed DPI's attorney to instruct the appraiser hired by DPI to value the DPI stock at a discounted, non-controlling value despite its controlling characteristics. DPI could no longer redeem all of the shares of stock in DPI held by the estate based on the new valuation, but it redeemed as much of the stock as it could, including all of the voting stock, after the share prices were adjusted. Some non-voting stock passed to the foundation.

The foundation, after the redemptions, received assets from the estate worth about one-third of what was claimed as a charitable deduction for those assets on decedent's estate tax return. Instead of interests in DPI worth approximately $18 million, the foundation received assets worth only $6.5 to $7 million. However, the executor claimed that the value of the assets held in the decedent's estate as of the decedent's date of death is the relevant value for purposes of calculating the charitable deduction.

The IRS asserted a deficiency related to the assets for which an estate tax charitable deduction had been claimed that did not actually pass to the foundation as well as some minor reductions in other charitable gifts.

2. Arguments by the IRS and the Estate

The IRS set forth a number of arguments in support of its position that the estate should not be able to claim an estate tax charitable deduction for charitable contributions in excess of the amount that the foundation actually received. The primary reason was the valuation discounts applied in valuing the redeemed shares, which were not applied when the shares were valued for gross estate purposes. The IRS also pointed out that the non-voting shares retained by the foundation lost value because they were separated from the voting shares.

While the estate argued that the value of the assets as of the decedent's date of death should be used to determine the charitable deduction, the IRS argued that sometimes it is appropriate for the amount of a deduction for an asset passing to charity to differ from the value of that asset at the date of the decedent's death. The IRS asserted that, while the gross estate value is determined at the time of death, deductions are not determined at that time, and Congress would not want to allow a deduction for diverted assets. The IRS pointed to *Estate of Shedd v. Commissioner* as an example of when courts have considered events subsequent to the decedent's death for purposes of determining the estate tax obligation when the intent of Congress would be served by doing so.

The estate argued that the reduction in the value of the assets passing to the Dieringer Family Foundation was a result of external economic forces, but the IRS argued that the change resulted from acts of the fiduciary occurring after the decedent's death which were contemplated before her death, and that those actions also changed the value of the estate's charitable deduction. The IRS pointed to *Ahmanson Foundation* and several other cases as support. *See Irving Tr. Co. v. United States*, 221 F.2d

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[4] While the pleadings in the case clarify that the notes were to bear interest, the interest rate was not specified.

303, 306 (2d Cir. 1955); *Thompson's Estate v. Comm'r*, 123 F.2d 816, 817 (2d Cir. 1941); *In Re Sage's Estate*, 122 F.2d at 484.

In light of the reasons for the reduction in the value of the assets passing to the Dieringer Family Foundation, the IRS argued that allowing a charitable deduction for the full value of the shares as of the decedent's date of death would elevate form over substance in violation of general tax principles.

3. Holding and Rationale of the Ninth Circuit

The Ninth Circuit affirmed that Tax Court's opinion. The Ninth Circuit explained that while the value of the gross estate is typically assessed at the time of the decedent's death, deductions are valued separately from the valuation of the gross estate and can take into account post-death changes in value. The court further stated that there is no one rule for when a deduction is valued that applies in all circumstances. While a date of death value will apply sometimes, at other times subsequent events affecting the value of the bequest will be taken into account. The court pointed to some circumstances where taking into account later events for determining the value of a charitable deduction is necessary – for example, funeral expenses or a provision requiring that the portion of the estate passing to charity must bear some estate tax.

The Ninth Circuit relied heavily on its decision in *Ahmanson Foundation* in determining that the charitable deduction is limited to the value of property actually passing to the charity. The court concluded that the *Ahmanson Foundation* holding is not limited to changes in value effected by the testamentary plan, but also extends to situations where manipulation enabled by relationships and powers created by the testator reduces the value of the property passing to charity.

Notably, the court's mismatch analysis did not address the value of any breach of fiduciary duty claims that the Dieringer Family Foundation may have against the estate, its fiduciary, and DPI in connection with the redemptions. The value of such claims (which could include monetary and constructive trust remedies) would certainly be an asset passing to the charity. Such claims, in combination with the redemption proceeds and stock received from the estate, could have made the charity "whole" from a mismatch perspective. Regardless, consideration of the value of those claims in the analysis would have produced a higher value than what the court determined the foundation received.

B. *Ahmanson Foundation v. United States*

The decedent in *Ahmanson Foundation* owned a 15% interest in the Home Savings & Loan Association, 81% of which he owned through a holding company called H. F. Ahmanson & Co. ("HFA"). HFA also held interests in other companies. In addition to common stock in HFA, the decedent owned 600 shares of voting stock in HFA, which represented a controlling interest. At the time of his death, all of the decedent's interest in the 600 shares of voting stock in HFA passed to a company called Ahmanco Inc. ("Ahmanco"). The decedent held through his revocable trust all (100 shares) of the stock of Ahmanco. Under the decedent's will, ninety-nine (nonvoting) shares of Ahmanco were distributed to a charitable foundation while one (voting) share of Ahmanco remained in the trust, with the right to vote vested in the decedent's son. The estate did not attribute any value to the 600 voting HFA shares when calculating the value of the gross estate, but rather calculated the value of the 1 voting share of Ahmanco and the 99 non-voting shares. The IRS argued that the 600 HFA shares should have been included in the gross estate at a value reflecting their controlling nature.

Among other issues, the Ninth Circuit addressed the extent to which the Ahmanco stock must be valued consistently for purposes of §§ 2031 and 2055 (valuing the gross estate and the charitable deduction, respectively), ultimately concluding that no such consistency was required. Indeed, the Ninth Circuit rejected arguments that the decedent's Ahmanco stock should be valued as separate blocks (as was done for purposes of calculating the charitable deduction under § 2055) for gross estate purposes based on the transfers required under the decedent's will, reasoning that "[the estate tax] is a tax on the privilege of passing property . . . [; t]here is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one." *Id.* at 768. Likewise, the Ninth Circuit also noted that "[the provision governing the calculation of the charitable deduction (§ 2055)] does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction." *Id.* at 771. Thus, valuation inconsistencies for purposes of the calculation of the gross estate, the calculation of the charitable deduction, and the calculation of the marital deduction based on properties' distribution pursuant to a decedent's will is permissible.

C. *Provident National Bank v. United States*

By contrast, the Third Circuit determined in *Provident National Bank,* 581 F.2d 1081 (3d Cir. 1978), that an estate tax marital deduction could be increased as a result of the manner in which assets passed pursuant to the decedent's will. Unlike the court in *Ahmanson Foundation*, the court in *Provident National Bank* held that "there can only be one value for each equity interest in [the entity.] The value must be considered for calculating both the gross estate and the marital deduction." *Id* at 1091.

In *Provident National Bank*, the decedent's will bequeathed to a marital trust benefiting his surviving spouse "[a]ll Class A Common Stock of Dial Shoe Company, Inc. in my name (to be exchanged for Preferred Stock of Dial Shoe Company, Inc. as hereafter provided)." *Id.* at 1083. The preferred stock to be created and issued under the decedent's will in exchange for his common stock had certain characteristics that made it more valuable than the common stock. *Id.* at 1083-84. Thus, the decedent's estate sought a marital deduction based on the stock's value as preferred stock, while the Commissioner determined the amount of the marital deduction based on the stock's value as common stock. *Id.* at 1084. The Third Circuit agreed that the amount of the marital deduction needed to incorporate the characteristics of the preferred stock resulting from the mandated exchange of common stock for preferred stock. *Id.* at 1085. The Third Circuit also held that there can be only one value for each equity interest at the time of the decedent's death, and that value must be considered for purposes of the calculation of the adjusted gross estate and the calculation of the marital deduction.

The court began its analysis by recognizing that, under the decedent's will and Pennsylvania law, the precise interest in Dial Shoe Company, Inc. that passed to the decedent's surviving spouse was a "legacy of one class of stock, subject to a direction that it be exchanged for another class, vested in the widow at the time of death." *Id.* Because the interest in property was devised subject to directions that required subsequent disposition, it needed to be valued in light of those directives. *Id.* The court also pointed out that the prospect of a challenge from minority shareholders, whose interests would have a corresponding decrease in value when the Class A Common Stock held by the decedent converts to preferred upon his death, could affect the value of the Class A Common Stock.

VI. SECTION 2519

A. *Estate of Kite v. Comm'r,* T.C. Memo. 2013-43 (Feb. 7, 2013)

In *Estate of Kite*, the Tax Court (Judge Paris) addressed issues involving (1) the application of § 2519 to a QTIP trust's creation of closely held entities, and (2) the sale of interests for a private annuity.

The decedent ("Mrs. Kite") was the current income beneficiary of numerous trusts, four of which were at issue in the case. The four trusts were: two QTIP trusts, one marital deduction trust, and Mrs. Kite's revocable trust. On December 31, 1996, the trusts formed Brentwood Limited Partnership, an Oklahoma limited partnership ("Brentwood"). The trusts received limited partnership interests in exchange for their contributions. Brentwood's general partner was Easterly Corp., an Oklahoma corporation ("Easterly Oklahoma") organized in December 1996 and wholly owned by Mrs. Kite and her children (either individually or through trusts).

In January of 1997, Mrs. Kite, as trustee of her trusts, transferred to her children approximately one-third of her Brentwood limited partnership interests. She also transferred to her children a portion of her Easterly Oklahoma shares. Mrs. Kite reported the transfers as gifts in 1997.

In 1998, Brentwood and Easterly Oklahoma reorganized in Texas seeking a more advantageous state tax jurisdiction. Brentwood merged into Baldwin Limited Partnership ("Baldwin"), a Texas limited partnership. Easterly merged into Easterly Corp., a Texas corporation ("Easterly Texas"). The ownership interests remained the same.

In May of 1998, Mrs. Kite, through her trusts, sold her remaining interest in Baldwin to her children for fully secured promissory notes (the "Baldwin Notes"). The Baldwin Notes required the Kite children (or their trusts) to make quarterly payments of principal and interest through May 1, 2013. Mrs. Kite, as the current income beneficiary of her trusts, received the payments on the Baldwin Notes.

On December 31, 2000, Mrs. Kite's trusts contributed the Baldwin Notes and Easterly Texas contributed assets to form Kite Family Investment Co., a Texas general partnership ("Kite Investment"). Mrs. Kite's trusts collectively held a 99% interest in Kite Investment and Easterly Texas held a 1% interest. Easterly Texas was the manager of Kite Investment.

On March 28, 2001, Mrs. Kite replaced the trustees of the QTIP trusts and the marital deduction trust with the Kite children retroactive to January 1. The Kite children, as trustees, contemporaneously executed documents to terminate the trusts effective January 1, 2001. The assets of the trusts, which consisted solely of Kite Investment general partnership interests, were transferred to Mrs. Kite's lifetime revocable trust. The next day, Baldwin, which was wholly owned by the Kite children and their trusts, contributed approximately $13.5 million of assets to Kite Investment, more than doubling Kite Investment's previous capital and diversified its holdings. In return, Baldwin received a 55.8215% general partnership interest in Kite Investment. Mrs. Kite's lifetime revocable trust and Easterly Texas owned Kite Investment's remaining interests.

On March 30, 2001, Mrs. Kite sold her interest in Kite Investment to her children (or their trusts) for three private annuities. The annuity agreements provided that the Kite children would begin payments 10 years after the effective date of the annuity agreements. If Mrs. Kite died within the 10-year deferral period, her annuity interest would terminate and her interest in Kite Investment (and indirectly her interest in the Baldwin Notes) would be effectively removed from her gross estate.

However, if Mrs. Kite survived the 10-year deferral period, her children would be personally liable for the annuity payments due on each annual payment date. If Mrs. Kite survived for 13 years or longer, her children could be insolvent after the first three years of payments, in view of their then-current personal assets. Mrs. Kite was 74 years old at the time of the transactions, and her doctor certified to her longevity and health.

1. The Private Annuity Agreements

The Commissioner argued that the transfer of Kite Investment interests for an unsecured private annuity (1) were disguised gifts, (2) lacked substance, and (3) were illusory. The Court rejected these arguments, noting that even though Mrs. Kite was elderly and her medical expenses were increasing, the private annuity exchange was at full fair market value. Relying on *Estate of McLendon v. Commissioner*, the Court held that Mrs. Kite could rely on the IRS actuarial tables under § 7520 in valuing the annuity interest. The opinion and testimony of Mrs. Kite's physician indicated that Mrs. Kite, 75 years old at the time of the annuity agreements, had at least a 50% possibility of surviving for at least 18 months. The Commissioner failed to present any contrary evidence. The Court noted that as demonstrated by the *McLendon* case, increased medical costs and home healthcare did not prove a terminal illness or other incurable disease for purposes of § 7520. The Court noted that "unlike the private annuity agreements in *Estate of Hurford*, the annuity agreements between Mrs. Kite and her children were enforceable, and the parties demonstrated their intention to comply with the terms of the annuity agreements."

2. Section 2519

The Commissioner argued that the creation of Brentwood triggered § 2519 with respect to the assets contributed by the QTIP trusts to Brentwood. The Commissioner asserted that under § 2056(b)(7), any disposition of a QTIP qualifying income interest during the income beneficiary's lifetime by gift, sale or otherwise will result in the QTIP assets being subject to gift tax (in lieu of a qualifying income interest). Relying on the Regulations under § 2519, the Tax Court concluded that the QTIPs' contribution of assets to Brentwood did not trigger § 2519. The Court opined that "[n]ot included as a disposition for purposes of § 2519 is the conversion of QTIP into other property in which the surviving spouse has a qualifying income interest for life." The Tax Court quoted Treas. Reg. § 25.2519-1(f), which provides "that the sale and reinvestment of assets of a trust holding QTIP is not a disposition of the qualifying income interest, provided that the surviving spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment."

However, the Court did conclude that the liquidation of the QTIP trusts and subsequent sale of Mrs. Kite's interests in Kite Investment was contrary to the QTIP rules and "was part of a prearranged and simultaneous transfer of the QTIP trust assets . . . ." The Court held that the termination of the QTIP trusts and the sale of Mrs. Kite's interests in Kite Investment was part of a single transaction for purposes of § 2519 and was subject to Federal gift tax to the extent of the entire value of the property transferred, less the value of Mrs. Kite's qualifying income interest, as to which she made no gift.

B. *Estate of Anenberg v. Comm'r*, 162 T.C. No. 9 (May 20, 2024)

In *Estate of Anenberg*, the Tax Court addressed the application of § 2519 to the judicial termination of a martial trust holding QTIP, the distribution of all QTIP to the surviving spouse, and the surviving spouse's subsequent sale of the QTIP in exchange for promissory notes. Addressing cross motions for summary judgment filed by the parties, the Tax Court, in a unanimous reviewed opinion, determined that no gifts resulted.

The court declined to address whether § 2519 was triggered by the termination of the marital trust. Rather, the court rejected as a matter of law the Commissioner's assertion that the termination of the marital trust resulted in a *taxable gift* by Sally Anenberg assuming that § 2519 had been triggered as claimed by the Commissioner. The Tax Court opined:

> Applying these principles to this case is simple. If we assume that Sally's relinquishment of her interest in the Marital Trusts in exchange for the Al-Sal shares was a disposition, section 2519(a) treats her as having transferred away (but not necessarily by gift) all the interests in the Al-Sal shares other than her qualifying income interest. *See* also Treas. Reg. § 25.2519-1(a). The value of the deemed transfer is the fair market value of the shares, less Sally's qualifying income interest. *See id.* para. (c)(1). To determine whether Sally is liable for any gift tax on this deemed transfer, we must consider whether the transfer was also a gift by Sally.
>
> This task turns out to be straightforward. To determine whether Sally made a gift, in connection with the deemed transfer, we compare what she had before and after the transaction. When doing so, we find that, after the transaction, Sally had full ownership of the Al-Sal shares. As a result of the Superior Court's order, she received free and clear the underlying property that section 2056(b)(7) deemed her to have received from Alvin to start with and with respect to which (we assume) section 2519(a) deemed her to have transferred remainder interests upon the termination of the Marital Trusts. Put another way, Sally's deemed transfer of the remainder interests in the Al-Sal shares held in trust (other than her qualifying income interest) resulted in her actual receipt of all the Al Sal shares unencumbered (other than those attributable to her qualifying income interest). ***At the end of the day, she gave away nothing of value as a result of the deemed transfer. Accordingly, the termination of the Marital Trusts did not result in any "gratuitous transfers" by Sally, deemed or otherwise.*** *See Irvine*, 511 U.S. at 232. ***Because there was no gratuitous transfer, she made no gift.***

Id. at 14-15 (emphasis added).

The Tax Court also held that Sally's subsequent sale of the assets held in the martial trust did not trigger § 2519 because "after the termination of the marital trusts [the surviving spouse's qualifying income interest for life in QTIP terminated and [§ 2519] did not apply to the sale."

The Tax Court pointed out the Commissioner's erroneous reliance on numerous authorities where it was determined that § 2519 applied to a transaction involving the termination of a marital trust holding QTIP property. Those authorities included *Estate of Novotny,* 93 T.C. 12 (1989)(holding that where the surviving spouse and remainderman divided the sale proceeds of QTIP proportionately on the basis of the actuarial values of their respective interests, the commutation constituted a disposition by the spouse of the qualifying income interest in the remainder under § 2519, resulting in a gift of the value of the remainder interest), Rev. Rul. 98-8, 1998-7 I.R.B. 24 (ruling that if a surviving spouse purchases the remainder interest in a QTIP trust from the remainder beneficiaries, the surviving spouse has made a gift to the remainder beneficiaries equal to the purchase price paid because the assets comprising the remainder interest were already included in the surviving spouse's gross estate), and Treas. Regs. §§ 25.2519-1(f) and (g), Ex. 2. The court opined that "the authorities the Commissioner

cites support a result contrary to the one he advances," as "Sally's receipt of the QTIP (and later the promissory notes) preserves the value of the marital assets in her hands for future gift or estate taxation." *Estate of Anenberg,* 162 T.C. at 22.

The Tax Court also distinguished the Commissioner's attempt to apply *Estate of Kite,* noting that (1) *Kite* applied the substance over form doctrine; and (2) the sale of assets for a deferred private annuity "involved an apparent attempt to prevent estate or gift tax from ever being imposed on the residual value of the QTIP." *Id.* at 25.

Finally, the Tax Court expressed no view on whether the remainder beneficiaries' consent to the termination of the marital trusts and the distribution of QTIP to the surviving spouse resulted in a gift to the surviving spouse. *Id.* at 18, fn. 18.

VII. ISSUES REGARDING GRAT AUDITS

The IRS has increasingly been auditing grantor retained annuity trusts transactions. The three principle focuses are: (1) whether the terms of the GRAT comply with the § 2702 regulations; (2) whether the GRAT has been operated in accordance with its terms; and (3) valuation issues.

The IRS will examine whether the initial transfer of assets was valued correctly. In addition, if hard to value assets are used to pay the annuity, the IRS will examine how the assets were valued. The IRS will seek to determine whether the valuation methodology is consistent with the methodology used to value the assets when they were transferred to the GRAT. A similar analysis may be undertaken when a GRAT grantor exercises a power of substitution that he or she may have over GRAT assets. When hard to value assets are substituted or used to pay the annuity, planners should consider the advisability of a *Wandry* type formula or a *King* clause.

The examiner will also seek to substantiate annuity all payments and, if not timely made, could argue that the retained annuity is non-qualified interest under an analysis based on *Estate of Atkinson v. Comm'r*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002).

In CCA 202152018, IRS Chief Counsel took the position that the retained annuity from a GRAT was a non-qualified interest under § 2702 and *Atkinson* because the valuation report used in the gift tax return to determine the value of the annuity did not take into account a potential merger. The CCA opined that "although the governing instrument . . . appears to meet the requirements of § 2702 and the corresponding regulations, intentionally basing the fixed amount required . . . on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust . . . [which] . . . is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of the Company, at a time that the Company had received offers in the multi-billion dollar range."

The IRS took a similar position to CCA 202152018 in *Baty v. Commissioner*, Tax Court Docket No. 12216-21, with respect to a GRAT that was funded with publicly traded stock by the company's CEO at a time when the company and third parties were negotiating a potential merger/acquisition. The value of the stock was reported at the average of the high and low public share prince of the stock on the day the GRAT was funded as required by Treas. Reg. § 25.2512-2(b). The IRS issued a deficiency based on the theory that the stock should be valued at the trading price when the merger took place (which occurred six months later). The IRS also argued that the taxpayer could not use the revaluation provisions in the § 2702 regulations and that the annuity was non-qualified because the stock was

intentionally undervalued by the taxpayer. The taxpayer filed a motion for summary judgement with respect to his use of the average of the high and low trading price of the stock, arguing (1) the valuation methodology was established for valuing publicly traded stock and cited cases that note that the public trading price reflect potential merger negotiations, (2) post-valuation date events cannot be used to value a gift, (3) the hypothetical buyer/seller would not have known about the merger negotiations, (4) the merger was not practically certain to occur, and (6) the IRS's proposed methodology is unworkable. The IRS conceded the case entirely before filing its response to the motion.

VIII. Valuation Effect of Life Insurance Funded Redemption Agreements

A. *Connelly v. United States*, 602 U.S. ___ (June 6, 2024)

Brothers Michael Connelly and Thomas Connelly owned and operated Crown C Supply, Inc., which sold roofing and siding materials in the St. Louis area. Michael was more involved in Crown C's operations than his brother and served as CEO and President. Michael also was the majority owner (77.18%), with Thomas owning the remaining interest (22.82%). Both brothers, however, wanted to ensure that Crown C would stay within the family's control if either one of them were to die.

To accomplish that goal, Michael, Thomas, and Crown C entered into a Stock Purchase Agreement in 2001, which provided that upon one brother's death, the surviving brother had the right to buy the decedent's outstanding shares; however, if the surviving brother chose not to purchase the outstanding shares, Crown C was obligated to repurchase/redeem the decedent's outstanding shares. In case Crown C was obligated to redeem Michael's shares, Crown C purchased $3.5 million life insurance policies on each brother.

The Stock Purchase Agreement, however, also included a comprehensive appraisal process that should have occurred each year the agreement was in effect, as described by the District Court for the Eastern District of Missouri:

> To fund its redemption obligation, Crown C bought $3.5 million in life-insurance policies on both Connelly brothers. Article VII of the Stock Agreement provided two mechanisms for determining the price at which Crown C would redeem the shares. Article VII specified that the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed Value" at the end of every tax year. If the brothers failed to execute a "Certificate of Agreed Value," the brothers would determine the "Appraised Value Per Share" by securing two or more appraisals. The Connelly brothers never signed a single Certificate of Agreed Value under the Stock Agreement.

Connelly, Case No. 4:19-cv-01410-SRC, 2021 WL 4281288 at *4 (E.D. Mo. 2021).

On October 1, 2013, Michael died, and Thomas served as the executor of Michael's estate (the "Estate"). Pursuant to the Stock Purchase Agreement, Thomas chose not to purchase Michael's outstanding shares, which then required Crown C to purchase Michael's outstanding shares. Crown C then used a portion of the $3.5 million life insurance proceeds it received upon Michael's death to redeem Michael's outstanding shares. In valuing Michael's shares for federal estate tax purposes, the Estate took the position that the life insurance proceeds did not increase the value of Crown C because the proceeds were directly offset by Crown C's contractual obligation to redeem Michael's shares. The

Commissioner disagreed and determined that Crown C's net asset value for federal estate tax purposes was increased by the amount of the life insurance proceeds received.

The Supreme Court stated the issue succinctly: "The only question is whether Crown's contractual obligation to redeem Michael's shares at fair market value offsets the value of life-insurance proceeds committed to funding that redemption." *Connelly*, No. 23-146 at 5.

In line with the Eighth Circuit and the United States District Court for the Eastern District of Missouri, the Supreme Court held that "Crown's contractual obligation to redeem Michael's shares did not diminish the value of those shares. Because redemption obligations **are not *necessarily* liabilities** that reduce a corporation's value for purposes of the federal estate tax, we affirm the judgment of the Court of Appeals." *Id.* at 9. In addition, the Supreme Court stated the following in its final footnote:

> We do not hold that a redemption obligation can *never* decrease a corporation's value. A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject Thomas's position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more.

Id. at 9, n.2 (emphasis in original).

The *Connelly* decision repudiated the contrary holding of the Eleventh Circuit in *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005).

IX. NET/NET GIFTS

A. *Steinberg* I

In *Steinberg v. Commissioner*, 141 T.C. 258 (2013), the donor (who was 89 years old) made gifts of cash and marketable securities to her four daughters. The daughters agreed to pay (1) the gift tax, (2) any additional estate tax liability resulting from the addition of the gift tax to their mother's gross estate under § 2035(b) if she died within three years. In reporting the gifts, the donor subtracted both the amount of the gift tax (a net gift pursuant to Rev. Rul. 75-72) and the present value of the daughters' undertaking to pay any estate tax related to the gift under § 2035(b). The IRS's deficiency allowed net gift treatment but disallowed the "net, net gift" deduction. Mrs. Steinberg challenged the deficiency in the Tax Court.

The IRS filed a motion for summary judgment in the Tax Court, citing the Tax Court's 2003 decision in *McCord v. Commissioner* (which had been reversed by the Fifth Circuit Court of Appeals). The IRS argued that the donees' assumption of potential § 2035(b) estate tax liability was worthless and provided no benefit to Mrs. Steinberg. Because the assumption was worthless, it was not consideration for a gift under the estate depletion theory of gift tax, the IRS argued. Under that theory, a donor receives consideration in money or money's worth if the donor's estate receives some benefit from the consideration offered for a gratuitous transfer.

The Tax Court, in a split decision, denied the IRS's motion. The majority declined to agree with the IRS that as a matter of law, the donees' obligation to pay the tax did not result in any benefit to the donor. The majority opinion also overruled the Tax Court's decision in *McCord* and held that the value of the gift may be reduced by the present value of the donee's contingent obligation to pay estate taxes.

The majority opined that the daughters' commitment to pay the § 2035(b) estate tax liability was not "too speculative as a matter of law" to be reduced to a monetary value. The likelihood that the donor would survive three years was actuarial ascertainable, and a willing buyer would assume the existing marginal rates and exemption amounts would remain in place. Therefore, the majority refused to rule as a matter of law that the taxpayer had not established an appropriate method of valuing the contingent incremental estate tax liability.

Six judges issued a separate opinion, concurring with the result but not the reasoning of the majority. The concurring opinion found that it was premature to overrule *McCord* on the ground that the daughters' commitment was too speculative because the IRS had not raised that issue in its motion. With respect to the estate depletion argument, the concurring opinion agreed that the motion for summary judgment should be denied on different grounds. The IRS had argued that the daughters' commitment to pay the § 2035(b) estate tax amounted to an agreement to apportion of taxes in their mother's estate and that the same result would occur under applicable state law absent the agreement. Thus, no benefit was received by the donor. The concurrence noted that a fact issue existed as this would be true only if the daughters were in fact residuary legatees of the estate, and only if their commitment did not provide an enforcement mechanism not otherwise existing under state law. The concurrence noted, however, that if the only function of the daughters' commitment was an enforcement mechanism for an existing liability, this would substantially reduce the value of the agreement to pay taxes.

Several problems exist with respect to the concurring analysis. First, part of the consideration for the transfer was the assumption of the obligation to pay the § 2035(b) estate tax. It does not matter whether that obligation is contractual or imposed by statute. Absent contract (or statute), it is an obligation that would have otherwise rested with the donor or her estate. Second, if the willing buyer/willing seller test assumes hypothetical buyers and sellers, how can the actual recipient be relevant to the analysis? The concurring opinion appears to be a family attribution argument. That is, even assuming the daughters are the beneficiaries of the estate under the donor's current will, that should be irrelevant for valuation purposes. The concurring opinion addressed not only on the property rights exchanged, but made assumptions about other rights possessed (or not) by the daughters (*i.e.*, the existence of an expectancy under the will).

B. *Steinberg* II

After a trial in which the Taxpayer (but not the IRS) submitted valuation evidence, the Tax Court issued a decision confirming the Taxpayer's position. *Steinberg v. Commissioner*, 145 T.C. No. 184 (2015). The Court began its analysis by stating that the "fundamental question posed by this case is the fair market value of the property rights transferred under the net gift agreement." *Id.* at 193. The Court opined that circumstances warranting consideration of the donee's assumption of § 2035(b) estate tax liability "arise when the donee's assumption of the § 2035(b) estate tax liability is a detriment to the donee and of benefit to the donor." *Id.* at 16.

The Court held that the § 2035(b) estate tax liability was a detriment to the donees because the estate tax liability assumed did not exist before the net gift agreement and arose as a result of the net gift agreement. In other words, the daughters had to agree to assume the liability in order to gain the benefit of the property they received under the net gift agreement. Analogizing the case to the situation where a donor makes a gift of property subject to built-in capital gains, the Court noted that a hypothetical willing buyer would recognize that to obtain the properties transferred, he or she would need to assume both the gift tax liability and the § 2035(b) estate tax liability and would demand that the price be reduced to account for both. *Id.* at 196.

The Court also held that the daughters' agreement to pay the § 2035(b) estate tax liability was of benefit to the donor. Under federal law, the tax cost of the § 2035(b) estate tax liability is generally borne by the donor's estate and not the donee of the gift. Since the daughters assumed this liability, Mrs. Steinberg's assets were relieved of both the gift tax liability and the § 2035(b) estate tax liability.

The Tax Court rejected the IRS' argument that the assumption of the § 2035(b) estate tax liability did not create any new burden on the daughters or benefit Mrs. Steinberg because the daughters would have the obligation to pay the liability either under New York law or as beneficiaries of Mrs. Steinberg's residuary estate. The Court noted that at the time the gifts were made, it was not possible to determine whether the New York apportionment law would apply. Mrs. Steinberg was alive and capable of changing her domicile before her death and there was a possibility that the law of a state other than New York would apply. It was also not possible to determine the provisions of Mrs. Steinberg's will that would exist at the time of her death as Mrs. Steinberg could change these provisions. The Court also noted there was no certainty that her four daughters would be beneficiaries of the will, stating that Mrs. Steinberg had made changes to her will which at one point excluded one of the daughters as a beneficiary.

The Court stated that while the value of the assumption might not be precisely equal to the actuarial value of the estate tax liability that the daughters assumed, the IRS introduced no expert testimony to support a value lower than the value determined by Mrs. Steinberg's expert. The IRS also provided no valuation testimony to address the uncertainties surrounding the application of the New York apportionment statute.

The Court accepted the testimony of Mrs. Steinberg's expert regarding the valuation effect of the daughters' agreement to pay the § 2035(b) liability. The expert used the Commissioner's actuarial tables to calculate the probability that Mrs. Steinberg would die within each of the three years after the date of the net gift agreement. He used the § 7520 interest rate applicable on the date of the transfer to determine the present value factors for each of the three years. He then took the effective state and federal and estate tax rates for each of the three years and multiplied them by the gift tax that would be included in the estate under § 2035(b). Using this methodology, which was identical to the approach he used in *McCord*, the expert calculated the daughters' assumption of the § 2035(b) estate tax liability reduced by the value of the gift by $5,838,540.00.

The Commissioner raised two issues regarding the expert's methodology. First, the Commissioner claimed that the analysis was flawed because it failed to consider contingencies such as Mrs. Steinberg's health and general medical prognosis. The Tax Court rejected this critique, noting that the most common way to measure the value of a property interest that is dependent on the life expectancy of an individual is to use the Commissioner's tables. Since the Commissioner failed to introduce any evidence to support a departure from the tables, the Court rejected the Commissioner's position.

Second, the Commissioner alleged that the expert incorrectly used the § 7520 rates in calculating the present value of the daughters' assumption of the contingent estate tax liability, claiming that the § 7520 rates only apply to annuities, life interests, terms of years, remainders, and reversionary interests. The Court noted the fact that payment is contingent rather than certain does not preclude the use of the § 7520 rates. It simply requires adjusting the value of payments taken into account and the likelihood of the contingency, which the expert did by using the actuarial tables.

X. VARIOUS VALUATION ADJUSTMENTS

A. Unrealized Capital Gains

In *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998), the Tax Court recognized the real liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation for the first time since the repeal of the General Utilities doctrine. At issue in *Davis* was the gift tax value of two 25 share blocks of stock (of the total of 97 shares) of A.D.D. Investment & Cattle Company ("ADDIC") given to each of two sons. ADDIC was a family owned holding company, the assets of which included over 1% of the issued and outstanding common stock of Winn-Dixie, listed on the New York Stock Exchange, and assets related to ADDIC's cattle operations. ADDIC assets had a total built-in capital gains tax liability of $26.7 million, about 96% of the gain being attributable to its Winn-Dixie stock. The Court allowed a $9 million adjustment for built-in capital gains tax, representing approximately 1/3 of the total capital gains tax liability on all of the corporate assets. The petitioner's two experts and the IRS's expert (but not the IRS) believe that an adjustment was warranted – that is, a willing buyer and a willing seller would have taken the built-in tax liability into account in arriving at a purchase price for the stock. The dispute was over the amount of the adjustment. The Court found that the full amount of built-in tax liability could not be taken as a discount when there was no evidence that ADDIC planned to liquidate or sell its assets. The Court concluded that a $9 million discount was properly included as a part of the lack of marketability discount to be applied in value in the two blocks of stock.

Following quickly on the heels of the *Davis* decision was the Second Circuit's decision in *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998), reversing a memorandum decision of the Tax Court. The Appeals Court found that the Tax Court erred in not considering the built-in capital gains tax as a liability and remanded the case back to the Tax Court to decide on the amount of the liability. This reversal was the last nail in the coffin of the notion that built-in capital gains taxes should not be considered in valuing C corporations. The IRS has acquiesced in *Eisenberg* "to the extent that it holds that there is no legal prohibition against such a discount." AOD 1999-001.

In *Estate of Jameson v. Commissioner*, 77 T.C.M. (CCH) 1383 (1999), the Tax Court again allowed a discount for unrealized capital gains. In *Jameson*, the decedent owned a 97% interest in a closely held corporation which had as its primary asset 5,405 acres of timberland in Louisiana. The fair market value of the timber property was $6 million. Its tax basis was approximately $200,000. Citing *Davis*, the Court allowed a built-in capital gains discount. In discussing this opinion, Judge Gayle stated:

> We may allow the application of a built-in capital gains discount if we believe that a hypothetical buyer would have taken into account the tax consequences of built-in capital gains when arriving at the amount he would be willing to pay for decedent's Johnco stock. Because Johnco's timber assets are the principal source of the built in capital gains and, as discussed infra, are subject to special tax rules that make certain the recognition of the built in capital gains over time, we think it is clear that a hypothetical buyer would take into account some measure of Johnco's built in capital gains in valuing decedent's Johnco stock.

77 T.C.M. at 1396.

The Court concluded that since capital gains taxes would be incurred as Johnco's timber was cut and sold, recognition of the gain was certain to occur independently of any liquidation that a hypothetical willing buyer of decedent's Johnco stock "would take into account Johnco's built in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis." However, the court limited the discount "an amount reflecting the rate at which they [the capital gains taxes] will be recognized, measured as the net present value of the built in capital gains tax liability that will be incurred over time as timber is cut." *Id.*

The Fifth Circuit Court of Appeals reversed the Tax Court's decision. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001). The Court noted that the Tax Court had "deviated from several criteria of fair market value analysis, including assuming that a buyer was a strategic buyer who would continue to operate the corporation for timber production, peremptorily denying a full discount for the accrued capital gains liability based upon the erroneous assumption that the purchaser would engage in long range timber production." 267 F.3d at 371-72. The Court also noted that the Tax Court had internally inconsistent assumptions, assuming that a hypothetical purchaser of the stock would engage in long range timber production earning a 14% gross annual rate of return while requiring a 20% rate of return. Since the buyer would be earning less than his required rate of return, the buyer would either lower the purchase price or sell the interest quickly and redeploy the proceeds elsewhere. The Fifth Circuit remanded the case back to the Tax Court for valuation analysis consistent with its opinion.

In *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002), the Fifth Circuit applied a dollar-for-dollar discount for unrealized capital gains when determining the value of a 62.96% interest in a closely-held Texas corporation under an asset-based approach. At her death, Mrs. Dunn owned 62.96% of Dunn Equipment was family-owned and operated company in the business of renting heavy equipment to refinery and petrochemical businesses. Reversing the Tax Court, the Fifth Circuit held, as a matter of law, the $7.1 million built-in capital gains tax liability of Dunn Equipment's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of Dunn Equipment.[5] The Court opined that the very definition of the asset-based approach contemplates the consummation of the sale of the asset being valued, triggering the built-in capital gains tax. The holding makes rational sense, and should be applied in any asset-based valuation of a C corporation since the asset-based approach assumes that the buyer is paying for the stock of the entity based upon the price the buyer could realize for the assets of such entity. Before the buyer can realize such value, however, the corporate level capital gains tax must be incurred.

In *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007), the Eleventh Circuit adopted the Fifth Circuit's dollar-for-dollar discount in *Dunn*.

In *Estate of Litchfield v. Commissioner*, T.C. Memo. 2009-21 (January 29, 2009), the Court allowed an unrealized capital gain discount based upon the assumption that the assets would be sold over time. The estate's expert projected holding periods and estimated sales dates for the corporation's assets, anticipated appreciation to the sales dates, and discounted the capital gains back to the valuation date. The Court adopted this approach.

In *Estate of Jensen v. Commissioner*, T.C. Memo. 2010-182 (August 10, 2010), the Court determined the unrealized capital gains tax discount to be applied when valuing an 82% interest in a C corporation holding appreciated assets. The principal assets of the corporation were real estate and

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[5] It did not apply the same reduction when determining value under the income-based approach.

improvements. The built-in capital gains tax would have been approximately $1.1 million if the assets had been sold on the date of the decedent's death. The Estate's expert determined that a dollar-for-dollar discount was appropriate because the "adjusted value method is based upon the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation of the assets." This approach was similar to that used by the courts in *Estate of Dunn* and *Estate of Jelke*. However, because this case was appealable to the Second Circuit, the Court was unwilling to speculate as to whether or not the Second Circuit would apply a dollar-for-dollar unrealized capital gains discount as a matter of law and declined to adopt the expert's analysis.

The IRS's expert analogized the corporation to six closed-end investment funds. He determined that the unrealized capital gains tax exposure did not exceed 41.5% of the net asset value for any of the six funds. He thus opined that a dollar-for-dollar discount should be applied only for that portion of the unrealized capital gains tax that exceeded 41.5% of the net asset value, but no discount to the extent that the unrealized capital gains tax did not exceed 41.5% of the net asset value. This resulted in a discount of approximately 50% of the built-in capital gains tax. The Court did not give much weight to Respondent's expert's valuation because it was not convinced that the closed-end funds were comparable to the real estate owned by the corporation and because discounts for closed-end funds are attributable to factors other than built-in capital gains.

The Court used a present value approach to determine the built-in capital gains discount. The Court calculated the estimated future value of the land and improvements under two scenarios: (1) using a 5% appreciation rate (the rate of appreciation assumed in the taxpayer's real estate appraisal); and (2) using a 7.5% appreciation rate (based on pre-tax return of income data in the taxpayer's expert's report). It also assumed that the assets would be sold over a 17-year period, based upon the average useful life from the depreciation figures in the taxpayer's real estate report. The resulting tax amounts were discounted to present value using a discount rate equal to the assumed appreciation rate (although the Court did not discuss how the discount rate was determined). The Court's analysis resulted in unrealized capital gains tax with a present value of $1.23 million and $1.26 million under the two scenarios. Because these calculations exceeded the Estate's $1.13 million discount, the Estate's requested discount was allowed.

In *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26 (February 11, 2014), the Court determined the value of the Decedent's 23.44% in a closely held investment company (a C Corporation) that owned $52 million worth of publicly traded securities. As an initial matter, the Court rejected the Estate's expert's valuation of the stock based on a capitalization of dividend's approach, holding that the net asset value of approach was more appropriate for a non-operating entity holding publicly traded stock.

The Court opinioned that the present value of the built-in gains tax liability should be determined at the entity level. A dollar-for-dollar liability discount was not allowed. The Court determined the present value of the built-in gain tax by assuming the stock portfolio (which had been held intact for decades) would be sold over twenty and thirty year periods using various discount rate assumptions. The Court did not consider the built-in gains tax on future appreciation. The total amount of liability allowed by the Court was 43.16% of the total built-in capital gains tax liability assuming all of the assets were sold on the valuation date. The Court also applied a discount for lack of control of 7.75% and a discount for lack of marketability of 32.1%.

B. Undivided Interests in Real Estate

The IRS has often asserted that the only discount which should be applied when determining the fair market value of undivided interests in real property are the costs and expenses associated with a partition of that property. *See* PLR 9336002 (May 28, 1993). The Tax Court has consistently recognized, however, that IRS reliance on partition costs as the sole basis for the discount is misplaced.

In *Estate of van Loben Sels v. Commissioner*, 52 T.C.M. (CCH) 731 (1986), the Tax Court held that "a discount from the value determined by reference to the fee value is warranted because of the disabilities associated with decedent's undivided interest. The disabilities include lack of marketability, lack of management, lack of general control, lack of liquidity, and potential partitionment expenses." *Id.* at 742. The Court held that because of the disability associated with owning an undivided interest in the properties, "a minority discount of 60% is reasonable in this case." *Id.* at 743. *See also Estate of Forbes v. Comm'r*, 81 T.C.M. (CCH) 1399 (2001) (30% discount allowed for undivided 42% interest in 5,354 acres of real property); *Williams v. Comm'r*, 75 T.C.M. (CCH) 1758 (1998) (44% discount for undivided interest applied to a one-half undivided interest in approximately 4,600 acres of timber property in Florida); *LeFrak v. Comm'r*, 66 T.C.M. (CCH) 1297, 1308-10 (1993) (holding that a 20% minority interest and 10% lack of marketability discount applied for undivided interest in New York apartment and office buildings); *Estate of Baird v. Comm'r*, 82 T.C.M. (CCH) 666 (2001), holding that a 60% discount in valuing undivided interests in 16 non-contiguous tracts of Louisiana timber property.

In *Ludwick v. Commissioner*, T.C. Memo. 2010-104 (May 10, 2010), the Tax Court determined the undivided interest discount for a 50% interest in a Hawaiian vacation home. In response to the Tax Court's question of why the discount should be any greater than the costs of partition, the experts for both the taxpayer and the IRS agreed that adjustments beyond the cost of partition should be allowed for lack of marketability and illiquidity risks because of the inability to sell the house quickly at fair market value. Essentially rejecting the opinions of both experts, the Court determined the discount under a present value approach assuming (1) a two-year partition action would be required (resulting in a 26.5% discount) and (2) the property could be sold in one year without a partition action (resulting in a 16.2% discount). The Court weighted those outcomes, concluding that there was a 90 percent likelihood that no partition action would be needed. This resulted in a discount of 17.2%. Given the Court's short holding period, the principal reason for the 17.2% discount was the existence of operating expenses of $350,000 per year. Had those operating expenses not been present, the discount would have been much lower. One factor that appears missing from the analysis is the general lack of marketability inherent in the interest. In other words, why would a buyer be interested in purchasing a property that they would simply turn around and sell in a partition action at a discount based on costs of partition and the time value of money?

C. Tiered Discounts

The IRS often takes the position that successive or tiered discounts should not be applied in determining the value of an interest in an entity which in turns owns an interest in another entity. But both the Tax Court and other courts have recognized the existence of "tiered discounts" when valuing an interest in a closely held entity. *See*, *e.g.*, *Astleford v. Comm'r*, T.C. Memo. 2008-128 (May 5, 2008) (court applied discounts of 30% and 36% in valuing limited partnership interest in partnership that owned a general partnership interest in real estate venture); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680 (2000) (court applied combined discounts for lack of control and lack of marketability in valuing the stock of the top tier entity for 1989 and 1990, respectively, of 44% and 51%, and 41% in valuing the

interest in the second tier entity); *Kosman v. Comm'r*, 71 T.C.M. (CCH) 2356 (1996); *Dean v. Comm'r*, 19 T.C.M. (CCH) 281 (1960); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954).

D. Tax Affecting Cash Flows of Flow Through Entities

A fundamental question when determining the value of a pass-through entity is whether owner-level taxes affect the value of an equity interest. If the answer is yes, then it is inconceivable that those taxes would not be considered in determining its fair market value. Treas. Res. § 25.2512-1 ("All relevant facts and elements of value must be considered in every case.").

A wealth of publicly available research demonstrates that owner-level taxes affect the value of an equity interest. *See* Nancy J. Fannon & Keith F. Sellers, Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle 29-39 (2015) ("[A]cademic research clearly demonstrates that shareholder dividend and capital gains taxes affect the cost of capital. Stock prices are reduced (and, therefore, the return derived from it is higher than it would otherwise be) because investors have to pay personal taxes."). Because owner-level taxes impact stock values and because taxes on income for pass-through entities are paid at the owner level, the effect of those taxes logically must be considered in the valuation analysis.

To determine the present value of an operating entity's cash flows under the income approach, appraisers typically apply a required rate of return derived from publicly traded companies. Those publicly traded companies all paid taxes on their corporate income at the entity level, with a second level of tax imposed on shareholders at the shareholder level when dividends are paid. Since taxes on a flow through entity's income are paid at the owner level, there is a mismatch (perhaps best understood as a tax timing difference) between the entity's cash flows and those from publicly traded companies used to determine the required rate of return. Tax affecting the cash flows is appropriate to correct that mismatch because equity owners (and hypothetical non-corporate buyers) of interests in flow through entities understand that, as a pass-through entity, the income will be imputed to (and related income taxes will be paid by) them. As Dr. Shannon Pratt, a leading expert in the valuation profession has stated:

> It is important to recognize that both C corps and S corps pay taxes on corporate income. Whether that tax is actually paid by the corporation or the individual is absolutely irrelevant. What is relevant is the difference between the value of a company valued as a C corporation, valued using publicly traded C corporation data (because it is by reference to publicly traded C corporations that we value the S corporation), and as an S corporation. It is for this reason that most S corporation models begin by valuing the company "as if" a C corporation, using the rates of return derived from publicly traded C corporations, and then go on to recognize the benefits of the Subchapter S election.

VALUING A BUSINESS at 618-19.

The rational assumption supporting tax affecting is that who pays the taxes—the C corporation (as an entity) or the pass-through entity's owner—is irrelevant because the dollars used to satisfy the liability are not available for reinvestment and do not create wealth for the entity or its owners. As a result, investors make investment decisions based on net proceeds (after the satisfaction of tax liabilities directly attributed to the investment) whether those liabilities are taxed at the entity level or the investor level. This approach is consistent with the empirical evidence discussed above that demonstrates that

both entity-level taxes ***and*** shareholder-level taxes (*i.e.*, the total tax burden) affect the value of equity interests in a company. *See* FANNON & SELLERS, *supra*, at Ch. 3-4.

The IRS has taken the position in a number of cases that the cash flows of a flow through entity should not be tax affected in determining the value of interests in the entity since no taxes are owed at the entity level. The IRS's general position on the issue is based on a handful of Tax Court cases addressing the issue. However, the Tax Court cases that address tax affecting do not uniformly condemn tax affecting cash flows of a flow-through entity.

To begin, the Tax Court cases addressing this issue before the *Jones* case are Tax Court Memorandum cases authored by only three judges, none of whom are currently sitting. *See Estate of Gallagher v. Comm'r*, 101 T.C.M. (CCH) 1702 (2011) (Halpern, J.); *Dallas v. Comm'r*, 92 T.C.M. (CCH) 313 (2006) (Colvin, C.J.); *Estate of Heck v. Comm'r*, 83 T.C.M. (CCH) 1181 (2002) (Halpern, J.); *Estate of Adams v. Comm'r*, 83 T.C.M. (CCH) 1421 (2002) (Colvin, J.); *Wall v. Comm'r*, 81 T.C.M. (CCH) 1425 (2001) (Beghe, J.); *Gross v. Comm'r*, 78 T.C.M. (CCH) 201 (1999) (Halpern, J.). As such, these cases "are case-fact specific and do not reflect the opinion of the Tax Court as a whole." VALUING A BUSINESS, *supra*, at 614.

In fact, the Tax Court as a whole has not expressed its opinion on whether tax affecting the earnings of a pass-through entity is appropriate. Rather, the cases reflect that, in each individual factual scenario presented, three of the judges of the Tax Court decided that tax affecting was not appropriate. The issue certainly has not been decided as a matter of law. The late-Judge David Laro emphasized that point during a panel presentation at the 2015 AICPA FVS conference in Las Vegas:

> [T]he IRS's position of no tax affecting leans on *Gross v. Commissioner* and progeny, but it contradicts sound valuation practices. All of the cases were Tax Court memos and it should be kept in mind these opinions are not binding on other judges. The final chapter on tax affecting has not yet been written.

See Gilbert E. Matthews & Michelle Patterson, *Judge Laro Toplines Panel on Hot Issues in Tax Valuation*, 22 BUS. VALUATION UPDATE 3 (2016). Likewise, as Judge Colvin (author of the *Adams* opinion) emphasized: "[w]hether tax-affecting applies turns on valuation principles including consideration of the hypothetical willing seller and buyer, the experts, and specific facts of the case." *Dallas*, 92 T.C.M. (CCH) at 317 n.9. Given the lack of consensus and the fact-specific nature of the tax affecting cases, a blanket prohibition against tax affecting is unsupportable.

Instead of rejecting tax affecting on ***entity***-level value, what the Tax Court has attempted to do is recognize that pass-through status might impact ***owner***-level value. *Gross*, 78 T.C.M. (CCH) at 209 ("The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation."); Courtney Sparks White, Comment, *S Corporations: A Taxing Analysis of Proper Valuation*, 37 CAP. U. L. REV. 1117, 1150 (2009). The question is how much an investor's return is enhanced, if any, from pass-through status? An analysis which properly captures the tradeoff associated with flow-through status is much more reasonable than the Commissioner's typical approach, which categorically rejects tax affecting and grossly inflated the value of the flow through entity's stock by ignoring the effect of owner-level taxes on entity income.

The recent decision in *Kress v. United States*, 16-C-795, 2019 WL 1352944 (E.D. Wisc. Mar. 25, 2019), also supports the tax affecting approach to interests in a flow through entity. The *Kress* court determined the value of interests in an S corporation under the income approach by first valuing the company on a C corporation equivalent basis, which included tax affecting the entity's earnings at the

corporate tax rate, followed by a determination of whether any economic adjustment/benefit should be ascribed to flow through status. In that case, both experts tax affected the entity's earnings. The only question is whether a premium for flow through status should be applied. The court found no reason to do so.

The Tax Court's recent decision in *Estate of Jones v. Comm'r*, T.C. Memo. 2019-101 (August 26, 2019) (Judge Pugh) dealt the IRS non-tax affecting position a significant blow. In this case, the court determined the value of interest in a timber operating company under an income approach. The taxpayer's expert tax affected the earnings. The IRS's expert did not.

The court noted that the prior Tax Court cases did not prohibit tax affecting per se. Rather, the court noted that each was decided on its own facts and that expert testimony introduced. The court noted that in this case, the taxpayer's expert's tax affecting analysis was more persuasive:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flow-through status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction of the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. … Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

In *Estate Jackson v. Comm'r*, T.C. Memo. 2021-48, the Tax Court (Judge Holmes) declined to tax-affect the cash flows projected to be earned the following assets: (1) Michael Jackson's image and likeness, (2) MJJ Productions, Inc. and (3) Michael Jackson's master recordings. Each of the assets was held in a flow-through entity.

Each of the estate's experts reduced the cash flows by the income tax liability that would be paid by a hypothetical C corporation buyer (two of the three included a combined federal/state tax rate). The IRS's expert did not tax affect. The court noted that whether or not to tax affect was a question of fact. However, the court declined to tax affect the earnings because the estate's experts (1) did not persuade the court that a taxpaying entity would be the likely hypothetical buyer of the assets at issue, (2) did not consider the tax detriments and benefits of pass-through status, and (3) disagreed on the appropriate tax rate.

Estate of Jones and *Estate of Jackson* highlight the need for the expert to explain in detail why tax affecting is appropriate and to determine the benefit, if any, of flow through status.

XI. PROMISSORY NOTES

A. THE SECTION 7872 SAFE HARBOR

1. Application of § 7872

From time to time, the IRS has taken the position that a loan at the AFR rate can be valued at less than face value for gift tax purposes. Set forth in this section is the response we often provide to that argument.

In deciding whether the interest charged on a loan is a gift, the governing Code provision is § 7872. Section 7872 applies to certain loans that charge below-market interest rates. The consequence

of a loan violating § 7872 is that the transaction is recharacterized as one in which the amount of interest needed for the loan to charge market interest is gifted from the lender to the borrower and then retransferred by the borrower to the lender as interest. I.R.C. § 7872(a)(1).

Section 7872 applies to gifts, compensation-related loans, corporation-shareholder loans, tax avoidance loans, and other below-market loans. *Id.* § 7872(c)(1). The determination of what constitutes a gift loan differs depending on whether the loan is a demand loan or a term loan. *Id.* § 7872(e)(1). If the loan is a demand loan, the test is whether the interest payable is at a rate less than the applicable Federal rate ("AFR"). *Id.* § 7872(e)(1)(A). If the loan is a term loan, the test is whether the amount of money loaned exceeds the present value of the payments. *Id.* § 7872(e)(1)(B). The discount rate used in that present value calculation is the AFR. *Id.* § 7872(f)(1)(B). As the test for a demand loan and a term loan both look to the AFR, if a loan charges interest that is at least equal to the AFR, it will not be a below-market loan and § 7872 will not apply.

Section 7872 was created in response to the Supreme Court's holding in *Dickman v. Commissioner* that an interest-free demand loan "result[s] in a taxable gift of the reasonable value of the use of the money lent." 465 U.S. 330, 344 (1984). The Court noted that "[t]he right to use money is plainly a valuable right, readily measurable by reference to current interest rates; the vast banking industry is positive evidence of this reality." *Id.* at 337-38. The Court's reference to a readily measurable rate set the stage for Congress to enact § 7872. In the House Report, Congress noted the appropriateness of charging a market rate of interest to reflect the economic substance of a transaction:

> [A]n interest-free or below-market interest rate loan is the economic equivalent of a loan with a market rate of interest required to be paid by the borrower, and a payment by the lender to the borrower to fund the borrower's payment of interest. Further, the committee believes that in many instances the failure to tax these transactions in accordance with their economic substance provides taxpayers with opportunities to avoid a number of tax rules.

H.R. Rep. 98-432(II) (1984), *reprinted at* 1984 U.S.C.C.A.N. 697, 1021. Additionally, the House Report notes that § 7872 applies to term loans and demand loans, without reference to whether the loan is below-market or at-market. *Id.* at 1027.

Congress' goal in enacting § 7872 was to require taxpayers to charge interest at the applicable Federal rate on loans or face recharacterization of their transaction. If below-market loans must be recharacterized by reference to the applicable Federal rate to reflect their economic substance, then the logical extension of that rule is that loans at the applicable Federal rate already reflect the proper economic substance of the transaction and are at fair market value.

In PLR 9535026, the Commissioner acknowledged that a note bearing interest at the applicable Federal rate does not result in a gift subject to gift tax. PLR 9535026 (Sept. 1, 1995) ("In the present case, the stated interest rate on the notes will equal the rate prescribed by § 7872. Thus, we conclude that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax.").

This result is also supported by the proposed regulations for § 7872, which provide a safe harbor for notes bearing interest at the applicable Federal rate. The proposed regulations observe that § 7872 exists to treat below-market loans as "economically equivalent to loans bearing interest at the applicable Federal rate, coupled with a payment by the lender to the borrower sufficient to fund all or part of the

payment of interest by the borrower." Prop. Treas. Reg. § 1.7872-1, 50 Fed. Reg. 33553-01, 33556 (Aug. 20, 1985).

Commentators also write that notes bearing interest at the applicable Federal rate are not gifts. *See, e.g.*, Jonathan G. Blattmachr, et al., *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 22 (July 2008) (noting that *Dickman* led to the enactment of § 7872, "which in essence direct[s] that there will be a gift only to the extent the loan bears interest at a rate lower than the AFR," and that "[i]f the term note bears at least AFR, its value will not be determined to be lower for purposes of Section 7872 than the amount borrowed and, as a result, the lender will not be deemed to have made a gift to the borrower"); C. Christine Borrett, *Intra-Family Loans*, 1 EST. PLAN. & CMTY. L.J. 257, 268 (2008-09) (noting that § 7872 provides that "there are gift tax consequences for intra-family loans only to the extent that the loan bears interest at a rate lower than the AFR").

2. *Frazee* Court Determines Exclusivity of § 7872

In *Frazee*, the taxpayers transferred land to their children in exchange for a note bearing interest at 7% per year and secured the note with a deed of trust on the transferred land. *Frazee v. Comm'r*, 98 T.C. 554, 555 (1992). After determining the value of the land, the Tax Court turned to whether the taxpayers made a taxable gift because the promissory note bore a below market interest rate. *Id*. at 579-80.

The Commissioner asserted that § 7872 provides the sole method for determining if the interest on a loan qualifies as a gift. *Id*. The taxpayers argued that § 483 or § 1274 applied. *Id*. at 581. Sections 483 and 1274 establish two alternative schemes for determining interest on debt instruments and feature different safe harbors provisions than § 7872. *Id*. The Tax Court agreed with the Commissioner and held that § 483 and § 1274 are not relevant for determining the gift tax consequences of interest on a loan. *Id*. at 586.

In so holding, the court noted that § 7872 reaches a variety of loans and purports to provide comprehensive treatment of below-market loans for gift tax purposes. *Id*. at 588. Instead of setting safe harbor interest rates for loans, the Tax Court explained that § 483 and § 1274 dealt with the income tax ramifications of below-market loans. *Id*. at 586.

Having established § 7872's expansive application, the Tax Court turned to decide whether the loan in question was covered by the statute. *Id*. at 589. It noted that § 7872 generally applies to below-market gift term loans. *Id*. First, the court determined whether it was a loan. *Id*. The court examined § 7872's legislative history and determined that the word "loan" is to be interpreted broadly to include any extension of credit. *Id*. The Tax Court then went on to decide whether the loan was a below-market loan and whether it was a gift loan. However, rather than make those two determinations separately, the Tax Court collapsed them together when it said, "a below-market loan will be treated as a gift loan unless it is a transfer made in the ordinary course of business, that is, unless it is a transaction which is bona fide, at arm's length, and free of donative intent." *Id*. Because the loan charged interest below the AFR and was not made in the ordinary course of business, the Tax Court held that the loan was subject to § 7872. *Id*. at 589-90.

3. *Estate of True* Emphasizes Extent of § 7872's Applicability

Estate of True further clarified the rule of *Frazee*. *Estate of True v. Comm'r*, 82 T.C.M. (CCH) 27 (2001). *Estate of True* involved a family buy-sell agreement. *Id*. at 118. Those buy-sell agreements

were triggered when True sold interests in 22 family companies she inherited as a result of her husband's death. *Id*. at 45-46. The buy-sell agreements provided that once they were triggered by the seller's notice, the other parties (in this case, True's sons) were required to purchase the interests. *Id*. While the buy-sell agreements specified that the notice date was the effective date, they also provided that the sale did not have to be consummated until up to six months later. *Id*. Notably, the buy-sell agreements did not provide for any interest if the purchase date differed from the effective date. *Id*. at 119. Using that provision, the sons did not complete the purchase until they paid the amount specified in the buy-sell agreements three months after the notice date. *Id*. at 118.

The Commissioner asserted, and the Tax Court agreed, that the sales were complete as of the notice date. *Id*. at 121-22. Thus, the three month delay in paying the purchase price amounted to a deferred payment arrangement. *Id*. at 123. The question for the Tax Court was whether that deferred payment arrangement ran afoul of § 7872. *Id*.

The arrangement was determined to be a term loan, since True did not have the right to payment on demand. *Id*. at 125. The Tax Court performed a present value calculation to determine if the amount loaned exceeded the present value of the payments. *Id*. As the sons paid no interest in conjunction with the deferred payment arrangement, the amount loaned exceeded the present value of the payments. *Id*. The deferred payment arrangement thus qualified as a below-market loan. *Id*.

The Tax Court next determined whether the below-market loan was a gift loan. *Id*. It quoted the *Frazee* case for the proposition that a below-market loan only escapes gift loan status if it is made in the ordinary course of business. *Id*. The Tax Court decided that parties dealing at arm's length would not have transferred ownership without payment. *Id*. at 126. Independent parties would have required either some payment of interest or some adjustment to reflect the performance of the companies during that period. *Id*. Since the transactions were not in the ordinary course of business, the deferred payment arrangement was a gift loan and the non-payment of interest was a gift by True to her sons. *Id*.

B. BONA FIDE LOAN OR GIFT?

1. Overview

Outside of the interest rate context, a question often asked in an intra-family situation is whether the loan transaction was a bona fide loan or a gift. *See, e.g., Estate of Lockett v. Comm'r*, T.C. Memo. 2012-123. In a related party or family setting, courts will respect a loan as debt as long as the parties intended the loan to be debt and the parties had a reasonable expectation of repayment.

2. Key to Analysis: Expectation of Repayment

For related parties, courts will respect a loan as debt as long as the parties intended the loan to be debt and the parties had a reasonable expectation of repayment. *See, e.g., Elkins' Estate v. United States*, 457 F. Supp. 870 (S.D. Tex. 1978) ("In an effort to analyze the criteria which have been applied by the courts in determining whether or not an intra-family loan is 'bona fide,' the [court] has attempted to review most of the cases relating to this problem. As will be demonstrated in the analysis set forth below, the key inquiry in all of these cases is: 'Was there an intent by the parties that the loan be repaid?'"); *Bowman v. Comm'r*, T.C. Memo. 1995-259 (respecting advances from father to daughter to start up a new venture in which daughter had no professional experience, even though such advances contained few, if any, indicia of true debt); *Hunt v. Comm'r*, T.C. Memo. 1989-335 ("In order to prove bona fide indebtedness, the taxpayer must show that the loan is not contingent and that the loan was made with a reasonable expectation, belief and intention that the advance would be repaid.").

3. Loan to Related Party to Invest in New Venture – Anticipated Success at Venture Is Sufficient for True Debt to Exist

Courts generally respect loans as long as success for debtor's activities is anticipated; guarantee of debtor success is not required. *See, e.g.*, *Drown v. United States,* 203 F. Supp. 514, 520 (S.D. Cal. 1962) ("The criterion is whether or not the person making the advancements considered them to be loans and expected them to be paid. Expectation of repayment may be based solely on anticipated success of the corporate venture, even though such anticipation flows from an excess of confidence."); *Schenk v. Comm'r*, T.C. Memo. 1996-113 (finding true debt in the absence of notes, collateral, or other formal indicia when repayment was expected from the anticipated success of debtor's business operations); *Rodgers v. Comm'r*, T.C. Memo. 1985-220 (finding true debt with respect to advances to a spouse, even when such advances were necessary to keep the business operating, when the debtor's manager repeatedly told taxpayer that the debtor's business would soon be profitable).

Courts routinely respect loans to or for a new venture as true debt if repayment is based on reasonable projections of the new venture's profitability. *See, e.g.*, *Miller v. Comm'r*, T.C. Memo. 1982-629, *rev'd on other issue* (9th Cir. 1984), unpublished op. ("We think that [debtor] and petitioner intended for the 1973 advancements to be repaid and that this intention was evidenced by the interest bearing promissory notes, the loan/employment contract, and the economic prospects of the Bronxville project."); *Earle,* 200 F.2d 846 (respecting advances as true debt after concluding that "advances were not excessive in light of fairly well grounded estimates of the value of the mining property at the time the advances were made" despite unanticipated costs when the anticipated success would still permit the repayment of such advances).

4. In Determining Whether Transfer Is Loan or Gift, Courts Do Not Apply Factors Formulaically

Courts frequently list numerous factors in determining whether an advance is respected as a loan. Those factors include: (1) the existence of a note (2) interest (3) schedule of repayment (4) security or collateral (5) demand for repayment made (6) records reflecting a loan (7) actual repayment (8) borrower solvency. No one factor is determinative. *See Miller v. Comm'r*, 71 T.C.M. CCH 1674 (1996), *aff'd* 113 F.3d 1241 (9th Cir. 1997).

But whether an advance is a gift or a loan does not turn on the formulaic application of debt "factors" (whether there are 7, 8, 9, or 13 of them) but on a full and proper inquiry of whether there was a reasonable expectation of repayment. *See, e.g.*, *Klaue*, T.C. Memo. 1999-151 ("The key inquiry is not whether certain indicia of a bona fide loan exist or do not exist, but whether the parties actually intended and regarded the transaction as a loan."); *Schenk*, T.C. Memo. 1996-113 (finding true debt, despite *no* objective factors supporting such a finding, when taxpayer intended that the advances be repaid); *Bowman*, T.C. Memo. 1995-259 (finding true debt when the only objective factor supporting such a finding was taxpayer's writing "note" on the advance check).

Compare those cases where the courts found true debt without discussing the debt factors with those cases where the court did not find true debt treatment. In *Mellen v. Comm'r*, T.C. Memo. 1968-94, taxpayer made a series of advances to help his brother-in-law's new business, which was financed primarily by such advances. Without mentioning any debt factors, the Tax Court found: "Both [taxpayer] and [debtor] testified categorically that at the time of the advances to [debtor] they both fully expected that the amounts advanced would be repaid. The record does not reveal any indication that a gift was either intended by [taxpayer] or imagined by [debtor]." In *W.F. Young, Inc. v. Comm'r*, 120 F.2d 159 (1st Cir. 1941), officers of the taxpayer believed that the amounts would never be repaid but

made the advances to protect the credit and reputation of the taxpayer. Without mentioning any debt factors, the First Circuit denied the bad debt deduction because the taxpayer never expected to be repaid.

5. Willing Third-Party Lender Unnecessary

Courts examining whether an advance is a gift or loan do not list the ability to obtain third party financing as a relevant factor: *See, e.g., Barnett v. United States*, 2009 WL 2426246 (W.D. Pa.); *Barr v. Comm'r*, T.C. Memo. 1999-40; *Bowman*, T.C. Memo. 1995-259; *Edwards v. Comm'r*, T.C. Memo. 1959-150; *Furey v. Comm'r*, T.C. Memo. 1995-15; *Hunt*, T.C. Memo. 1989-335; *Mann Constr. Co.*, T.C. Memo. 1999-183; *Mellen*, T.C. Memo. 1968-94; *Miller*, T.C. Memo. 1982-629; *Oatman v. Comm'r*, T.C. Memo. 1982-684; *Rodgers*, T.C. Memo. 1985-220; *Schenk*, T.C. Memo. 1996-113; *Sooy v. Comm'r*, 10 B.T.A. 493; *Stivers*, T.C. Memo. 1973-244.

When presented with the argument that they should consider whether third parties would have made similar advances, courts routinely reject doing so. *See Elkins' Estate*, 457 F. Supp. 870 ("The cases do not negate bona fides simply because a family member was willing to make concessions to his family member which he would not have made to a stranger."); *Hunt*, T.C. Memo. 1989-335 (rejecting the government's argument that the court should consider, among other factors, whether the debtor was able to obtain loans from outside lenders by stating that "Respondent does not direct us to any intra-family loan cases where any of these factors are explicitly applied").

All that is required to be respected as true debt is that the parties had a reasonable expectation of repayment, which is not equivalent to whether a third party would loan funds to the enterprise.

C. Refinancing a Note at the AFR

In the last ten years, interest rates have declined dramatically. During this period, numerous notes have been refinanced at an AFR rate that is lower than the interest rate payable on the old note. For an interesting discussion of the tax effects of such a refinancing, *see* Jonathan G. Blattmachr, et al., *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 22 (July 2008).

XII. SPLIT DOLLAR LIFE INSURANCE

A. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84

Decedent's son was trustee of decedent's revocable trust and decedent's attorney-in-fact (decedent was 90 years old and unable to manage his affairs), and as attorney-in-fact, he established an irrevocable trust (whose trustees had close relationship to the son) to purchase life insurance. Decedent's revocable trust purchased life insurance policies on the lives of decedent's son and the son's wife and designated the irrevocable trust as the owner. The trusts entered into split dollar agreements under which the revocable trust would be reimbursed for the $10 million premiums it advance at the earlier of (i) the termination of the agreement, if the trusts agreed; or (ii) the insureds' death. The revocable trust borrowed the $10 used to finance the split dollar from an unrelated third party. Obligors on the loan were the decedent (loan agreements signed by son using a power of attorney) and revocable trust.

The decedent's gift tax return reported a gift of $7,578 on the split dollar transaction under the economic benefit regime pursuant to Treas. Reg. § 1.61-22, which treats the premiums as a gift equal to the annual cost of current protection. At the time of the decedent's death, the cash surrender value of the

policies was $9.61 million. However, the estate reported the value of the decedent's split dollar rights at a present value of $183,700 because the insureds were projected to live for many years and the trustee had no unilateral right to terminate the split dollar agreement. The IRS argued that the entire cash surrender value was included in the gross estate under §§ 2036, 2038, and 2703.

The estate moved for partial summary judgment under §§ 2036, 2038, and 2703, which the Tax Court (Judge Thornton) denied.

As to §§ 2036(a)(2) and 2038(a)(1), the court held that the right to terminate the agreement and recover at least the cash surrender value was a "right" (an ascertainable and legally enforceable power) within § 2036(a)(2) and § 2038(a)(1) (citing *Powell* and *Strangi*), as neither statute requires decedent to have unilateral control. The court noted that unresolved fact issues precluded deciding whether there was a bona fide sale, although the transfer was not for adequate and full consideration by the estate's admission (~98% discount at creation of the split dollar arrangement).

As to § 2703, the court held that the provisions of the agreements that prevented decedent from immediately withdrawing his investment and allowed the irrevocable trust to veto its termination were disregarded under § 2703(a)(1)-(2) when valuing the decedent's rights under the agreements. No decision was made on the application of the safe harbor provisions of § 2703(b).

B. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016) (gift tax), T.C. Memo. 2021-60 (estate tax)

In 2006, the decedent set in motion a plan to pass family stock in a closely-held moving company to her sons. The sons had a difficult time getting along and their parents wanted to help them continue the business with equal ownership.

To accomplish this result, Mrs. Morrissette entered into a series of transactions. First, she made her sons trustees of her revocable trust. Second, she created three dynasty trusts – one for each of her sons. The company's shareholder agreements provided that the trusts would purchase the stock held by each of the brothers when one of them died.

To fund the buyouts, each trust secured a life insurance policy on the lives of the two other brothers. The decedent arranged to pay all of the projected premiums for the policies in lump sums sufficient to maintain them for her son's life expectancies (14 to 18 years). The trusts entered into split dollar agreements under which the revocable trust would be reimbursed for the greater of the $30 million of premiums it advanced or the cash surrender value of the policy at the earlier of (i) the termination of the agreement, if the trusts agreed; or (ii) the insureds' death. The parties to the agreements could terminate them by mutual assent, and the revocable trust could not unilaterally terminate the policies or the split dollar agreement. However, the dynasty trusts could terminate the split dollar agreements without Mrs. Morrissette's consent by cancelling the policies subject to their contractual obligations under the split dollar agreements.

Mrs. Morrisette reported the payment of the premiums in 2006 as gifts to her sons to the extent required under the economic benefit regime of Treas. Reg. § 1.61-22. She died in 2009, three years after the split-dollar agreements were entered into. The estate reported the value of Mrs. Morrissette's split dollar rights at a value of $7,479,000.

1. Gift Tax Case Holding

The Tax Court (Judge Goeke) held that the split-dollar agreements complied with the economic benefit regime and that Mrs. Morrissette made annual gifts only of the cost of current protection for gift tax purposes. A win for the taxpayer.

2. Estate Tax Case Holdings

a. 2036/2038

The IRS argued that §§ 2036 and 2038 should be applied to include in the gross estate either the total amount of the transferred premiums ($30 million) or the cash surrender values of the policies ($32.6 million). The court rejected this argument, holding that Mrs. Morrissette had a legitimate and significant nontax purpose for entering into the split dollar agreements since the arrangement sought to ensure management succession in the Morrissette family business, which has long been held to constitute a legitimate and significant non-tax purpose. Accordingly, neither the policies' cash surrender values nor the premiums paid were included in the gross estate under §§ 2036 or 2038.

b. Valuation/2703

In determining the value of the split dollar rights included in the estate under § 2033, the court rejected the IRS assertion that § 2703 should be applied to disregard the provisions of the agreements that prevented decedent from immediately withdrawing her split dollar investments when valuing the decedent's rights under the agreements. The split dollar agreements had business purpose, were not a way to transfer property for less than full and adequate consideration, and were comparable to agreements entered into in arm's length transactions in light of the brothers' acrimonious relationships and disputes regarding the company.

c. Valuation/present value assumptions

The court noted that the primary issues affecting the value of the split-dollar rights were (1) the data to be used to derive the present value discount rate, and (2) the assumptions regarding early termination. The court rejected life settlement yields in favor of the debt yields of insurance companies to determined present value discount rate, as it deemed the latter to be more reliable. Most importantly, the court adopted a termination assumption 4.5 years from the valuation date rather than the life expectancy of the insured because the family and their advisors has discussed cancelling certain policies, the advisor insisted the policies not be cancelled until three years after estate tax limitations period expired, and the Morrissette brothers (as trustees of the dynasty trusts had complete control over the arrangement. The court did not determine the value of the rights but rather directed the parties to determine the values based on the present values assumptions that it determined.

d. Penalties

Given the substantial increase in valuation that would result from the court's 4.5 year termination assumption, the court addressed whether the reasonable cause defense of § 6664(c)(1) would apply to avoid a 40% gross valuation misstatement penalty. The court held that it did not. First, the court noted that the legal advice portion of the defense was waived because the estate asserted the attorney client privilege. Second, the court held that reliance on the appraisal filed with the estate tax return not reasonable because (1) the $7.5 million appraised value was not reasonable given that $30 million had been paid just three years earlier for the split dollar rights, (2) the insurance agent and the estate

planning attorney marketed the arrangement as an estate tax savings strategy whose benefits would be obtained through "undervaluation" of the split dollar rights at a substantial discount, and (3) the attorney (i) recommended the appraiser and (ii) asked the appraiser to make changes to the report that reduced the values of a 40% gross valuation.

C. *Levine v. Commissioner*, 158 T.C. No. 2 (February 28, 2022)

In 2008, the decedent created a life insurance trust (signed by her three attorneys-in-fact) and South Dakota Trust Company as the independent/directed trustee. The beneficiaries were the decedent's children and grandchildren. The insurance trust's "investment committee" consisted of a family business advisor who also served as one of her attorneys-in-fact.

The insurance trust purchased life insurance on the lives of the decedent's daughter and her husband. To pay the $6.5 million premiums, the insurance trust borrowed most of the funds through a split-dollar arrangement. Under the split-dollar agreements: (1) the decedent's revocable trust loaned the funds to pay the premiums, and (2) the insurance trust assigned the policies to the revocable trust as collateral for the split-dollar loans. The revocable trust would be repaid greater of (1) $6.5 million of premiums paid, and (2) either (a) the current cash-surrender value of the policies upon the death of the last surviving insured, or (b) the cash-surrender values of the policies on termination, if before the death of both insureds. Only the insurance trust (through the "investment committee") could terminate the life insurance. Neither the decedent nor the trustees of the revocable trust had any right to terminate the policies.

The decedent owned a split-dollar receivable at her death in 2009, which was valued at $2 million on her estate tax return.

The IRS asserted that §§ 2036 and 2038 applied to include the cash surrender value of the policies in her estate and that the split dollar agreements should be ignored under § 2703 because the agreements constituted restrictions on the decedent's right to access the cash surrender value of the policies. The Tax Court disagreed.

With respect to §§ 2036 and 2038, the court opined that (1) the decedent did not have a right, alone or in conjunction with any other person, to terminate the policies or receive the cash surrender value of the polices because only the irrevocable trust had that right, (2) the insurance trust was irrevocable and the decedent had no right to change, modify, amend or revoke it, and (3) neither the policies' cash-surrender values nor the premiums paid were included in the gross estate under §§ 2036 or 2038.

With respect to § 2703, the court opined that that § 2703 only applies to property interests held by the decedent at the time of death, which was a split-dollar receivable. Because there were no restrictions on the split-dollar receivable (it was defined by the agreement), the court held that § 2703 did not apply to it.

XIII. ADEQUATE DISCLOSURE TO START THE GIFT TAX STATUTE OF LIMITATIONS

A three-year statute of limitations generally applies from the date a gift tax return is filed for the IRS to assess gift tax. I.R.C. § 6501(a). The question is what is required to be included in the gift tax return to start the statute running.

A. Prior Law

Prior to the Taxpayer Relief Act of 1997, § 2504(c) provided that a gift could not be revalued for gift tax purposes after the statute of limitations had run, but only if a gift tax was paid or assessed for the period in which the gift was made. *See* Rev. Rul. 84-11, 1984-1 CB 201. Because a tax offset by the unified credit was not treated as paid or assessed for this purpose and use of any available credit to offset the tax that would otherwise be due was mandatory, § 2504(c) provided very limited protection for taxpayers. For an example of a similar analysis, *see* I.R.S. CCA 201249015, 2012 WL 6062479 (Aug. 14, 2012) (concluding that a taxpayer was subject to gift tax on an unreported gift because the taxpayer's unified credit was used against subsequent gifts, even though there would not have been any tax due if the earlier gift had been reported because the tax would have been offset by the unified credit).

Further, even if § 2504(c) applied, there was no bar to revaluing prior gifts for purposes of asserting transferee liability against the donees or as adjusted taxable gifts for purposes of the estate tax computation. *See, e.g.*, *O'Neal v. Comm'r*, 102 T.C. 666, 682-83 (1994) (revaluing gift in the context of transferee liability); *Estate of Smith v. Comm'r*, 94 T.C. 55 (1990), *acq.* 1990-2 CB 1 (adjusting value of a prior gift for the purpose of determining estate tax liability).

B. The Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 changed the statute of limitations for estate tax liabilities; it provided that, generally, once the gift tax statute of limitations has run, a gift cannot be revalued for gift or estate tax purposes.

1. The Statutes

Under the current statutes, the value of a prior taxable gift will be treated as finally determined if the gift is adequately disclosed on a Form 709 and the Commissioner does not contest the value of the gift before the period of limitations on assessment has run. I.R.C. §§ 2001(f)(2), 2504(c), 6501.

Section 6501(a) prescribes a period of three years after a gift tax return is filed within which the Commissioner may assess any gift tax imposed by the Code. Section 6501(c)(9) provides an exception to the general three-year period in the case of gift tax on certain gifts not shown on a gift tax return. Under § 6501(c)(9), the period of limitations is extended indefinitely if a gift of property, the value of which is required to be shown on the return, is not shown on such return. The indefinite extension does not apply to any item "which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item." I.R.C. § 6501(c)(9). "Whether a statement attached to a gift tax return adequately discloses a gift is a question of fact." *Estate of Sanders v. Comm'r*, 107 T.C.M. (CCH) 1493 (2014) (discussed below).

A second exception to the three-year period of limitations is found in § 6501(e)(2), which extends the limitations period to six years where the taxpayer omits from the total amount of gifts made during the period for which the gift tax return was filed an amount that exceeds 25% of the total amount of gifts stated on the return. To obtain the benefit of the exception, the Service must show: (1) that the omitted items were properly includable in the total gifts for the calendar year, (2) the omitted items are more than 25% of the total gifts shown on the return, and (3) the information on the gift tax return or on any statement attached to the return was not sufficient to apprise the Service of the nature and amount of the omitted item or items.

If the transfer is adequately disclosed on the gift tax return and the period of limitations on assessment of gift tax has expired, then, under § 2504(c), the value of the gift cannot be adjusted for purposes of determining "prior taxable gifts" and the current gift tax liability and, under § 2001(f), the value of the gift cannot be adjusted for purposes of determining "adjusted taxable gifts" and the estate tax liability.

2. The Treasury Regulations

Treasury Regulation § 301.6501(c)-1(e) provides guidelines for transactions subject to the special valuation rules of §§ 2701 and 2702. Treasury Regulation § 301.6501(c)-1(f) provides guidelines for gifts made after December 31, 1996 not adequately disclosed on a return filed after December 3, 1999. Subsections (e) and (f) are discussed separately here.

3. Adequate Disclosure Requirements in Treas. Reg. § 301.6501(c)-1(e)

Subsection (e) of Regulation § 301.6501(c)-1 addresses adequate disclosure of "any transfer of property subject to the special valuation rules of section 2701 or section 2702" and of "any taxable event as described in section § 25.2701-4." Treas. Reg. § 301.6501(c)-1(e)(1).[6] If adequate disclosure is not provided, then the collection of the appropriate tax may be begun without assessment at any time. *Id.*

Section 301.6501(c)-1(e)(2) states, "A transfer of property valued under the rules of section 2701 or section 2702 or any taxable event described in § 25.2701-4 of this chapter will be considered adequately shown on a return of tax imposed by chapter 12 of subtitle B of the [Code] only if, ***with respect to the entire transaction or series of transactions (including any transaction that affected the transferred interest) of which the transfer (or taxable event) was a part***, the return provides:"

1. "A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;"	Reg. § 301.6501(c)-1(e)(2)(i)
2. "Identity of, and relationship between, the transferor and each transferee, all other persons participating in the transaction, and all parties related to the transferor holding an equity interest in any entity involved in the transaction;" and	Reg. § 301.6501(c)-1(e)(2)(ii)
3. "A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date."	Reg. § 301.6501(c)-1(e)(2)(iii)

(emphasis added).

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[6] This language was in place prior to the Taxpayer Relief Act of 1997.

The language, "with respect to the entire transaction or series of transactions (including any transaction that affected the transferred interest" is of interest because it is unique to subsection (e). The Regulations do not provide any examples to accompany subsection (e).

4. Adequate Disclosure Requirements in Treas. Reg. § 301.6501(c)-1(f)

Subsection (f) of § 301.6501(c)-1 addresses gifts made after December 31, 1996, not adequately disclosed on the return. Like subsection (e), discussed above, subsection (f) states that if adequate disclosure is not provided, then the collection of the appropriate tax may be begun without assessment at any time. Treas. Reg. § 301.6501(c)-1(f)(1).

Section 301.6501(c)-1(f)(2) states: "A transfer reported on the gift tax return as a transfer of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides" the items listed in the five subparagraphs of (f)(2). These requirements are: (i) a description of the transferred property and any consideration received by the transferor, (ii) the identity of, and relationship between, the transferor and transferee, (iii) if the property is transferred in trust, certain information about the trust, (iv) either a detailed description of the method used to determine the value of the property or a qualified appraisal, and (v) a statement describing any position taken that is contrary to any proposed, temporary, or final regulation or revenue ruling. Treas. Reg. § 301.6501(c)-1(f). The following table lists these five requirements and provides additional details about the detailed description/qualified appraisal requirement:

1. A description of the transferred property and consideration received by the transferor	Reg. § 301.6501(c)-1(f)(2)(i)
2. Identity of, and relationship between, the transferor and each transferee	Reg. § 301.6501(c)-1(f)(2)(ii)
3. If the property is transferred in trust, the trust's tax ID and either a brief description of the trust terms or a copy of the trust instrument	Reg. § 301.6501(c)-1(f)(2)(iii)
4. Either 4(a) or 4(b)	Reg. § 301.6501(c)-1(f)(2)(iv)
4(a). Detailed description of the method used to determine the fair market value of the property transferred (i) including: • "any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest" • "any restrictions on the transferred property that were considered in determining the fair market value of the property" and • "a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of	Reg. § 301.6501(c)-1(f)(2)(iv)

marketability, claimed in valuing the property” (ii) and, where the interest in the entity is not actively traded: • a description of any discounts claimed in valuing the interests in entity or assets owned by entity • if the value is properly determined based on net asset value, then a statement regarding the fair market value of 100% of the entity (without discounts), the pro rata portion of the entity subject to transfer, and the fair market value of the transferred interest • if 100% of the value is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than net-asset-value method (iii) and, if the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through another entity), then the information required by paragraph (f)(2)(iv) (this box or 4(b)) must be provided for each entity “if the information is relevant and material in determining the value of the interest”	
4(b). An appraisal may be submitted instead of the detailed description (4(a)), if the appraisal (i) is prepared by an appraiser who: • holds himself out to the public as an appraiser who regularly performs appraisals • is qualified to make appraisals of the type of property being valued (as evidenced by appraisal which details the appraiser’s background, education, experience, and membership in any professional appraisal associations) • is not the donor, donee, or a member of the donor’s or donee’s family, or employed by the donor, donee, or their respective family members, and (ii) and contains “all of the following”: • the dates of transfer and appraisal, and the purpose of the appraisal • a description of the property	Reg. § 301.6501(c)-1(f)(3)

• a description of the appraisal process employed • a description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions • the information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value, sufficiently detailed so that another person can replicate the process and arrive at the appraised value • the appraisal procedures followed and the underlying supporting reasoning for the analyses, opinions, and conclusions • the valuation method used, the rationale for the method, and the procedure used in determining the fair market value of the transferred property, and • the specific basis for the valuation, such specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.	
5. A statement describing any position that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer	Reg. § 301.6501(c)-1(f)(2)(v)

C. Preamble to the Final Regulations

On December 3, 1999, the Treasury issued final regulations under § 6501 relating to the changes made by the Taxpayer Relief Act. The following quotes from the preamble to the final regulations are relevant to this analysis (emphasis added):

- Commentators also noted that, under the proposed regulations, if a taxpayer failed to provide, for example, one item of information, the adequate disclosure requirement would not be satisfied, regardless of the significance of the item. The comments suggested that "substantial compliance" with the requirements of the regulations or a good-faith effort to comply should be deemed actual compliance. This suggestion was not adopted in view of the difficulty in defining and illustrating what would constitute substantial compliance. However, ***it is not intended that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided***. 64 FR 67767-01, 67767 (Dec. 3, 1999).

- The proposed regulations also require valuation for each entity (and its assets) that is owned or controlled by the entity subject to the transfer. Comments indicated that this requirement would

be difficult to satisfy, because in some cases the information would not be within the control of the taxpayer and the entity subject to the transfer would not normally be required to maintain the financial records with respect to lower-tiered entities. The comments suggested that information should be required only to the extent that such information is essential to a reasonable appraisal of the interest transferred and is in the personal control of the taxpayer. Many commentators suggested that the regulations require the submission of only that information that a qualified and competent appraiser would use in valuing the interest. ***In response to these comments, the final regulations provide that the information on the lower-tiered entities must be submitted if the information is relevant and material in determining the value of the interest in the entity***. *Id.* at 67767-68.

- The proposed regulations require the submission of a detailed description of the method used in determining the fair market value of the property, including "any relevant financial data." Commentators contended that [that standard] is a subjective concept that lacks specificity. Rather, the regulations should specify exactly what financial data must be submitted, such as balance sheets, net earnings statements, etc. ***In response to these comments, the final regulations require that any financial data that was used in valuing the interest must be submitted.*** This ensures that the information requested is available and was deemed relevant by the person valuing the interest. *Id.*

- [C]omments suggested that a properly completed appraisal would contain all the information that is material and relevant to the valuation of the transferred property and, therefore, should be sufficient to satisfy any disclosure requirement. ***Accordingly, under the final regulations, an appraisal satisfying specific requirements may be submitted in lieu of a detailed description of the method used to determine the fair market value and in lieu of information regarding tiered entities***. *Id.*

- Several commentators suggested that the language [in the] proposed regulations imposed two requirements for adequate disclosure. That is, the taxpayer had to provide information adequate to apprise the IRS of the nature of the gift, etc. and in addition, the taxpayer had to provide the information listed in the regulation. In response to these comments, the final regulations clarify that the adequate disclosure requirement is satisfied if the information listed in the regulation is provided. *Id.* at 67767.

- Some commentators argued that Congress intended that the new adequate disclosure requirements be the same as the existing disclosure requirements under prior § 6501(c)(9) for pre-August 5, 1997 gifts of property subject to the special valuation rules of §§ 2701 and 2702. ***Therefore, commentators suggested that the IRS adopt the disclosure requirements under § 301.6501(c)-1(e)(2) for transfers of those interests. This suggestion was not adopted. The IRS and Treasury believe it is necessary to expand on those disclosure requirements to address the broader range of transfers covered by the new legislation, as well as transactions and entities that may not have been prevalent when the prior regulations were promulgated.*** *Id.*

D. Case and Other Sources

1. Treas. Reg. § 301.6501(c)-1(f)

Two opinions that involve adequate disclosure under § 6501(c)(9): *Estate of Brown v. Commissioner*, 105 T.C.M. (CCH) 1327 (2013), and *Estate of Sanders v. Commissioner*, 107 T.C.M. (CCH) 1493 (2014), denied motions for summary judgment without analyzing whether the respective

taxpayers had in fact adequately disclosed their gifts. *Redstone v. Commissioner*, 110 T.C.M. (CCH) 564 (2015), also mentions § 6501, but in *Redstone*, the taxpayer had not filed a gift tax return at all, so the Tax Court did not address the issue of sufficient disclosure.

Estate of Brown involved sales of partnership interests. The Commissioner asserted that the transfers of the partnership interests were for less than full and adequate consideration. The Court found that there were genuine issues of material fact regarding whether the transfers at issue resulted in gifts at all. Consequently, the Tax Court did not reach the question whether disclosure of the transactions was adequate under Treas. Reg. § 301.6501(c)-1(f).

In *Estate of Sanders*, the court denied a taxpayer's request for summary judgment that the gift tax returns at issue "adequately disclosed the nature of the [gifted] stock or the basis of the value so reported so as to trigger the running of the periods of limitation on assessment." The decedent made gifts of stock to her family members each year for the period of years at issues (1999-2008) and reported the gifts on her gift tax returns. In 2012, after the decedent's death and after the statute of limitations would have passed for all but the 2008 return, the Commissioner issued notices of deficiency for all 9 years. The estate filed a motion for partial summary judgment, arguing that the statute of limitations prevented a reassessment of gift tax liability.

The Tax Court referred to the adequate disclosure regulations and to *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), aff'd, 444 F.2d 90 (8th Cir. 1971), a case applying the adequate disclosure regulations under § 6501(e)(1) (discussed below), stating that whether a gift has been adequately disclosed is a question of fact. *Estate of Sanders* involved a tiered entity, and the Commissioner pointed out that the taxpayer did not disclose that the entity in which interests were transferred owned another closely held entity. On those facts, the Tax Court held that the taxpayer could not obtain summary judgment on the issue of adequate disclosure.

The Tax Court's recent decision in *Schlapfer v. Commissioner,* T.C. Memo. 2023-65, 3 (May 22, 2023), provided long-overdue guidance that adequate disclosure requires substantial compliance rather than strict compliance with the adequate disclosure rules. In *Schlapfer*, the taxpayer's gift tax return reported a gift of stock to his mother, which stemmed from the assignment of a universal variable life insurance policy to his mother, which had been funded with the stock. The transfer was disclosed in the taxpayer's 2006 gift tax return. The IRS first argued that the gift should have been disclosed in a 2007 gift tax return because that was the year it was completed. The Tax Court rejected that argument, holding that whether the gift was completed in 2006 or 2007 made no different because the adequate disclosure regulations provide that disclosure of a gift as a completed gift on a gift tax return for a particular year can constituted adequate disclosure even if the gift is later determined to be incomplete in that year, citing Treas. Reg § 301.6501(c)-1((f)(5). In a detailed analysis, the court held that substantial compliance, rather than strict compliance with the adequate disclosure rules, was sufficient to start limitations running. The court further noted that "when deciding whether an item has been adequately disclosed, we may consider not only a return, but also documents attached to the return plus in formation documents reference in the return." In its analysis, the court relied on caselaw (addressed below) in the income tax context to determine whether adequate disclosure occurred. However, it is important to note that the court held that the taxpayer must substantially comply with *each* requirement of the regulations, not substantially comply with the regulations overall: "[I]f Mr. Schlapfer fails to strictly comply with a requirement, we will find that he substantially complied with it if he has fulfilled all essential purposes of the requirement." *Schlapfer v. Commissioner*, T.C. Memo. 2023-65, 10 (May 22, 2023).

2. Cases related to I.R.C. § 6501(e)(1), omission of items of income

In interpreting the adequate disclosure requirements, the Tax Court has looked to cases addressing the adequate disclosure rules under § 6501(e)(1), the income tax statute. The Tax Court has stated, "Although no estate tax cases have been found interpreting section 6501(e)(2) of the code, an examination of section 6501(e)(1) and (2) shows that the two are in pari materia in dealing with the same subject—the application of the statute of limitations—and, accordingly, we may give due consideration to income tax cases in deciding estate tax cases on this same subject." *Estate of Williamson v. Comm'r*, 72 T.C.M. (CCH) 687 (1996)

In addition, a Chief Counsel Advice explicitly applies the standard articulated by courts in the § 6501(e)(1) context to the application of § 6501(c)(9), i.e., determining whether an item has been disclosed in a manner adequate to apprise the Secretary of the nature of such item. IRS CCA 200221010, 2002 WL 1046519 (May 24, 2002).

Cases interpreting § 6501(e)(1) vary somewhat in their articulation of the disclosure standard. The most common description, however, is that a return must provide a "clue" with respect to the omission of income. *See, e.g.*, *Univ. Country Club, Inc. v. Comm'r*, 64 T.C. 460, 470 (1975) ("We think that in enacting [now § 6501(e)] Congress manifested no broader purpose than to give the Commissioner an additional two years (now 3 years) to investigate tax returns in cases where, because of a taxpayer's omission . . . the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item."); *Estate of Williamson v. Comm'r*, T.C.M. (CCH) (1996). (describing a clue as something between "a detailed revelation of each and every underlying fact" and "a 'clue' which would be sufficient to intrigue a Sherlock Holmes" (citing *Quick Trust v. Comm'r*, 54 T.C. at 1347) (internal quotation marks omitted)). In a similar vein, *Estate of Fry v. Commissioner* states that the disclosure must be "sufficiently detailed that a decision whether to select the return for audit may be a reasonably informed one." 88 T.C. 1020, 1023 (1987) (citations omitted).

XIV. PRIVILEGES IN THE ESTATE PLANNING CONTEXT

Because of the recent IRS attacks on family limited partnerships and limited liability companies, IRS requests for documents at the audit level and in estate tax litigation increasingly include requests for communications with counsel and other persons involved in the estate planning process seeking to determine the motives for creating the entity. This is particularly true in the area of buy-sell agreements, family limited partnerships, and closely-held corporations, where the IRS has become more aggressive in seeking to have entities ignored for estate tax purposes on the grounds that the entity lacks "business purpose" or was created solely as a "device" to avoid estate taxes. Attached as Exhibit A is an example of the type of IRS document requests that have been served on taxpayers over the last several years in audits involving closely held entities. The requests are extremely intrusive and cover every aspect of the estate planning and entity administration process.

A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level – Anticipate Your Potential Audience

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case

with the examiner or in litigation. With that goal in mind, as you are working on a client's estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

Preparation for the transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction or just the estate and gift tax savings that might be achieved through the transaction? Advise your client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their correspondence and their files may also be subject to production in a tax audit or in litigation.

B. Understand the IRS's Broad Subpoena Power

The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax," the IRS is authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

Subject to any applicable privileges, the IRS can summon the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and others involved in the planning process. It also includes doctors or other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, computer files and emails).

To enforce a summons, the IRS must show that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS' possession; and (4) satisfies all administrative steps required by the United States Code. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney-client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

C. Understand and Preserve All Privileges

As noted above, the IRS's subpoena power is limited to nonprivileged material. Whether or not a privilege exists in the context of an IRS examination is a question of federal law. *Jaffee v. Redmond*, 518 U.S. 1 (1996); Fed. R. Evid. 501. There are three types of privileges that may apply to a lawyer's file and correspondence: (i) the attorney-client privilege; (ii) the attorney work product privilege; and (iii) the tax practitioner's privilege. With respect to medical records, the doctor-patient privilege and psychotherapist-patient privilege may also come into play. None of the privileges is as broad as most lawyers believe.

1. The Attorney-Client Privilege

a. What the Privilege Covers

The attorney-client privilege generally protects the disclosure of confidential communications between counsel and the client made for the purpose of facilitating the rendition of legal advice. The attorney-client privilege also protects "an attorney's advice in response to such disclosures." *In Re Grand Jury Investigation*, 974 F.2d 1068, 1070 (9th Cir. 1992). In addition, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Communications with third parties, such as accountants or financial advisors, that are made to "assist the attorney in rendering advice to the client" are also generally protected. *See United States. v. Adlman*, 68 F.3d 1495, 1499 (2d Cir. 1995), *aff'g in part and vacating in part*, 1994 WL 191869 (May 16, 1994) ("[T]he privilege would extend to . . . an accountant hired by the attorney to assist the attorney in understanding the client's financial information.").

A privileged communication is "any expression through which a privileged person . . . undertakes to convey information to another privileged person and any document or other record revealing such an expression." *See*, *e.g.*, Restatement of the Law Governing Lawyers § 119 (Proposed Final Draft No. 1 1996). Documents protected by the privilege include those that consist of or reflect communications between the lawyer and the client, as well as the advice given to the client. Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. *Cedrone v. Unity Sav. Ass'n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) ("[I]t is inconceivable that an internal memorandum between attorneys in the same office concerning the representation of a client, utilizing confidential information provided by that client, could be anything but protected by the privilege."); *New York Underwriters Ins. Co. v. Union Constr. Co*., 285 F. Supp. 868, 869 (D. Kan. 1968) (holding that interoffice memorandum between lawyers and communications and consultations between attorneys representing same party were covered by attorney-client privilege). Even an attorney's billing records, expense reports, and travel records that reveal particular areas of research or that reveal the nature of the services provided are protected under the privilege. *In Re: Grand Jury Witness*, 695 F.2d 359, 362 (9th Cir. 1982) (holding that bills, ledgers, statements, time records, and the like that reveal "the nature of the services provided" should be privileged).

The attorney-client privilege survives the death of the client. *Swidler & Berlin and James Hamilton v. United States*, 524 U.S. 399 (1998).

b. What the Privilege Does Not Cover

Communications with nonclients such as stock brokers, accountants, or other third parties that are *not* made to "assist the attorney in rendering advice to the client" are generally not privileged. *Adlman*, 68 F.3d at 1499. "What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer*. If what is sought is not legal advice but only accounting service . . . or the advice sought is the accountant's rather than the lawyer's, no privilege exists." *Id*. at 1499-1500, citing *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

Work papers of the attorney that do not constitute or contain communications from the client, drafts of documents, or correspondence with third parties do not fall within the attorney-client privilege. *See Hickman v. Taylor*, 329 U.S. 495, 508 (1947) (holding that the privilege did not attach to

"memoranda, briefs, communications and other writings prepared by counsel for his own use in prosecuting his client's case; and it is equally unrelated to writings which reflect an attorney's mental impressions, conclusions, opinions or legal theories").

In addition, advice rendered in connection with tax return preparation has been held not to be privileged. *See United States v. Frederick*, 182 F.3d 496, 500 (1999). The *Frederick* Court's refusal to apply the attorney-client privilege in the context of return preparation is based on the theory that return preparation is "accountant's work," whether performed by an accountant or a lawyer. For lawyers who prepare tax returns for clients, *Frederick* is a must read case.

c. Waiver

Beware: even if a document is privileged, that privilege can be waived. Disclosing otherwise privileged communications between a lawyer and client to third parties may cause those communications to lose their privileged status. *See, e.g., United States v. Brown*, 478 F.2d 1038 (7th Cir. 1973).

Moreover, under the doctrine of subject matter waiver, other communications related to the disclosed materials may lose their privileged status. Note that communications with accountants or other advisors, when made "to assist the attorney in rendering advice to the client," are protected under the attorney-client privilege. *See*, *e.g.*, *Adlman*, 68 F.3d at 1499; *Kovel*, 296 F.2d at 921-24 (holding that privilege may be properly invoked by accountant if communications were made pursuant to consultative role to attorney and at attorney's direction); *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) ("Information provided to an accountant by a client at the behest of his attorney for the purposes of interpretation and analysis is privileged to the extent that it is imparted in connection with the legal representation."); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (providing short form opinion did not constitute waiver of attorney work product privilege); *In re G-I Holdings Inc.*, 218 F.R.D. 428 (D. N.J. 2003) (privilege deemed waived by asserting reasonable cause defense on the basis of legal advice). As with other communications sought to be protected by the privilege, to invoke the privilege, the client must establish that the communication with the third party was made "in confidence for the purpose of obtaining legal advice." *United States v. Gurtner*, 474 F.2d 297, 298 (9th Cir. 1973).

In a dispute we handled several years ago over whether the Service's summonses were enforceable in light of privilege issues, we argued that a holding of waiver in the context of communications to and from the client's financial advisors — where the communications were necessary for the purpose of rendering legal advice to the client in forming a business entity —would be contrary to the logic of the principle of the attorney-client privilege. *Segerstrom v. U.S.*, 87 A.F.T.R.2d 2001-1702, 2001 WL 263449 (N.D. Cal. 2001). The Court granted the taxpayer's request to quash the IRS's summonses, given the facts — disclosure to third parties was shown to be necessary for the lawyer to render legal advice to the client.

2. The Attorney Work Product Privilege

Many lawyers believe that the attorney work product privilege absolutely protects their file from disclosure to third parties. The work product privilege is actually much narrower; it only shields from disclosure materials prepared "in anticipation of litigation" by a party or the party's representative, absent a showing of substantial need. Fed. R. Civ. P. 26(b)(3). The purpose of the doctrine is to establish a zone of privacy for strategic litigation planning and to prevent one party from piggybacking on the adversary's preparation. *See United States v. Nobles*, 422 U.S. 225, 238 (1975).

There is no bright line test to determine whether a document has been prepared "in anticipation of litigation." In the transaction planning process, however, it will be difficult to argue that an attorney's internal memos or work papers were prepared "in anticipation of subsequent litigation" with the IRS. *See United States v. Adlman*, 96-2 U.S.T.C. ¶ 50,493 (S.D.N.Y. 1996) (refusing to apply the work product privilege to an accountant's memorandum analyzing the "legal ramification of a proposed transaction to determine whether, despite a likely challenge, the legal risk was acceptable," and holding that "[t]he primary purpose of these documents was not to prepare for litigation; the primary purpose was to decide whether or not to go through with a multi-million dollar transaction"), *aff'd in part and rev'd in part,* 68 F.3d 1495 (2d Cir. 1995) (nothing that there is no bar to "application of work product protection to documents created prior to the event giving rise to litigation"), *supp. proceeding*, 134 F.3d 1194 (2d Cir. 1998) ("a document created because of anticipated litigation, which tends to reveal mental impressions, conclusions, opinions or theories concerning the litigation, does not lose work-product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation. Where a document was created because of anticipated litigation, and would not have been prepared in substantially similar form but for the prospect of that litigation").

3. The Tax Practitioner's Privilege

In the Internal Revenue Restructuring Act of 1998, Congress added § 7525, which extends the attorney-client privilege to confidential communications between taxpayers and practitioners that would protect the same "communication[s] between a taxpayer and an attorney." The privilege, however, is limited to (1) "non-criminal tax matters before the Internal Revenue Service" and (2) "non-criminal tax proceedings in Federal court brought by or against the United States." I.R.C. § 7525. Because the work product doctrine is separate from the attorney-client privilege, the new privilege provision does not grant the work product privilege to non-attorney advisors.

Frederick was the first case to address the tax practitioner privilege. The *Frederick* court took § 7525 into account in reaching its decision in concluding that, because the audit services rendered by the lawyer would not have qualified for the attorney-client privilege before enactment of the new privilege, the new privilege would not apply to the audit services rendered. *Frederick*, 182 F.3d at 502. Therefore, any information included in the documents involved in preparation of a tax return or involved in verification of a tax return during audit may lose either the attorney-client privilege or the new tax practitioner's privilege.

The First Circuit reinforced the *Frederick* court's construction of § 7525 in *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). In *Cavallaro*, the First Circuit upheld the granting of enforcement of summonses issued by the IRS given that information was disclosed to accountants in a merger deal, and the accountants were providing accounting services, not facilitating communication of legal advice. The First Circuit reasoned that an attorney does not render client communications to an accountant privileged merely by engaging the accountant.

The district court for the District of Columbia has also issued several important decisions in the tax shelter litigation involving KPMG. In *United States v. KPMG*¸ 237 F. Supp. 2d 35 (D. D.C. 2002), citing *Frederick*, the court determined that the § 7525 privilege did not extend to KPMG opinion letters issued to its client because such letters were prepared in connection of preparing a tax return. In a subsequent decision, the court determined that some of the documents KPMG claimed to be protected by § 7525 were in fact so protected. *United States v. KPMG,* 2003-2 U.S.T.C. ¶50,691 (D. D.C. 2003). *See also United States v. BDO Seidman, LLP*¸ 225 F. Supp. 2d 918 (N.D. Il. 2003), *aff'd,* 337 F.3d 802 (7th Cir. 2003) (name of clients not privileged under § 7525); *Black & Decker Corp. v. United States*,

219 F.R.D. 87 (D. Md. 2003) (accounting firm's advice not privileged because such accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

4. The Physician-Patient Privilege

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. *See, e.g., United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992). The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

D. Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client's Best Interest to Do So

The assertion of the privileges at the audit or Tax Court level lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney-client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm'r*, 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) ("Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons' law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.").

In cases where the IRS questions motives or business purpose, the best evidence can come from the correspondence prepared in connection with the transaction at issue. Well-drafted, contemporaneous correspondence outlining the business and financial reasons (*i.e.*, the nontax reasons) for the transaction being challenged, such as a buy-sell agreement or the creation of a family limited partnership or corporation, serve as wonderful evidence to rebut an argument from the IRS that an entity was created as "a device solely to avoid taxes" or lacks "business purpose." *See, e.g.*, *John J. Wells, Inc. v. Comm'r*, 47 T.C.M. (CCH) 1114, 1116 (1984). ("While obviously the true facts can never be known with complete certainty by an outsider. . . . We base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience.").

XV. AVOIDING VALUATION PENALTIES

In recent years, the IRS has increasingly attempted to impose valuation penalties in transfer tax audits.

The substantial valuation understatement penalty applies when the value of an item reported is 65% or less of value is finally determined for transfer tax purposes. The substantial valuation penalty is 20% of the additional tax due. I.R.C. § 6662 (h).

The gross valuation understatement penalty applies when the value of an item reported is 40% or less than the value as finally determined for transfer tax purposes. The gross valuation understatement is 40% of the additional tax due. I.R.C. § 6662 (g).

A reasonable cause exception exists under § 6664 (c). That exception requires the taxpayer to act in good faith and with reasonable cause in reporting the value of transferred assets. Reasonable

reliance on professional advice, including accounting or appraisal advice, can satisfy this test. Treas. Reg. § 1.6664. Whether reliance on an appraisal constitutes reasonable cause depends upon the specific facts of the case. For example, in *Estate of Richmond v. Comm'r*, T.C. Memo. 2014-26 (February 11, 2014), Tax Court held that reliance on an unsigned draft of an appraisal did not constitute reasonable reliance. On the other hand, in *Litman, et. al v. United States*, 326 F.3d 1268 (Fed. Ct. 2008), the Claims Court held that good faith reliance on an appraisal from a qualified appraiser satisfied reasonable cause exception, even though the appraiser applied an 80% discount in determining the fair market value of restricted stock.

XVI. WHERE ARE WE NOW AND WHERE ARE WE HEADED?

Court decisions have dealt a significant blow to the lack of economic substance, lack of business purpose, and gift on formation positions taken by the IRS in the family limited partnership area. Subject to the continuing development of case law and § 2036, if a partnership is valid under applicable state law, significant and legitimate non-tax reasons exist for its creation, and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes. In fact, the § 2036(a)(1) cases where the IRS has successfully disregarded the existence of an entity involve situations where the Tax Court has found that the partners have not respected and treated the partnership as a separate legal entity for state law purposes.

In light of these decisions, the IRS is primarily left arguing over the value of the partnership interest or, in cases where the entity has not been respected or where the decedent retained a significant amount of control, an argument that the entity should be ignored under § 2036. In dealing with the IRS at the audit level and in litigation, I have seen the IRS increase its focus on the actual operations of the partnership. The IRS routinely requests the opportunity to examine the books and records of the partnership, the partnership's bank statements, and the documents conveying assets into the partnership. If distributions were made, were they made in accordance with the terms of the partnership agreement? Was the partnership operated as a separate legal entity, or merely a second bank account for the decedent? The IRS is inquiring, as did Judge Cohen in the *Strangi* opinion, whether the proverbial "i's are dotted and t's are crossed?" The IRS attacks on partnership based valuation discounts can be thwarted with careful planning, documentation and operation of the entity. This includes ensuring that the partners respect the entity and that qualified, supportable, and well reasoned appraisals are obtained when valuing the transferred interests.

Valuation discounts for lack of control and lack of marketability are real. A person acquiring an interest in a family limited partnership, particularly a non-controlling interest, lacks the ability to dictate how the partnership will be run and how distributions will be made. There is no established market on which the interest can be traded.

As can be seen from the table set forth below, taxpayers have sustained substantial valuation discounts in cases where the Court found their expert's valuation testimony more persuasive than the valuation testimony presented the Government. Practitioners must remember that the valuation report is the most important piece of evidence in a transfer tax dispute. Because the valuation filed with the transfer tax return constitutes an "admission" of value by the taxpayer, it is important for the taxpayer to obtain well-reasoned appraisals from a qualified appraiser ***when the return is filed***.

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
Strangi I (2000)	securities	Tax	31%
Knight (2000)	securities/real estate	Tax	15%
Jones (2001)	real estate	Tax	8%; 44%
Dailey (2001)	securities	Tax	40%
Adams (2001)	securities/real estate/minerals	Fed. Dist.	54%
Church (2002)	securities/real estate	Fed. Dist.	63%
McCord (2003)	securities/real estate	Tax	32%
Lappo (2003)	securities/real estate	Tax	35.4%
Peracchio (2003)	securities	Tax	29.5%
Deputy (2003)	boat company	Tax	30%
Green (2003)	bank stock	Tax	46%
Thompson (2004)	publishing company	Tax	40.5%
Kelley (2005)	cash	Tax	32%
Temple (2006)	marketable securities	Fed. Dist.	21.25%
Temple (2006)	ranch	Fed. Dist.	38%
Temple (2006)	winery	Fed. Dist.	60%
Astleford (2008)	real estate	Tax	30% (GP); 36% (LP)
Holman (2008)	Dell stock	Tax	22.5%
Keller (2009)	securities	Fed. Dist.	47.5%
Murphy (2009)	securities/real estate	Fed. Dist.	41%
Gallagher (2011)	publishing company	Tax	47%
Koons (2013)	cash	Tax	7.5%
Richmond (2014)	marketable securities	Tax	46.5% (37% LOC/LOM & 15% BIG)
Giustina (2016)	timber company	Tax	25% LOM
Streightoff (2018)	marketable securities	Tax	18% LOM
Grieve (2020)	marketable securities	Tax	35% (98.8% non-vot. LLC int.)
Nelson (2020)	equipment co.	Tax	40.5% (stock); 31.6% (LP)

EXHIBIT A

Internal Revenue Service

Date:

Department of the Treasury

In Reply Refer to:

Person to Contact:

Contact Telephone Number:

Fax Number:

Re:

Dear

The United States Gift Tax Return you filed for the year _____ is being audited by this office. We need the information listed below furnished or made available for our inspection within the next three (3) weeks:

1. Copies of donor's Federal Income Tax Returns (1040) for the year before, the year of and the year after the gift referenced above.

2. Copies of all 709's filed with appraisals, acts of donation and other supporting documentation. This includes 709's filed by your spouse.

3. If any assets subject to any of the above referenced gifts have been sold or agreements to sell have been entered into subsequent to date of donation please provide complete details, including contracts, deeds and closing statements.

4. A list of donations of any kind, other than customary holiday and birthday gifts of small value, made during your life time regardless of whether a Gift Tax Return Form 709 was filed.

5. If the object of any of the above donations was an interest in any closely held corporation, partnership, limited liability company or other business organization, we need the following:

   a) All documents relating to the creation of the entity (including bills) from any attorney, accountant or firm involved in recommending the creation of the entity or in drafting the necessary documents. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
   b) Articles of organization and operating agreement, with any amendments.
   c) All documents that were prepared to meet state law requirements on the formation and operation of the entity.
   d) All financial statements and tax returns prepared and/or filed since inception.
   e) All of the entities' bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to owner/members, for the period since the entity was formed to the current period.
   f) Minutes of all meetings; if none, indicate the dates of all meetings and the business discussed.
   g) Evidence showing how the value of each entity asset was arrived at as of the date:

1. it was contributed to the entity;
2. of each gift of an interest in the entity;

provide all appraisals and supporting workpapers.

h) Evidence as to how the entity was valued as a whole as well as fractional interest. Provide all appraisals if not already furnished.

i) Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by owners other than the donor.

j) For any entity asset that has been sold or offered for sale since the formation of the entity, provide evidence which documents the sale or attempted sale (i.e., sales agreement, listing agreement, etc.).

k) For each entity asset, explain/provide:
   1. evidence that the entity owns the asset;
   2. when the donor acquired the asset;
   3. how the asset was used by the donor since its acquisition and how the entity has used the asset since; and
   4. who managed the asset prior to and after its contribution, explain in detail what management consisted of and how it changed after the entity was formed.

l) Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the entity for the period beginning one year prior to the formation of the entity and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the entity's assets, if different from the foregoing.

m) For each gift or transfer of an interest, provide:
   1. evidence that the interest was legally transferred under state law and under the terms of any agreement among the owner/members.
   2. any assignment of any interest along with the terms of the assignment;
   3. the amount and source of any consideration paid along with an explanation as to how the amount was arrived at.

n) Provide the following with respect to the donor, all other original members and any recipients of gifts or transfers of interests:
   1. date of birth;
   2. education and occupation;
   3. experience and expertise in dealing with real estate, financial affairs and investments;
   4. extent of the donor's investments as of the date of the formation of the entity, including a summary of assets that were not contributed to the entity; provide tangible evidence thereof; and
   5. any personal financial statements and credit applications which were prepared in connection with loan applications after the LLC was created.

o) Indicate whether the entity is currently in existence, and, if so, provide the current ownership interests.

p) Provide a summary of any other transfers of business interests not reflected in the gift tax returns filed.

q) A statement describing the donor's state of health at the time of the formation of the entity and for the six month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's state of health during this period to the present date and provide these doctors with authorization to respond to the Service's future requests for information, including a copy of the medical records, in necessary.

r) A copy of the Donor's will, revocable trust, and any executed power of attorney, if not submitted with the return.

s) A statement indicating the identity of the parties recommending the use of the LLC or partnership, when the recommendations were made, and the reasons set forth in support of using such an entity.

t) Names, addresses, and current telephone numbers of the representatives of the Donor/Estate, all donees/beneficiaries, all partners or members, accountants/bookkeepers, and brokers/investment advisors.

Each item should be responded to either by furnishing the requested documentation; a written response, if called for, under the signature of the donor or a written explanation as to why the information will not be provided.

Should you have any questions call or write to me at the above number and address. A Form 2848 is enclosed for your execution if you wish to appoint your attorney or CPA to represent you.

Very truly yours,

Enclosures:
IRS Publication 1
Form 2848 Power of Attorney