The Candidates On Estate Tax Reform

By Patricia M. Soldano, president and CEO of the Costa Mesa, Calif.-based Cymric Family Office Services

While neither the presumptive Republican nor Democratic candidate for president has been very vocal about estate tax reform legislation, both have expressed a position:

Senator John McCain (R-Arizona) voted for full repeal of the estate tax in the past but then changed his position, deciding that repeal was not the right answer. Since changing his mind on repeal but before running for president in 2008, he supported a proposal by Senator Jon Kyl (R-Arizona) that the top rate be reduced to 35 percent and the exemption raised to $5 million per spouse in 2007. Now that McCain is vying for the White House, he instead supports a $5 million exemption per spouse and a 15 percent to 20 percent estate tax rate. He also suggests that the lifetime exemption should be indexed for inflation.

Senator Barack Obama (D-Illinois) has said little about the estate tax, but has indicated that he supports a 45 percent rate and a $3.5 million exemption per spouse—with the exemption indexed for inflation. That is what the law will be in 2009. Obama thus favors freezing the tax at the 2009 level and not allowing repeal to occur in 2010.

Even though estate tax reform has not played a large role in the presidential debates, it will be an issue that the new president will have to face in 2009, as current law calls for a full repeal in 2010 and for 2011 to bring the return of the pre-2001 tax regime.

Both Democrats and Republicans in the House and Senate know that they must act to avoid having just one year of repeal (often referred to as the "throw momma from the train" year). As a result, the consensus is that some legislation finally will emerge from Congress and be sent to the new president for his signature.

That compromise will be driven by the politics of both houses of Congress and estimates of how much revenue will be lost as a result of that reform. These estimates, in turn, will depend in part on which party controls the House and the Senate in 2009.

Tax Law Update

By David A. Handler, partner, & Alison E. Lothes, associate, in the Chicago office of Kirkland & Ellis LLP

Partnership restrictions disregarded under IRC Section 2703. Estate-planning lawyers are buzzing about the Tax Court's recent decision on family limited partnerships, *H. Holman, Jr.*, 130 TC 12 (May 27, 2008), because the court ignored commonly used restrictions on transfers of partnership interests for gift tax valuation purposes under Internal Revenue Code Section 2703.

In November 1999, Thomas and Kim Holman transferred about 70,000 shares of Dell stock to a limited partnership in exchange for general and limited partnership interests. A trust for their children contributed 100 Dell shares for limited partnership (LP) interests. Just one week later, they made a gift of LP interests to a custodial account for one of their daughters. A month later, custodial accounts for their other three children contributed Dell stock for LP interests. In January 2000 and January 2001, the Holmans made gifts of LP interests to the trust for their children.

The Internal Revenue Service audited the gift tax returns on which the gifts were reported, claiming:

(1) the first gift of LP interests in November 1999 was an indirect gift of Dell stock rather than LP interests; and

(2) certain provisions in the partnership should be disregarded under IRC Section 2703 when valuing the LP interests.

The IRS argued that the Holmans' transfers were like those in *Shepherd v. Commissioner*, 115 T.C. 376, 389 (2000), *aff'd.* 283 F.3d 1258 (11th Cir. 2002), and in *Senda v. Comm'r*, T.C. Memo. 2004-160, *aff'd.* 433

F.3d 1044 (8th Cir. 2006).

But the court found both cases were distinguishable from *Holman*. In *Shepherd*, the property was transferred to a partnership in which the children owned 50 percent. The *Shepherd* court held that the taxpayer made an indirect gift of the property to the partners, rather than a gift of interests in the partnership. In *Senda*, not only was stock transferred to the partnership and partnership interests transferred to the children on the same day, but also the Sendas could not prove they transferred the stock to the partnership before transferring partnership interests to their children. As a result, the court held that the Sendas made an indirect gift of the stock to the children.

In this case, the Holmans did not make indirect gifts by transferring stock to the partnership, but instead transferred partnership interests. They also did not transfer the Dell stock to the partnership on the same day as the gift of LP interests, and could prove the Dell stock was transferred before the gift was made.

Step Transaction

The IRS argued that the step transaction doctrine should apply under the "interdependence" test to treat the formation and funding of the partnership as occurring simultaneously with their 1999 gift of LP units, because the events were interdependent and the separation in time between the formation of the partnership and the gift served no purpose other than to avoid making an indirect gift. As *Santa Monica Pictures, L.L.C. v. Comm'r*, T.C. Memo. 2005-104 put it, the interdependence test will invoke the step transaction doctrine "where the steps in a series of transactions are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." While the *Holman* court acknowledged that one purpose of forming the partnership was to make gifts, the court also noted it could not be said that "the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift."

Moreover, the court held that the IRS' failure to argue that the gifts made in 2000 and 2001 would constitute indirect gifts suggests that "the passage of time may be 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 IRS effectively conceded that a two-month separation suffices to give independent significance to the funding of the partnership and a subsequent gift of LP units.

The court assumed that concession to be on account of the IRS' recognition of the economic risk of a change in value of the partnership that the Holmans bore by delaying the 2000 gift for two months. Because the Holmans also sustained 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 and the date of the 1999 gift, the court held that the 1999 gift should be treated the same way and the step transaction doctrine would not apply.

Gift Tax Valuation

The IRS also argued that certain restrictions on transfers of LP units contained in the partnership agreement should be disregarded under IRC Section 2703(a) for gift tax valuation purposes. Section 2703(a) provides that the value of any property transferred by gift is determined without regard to any right or restriction relating to the property unless the restriction meets each of the following three requirements contained in Section 2703(b): (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; and (3) its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

Section 9.1 of the partnership prohibited transfers of partnership interests without consent of all the partners, although Section 9.2 permitted transfers to, or in trust for, members of the Holman family. Under Section 9.3 of the partnership agreement, if a transfer to a non-family member nonetheless occurs, the partnership has an option to purchase the assignee's interest for its fair market value (FMV), payable over five years. The court held that Section 9.3 was not a bona fide business arrangement and was a device to transfer property to members of the Holman family for less than full and adequate consideration. As a result, the LP interests were valued without taking into account these restrictions.

First, the court found that the provision was not a bona fide business arrangement. The court noted that the partnership was not a closely held business, but merely held stock in Dell, which was not a closely held business. While Section 9.3 controls the transfer of LP units, it does not serve bona fide business purposes such as those cited by a report of the Senate Committee on Finance on buy-sell agreements contained in IRC Section 2703's

legislative history: to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance.

In this case, there was no closely held business to protect, and the Holmans' stated purposes for the partnership did not match those contained in the Senate Finance Committee report. Their purposes were "very long-term growth," "asset preservation," "asset protection," and "education." (It seems to us that preventing transfers to unrelated parties, as listed in the Senate Finance Committee report, would fall under "asset protection" and "asset preservation.")

Second, Section 9.3 was considered a device to transfer property to members of the Holman family for less than full and adequate consideration. If Section 9.3 is triggered, the assignee is redeemed at FMV, and not for a price equal to his share of the partnership's net asset value (NAV). Redemption at a discount would benefit the remaining partners, who were members of the Holman family. Therefore, Section 9.3 could be used to redistribute wealth from a child who makes an impermissible transfer to the other children. (This clearly was not the intent of this provision, but nonetheless was held to be such a device.)

Oddly, the court held that Section 9.1 of the partnership agreement did not serve a bona fide business purpose (and therefore should be disregarded under Section 2703). But the opinion's discussion of valuation only mentioned disregarding the agreement's Section 9.3. Thus, it is unclear whether the prohibition on transfers without consent of the partners was to be considered in the gift tax valuation.

Turning to the value of the LP units, the court stated that the starting point is determining the NAV of the partnership's assets, and in doing so, the Dell stock should be valued at the mean of its high and low trading price on the date of valuation, rather than at its closing price on that date. The court points out that the gift tax regulations for valuing marketable shares of stock are not limited to only those situations in which the stock itself is the subject of the gift, and the Holmans provided no authority for disregarding the rules.

In calculating the value of the gifts of the LP units, discounts were allowed for lack of control and lack of marketability. But the court utilized the IRS expert's determination of the discount for lack of control, because he provided a more thorough and reasonable sample of comparables. Also, the Holmans' expert's own analysis regarding the marketability discount doomed him. He started by comparing to restricted shares of publicly traded stock, but rather than building on that analysis to reach a supported conclusion, he stated that the willing buyer of a limited partner interest "has no real prospects of being able to sell the interest in the public market at the full, freely traded value at any time." As a result, he concluded that the discount for lack of marketability should be "at least 35%." The court held that it cannot rely on an unsupported opinion. Moreover, the court agreed with the IRS in saying that the Holmans' expert arbitrarily stopped at 35 percent; because he believes that an LP unit cannot be sold, the appropriate discount for lack of marketability should be 100 percent.

Finally, the court adopted the IRS expert's determination that minority interest discounts of 11.32 percent, 14.34 percent and 4.63 percent should apply (for 1999, 2000 and 2001, respectively), and a marketability discount of 12.5 percent should apply.

• **Contribution of land with a residence and a retained right to lease property does not prevent the trust from qualifying as a QPRT.** In Private Letter Ruling 200822001 (released June 4, 2008 but issued Feb. 9, 2008), the grantor contributed his residence, situated on several acres of land with a barn and several sheds, to a trust intended to qualify as a qualified personal residence trust (QPRT). During the QPRT's term, the grantor retained the right to use the residence, rent-free. The QPRT terminated on the earlier of either a term of years or the grantor's death. If the grantor survived the term of years, the residence remained in trust. The grantor retained the right to lease the residence from the trust for market rent, renewable annually, until his death.

Treasury Regulations Section 25.2702-5(c)(5) prohibits a QPRT from holding any asset other than a personal residence. But a personal residence can include appurtenant structures used for residential purposes and adjacent land that is reasonably appropriate for residential purposes, taking into account the residence's size and location. Because in this case the additional land was comparable to that of other residential properties in the vicinity, the IRS ruled that the property transferred met the definition of a personal residence, and as a result, the

trust qualified as a QPRT under IRC Section 2702.

In addition, the IRS ruled that the lease of the residence would not result in the property being included in the grantor's gross estate. IRC Section 2036 includes in a decedent's estate any property transferred by the decedent (other than in a bona fide sale for an adequate and full consideration) if the decedent retained the possession or enjoyment of the property until his death. Although retaining the right to live in the residence rent-free would cause the property to be included in the grantor's estate under Section 2036, the grantor's lease of the residence for fair market rent would not cause it to be included in his taxable estate, so long as there was no express or implied agreement for the grantor to retain use of the property without paying rent.

• **Payments made pursuant to a split-dollar agreement are neither gifts nor cause insurance to be includible in the grantor's estate.** In PLR 200822003 (released June 4, 2008 but issued Jan. 28, 2008), the IRS ruled that payments made by a couple pursuant to a split-dollar agreement were not taxable gifts, and that the portion of the insurance death benefit paid to the trust pursuant to the split-dollar agreement is not includible the couple's estates.

The husband created an irrevocable trust and transferred two second-to-die life insurance policies on the lives of himself and his wife. The husband, wife and the trustee entered into a collateral assignment split-dollar agreement, in which the trustee was designated as the owner of the policies. The trustee could exercise all rights of ownership, except the estate of the husband and wife's survivor was entitled to a portion of the proceeds of the policies equal to the cash surrender value of the policies immediately before the second spouse's death.

While both the husband and wife were living, the trust was obligated to pay a portion of the premiums equal to the cost of current life insurance protection on their lives, calculated using U.S. Life Table 38. After the first spouse died, the trust paid the lesser of the amount calculated under P.S. 58 Tables (as described in Revenue Rulings 64-328 and 55-747) or the insurer's current published premium rates (described in Rev. Rul. 66-110 and Notice 2002-8). The husband and wife paid the balance of the premiums.

The IRS ruled that as long as the policy premiums paid by the trust for the benefit that it received under the agreement was at least equal to the amount prescribed in Rev. Ruls. 64-328, 55-747 and 66-110 and Notice 2002-8, the premium payments were not gifts by the couple. But the IRS did note that if the trust used some of the cash value of the policies directly or indirectly to fund the trust's obligation to pay premiums, the couple would be treated as making a gift.

As far as the estate tax inclusion, because the trustee retained all incidents of ownership in the policies under the agreement, the proceeds of the policies payable to the trust were not includible in the gross estate of the second-to-die of either spouse under IRC Section 2042(2). Of course, the portion of the proceeds payable to the survivor's estate were includible under Section 2042(1).

• **Proposed regulations provide guidance on procedures for petitions regarding gift tax disputes.** IRC Section 7477 provides a procedure to obtain a declaratory judgment to contest in Tax Court an IRS determination regarding the value of a gift.

Generally, to obtain relief under Section 7477:

(1) the gift must be disclosed on a federal gift tax return Form 709 or its attachments;

(2) there must be an actual controversy with respect to the IRS determination of the value of the gift (as set out in a "Letter 3569");

(3) the donor must file its petition with the Tax Court before the 91st day after the mailing of the Letter 3569; and

(4) the donor must first exhaust all administrative remedies.

Generally, if a donor does not resolve a dispute at the IRS examination level, the IRS will send the taxpayer a "Preliminary Determination Letter" inviting the donor to file a formal protest and request consideration by IRS Appeals office. Subsequently, the IRS will send a notice of determination of value (Letter 3569) to notify the taxpayer of the adjustment proposed by the IRS and advise the taxpayer that he may contest that determination by filing a petition with the Tax Court.

Without Section 7477 and an actual gift tax deficiency or overpayment of tax, a taxpayer could not petition the Tax Court to contest the IRS' determination. Such a situation could occur, for example, when the increased valuation of a gift is offset by the donor's gift tax credit.

Proposed revisions to Treas. Regs. Section 301.7477-1 define the administrative remedies available to the donor who contests the valuation of a gift that does not result in a tax deficiency or refund. It also defines the situations under which the donor is considered to have exhausted those remedies. Under the proposed regulations, the petition may include all issues with respect to the gift under consideration, including both valuation and legal issues.

Under the proposed regs, the IRS will not contest the donor's allegation that the administrative remedies have been exhausted if, before filing its petition in Tax Court:

(1) the donor requests IRS appeals consideration in writing within 30 days after the IRS mailed its notice of preliminary determination ("Preliminary Determination Letter") of value of the gift at issue; and

(2) the donor fully participates in the appeals consideration process.

Then, after the IRS mails the Letter 3569, the donor has 90 days from the date of its mailing to file a petition in Tax Court. In addition, the proposed regulations provide that, in certain circumstances, if the IRS fails to follow this process (that is to say, if the IRS mails a Letter 3569 in the absence of a Preliminary Determination Letter because the statute of limitations has expired), the IRS will not contest the donor's allegations that the donor has exhausted administrative remedies.

The proposed regs also provide that the donor is not required to consent to an extension of time in which the gift tax for the transfer at issue may be assessed.

Treat Yourself

By Irina S. Shea,
a New York-based trusts and estates lawyer who specializes in mediation

There's a little book of 84-pages now out in paperback, *The Time is Now: Choose Your Trustee Wisely* by Michele Moore, that is a user-friendly guide to fiduciary appointments and could be very useful in a client introduction packet.

The Time is Now (which Moore self-published through Authorhouse) could give grantors a much-needed perspective of potential problems before they make their estate-planning arrangements.

Moore neatly packages the grantor's fiduciary decisions into pre-death (lifetime trustees, attorneys-in-fact and health care agents) and post-death (executors and successor trustees). She draws on what she describes as years of experience as a trust officer (although she doesn't say where) and fills her practical advice with real life stories that have both happy and unhappy endings.

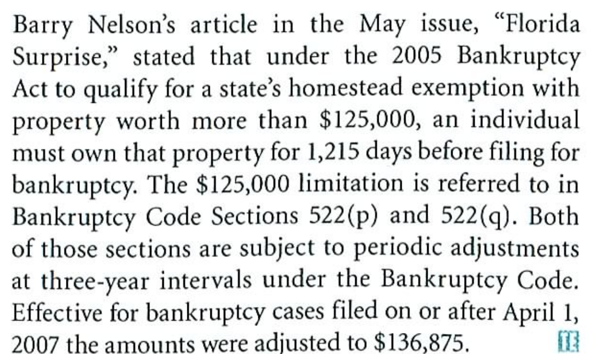
Grantors learn in concrete terms what fiduciaries really do. Grantors also are given a set of suggested criteria when selecting fiduciaries that reaches far beyond the default of simply selecting a spouse or eldest child. For example, Moore offers pros and cons of selecting family members, corporate fiduciaries, or private fiduciaries and wisely suggests that a combination of these often provides the smoothest administration with least conflict.

Perhaps the most useful chapter comes at the end with Part V: "Sources of Litigation." Grantors often assume that because their children are adults and get along reasonably well, that the disposition of their assets at death will go smoothly. They may plan differently for different children with the best of intentions. They may intend to fund their revocable trusts but not accomplish it fully. Each of these areas leaves the estate ripe for conflict and should be discussed by the estate-planning attorney up-front, as much as possible.

Moore also includes a helpful, albeit lengthy, checklist for financial information and fiduciary designations, as well as a comprehensive glossary of estate planning terms.

This is not a book that will rock the estate-planning world. But it could save a lot of time for estate planners who find themselves repeating this information during planning meetings and being told, "We need to think about this and get back to you."

Instead, before you meet with clients, send them a copy of Moore's *The Time Is Now.* You'll be doing both yourself and your clients a tremendous service



And Please Note

Barry Nelson's article in the May issue, "Florida Surprise," stated that under the 2005 Bankruptcy Act to qualify for a state's homestead exemption with property worth more than $125,000, an individual must own that property for 1,215 days before filing for bankruptcy. The $125,000 limitation is referred to in Bankruptcy Code Sections 522(p) and 522(q). Both of those sections are subject to periodic adjustments at three-year intervals under the Bankruptcy Code. Effective for bankruptcy cases filed on or after April 1, 2007 the amounts were adjusted to $136,875.