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Estate Planning for Real Estate

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ESTATE PLANNING FOR REAL ESTATE

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September, 2005
# ESTATE PLANNING FOR REAL ESTATE

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## I. INTRODUCTION

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Scope</td>
<td>3</td>
</tr>
<tr>
<td>B. Overview and Goals of Estate Planning for Real Estate</td>
<td>3</td>
</tr>
</tbody>
</table>

## II. FEDERAL ESTATE AND GIFT TAX HIGHLIGHTS

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. The Gift Tax</td>
<td>3</td>
</tr>
<tr>
<td>B. Estate Tax</td>
<td>6</td>
</tr>
<tr>
<td>C. The Generation-Skipping Transfer (&quot;GST&quot;) Tax</td>
<td>8</td>
</tr>
<tr>
<td>D. The State Estate Tax</td>
<td>10</td>
</tr>
<tr>
<td>E. Basis Rules</td>
<td>10</td>
</tr>
</tbody>
</table>

## III. COMPARISON OF LIFETIME GIFTS TO TESTAMENTARY BEQUESTS

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Comparison of Tax Consequences</td>
<td>17</td>
</tr>
<tr>
<td>B. Non-Tax Consequences</td>
<td>19</td>
</tr>
</tbody>
</table>

## IV. NON-TAX REASONS FOR ENTITY OWNERSHIP OF REAL ESTATE

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Creditor Protection Provided by These Entities and the Creditor Remedies Against Entity Owners</td>
<td>20</td>
</tr>
<tr>
<td>B. Avoidance of Probate and Other Benefits</td>
<td>23</td>
</tr>
<tr>
<td>C. Use of Limited Liability Companies</td>
<td>27</td>
</tr>
</tbody>
</table>

## V. VALUATION ISSUES ARISING FROM ENTITY OWNERSHIP

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Valuation of Real Estate</td>
<td>27</td>
</tr>
<tr>
<td>B. Discounts and Premium Adjustments to Valuation</td>
<td>30</td>
</tr>
<tr>
<td>C. Exception to Valuation Adjustments for Purposes of Gift and Estate Tax</td>
<td>33</td>
</tr>
<tr>
<td>D. Exception to Valuation Adjustments for Purposes of Estate Tax: Retention of Interest in Gifted Property</td>
<td>37</td>
</tr>
</tbody>
</table>

## VI. REDUCTION IN VALUATION THROUGH RETAINED INTERESTS

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Gifts of Trust Interests</td>
<td>41</td>
</tr>
<tr>
<td>B. GRATS and GRUTs</td>
<td>42</td>
</tr>
<tr>
<td>C. QRTS and QPRRTS</td>
<td>44</td>
</tr>
</tbody>
</table>

## VII. FREEZING VALUES FOR ESTATE TAX PURPOSES

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Intramural Sales of Property</td>
<td>46</td>
</tr>
<tr>
<td>B. Joint Purchases</td>
<td>55</td>
</tr>
<tr>
<td>C. Partnership Freezes</td>
<td>56</td>
</tr>
</tbody>
</table>

## VIII. PLANNING FOR ESTATE TAX STATUTORY RELIEF

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Section 2032A</td>
<td>58</td>
</tr>
<tr>
<td>B. Section 6166</td>
<td>61</td>
</tr>
<tr>
<td>C. Section 6161</td>
<td>65</td>
</tr>
</tbody>
</table>

## IX. CHARITABLE GIVING WITH REAL ESTATE

<table>
<thead>
<tr>
<th>Subsection</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Introduction</td>
<td>65</td>
</tr>
<tr>
<td>B. Substantiation Requirements and Requirement for a Qualified Appraisal</td>
<td>66</td>
</tr>
<tr>
<td>C. Transfers of Entire Interests in Property - Special Circumstances</td>
<td>66</td>
</tr>
<tr>
<td>D. Estate Tax Exclusion for Real Estate Subject to Conservation Easement</td>
<td>72</td>
</tr>
<tr>
<td>E. Use of Trusts to Make Charitable Gifts of Real Estate</td>
<td>74</td>
</tr>
</tbody>
</table>
ESTATE PLANNING FOR REAL ESTATE

Mary Ann Mancini, Esquire
Stefan F. Tucker, Esquire

September, 2005

I. INTRODUCTION

A. Scope

This outline will provide a summary of the main features of estate planning
techniques and considerations as they affect real estate ownership in order to assist the
practitioner who is not an estate planning attorney in recognizing estate planning opportunities
for his or her client's real estate and real estate related assets. Consequently, this outline is not
intended to provide an exhaustive analysis of Federal estate or gift taxation or estate planning. In
addition, no attempt has been made to analyze any state or local gift, estate or inheritance taxes,
although such taxes must also be considered as a factor affecting the advisability of any lifetime
or testamentary transfer of real estate. Finally, this outline only addresses estate planning for
citizens of the United States.

B. Overview and Goals of Estate Planning for Real Estate

There are three basic goals of estate and gift tax planning for real estate: (1) the
reduction of estate and gift taxes upon transfer; (2) the deferral of the estate and gift tax burden;
and (3) the provision of the necessary liquidity to pay the taxes imposed on an illiquid asset.
While taxes cannot be ignored when planning for real estate, the additional goals, which can be
as important as tax planning, include (1) creditor protection, (2) retention of control over the real
estate by the client, (3) management succession, and (4) economic support of the family.

II. FEDERAL ESTATE AND GIFT TAX HIGHLIGHTS

A. The Gift Tax

1. Essentially, the gift tax is an excise tax imposed on the transfer of property
by gift during any calendar year; however, neither the Internal Revenue Code (“Code”) nor the
Regulations thereunder attempt to define the term “gift”. The Regulations do state that the tax
applies to “any transaction in which an interest in property is gratuitously passed or conferred
upon another, regardless of the means or device employed”.

2. The tax applies to all transfers, whether direct or indirect, whether outright
or in trust, and whether the property transferred is real or personal, tangible or intangible.

3. General Rules
a. Generally, if the owner of real property wishes to make a lifetime gift of all or a portion of such property, the amount of the gift is the fair market value of the transferred property at the time of the gift; and the amount of tax due in connection with the gift is calculated using the rate schedule set forth in Section 2001(c). For decedents dying before January 1, 2010, the maximum gift tax rates range from 35% to 49%, depending on the year in which the gift was made. After December 31, 2009, the maximum gift tax rate will be reduced to a maximum individual rate. For gifts over $500,000, the applicable rate after 2009 will be 35%.

b. Gift tax rates are cumulative, which means that, as a donor makes gifts over the years that are subject to gift tax, the prior years' gifts are added together with gifts made in the current year in order to determine the gift tax bracket for the current gifts.

c. If the gift is mortgaged real property, the amount of the gift is netted, so as to exclude the amount of the mortgage, even if the donor remains liable on the mortgage, so long as the mortgage is secured by the property and the donee does not have a right of subrogation against the donor. When a gift is so netted, then, as the donor makes subsequent payments on the mortgage, each such payment constitutes an additional gift.

4. Exceptions

There are five exceptions to the requirement that transfers without consideration are subject to gift tax. Four of these are as follows:

a. Annual Exclusion

(1) The Federal gift tax law provides, under Section 2503(b), for an annual exclusion for gifts of $11,000 per donee. Accordingly, a donor may give any number of people up to $11,000 per year and pay no gift tax on the total amount given by the donor.

(2) This annual exclusion amount will be adjusted for inflation; however, in any year that the annual exclusion amount is not a multiple of $1,000, the amount will be rounded to the next lowest multiple of $1,000.

(3) Under Section 2513(c), it is possible to treat a gift by husband and wife as being given one-half by each spouse, even though only one spouse is the owner of the gifted property. Therefore, one spouse can give $22,000 per donee each year, which will be treated as given one-half by each consenting spouse.

(4) The annual exclusion provisions of Sections 2503 and 2513(c) apply only to gifts of present interests. Section 2503(b) specifically excludes gifts of future interests in property. A gift which does not provide the donee with an immediate benefit is not a present interest, and, therefore, it cannot be excluded under Section 2503. For purposes of Section 2503, the term "future interest" includes "reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or
estate, which are limited to commence in use, possession, or enjoyment at some future date or time."

b. Medical and Tuition Expense Exclusion

(1) An exclusion from the gift tax is provided for any amounts paid as tuition or for medical care on behalf of any individual. Such amounts, if paid to an educational organization described in Section 170(b)(1)(A)(ii) or to any person who provides medical care will not be considered gifts for the purposes of gift tax, the unified credit or the annual exclusion from gift taxes.

(2) The exclusion is available regardless of the relationship between the donor and donee.

c. Marital Deduction

(1) Section 2523 allows for an unlimited marital deduction for qualifying gifts made to one’s spouse, so long as such spouse is a citizen of the United States.

(2) Qualifying gifts are outright gifts of property interests and certain gifts in trust or life estates, as described in Section 2523. Essentially, the donor will not receive a marital deduction for gifts other than outright gifts of property to his or her spouse unless the spouse has the use of the gifted property and its income for her or his lifetime and such use cannot be interfered with by any other person, including the donor.

(3) There are essentially two types of marital trusts created during the donor’s lifetime that are eligible for the marital deduction. In order to be eligible, each type of trust must give the spouse all the income earned in such trust for the rest of the spouse’s life. In neither trust does the spouse have to be given access to the trust principal, although no one else can receive any principal while the spouse is living. Nor does the spouse have to be named a trustee of either trust. In one type of trust, the spouse must be given a general power of appointment over the trust in order for the trust to qualify for the marital deduction. In the other type of trust, the spouse does not have to be given this power of disposition over the trust; however, the donor must file a gift tax return and elect marital deduction qualification upon funding the trust. In both cases, to the extent the marital deduction was claimed to shield the gift from gift tax, the trusts will be included in the spouse’s taxable estate at his or her death.

d. Charitable Deduction

(1) Section 2522 allows for an unlimited charitable deduction for qualifying gifts made to a public charity or private foundation.

(2) Qualifying gifts are limited to outright gifts of the transferor’s interest in the gifted property, with the following exceptions:
the transferor’s retained life estate);\(^{23}\) remainder interests in a farm or residence (despite 
(b) irrevocable qualified easements in real property;\(^{24}\) 
and 
(c) remainder interests in qualified charitable remainder 
trusts, pooled income funds and charitable gift annuities.\(^{25}\) 

(3) When a donor makes a charitable gift, there is no longer 
any requirement that a gift tax return must be filed unless the donor is making a gift that falls 
within one of the exceptions described above (other than a gift of a qualified easement) or the 
transferor is making a gift of only a portion of the property or an interest in an entity.\(^{26}\)

c. Gift Exemption

The fifth and final exception to the requirement that transfers 
without consideration are subject to gift and estate taxation is the unified credit. Section 2505 
provides a unified tax credit\(^{27}\) against the Federal gift tax liability.

(1) The exemption amount is currently \$1,000,000. This 
exemption will not increase, even though under current law the estate and generation-skipping 
transfer tax exemption has increased from \$1,000,000 to \$1,500,000.

(2) This means that an individual may make taxable gifts (that 
is, gifts in excess of annual exclusion amounts) valued up to the current exemption amount in the 
aggregate before having to pay any gift tax.

B. Estate Tax

1. Under Section 2001, an estate tax is imposed on the value of the property 
held by a decedent at the time of his or her death. Under current law, the estate tax will be 
gradually phased out, and estates of decedents dying during 2010 will not be subject to any estate 
tax. In 2011, the estate tax system in place prior to current law will be reinstituted.

2. To calculate the estate tax, the decedent’s taxable estate (which primarily 
includes all property owned at death less deductions for expenses of administering the decedent’s 
estate, funeral expenses, debts, casualty losses, charitable gifts, marital bequests and state death 
taxes paid) is aggregated with all the taxable gifts made by the decedent after 1976.\(^{28}\) A tentative 
estate tax is computed on that aggregate amount. Like the gift tax, the estate tax is a progressive 
tax. For decedents dying in calendar years after 2002 and before 2010, the minimum rate of tax 
is 18% for estates up to \$10,000, and the maximum rate of tax imposed is in accordance with the 
following table:
In calendar year:

<table>
<thead>
<tr>
<th></th>
<th>The maximum rate is:</th>
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<tbody>
<tr>
<td></td>
<td>(for estates over $2 million)</td>
</tr>
<tr>
<td>2004</td>
<td>48 percent</td>
</tr>
<tr>
<td>2005</td>
<td>47 percent</td>
</tr>
<tr>
<td>2006</td>
<td>46 percent</td>
</tr>
<tr>
<td>2007, 2008, and 2009</td>
<td>45 percent</td>
</tr>
<tr>
<td>2010</td>
<td>Estate tax is repealed</td>
</tr>
<tr>
<td>2011</td>
<td>55 – 60 percent</td>
</tr>
</tbody>
</table>

3. Once the appropriate estate tax bracket is selected and a tentative tax is computed, the gift tax payable on the post-1976 taxable gifts is immediately subtracted from the total tax, and the resulting amount is the estate tax imposed on the estate. Against this estate tax, the applicable credit amount is applied to reduce the estate tax on a dollar-for-dollar basis.

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Applicable Exclusion Amount</th>
<th>Applicable Credit Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 and 2005</td>
<td>$1,500,000</td>
<td>$555,800</td>
</tr>
<tr>
<td>2006, 2007 and 2008</td>
<td>$2,000,000</td>
<td>$780,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
<td>$1,525,800</td>
</tr>
<tr>
<td>2010</td>
<td>Estate tax is repealed</td>
<td>Estate tax is repealed</td>
</tr>
<tr>
<td>2011</td>
<td>$1,000,000</td>
<td>$345,800</td>
</tr>
</tbody>
</table>

4. Thus, the amount sheltered from estate tax will rise from $1,500,000 in 2004 to $3,500,000 in 2009.

5. All Federal estate taxes are due within nine months of the decedent’s death. This rule presents two key areas of concern for the real estate owner:

   a. how is such property to be valued for estate tax purposes; and
   b. will there be sufficient liquidity in the estate nine months after death to pay the estate taxes?

6. Marital Deduction

   a. As in the gift tax area, there is a marital deduction from the gross estate equal to the value of any interest in property which passes or has passed from the decedent to a surviving spouse who is a citizen of the United States, to the extent such interest is included in the decedent’s gross estate.29

   b. The marital deduction allows the decedent to transfer real property to the surviving spouse without incurring any Federal estate tax liability on the transfer. However, if the decedent leaves everything to the surviving spouse, the surviving spouse will end up with the entire estate at his or her death, but with only his or her own exemption from estate taxes. Under this type of disposition, the first decedent spouse’s exemption has been lost.
7. Charitable Deduction

a. As in the gift tax area, there is a charitable deduction from the gross estate equal to the value of any qualifying interest in property which passes or has passed from the decedent to a public charity or private foundation, to the extent such interest is included in the decedent's gross estate.  

b. Essentially, the same exceptions to the definition of qualifying interests that exist in the gift tax area also exist in the estate tax area.

C. The Generation-Skipping Transfer ("GST") Tax

The generation-skipping transfer tax is a flat tax, equal to the maximum Federal estate tax rate, that is in addition to the estate or gift tax and is imposed on transfers that, in effect, skip a generation. For example, if a grandparent makes a transfer to a grandchild or grandchild's trust that results in the property transferred by-passing a living child's estate, the grandparent has made a generation-skipping transfer. The theory behind this tax is that the government has lost revenue that it would have received as a result of the estate tax that would have been imposed had the property had been includable in the child's estate. GST Tax is a substitute for the estate tax that is not imposed at the child's death. As with the estate tax, generation-skipping transfer tax is eliminated for transfers after December 31, 2009. However, after December 31, 2010, the generation-skipping tax is reinstated.

1. The types of transfers that are considered generation-skipping transfers are as follows:

a. Direct Skips

   (1) These are transfers to any person who has been assigned to (or to a trust in which all of the beneficiaries are persons) two or more generations below that of the transferor. These persons are known as "skip persons". The assignment of generations is applied as follows:

   (a) When the transferee is a lineal descendant of the transferor or the transferor's spouse, then the generations are based on the relationship to the transferor, regardless of how many years are between the generations. Therefore, a transfer to a grandchild of the transferor is always a direct skip and a transfer to a child of the transferor is never a direct skip.

   (b) When the transferee is not a lineal descendant of the transferor or the transferor's spouse, but is, instead, a collateral descendant (such as a grandniece or grandnephew) or is unrelated to the transferor, then:

      (i) a transferee who is not more than 12-1/2 years younger than the transferor is assigned to the transferor's generation;
(ii) a transferee who is more than 12-1/2 years younger than the transferor but not more than 37-1/2 years younger is assigned to the first generation younger than the transferor; and

(iii) similar rules apply to create new generations every 25 years.31/

b. Taxable Terminations

These are deemed transfers for GST purposes when (i) the interests of all the beneficiaries of the trust who are in the generation immediately succeeding the transferor’s terminate; (ii) the trust fund is not includable in the estates of any of such beneficiaries; and (iii) the only remaining beneficiaries of the trust are skip persons.

c. Taxable Distributions

Whenever there is a distribution from a trust to a skip person, and such distribution is not a direct skip or taxable termination, this transfer will be considered a generation-skipping transfer.

2. There are two exemptions from GST:

a. Section 2631 GST Exemption

(1) Every individual has an exemption against GST tax. For transfers after December 31, 2003 and before January 1, 2010, the GST tax exemption amount will equal the estate tax applicable exclusion amount under Section 2010(c).32 Thus, the GST tax exemption will be as follows:

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>GST Exemption Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 and 2005</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>2006, 2007 and 2008</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>2010</td>
<td>GST tax repealed</td>
</tr>
<tr>
<td>2011</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

(plus post-1997 inflation adjustments)

(2) This exemption can be applied against a transfer immediately, if it is a direct skip. Moreover, the exemption amount can be allocated to transfers made to a trust which are not direct skips.

b. Predeceased Child Exemption

(1) If the transferee is a grandchild of transferor and, at the time a direct skip transfer is made, the parent of the grandchild, who is a lineal descendant of the
transferor, is deceased, then the grandchild will, for purposes of GST, be considered the child of
the transferor.

(2) If the transferor has no living lineal descendants at the time
of the transfer and a transfer is made to a collateral relative whose parent is dead, then such
transfers will also qualify for this exemption.33/

D. The State Estate Tax

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act
of 2001 (the "2001 Act"), and the resultant repeal of the Federal estate tax, most States imposed a
"pick-up" tax on a resident-decedent's estate which was equal to the Federal estate tax's
maximum allowable credit for state death taxes. After the Federal estate tax was calculated on
the Federal estate tax return, the State received an amount equal to the state death tax credit and
the amount paid to the State was a credit against the Federal estate tax. The Federal Government
received the remainder of the estate tax, after such state death tax payment was subtracted.

The 2001 Act changed this. As of 2005, there is no longer a state death tax credit. Any death taxes imposed by a State will be treated as a deduction rather than a credit on the
Federal estate tax return. In response to the elimination of the state death tax credit many States
have enacted their own estate tax, including a separate exemption from the State estate tax. The
State-level exemptions are oftentimes not as generous as the Federal estate tax exemptions. As a
result, an estate may not have any Federal estate tax due, but may have a State estate tax due
upon the decedent's death.

For example, in Maryland, the State exemption from State estate tax is currently
$1,000,000. Therefore, estates of $1,500,000 will have no Federal estate tax but will have a
Maryland estate tax on the excess over the Maryland estate tax exemption amount. The
Maryland estate tax on the $500,000 in this example is approximately $70,000. On the other
hand, Florida's estate tax exemption is tied to the Federal estate tax exemption and as the Federal
estate tax exemption rises, so does the Florida estate tax exemption.

State estate tax is imposed on all property of a resident-decedent other than real property
located in another state. State estate tax is imposed on nonresident-decedents who own real
property located in the subject state. As a result of this change in the State-level estate tax
systems, the residence or domicile of the decedent, for estate tax purposes, and the existence and
location of real property has become very important.

It is possible, for example, to have a Florida decedent with real property located in
Maryland and although there is no Florida estate tax, if the real property located in Maryland
exceeds $1,000,000 in value, there were will be an estate tax payable to Maryland.

E. Basis Rules

1. General Basis Rules under Present Law
a. Where property is acquired by purchase, the basis for such property is its cost.  

b. Property which is acquired by gift generally has, under Section 1015(a), a basis in the hands of the donee equal to that of the donor.  

(1) If the basis of the property at the time of the gift was higher than its fair market value and the property is later sold by the donee, the basis for determining loss will be the fair market value at the time of the gift and the basis for determining gain will be the basis in the hands of the donor. As a consequence, the donee does not recognize gain or loss in that situation where he sells the property at a price between the donor’s basis and the fair market value of the property at the time of the gift. If neither the donee nor the Director of the Internal Revenue Service (“Service”) is able to determine the basis of the property in the hands of the donor, the basis will be considered to be the fair market value of the property as of the date or the approximate date at which, according to the best information available, the property was acquired by the donor.  

(2) Increase of Basis for Gift Tax Paid  
The basis of gifted property is increased by the amount of gift tax paid with respect to the gift. Such increase, however, cannot exceed the gift tax attributable to the amount by which the fair market value of the property exceeds the adjusted basis of the property (the net appreciation of the property) as of the date of the gift.  

c. The basis of property distributed from a trust or estate is computed as follows:  

(1) Generally, the beneficiary receives property distributed from a trust or estate with the same basis of such property in the hands of the estate or trust immediately before distribution.  

(2) Exceptions to the General Rule  

(a) Section 643(e)(3) election. The fiduciary of the estate or trust may make an election under section 643(e) to treat the distribution as if the trust or estate had sold the property to the beneficiary at its fair market value and the beneficiary shall take the property with a basis equal to its fair market value. If a loss is recognized by the trust or estate, as a result of the deemed sale, the loss may be disallowed under the related party rules of section 267. However, if the beneficiary later sells the property at a gain, the beneficiary may reduce the gain by the amount of the disallowed loss.  

(b) Distribution in satisfaction of a pecuniary bequest. This distribution will be treated as a sale of the property at its fair market value and the recipient will take the property with a fair market value basis. If the property is sold at a loss that is disallowed under section 267, the beneficiary will have the same basis adjustment as described above.
d. Under present law, the basis of property acquired by inheritance generally will, under Section 1014, be its fair market value (or its special use value, if applicable) at the date of death or, if the alternate valuation date is used for Federal estate tax purposes, the fair market value at such date.

e. Exceptions to Stepped-up Basis at Death

(1) Income in respect of a decedent -- Property that is considered “income in respect of a decedent” will not receive a step-up in basis upon the death of the decedent under Section 1014. The term “income in respect of a decedent” is defined as those amounts to which a decedent was entitled as gross income, but which were not properly includable in computing the decedent’s taxable income during his lifetime.

(2) To the extent that the value of land subject to a qualified conservation easement is excluded from estate taxes, the basis of such land will not be stepped-up, but instead the basis of such land will remain the same as in the hands of the decedent.

(3) Gifts of appreciated property within one year of death -- Where appreciated property was gifted to a decedent within one year of his or her death, and upon the decedent’s death such property passes to the person who originally transferred it to the decedent, then, under Section 1014(e), the basis of such property will not be stepped-up under Section 1014(a). As a result, care should be taken when transferring property between spouses as gifts, if, upon the death of one spouse, the surviving spouse receives such property under the decedent’s Will.

(4) When spouses hold property as joint tenants or tenants by the entirety, then, at the death of one spouse, one-half of the property is deemed owned by the decedent and included in the deceased spouse’s estate, which thereby receives a step-up in basis. These types of property interests are referred to as “qualified joint interests”. The remaining half retains its original basis. For those other than spouses, all of the jointly held property is included in the estate of the first joint owner to die, with a resultant step-up in basis for all of the property, except to the extent that the surviving joint owner can show that he or she contributed to the acquisition cost of the property.

(a) Increase of Basis for Decedent Spouse’s Contribution in Pre-1977 Joint Tenancy. In Gallenstein v. United States, the Sixth Circuit carved out an exception to the general rules discussed above, which now exists in the Fourth, Ninth and Eleventh Circuits and in the Tax Court as well. Recently, the Service acquiesced to this position.

(b) Any jointly held property acquired by spouses prior to 1977 will be subject to the old rules of contribution rather than the deemed one-half rule because the rule for qualified joint interests did not apply to joint interests created before 1977. Under this reasoning, if practicable, it is now even more advantageous to show the decedent spouse contributed a disproportionately greater amount to the acquisition cost of the property. By doing so, a greater portion, if not all, of the property would receive a stepped-up

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basis in the property, and, as a result of the unlimited marital deduction, the property would pass
to the surviving spouse, with its new stepped-up basis, free of any estate tax. This is, however,
a two-edged sword. If the spouse who contributed little or nothing to the acquisition cost of
property acquired before 1977 dies first, then the surviving spouse receives little or no step-up
in basis.

f. Basis Adjustment under Section 754 for Partnership Interests

(1) The basis of a partnership interest held by an estate or any
successor partner is generally determined by reference to the fair market value of the partnership
interest on the date of death of the deceased partner, increased by the estate’s share of
partnership liabilities on such date. 54/

(2) In the absence of a pre-existing or timely Section 754
election 54/ by the partnership (or a distribution and election by the distributee partner under
Section 732(d)), the death of a partner does not affect the inside basis of the assets held by the
partnership at the time of the partner’s death. Accordingly, as a general rule, an estate or a
decedent’s successor partner will have a stepped-up basis in the partnership interest owned by
the decedent, while the basis of the partnership assets remains unchanged.

(3) However, if a partner dies and the partnership makes or
already has in effect a Section 754 election, then the basis of the partnership’s assets will be
adjusted with respect to the partnership interest of the deceased partner’s estate or successor
partner to reflect the Federal estate tax value of the deceased partner’s interest in the partnership.
Thus, for purposes of determining the estate or successor partner’s distributive shares of
depreciation or gain or loss of the partnership for income tax purposes, the partnership uses this
new basis for the partnership’s assets. 56/

(4) As a result of the application of the foregoing rules, if a
Section 754 election is not made by the partnership, the sale of an appreciated partnership asset
by the partnership would require the partnership, and therefore the successor partner or the
estate, to recognize gain on the sale, notwithstanding the stepped-up basis in the partnership
interest owned by the successor partner or the estate. Thus, the absence of a Section 754 election
by the partnership generally can cause tax disadvantages where a deceased partner’s estate or
successor remains as a partner in the partnership because the basis in the partnership’s assets is
not adjusted for purposes of computing gain or depreciation. 57/

(5) Under Section 754, however, the basis will be stepped-
down if the value of the property has dropped below its basis. A Section 754 election can
therefore result in the inability to take a loss when such an asset is sold because of the stepped-
down basis. A Section 754 election, once made, is applicable to all partners, not just the partner
whose death prompted the election by the partnership. 58/ Accordingly, the election must be
carefully considered.

(6) On the other hand, even when there is no Section 754
election in effect, if a deceased partner’s interest is completely liquidated, the estate or successor
partner generally takes a basis in the distributed assets equal to the basis in its partnership interest, resulting in a stepped-up basis in the distributed assets.59/

2. Basis Rules under Estate Tax Repeal Law

a. In 2010, under the 2001 Act, when the estate and generation-skipping tax is completely repealed, a "modified carryover basis" regime will be applied to property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, property passing from the decedent to the extent such property passes without consideration, and certain other property.60/

b. Recipients of property transferred at a decedent's death will receive a "carryover basis."61/ This will be the lower of the adjusted basis of the decedent or the property's fair market value on the date the decedent died.

c. The character of the property is also carried over.

d. Limited Basis Increase for Certain Property:

(1) Each estate would be allowed to increase the basis of assets transferred up to a total of $1.3 million.62/

(a) This $1.3 million can be increased by the amount of unused capital losses, net operating losses and certain "built-in" losses of the decedent.63/

(b) The basis of property transferred to a surviving spouse or to a qualified terminable interest property trust can be increased by an additional $3 million.64/

(c) Nonresidents who are not U.S. citizens will be allowed to increase the basis of property up to $60,000.65/

(d) The $1.3 million, $3 million and $60,000 amounts are each adjusted annually for inflation occurring after December 31, 2010.66/

(2) An executor or administrator of a decedent’s estate will determine which assets will receive a step up and to what extent; and is empowered to allocate basis asset-by-asset.67/ For instance, a personal representative can increase the basis of a single share of stock or a block of stock. The basis cannot be increased above the asset’s fair market value.68/

(3) To obtain the limited basis increase, the property must both be “owned by the decedent” and “acquired from the decedent.”69/

(a) Property owned by the decedent.
(i) Generally, only property that is owned, or is treated as owned, by the decedent at the time of the decedent's death is eligible for the basis increase. 70/

(ii) Joint tenancy property held by spouses or property held between spouses as tenants by the entireties can only receive a partial step-up – since one-half of the property is treated having been owned by the decedent and thus only this portion is considered owned by the decedent. 71/

(iii) A different result occurs in the case of property held jointly with a person other than the decedent's surviving spouse; or, possibly, with pre-1977 spousal joint tenancies. In this case, the percentage of contribution test would be used. This means the portion of the property attributable to the decedent's contribution is treated has having been owned by the decedent. 72/

(iv) If property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent, the decedent is considered owner of that property for estate tax inclusion purposes. 73/

(v) The decedent is not considered the owner of any property solely by reason of holding a power of appointment with respect to such property. 74/

(b) Property acquired from the decedent is defined as:

(i) Property acquired by bequest, devise, or inheritance.

(ii) Property acquired by the decedent's estate from the decedent.

(iii) Property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his or her death to revoke the trust.

(iv) Property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his or her death to make any change to the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust.

(v) Property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties).
(vi) The surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.

(4) No increase in basis is allowed for the following property:

(a) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death;\(^{25}\)

(b) property that constitutes a right to receive income in respect of a decedent;\(^ {26}\)

(c) stock or securities of a foreign personal holding company;\(^ {27}\)

(d) stock of a domestic international sales corporation (or former domestic international sales corporation);\(^ {28}\)

(e) stock of a foreign investment company;\(^ {29}\) and

(f) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).\(^ {30}\)

(5) Rules Implemented to Ameliorate the Consequences of Modified Basis:

(a) Transfers of property in satisfaction of a pecuniary bequest for estates of decedents dying after December 31, 2009. Gain or loss on the transfer of property in satisfaction of a pecuniary bequest is recognized to the estate only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).\(^ {31}\)

(b) Transfer of property subject to a liability. Gain is not recognized at the time of death when the estate or heir (other than a tax-exempt beneficiary) acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property.\(^ {32}\) Also no gain is recognized by the estate on the distribution of such property to a beneficiary (other than a tax-exempt beneficiary) of the estate because of the liability.\(^ {33}\) A tax-exempt beneficiary is defined as the United States, a state, a possession, an organization that is exempt from income tax, any foreign person or entity and, to the extent provided in the regulations, any person to whom property is transferred for the principal purpose of tax avoidance.

(c) Income tax exclusion for the gain on the sale of a principal residence for estates of decedents dying after December 31, 2009. If the decedent's estate, an heir or a trust which, immediately before the death of the decedent was a qualified revocable trust as defined in section 645, sells the decedent's principal residence, $250,000 of
gain can be excluded on the sale of the residence, if the decedent used the property as a principal
residence for two or more years during the five-year period prior to the sale.\textsuperscript{44}

III. COMPARISON OF LIFETIME GIFTS TO TESTAMENTARY BEQUESTS

A. Comparison of Tax Consequences

1. Overriding consideration

Because the estate tax is scheduled to be repealed in 2010, lifetime gifts in
excess of the applicable exemption amount should be carefully considered. The possibility that
no transfer tax will be due upon a transferor's death is a strong incentive to avoid paying transfer
taxes during life.

2. Revaluation of Prior Taxable Gifts

a. Effective for gifts made after August 5, 1997, the Service is barred
from revaluing gifts made in prior taxable periods for all purposes where a gift tax return has been
filed, the three year statute of limitations has run, and the gifts have been adequately disclosed on
the return.\textsuperscript{85}

(1) Final Regulations on what is an adequate disclosure of gifts
were issued on December 3, 1999.\textsuperscript{86}

(a) Requirements of Adequate Disclosure.

In order to be considered to have provided adequate
disclosure of a gift, the Service must be apprised of the nature of the gift and the taxpayer's
basis for the reported value. This requirement can be satisfied by submitting one of two reports:

(i) a description of the property, any
consideration received, the parties involved in the transfer, a detailed description of the method
used to determine the fair market value of the transferred property including any financial data
that was used and any discounts claimed in valuing the property must be set forth and a
statement of any position taken that is contrary to any proposed, temporary or final Treasury
regulation or revenue ruling published at the time of the transfer;\textsuperscript{87}
or

(ii) an appraisal prepared by a qualified
apraiser that contains a description of the property, the appraisal process, the method of
valuation used and any assumptions made.\textsuperscript{88}

(b) If a Gift is Considered to be Adequately Disclosed.
The three-year statute of limitations starts to run, and upon the expiration of the statute, the Service must use the value of such gift for purposes of determining any subsequent gift or estate tax liability. The value of the gift shall be the value as “finally determined” regardless of whether the gift tax is paid. Accordingly, the statute of limitations will not begin to run unless a return is filed or the matter is adjudicated or settled.

(c) If a Gift is Not Considered to be Adequately Disclosed.

Transfers to members of the transferor’s family (as defined in Section 2032A) that are made in the ordinary course of operating a business are deemed to be adequately disclosed if the transfers are properly reported by all parties for income tax purposes.

(2) The donor now has an opportunity to resolve the valuation of a gift by petitioning the Tax Court for declaratory judgment relief as to the value of such gift, so long as (i) the value is in actual controversy with the Service and (ii) the petition is filed within 90 days of the Service’s Notice of Determination regarding the value of the gift.

b. Upon the death of an individual, all of the taxable gifts the decedent made that utilized his or her unified credit are brought back into the estate at their values as of the dates of the gifts for purposes of determining the estate tax bracket to which the estate will be subject. Any subsequent appreciation in the value of the gifted property is not brought back into the estate. The amount of any unified credit is also restored to the estate to provide a full credit against the estate tax calculated at the higher bracket.

3. Three Year Rule for Gift Taxes Paid

Under Section 2035, if any gift tax is paid as the result of a lifetime gift, and the donor survives the payment of such gift tax by three years, the gift tax paid is removed from the estate. If, however, the donor does not so survive, then, for purposes of determining the decedent’s estate tax bracket, the gift tax is brought back into the estate along with the value of the gift determined as of the date of the gift and not at the date of the decedent’s death.

4. Removal of Appreciation from Estate

One of the most common reasons for making a lifetime gift of real property is to remove from the transferor’s estate tax base any further appreciation in the value of the gifted property. Thus, a gift effectively freezes the tax cost of transferring the property to the transferor’s intended beneficiary.
B. Non-Tax Consequences

Non-tax consequences real estate owners must consider (or are concerned about) when planning gifts, are as follows:

1. **Reduction in Size of Financial Statement.**

   As gifts are made, the real estate owner/donor’s wealth is reduced, naturally, which is the intended goal from an estate and gift tax perspective. But it may have some unintended, and undesirable, non-tax results.

   a. Impact on guarantee, borrowing power.

      Many times, an entity’s ability to operate requires loans, such as when an unoccupied building will be refurbished in order to become income producing. Borrowing the refurbishment funds based on the equity in the building is often times not enough. If that is the case, the original real estate owner/donor is called upon to be the borrower or guarantor of the loan, based on his or her personal financial statement. Reducing the size of the financial statement through gifting will impede his or her ability to borrow or guarantee.

   b. Impact on bonding requirements.

      In the area of commercial real estate and construction, the owner is bonded. The provisions of the bond can include a default provision if the owner’s financial statement drops below a certain level.

2. **Uncertainty about Future.**

   a. Will donees have to support donor?

      No matter how wealthy a donor is, the question always comes up; if all else fails, and the donor has nothing left, will he or she have to ask the donees for money to live? This issue must be addressed prior to any gifting.

   b. Creditor and divorce claims against donee

      One issue that is always a concern to a donor is the possibility that the gifted asset will end up in the hands of an ex-spouse or creditor of the donee. Although a common solution to this concern is to make the gift to a trust, rather than the donee directly, many practitioners have become concerned, as more states adopt the Uniform Trust Code (“UTC”), that due to some UTC provisions, creditors have greater rights against trusts than before. If this is the case, gifting entity interests into a trust for the benefit of the donee may not protect those assets.
IV. NON-TAX REASONS FOR ENTITY OWNERSHIP OF REAL ESTATE

Real estate owners use entities such as Limited Partnerships or Family Limited Partnerships ("FLPs") and Limited Liability Partnerships ("LLCs") companies for several reasons, the most important of which are not tax related. These entities allow the owner to continue to control the management of the real estate and establish a plan for the succession of that management, no matter who the limited partners or members may be, which is imperative, given the specialized nature of real estate management and development. Furthermore, the entities protect the real estate from creditor claims that are made against any of the entity’s owners or against any other real estate the individual owns, which presumably are held in separate entities. Finally, these entities provide many non-tax estate planning benefits, such as probate avoidance.

A. Creditor Protection Provided by these Entities and the Creditor Remedies against Entity Owners

1. State Law Remedies

a. Assignment of Partnership or LLC Interest to Creditor:

If a creditor is able to force an owner to assign his or her interest in the entity to the creditor, the creditor could become a partner or member (and, if a general partner interest or Manager interest is so assigned, control the entity) unless the entity’s agreement provides otherwise. The agreement should provide that an assignee of a limited partner or member interest does not become a limited partner or member without the consent of a general partner or Manager and the assignee of a general partner or Manager interest does not become a limited partner or member without the consent of all (or some significant percentage in interest) of the partners. In all cases the agreement should prohibit any assignee from becoming a general partner or manager without the consent of all owners. A problem arises with the use of a corporate general partner in a limited partnership since the corporate general partner remains general partner, regardless of the financial circumstances of the owner of the shares of the corporate general partner. As a result, if the creditor forces the owner to assign his or her shares in the corporate general partner, the creditor will be able to control the partnership, and, for purposes of the partnership agreement, there has been no transfer that would prevent the creditor’s admission to the partnership. If this is a possibility, the owner should consider giving up majority ownership of the corporate general partner and merely acting as president and a director of the corporation. Alternatively, a limited liability company should be considered, in order to hold the general partner interest. The owner would be irrevocably designated as the Manager and his or her ownership interest in the LLC would become irrelevant.

b. Charging Orders:

A charging order is the court-ordered remedy of a creditor if the creditor is unable to force a partner or member to assign his or her interest. A charging order is neither an assignment or an attachment. It is a court order that directs the entity to make any
distributions to the owner’s creditors that it otherwise would have made to the owner. The theory behind the remedy is that, to allow a creditor access to the entity’s assets, records and, perhaps, management, as a result of the creditors’ claims against one owner, will disrupt the entity’s business to the detriment of the other owners. It is used in fairness to other (presumably unrelated) owners. It has been argued that this remedy is only appropriate in non-family situations; in family situations, where every partner or member is presumably aware of each other’s financial situation (and, indeed, the entity may have been formed in response to such situation), it is contended that the other owners are not entitled to the benefits of the creditor being able to secure only a charging order, so that creditors should be allowed to force the sale of the entity interest and/or reach the entity’s assets. As a court-ordered remedy, a charging order is strictly construed. If the creditor attempts to reach any interest other than what is provided in the order, he or she must obtain court approval. This remedy, therefore, results in greater legal expenses to the creditor than an assignment. As either an assignee or a holder of a charging order, the creditor may well be treated as a partner for income tax purposes; if no distributions are forthcoming, he or she would nonetheless have to pay tax on income not received.

c. Power to Sell Interest:

Normally, a court will only impose a charging order. If, however, a creditor can establish that the claim may never be paid, a court may consider an order forcing the sale of the debtor’s entity interest, although such an order is rare since a sale could cause a material adverse disruption to the entity. Even if such an order is obtained, the interest will have little value to an outside party, especially since the purchaser will merely become an assignee. Under most state Revised Uniform Limited Partnership Acts, a creditor cannot force the sale of a limited partner interest. In addition, under many limited liability company statutes, a charging order is the only remedy a creditor possesses. Nonetheless, since Federal bankruptcy law supersedes state law, it would be possible to obtain a Federal bankruptcy order to sell a entity interest, regardless of whether it is a general or limited partner interest, a member interest or a manager-member interest. In neither case, however, could a creditor force the sale of the underlying entity property, unless the claim was secured by such property.

In all events, the entity agreement should provide that the other owners and the entity should have the first right to purchase the interest, if it is to be sold.

d. Since LLCs are relatively new, the state law remedies for LLCs are not as certain.

2. Federal Bankruptcy Law:

Under Federal bankruptcy law, a bankruptcy trustee may attempt to withdraw from the partnership. Such an attempt should be addressed in the agreement by providing that the withdrawing partner or member (or his or her representative) does not receive fair value until the dissolution of the partnership. This must apply to any partner under any withdrawal in order to be supportable against a creditor.

3. Owner’s Right to Receive “Fair Value” upon Withdrawal or Dissolution.
a. Notwithstanding the right of an owner to receive fair value upon liquidation, the ambiguity of the term “fair value” may well provide protection against creditors. For creditor purposes, unlike for purposes of Section 2704(b) (discussed below), the agreement determines what rights the owners have to withdraw and liquidate his or her interest, and, further, the value such owner will get for his or her interest upon withdrawal.

b. The valuation of the interest to which an owner is entitled is binding on creditors as well. As a result, the agreement should address two goals: (i) making the entity interest as unattractive as possible to a creditor by imposing a method of valuing the interest that will result in the lowest value possible, and (ii) establishing a value that the family can afford to pay when buying the owner out of the entity. Generally, the basis on which value can be determined is either “going concern” value, under which the entity is valued as a going business with no disruptions, including the element of goodwill, or “liquidation” value, which is the value the assets would bring if the owners were to sell all of the assets at one time for whatever they could obtain, without any element of goodwill. Obviously, valuing the interests by using the liquidation value method will result in a lower value. Furthermore, the agreement will either give the owner a pro rata percent of the entity assets, as valued either on a going concern or liquidation basis, or an amount after discounting the pro rata percent of the assets for the owner’s minority interest in the entity. Again, the second alternative will result in a lower value for both creditor attachment purposes (thereby forcing the creditor to look elsewhere for repayment) and family repurchase purposes.

c. The disadvantage of these valuation alternatives is that they cannot be used only for creditor protection purposes if they are to withstand court scrutiny. As a result, there may be reasons that a owner wants to withdraw that have nothing to do with financial issues, but the entity must (in the absence of new negotiations) pay the owner this lower value, thereby forcing the owner to remain in the entity so that he or she may recoup his or her investment.

4. Use of Separate Entities

The use of more than one entity to hold ownership interest in real estate should be considered for the following reasons:

a. Claims against an entity’s property (such as environmental claims) will only extend to the assets held in that entity, to the general partner’s assets (if it’s a partnership), or, if the general partner is a corporation or other entity, to such entity’s assets. Accordingly, if assets are held in different entities, the claims against one entity will not “taint” the assets in a separate entity. As a result of the general partner’s liability, consideration should be given to using a separate entity general partner for each partnership, since the entity general partner’s interest in the other partnerships could be reached because of the claims against one partnership’s assets.

b. Creating more than one entity and choosing different jurisdictions for each entity will make it much more difficult on the part of a creditor to reach all of the assets,
so that the creditor may decide to attempt to reach the interests in the entities closest to the creditor or to seek to reach only certain entities, leaving the rest undisturbed.

c. There may be an adverse income tax consequence of creating more than one entity and holding different assets in different entities.94/

B. Avoidance of Probate and Other Benefits

1. Use of a Partnership or LLC Converts Real Property to Personalty.

A partnership or LLC interest is personalty and, as a result, the situs of the entity may be established in any jurisdiction, including a foreign jurisdiction. Real property not held in an entity is probated in the place where it is located. However, personal property is subject to probate in the decedent’s domicile and may even avoid probate all together, if the personal property is converted into a non-probate asset, such as transferring it to a revocable trust or into joint ownership.

As personalty, the real estate may, depending on state law, be subject to state estate tax in the descendant’s state of residence and not in the state where the real estate is located.

Being able to change the situs of personal property can also have creditor and tax advantages, although it is recommended that there be some ties to the jurisdiction selected so that the choice of jurisdiction is not perceived as shopping for the most favorable situs for creditor, probate or tax purposes. As a result, it is possible to change the situs of real property by placing it into a partnership and moving the situs to a more favorable jurisdiction for probate (at least to the extent of moving the situs from the location of real estate to the decedent’s domicile), state transfer tax and creditor purposes.

2. Estate Planning Benefits of Entities

a. Gifts of Real Property: giving undivided interests in real property is one of the simplest methods of transfers, however, although such gifts have the advantage of simplicity, there are far greater disadvantages. As a tenant in common, the donee’s interest will be subject to his creditors, who will at the least have the right to compel the sale of that tenant in common interest, and may have the right to compel the sale of the entire property, in order to satisfy their claims. Another drawback to such gifts is that the property interest can be gifted or devised to any person, thereby leaving the remaining co-tenants with no control over their future co-owners. Finally, such interests will pass through probate upon each co-tenant’s death with the resulting delay or other impediments in conveyancing.

b. A family can pool together its individual holdings especially when such holdings are interests in real estate. Once pooled together in a common ownership, the development and management of the various assets become much easier and more cost-efficient.

c. Entity arrangements allow families to negotiate with each other to determine a means of managing the property without intra-family litigation. If the family
members are beyond negotiation, then the entity agreement allows the parents/older generation a means of imposing a system of management on future owners.

d. Use of FLPs and LLCs in Estate Planning

The use of a Family Limited Partnership ("FLP") or a Limited Liability Company ("LLC") achieves several estate planning goals, as described above, in addition to obtaining discounts in value for lack of marketability and minority interests discussed below. However, care must be taken in drafting the operating agreement, selecting the owners of the partnership, choosing which assets the partnership will hold, and operating the partnership as a business or investment activity and not merely as a family bank account or a place to hold personal assets or assets the donor needs to support himself. A client wishing to create a family limited partnership must be aware of all the entity’s risks and restrictions before reaping its rewards.

1. Structuring the Family Limited Partnership: non-transfer tax issues

(a) In structuring the FLP, the general partner(s) of such a partnership should be an entity. This is for creditor protection purposes since the general partner of a limited partnership has personal liability. By using an entity such as a LLC as general partner, the only amount that will be at risk in the FLP with respect to issues that arise from and after that time will be the amount by which the FLP (including the LLC general partner) is funded and only to the extent the partnership (or entity general partner) is obligated; of course, all equity build-up in the Partnership is likewise at risk. An entity general partner also allows the owners of the entity to determine who will manage the partnership in future years, or at least provide a mechanism for choosing that management, even if such management is better served by non-family, non-owner management. For example, if the general partner interest is held in an LLC, the operating agreement of the LLC can provide for a non-member manager which allows the owners to go outside of the family for the management expertise necessary for the partnership. If it is desirable that the family manage the partnership, then the operating agreement can set forth the process by which that management is selected and removed.

Another benefit to holding the general partner interest through a corporation or LLC occurs at the death of the donor. Because the death of the general partner may be considered an event of termination of the FLP, holding the general partnership interest via a corporation or LLC ensures that no termination will occur upon the donor’s death. Furthermore, the bankruptcy of a general partner of a FLP may dissolve the Partnership unless a successor is designated under the agreement. If such a dissolution occurs, the underlying partnership property is at risk, inasmuch as the partner’s share of such property will be subject to his or her (or its) creditors, and hence, vulnerable to a partition suit if the property is real estate.

(b) The limited partner interests held by the family can be held outright by family members or in entities and trusts. Each type of ownership has benefits and drawbacks.
(i) The first alternative is for a family member to hold the limited partnership interest in his or her sole name. As discussed above, if such individual has creditors who succeed in obtaining the limited partner’s interest as an assignee, their rights in the Family Limited Partnership are less than the limited partner’s rights. If it is desirable to restrict the individual’s ability to transfer the interest (in order to keep it in the family), then it will be necessary to subject the limited partner interest to a buy-sell agreement.

(ii) If the donee is a minor, it is possible under the Uniform Transfers to Minors Act statutes of most states to transfer the limited partner interest to a custodian who will hold the interest until the minor reaches the age of 18 or 21. Each state statute must be reviewed to ensure that a custodian is empowered under the statute to hold a limited partner interest. Under many of the older Uniform Gifts to Minors Act statutes, such an asset was not a permissible investment.

(iii) The use of a trust to hold the limited partner interest is recommended when a buy-sell agreement is not possible and the donor wishes to restrict the donee’s ability to transfer the limited partner interest, even more so than what is set forth in the entity agreement. If held in an irrevocable trust created by a person other than the beneficiary, the limited partner interest may be kept out of the donee’s ownership for creditor purposes (including a divorce situation) and out of the donee’s taxable estate. Furthermore, if the limited partner interest is held by a trust, any future unborn beneficiaries of the trust may participate in the Family Limited Partnership. Finally if there is more than one limited partner and a distribution to one limited partner, but not to all of the limited partners is desirable, the distributions can be made to all limited partners on a proportionate basis (the importance of which is discussed later in this outline) but the amounts distributed will be received by the trustee. The trustee of the trust held for the benefit of the family member to whom a distribution should be made, can distribute such amount to the beneficiary. The trustees of the other trusts can hold such distributed amounts in the trust for the benefit of those family members.

(2) Income Tax Consequences on Creation

(a) To create a Family Limited Partnership, certain assets are transferred to the Limited Partnership in exchange for all of the general and limited partner interests. Generally, there will be no income tax consequences upon the initial transfer as the donor will simply be receiving “basis” in his or her partner interests equal to the basis of the property transferred into the Family Limited Partnership. Nonetheless, the transfer of the property to the entity may be subject to local transfer and recordation taxes.

(b) If the donor transfers encumbered real estate into the Family Limited Partnership, the transfer may result in gain recognition by the donor because the donor will be deemed to have received a cash distribution to the extent of the liabilities from which the donor is considered relieved. This occurs because, if there are other partners in the partnership, the donor will be relieved of some portion of liability and will recognize gain to the extent that the amount from which the donor is relieved exceeds his or her basis in the property.
The following are some planning techniques designed to avoid the gain recognition that results when encumbered real estate is transferred to a Family Limited Partnership and, subsequently, limited partner interests are transferred to family members:

   (i) Have the donor personally guarantee the debt or indemnify the Partnership, to ensure there is no reduction in the donor’s liability upon the transfer.  

   (ii) Increase the donor’s basis prior to transferring the real estate to the Partnership.  

   (iii) Make capital improvements to the real estate.  

   (iv) Shift the debt security from the real estate that will be transferred to the Partnership to another parcel of real estate or other assets owned by the donor.  

   (v) Reduce the amount of the debt prior to transferring the real estate to the Partnership.  

   (d) Negative capital account.  

   (i) If the donor transfers a direct or indirect interest in property in which he or she has a negative capital account (as a result of prior years’ depreciation deductions taken with respect to such property or a financing or refinancing in which dollars were placed in his or her pocket) to a Family Limited Partnership and subsequently transfers a limited partner interest to a family member, such a transfer may trigger the recognition of gain to the extent of the donor’s negative capital account, as a deemed distribution under Section 752(b).  

   (ii) If the donor transfers a limited partner interest to his or her spouse, gain may not be recognized under the provisions of Section 1041(a). If it is possible for the donor, as general partner, to retain his or her partnership liabilities while gifting (in the form of limited partner interests) limited partner interests to family members, the provisions of Section 752(b) may not be triggered.  

   (e) Section 704(e)  

   (i) In forming a family limited partnership where capital is a material income-producing factor, one must be sure to comply with the provisions of Section 704(e). Specifically, (1) the donee partner must include the distributive
share of the partnership in his or her taxable income, and (2) there must be an allowance for reasonable compensation for any services rendered to the partnership by the donor.

(ii) The final "check-the-box" regulations allow taxpayers to elect, through a check-off system, income tax treatment as a partnership or an association taxable as a corporation. Thus, the conflict that once existed between the need to satisfy certain entity characteristics in order to qualify for partnership status and the attendant risk of doing so for estate and gift tax purposes has largely disappeared.

C. Use of Limited Liability Companies

Under most state statutes, a LLC may have one or more members who are responsible for the management of the entity, similar to a general partner, and the remaining members have limited rights similar to limited partners. LLCs generally have the same characteristics for income classification purposes that limited partnerships have—namely, restricted transferability and no continuity of life.

1. A disadvantage to using a LLC is the lack of case law with regard to creditor rights against a debtor’s limited liability company interest.

2. Advantages:
   a. A LLC is much easier to form than is a FLP.
   b. No member will be liable on the entity’s obligations, unlike a limited partnership wherein the general partner has liability. Even if the general partner is a limited liability company or an S corporation, the general partner-entity’s assets (which may be general partner interests in several limited partnerships) will be subject to these liabilities, even though there is no personal liability on the part of any partner.
   c. Another advantage of a LLC is that its members can actively participate in the entity’s management, whereas the limited partners of a limited partnership risk exposure to liability if they become actively involved in the management of the limited partnership.

V. VALUATION ISSUES ARISING FROM ENTITY OWNERSHIP

A. Valuation of Real Estate

In order to plan effectively for lifetime or testamentary transfers of real property, it will be necessary to ascertain its value. Unfortunately, valuation of real estate is a highly specialized area, and valuation of the property may be difficult.

1. Fair Market Value: Highest and Best Use
   a. There is no statute specifically dealing with the valuation of real estate. The Regulations apply the fair market value approach. The Service interprets fair
market value as the highest and best use of the property being valued on the valuation date. Thus, the value of a decedent's real property is the amount that would be paid by a willing buyer to a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts, and such value is generally based on the "highest and best use" to which the property could be put.\textsuperscript{102}

b. The highest and best use of the property is not based on the use to which the property is actually put at the time of valuation in the estate, but on that use to which the property could be put in order to produce its greatest return or benefits.\textsuperscript{103} The value of the property may be reduced for the costs of cleaning environmentally contaminated property; however, a discount for speculative environmental concerns may not be permitted unless the taxpayer can demonstrate that a potential buyer would have perceived the condition of the property as an environmental problem as of the date of the decedent's death.\textsuperscript{104}

c. Notwithstanding the foregoing, when property is sold within a reasonable time after death to disinterested third parties, the Service will ordinarily value the property at the sale price.\textsuperscript{105} However, if the later sale price reflects factors which were not present at the time of decedent’s death, the sale price may not properly reflect the date of death value of the property. Conversely, if the person buying the property is a relative or a close friend, the sale price probably will not establish fair market value.

d. The Service is likely to be persuaded by comparable sales or sales of similar property in the immediate neighborhood. However, obtaining comparables may be difficult since substantially identical buildings in large cities may vary greatly in value because of their specific locations or other factors, such as occupancy, the presence or absence of asbestos, availability of indoor parking and the like.

e. Under Reg. §20.2031-(b), property is not to be valued at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. The effect of the assessed value of real property varies from jurisdiction to jurisdiction. In some areas, assessed value represents fair market value; in others, assessed value is not at all related to the fair market value of the property.

f. Most often, in order to determine the highest and best use of the property, one of the three following general methods of appraisal is to be considered:\textsuperscript{106}

(1) Comparable Sales Approach:

The comparable sales approach is based on recent arms'-length sales of the same property or of properties which exhibit characteristics most similar to the property being sold.\textsuperscript{107} The comparability of property with other properties must focus on such factors as location, including proximity to schools, churches, transportation and amenities; financing terms; conditions of sales; configuration, topographic features and total area; restrictions on land use and zoning; road frontage and accessibility; available utilities and water rights; soil characteristics; mineral rights; riparian rights; and existing easements, covenants, rights of way, leases and other encumbrances in the land.\textsuperscript{108}
(2) Capitalization of Rental Income:

Rental real estate can be valued by capitalizing rental income. Under this method, the average annual income which may be derived from the property is determined, and then such income is capitalized by dividing it over its holding period by a selected capitalization rate. In determining such income, full occupancy is assumed at the highest sustainable rental, but the normal vacancy rate is subtracted, and expenses are adjusted to eliminate nonrecurring and extraordinary items. Moreover, depreciation and interest are generally factored in, although the Service may take issue with the same. The capitalization of such income involves two components, one of which is the interest rate, or return on investment, and the second of which is the recapture rate, or return necessary to recover the investment. The interest rate component must include considerations of the current interest rates on riskless forms of investment (such as savings accounts, money market certificiates and the like), the lack of liquidity in real estate and the probability of increases or decreases in the income stream from the property over a period of time. The recapture rate component is calculated in many respects like a bond repayment, in that there may be assumed: (1) a sinking fund method (annual payments, invested yearly at compound interest, producing repayment in full over the property’s estimated life), (2) a straight line method (level annual payments over the property’s estimated life), or (3) the annuity method (annual payments repaying principal, while paying an annual return on invested capital).

(3) Cost of Reproduction or Replacement:

This method is used relatively infrequently. It is most common where the property is of a unique or special purpose or is of a new or experimental type of construction as to which no market truly exists. This method has been utilized to set an upper limit on valuation on the theory that a user would not pay more for the property than the cost of reproduction or replacement thereof. This method starts with the estimation of the replacement cost of the structure or improvements, generally by calculating the per square foot costs, and then subtracts depreciation and obsolescence therefore. The discounted cash flow method is not generally used in the estate and gift tax area. This method looks at the value of the property by considering its cash flow and resale over its holding period and discounting to present value.

2. Dispute of Taxpayer’s Valuation by the Service

Particularly where assets are difficult to value, it is likely that the Service will dispute the value assigned to property for gift or estate tax purposes. If the Service does dispute such a value and makes its own determination thereof, the donor of the gift or the personal representative of the decedent’s estate may require the Service to show how its value was derived. The Service must furnish a written statement within 45 days of a written request therefor setting forth (1) the basis upon which its appraisal was determined, (2) any computation(s) made in such determination, and (3) a copy of any expert appraisal. The statement is for the purpose of providing full information to the parties involved, and it is not binding on the Service.
Courts adjudicating value will look at both parties’ appraisals and the methods used in the appraisals. The factors taken into consideration when reviewing the appraisals include the appraiser’s familiarity with the property and the appraiser’s qualifications. As a result, if a valuation dispute does reach litigation, it will often be resolved based on which appraiser is the most credible in his or her analysis.

4. Undervaluation Penalties

In addition to concern about whether the Service may dispute the taxpayer’s valuation, there is the possible exposure to penalties for undervaluing property for gift or estate tax purposes. The accuracy-related penalty rules of Section 6662 apply to estate and gift tax returns filed after December 31, 1989. The penalty is equal to 20% of any underpayment related to a substantial estate or gift tax valuation understatement if (i) the value of any property claimed on an estate or gift tax return is 50% or less of the amount determined to be correct and (ii) the amount of the underpayment exceeds $5,000. If the portion of the underpayment that is subject to this penalty is attributable to one or more gross valuation misstatements, the penalty increases to 40%. A gross valuation misstatement occurs if the asset value claimed on an estate or gift tax return is 25% or less of the value ultimately determined to be the correct value for such asset.

All property interests, not just real property, are subject to the penalty provisions of Section 6662. Nonetheless, taxpayers wishing to utilize real estate investments in their estate planning should not be unduly discouraged by problems of valuation and the potential penalty for incorrect valuation. The Service makes allowances for the fact that, in the gift and estate tax area, valuation problems are not uncommon. The penalty provisions are meant to target those who abuse the system by reporting unjustifiably low values.

B. Discounts and Premium Adjustments to Valuation

There are many discounts and possible premiums that can be imposed when valuing an asset (or an interest in an asset), whether held in an entity or not. Although these discounts are generally considered as one discount, they should be addressed separately.

1. Discounts that Recognize the Time and Expense of a Partition

When real estate is owned by two or more owners and is not subject to any agreement between the owners, any owner can force the sale of the real estate by petitioning a court for a partition of the real estate so that the court will force the sale of the real estate and the owners will receive a share of the proceeds. The risk and difficulties as well as the time and expense of such a partition suit, in order to sell an owner’s interest, has been recognized by the courts as a reduction in the value of the interest. However, in the past the Service has refused to recognize the Courts’ decisions. Recently, the Fifth Circuit awarded attorney's fees against the Service for continuing to take this position and the Service will probably begin to accept the valuation discounts in these situations, at least for taxpayers who own real estate in the applicable Circuits.
2. Minority Interest Discount

This discount reflects the minority owner’s lack of control in the entity. As a result of the lack of control or voting power, the owner has no ability to influence the entity’s future (i.e., the management of the entity or the liquidation or merger of the entity) or the future of the owner’s investment (i.e., control the payment of dividends or make cash distributions).125/

3. Lack of Marketability Discount

This discount reflects the inability or limited ability of the owner to liquidate his or her investment, either because of timing restrictions or because the resultant liquidation value will not be fair market value. This discount, unless limited by the valuation rules of Chapter 14, as discussed below, should logically be available to all closely held business owners who are under restrictions on the disposition of their ownership interests, regardless of their percentage ownership in the entity.126/

4. Blockage Discount

a. This discount is based on the theory that, if the owner’s entire holding in the asset were to be placed on the market at once, the availability of so much of the asset will drive down the value of the asset. Although the Regulations state that this discount is available only in “exceptional cases”, in recent Tax Court Memoranda the Court concluded that blockage discounts ranging from 3.3% to 6.2% were appropriate.127/

b. Most recently, a blockage discount was allowed for unimproved real estate held in a land development company.128/ The Tax Court agreed that the properties could not be sold all at once without depressing the market and, hence, a blockage discount was appropriate.

5. Built-in Gain Discount

Recent cases in the Tax Court and the Second Circuit have held that a reduction in the value of gifted stock to reflect unrealized capital gains inherent in the underlying assets was appropriate.129/

a. In a case decided in the Sixth Circuit, involving two corporations holding real estate, the Court held that a discount for the built-in capital gains tax on the real estate was appropriate,130/ despite the Service and the Tax Court disallowing the discount in light of the corporation’s ability to defer the recognition of the gain indefinitely under Section 1031.
b. The Tax Court recently held that the built-in gain discount would not be available in valuing interests in a partnership holding real estate, but did not dismiss such a discount for all partnerships. The Court distinguished a C corporation, where the discount was allowed even though the corporation could convert to an S corporation and avoid recognition of gains on assets retained for ten years, from a partnership because the consequences of a decision so to convert and the ten year period made the avoidance of recognition problematical in a corporation. On the other hand, in the case of a partnership, in which a Section 754 election would avoid the recognition of gain immediately thereafter, there was no reason to expect that the partnership would not make such election. However, if the Section 754 election is not in effect and the taxpayer has no means by which to require the partnership to make the Section 754 election, the built-in gain discount may be available.

c. The Tax Court has also held recently in a case involving a C corporation, that in determining the size of the discount, the likelihood of liquidation and when it will take place must be taken into account. If the liquidation is unlikely or will not take place for several years this discount will be reduced.

6. Control Premium

a. Instead of discounting the value of the gift (or the interest in the estate), it is possible that the interest in the entity will be valued at a premium to reflect the control the entity owner has over the entity. This type of premium will generally be imposed on the value of a partner’s general partner interest or the value of a majority shareholder’s stock in a closely held corporation. The Tax Court has held that such a premium will arise only when the entity owner has full and absolute control over the entity.

b. In the past, the Tax Court imposed a premium on voting stock equal to 3% of the entire value of the company, not, as many appraisers have held, a percentage of the value of the voting shares themselves. Although the decedent’s number of shares of voting stock was not large enough to give the decedent voting control, the Court held that a premium was appropriate because of the decedent’s voting privileges. This decision has been overturned.

c. The Tax Court has also held recently in a case involving a C corporation, that in determining the size of the discount, the likelihood of liquidation and when it will take place must be taken into account. If the liquidation is unlikely or will not take place for several years, this discount will be reduced.

7. Swing Vote Premium

Another Service argument is that a minority interest, when combined with other ownership interests in the entity, may actually have enhanced value because such interest represents the “swing vote” as to the entity and its assets.

8. Basis for Discount in Value
a. The discounts (and premiums) are imposed to reflect the true fair market value of an interest, in light of what a willing buyer and a willing seller would pay, when considering the restrictions imposed on such interest.

b. Even if the donor owns 100% of the entity, a discount will be allowed in valuing gifted interests in the entity because the value of the gift, for gift tax purposes, is based on the interest transferred, rather than on what the donor held immediately prior to the gift. For estate tax purposes, the value of the estate is based on what the decedent owned at the time of his or her death, rather than what the beneficiaries of the estate will receive.

c. In fact, the Service has accepted the discounts in determining fair market value and used these discounts to reduce the value of property passing under the marital deduction. For purposes of deductions taken against income, gift, estate or generation skipping transfer taxes, the value of the property giving rise to the deduction is based on the interest transferred, rather than what the donor or decedent held either immediately prior to the gift or at the time of his or her death. For example, in one Letter Ruling, the decedent owned all of the stock, but only a minority interest passed under the marital bequest. The difference between 100% of the value of the stock includable in the taxable estate and the discounted value of the minority interest passing under the marital deduction was, to the extent it exceeded the decedent’s available unified credit, subject to estate taxes.

C. Exception to Valuation Adjustments for Purposes of Gift and Estate Tax

1. Certain Lapsing Rights under Section 2704(a)

Section 2704(a) treats a lapse of voting or liquidation rights in certain family partnerships as a transfer of property for estate and gift tax purposes. The partnership must be one where the individual holding such right immediately before the lapse and members of such individual’s family hold, both before and after the lapse, control of the partnership.

a. The value of the property being transferred will be equal to the difference in value of all of the individual’s interest in the partnership before the lapse (determined as if the voting and liquidation rights were non-lapsing) and the value of such interests after the lapse.

b. The donee of such transfer is not identified in Section 2704(a), therefore making it very hard to claim a marital deduction, charitable deduction or even allocate generation-skipping transfer tax exemptions to the transfer.

2. Applicable Restrictions under Section 2704(b)

a. Section 2704(b) may cause the value of any transferred interests to be based on the value of the entity without regard to any restrictions contained in the entity’s agreement, depending on state law and the entity used. If stock in a corporation or an interest in a partnership or other entity is transferred to or for the benefit of a member of the transferor’s family, and if, immediately before the transfer, the donor and the members of the donor’s family controlled the entity and, after the transfer, the transferor’s family can remove the restriction,
then any “applicable restriction” will be disregarded in determining the value of the transferred interest.

b. Under Section 2704(b)(1), an “applicable restriction” is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than under state law. If such a restriction exists, it is ignored for purposes of valuation and the state law restrictions are used to determine the value. In the past, the Service has held that any restriction in the entity agreements is ignored if more onerous than what state law provides. Recently, the Tax Court has restricted the application of Section 2704(b) to only those restrictions on liquidation rights. As a result, all other restrictions that are not restrictions on liquidation rights, even if more onerous than what is set forth under state law, can be considered for purposes of valuating the interests in the entity.

(1) For example, the Service’s position under many states’ Revised Uniform Limited Partnership Acts is that any limited partner may withdraw from the partnership and receive “fair value” for his or her partnership interest unless a term of years for the partnership has been included in the agreement. As a result of this provision under the state statute, if the term of years included in the agreement is considered an “applicable restriction”, the value of a gift of a limited partner interest must take into account, under Section 2704(b), the limited partner’s right to withdraw upon six months’ notice and receive fair value for his or her interest, regardless of the actual restrictions on the limited partner’s ability to withdraw under the partnership agreement. The Tax Court has held that the right of withdrawal subject to a term of years is not a liquidation right so that particular provision granting these rights upon withdrawal under state law may be ignored for purposes of Section 2704(b).

(2) With respect to a limited liability company (“LLC”), if state law provides that, upon the death of a member, in the absence of an operating agreement, there must be unanimous consent by the remaining members to continue the limited liability company, then the likelihood that the limited liability company will dissolve upon the death of one of the members is very high. As a result, under the Tax Court’s holdings, despite any provisions to the contrary in the operating agreement (such as the LLC will be continued upon the consent of 51% of the members, thereby making dissolution upon the death of any one member less likely), under such state law, since the likelihood that the members’ ability to liquidate the entity and reach the limited liability company’s underlying property will be high, the lack of marketability discount used to value the gift of such an interest for gift tax purposes will be reduced pursuant to Section 2704(b) since the actual provisions of the agreement will be ignored for purposes of valuation under this Section. The Fifth Circuit just opened the door for more debate on this topic, however, reversing the Tax Court and rejecting the Service’s position by holding that the only restrictions which are limited by Section 2704(b) are restrictions on the ability to liquidate the entity.

3. Certain Rights and Restrictions Disregarded under Section 2703

The Service has attacked valuation discounts at the audit level under Section 2703 (discussed below in the context of buy-sell agreements) by attacking the partnership (or LLC) agreement (in which are provided the restrictions that give rise to discounts) as a device to transfer assets to family members for less than full and adequate
The Tax Court has rejected the Section 2703 argument, although the Service continues to advance it.\textsuperscript{143}

Buy-sell arrangements generally serve two purposes in the estate and gift tax area -- they can reduce the value of the gift by placing restrictions on the property gifted to the donor, and such arrangements, if structured properly, can fix the value of the asset for estate tax purposes.

a. If assets either held in an estate or gifted are subject to an agreement under which the rights of the owner are restricted, then, for gift tax purposes, assuming that this type of agreement meets certain requirements, the restrictions can be taken into account for purposes of valuing the gifted asset. For estate tax purposes, if the agreement set out a formula to establish the price of the stock upon death and met other requirements, the price established in the agreement could be determinative of the value of the asset.

b. Section 2703 controls the valuation of transferred assets subject to rights or restrictions for gift and estate tax purposes. As a general rule, the value of property is determined without regard to (i) any option, agreement or other right to acquire or use the property at a price less than fair market value or (ii) any restriction on the right to sell or use the property when family members own 50\% or more of the entity.\textsuperscript{146} If certain requirements are met, however, Section 2703 does not apply and the restrictions can be taken into account for valuation purposes. To fall within the exception, the right or restriction must satisfy the following three requirements:

(1) The right or restriction is a bona fide business arrangement;

(2) The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration; and

(3) At the time the right or restriction is created, its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.\textsuperscript{147}

c. These agreements afford the owner of the asset the advantage of certainty when planning for his or her estate tax burden and reduce the value of the asset for estate tax purposes through the choice of the pricing mechanism in the agreement and the restrictions imposed on the owner of the asset under the agreement.

d. Sec. 2703 has affected the goals of certainty in valuation by providing that any restrictions under such an agreement wherein family members own 50\% or more of an entity are to be ignored for purposes of valuation (both for gift tax purposes and estate tax purposes).\textsuperscript{148} Such restrictions are defined, under Reg. §25.2703-1(a)(2), as any option, agreement or other right to acquire or use the property at a price less than the fair market value of the property and any restriction on the right to sell or use such property. The key exception to Sec. 2703 is, under Reg. §25.2703-1(b), an agreement that meets the following requirements:

(1) It must be a \textit{bona fide} business arrangement.
(2) It cannot be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth. For these purposes, factors taken into account are: the expected term of the agreement; the adequacy of consideration given in exchange for the rights granted; the current fair market value of the property; and anticipated changes in the value of the property during the term of the arrangement.

(3) The terms of the agreement must be comparable to similar arrangements entered into by persons in an arms'-length transaction. In order to establish similar arrangements and an arms'-length transaction, under Reg. §25.2703-1(b)(4)(ii), the following should be considered: (i) isolated comparables will not be sufficient; (ii) if two or more valuation methods are commonly used in a business, use of one method should not cause the valuation to fail; (iii) it should not be necessary that terms parallel any particular agreement; (iv) if a business is unique, comparables from similar businesses may be used; and (v) expert testimony likely will be required.

e. These types of agreements, even if they do not meet the requirements of Sec. 2703, are still binding on the parties and on the creditors of any of the parties and, therefore, are still effective for creditor protection purposes. Because the agreements are binding on the parties, the Service may include the asset in the owner's estate at a significantly higher value than that at which the entity or other owners may purchase the asset upon the owner's death; the result of this may be that the estate will receive a price based on one value, while paying estate tax on a higher value. The proceeds of the sale may be insufficient to cover the tax liability, and an unusable capital loss carryforward may be created.

f. If a buy-sell agreement is binding on the parties but not on the Service and stock is sold at less than fair market value, such sale will be characterized as though an indirect transfer occurs with respect to the other owners. If one of those owners is the decedent's spouse, the estate may obtain a marital deduction with respect to the spouse's proportionate share. If, however, the unanticipated excess value of the asset does not pass to a spouse, then it may absorb or exceed the deceased owner's unified credit for estate tax purposes.

g. A buy-sell agreement is often used in the family context to ensure that, upon the death of a family member (or a divorce), the member's ownership interest in the entity does not pass outside the family.

h. A buy-sell agreement may be used to provide the family with the ability to buy out any partner who has creditor claims; it can restrict the ability of any partner to transfer his or her interest, either during his or her lifetime or upon his or her death, outside of the family, even to a spouse; and, if the partner wishes to sell the partnership interest, it can provide a mechanism by which the family can buy the partner's interest prior to it being offered outside of the family.

i. The purpose of maintaining family control and protecting against creditors should be considered a valid purpose for the buy-sell agreement for Federal estate and gift tax purposes; however, in light of recent case law, such an agreement between family
members will probably not succeed to fix the values of the assets subject to a buy-sell agreement for estate tax purposes.\textsuperscript{133/}

\section*{D. Exception to Valuation Adjustments for Purposes of Estate Tax: Retention of Interest in Gifted Property}

1. A gift can be a completed gift; but, if the donor has retained or holds at the time of his or her death control or enjoyment over the gifted asset, such control or enjoyment will bring the asset within the ambit of Sections 2036 or 2038,\textsuperscript{154/} in which case, despite the completion of the gift (and the possible payment of gift taxes), it is includable in the donor’s taxable estate (although any unified credit utilized at the time of the gift or any gift taxes paid will be credited against the estate tax that arises as a result of the inclusion of the gifted property in the donor’s estate).

   a. If this occurs, the donor has lost the use of the funds (or assets) used to make the gift and pay the gift tax, if any, but has not achieved any of the benefits discussed above of making a gift, rather than a bequest, since the property is includable in the donor’s taxable estate upon his or her death.

   b. Furthermore, if property is includable in the decedent’s taxable estate under Sections 2036 and/or 2038, it is not the value of the right or interest held by the decedent that is includable in the estate, but the value of the property (determined as of the date of the decedent’s death, or alternative valuation date, as the case may be) over which such interest or power is held that is includable in the estate.\textsuperscript{155/}

   c. The intent behind Sections 2036 and 2038 is that estate tax should be imposed on property that was given away by a decedent during his or her lifetime when the decedent:

      (1) retained the economic benefit of the property (Sections 2036(a)(1) and 2036(b));

      (2) made what is essentially a testamentary transfer because possession and enjoyment is deferred until the decedent’s death (Sections 2036(a)(2) and 2038); or

      (3) reserved significant powers over the possession and enjoyment of the property (Sections 2036(a)(2) and 2038).

   d. The gift can be found to have occurred at two times, at the outset when assets are transferred to the entity and when entity interest are transferred to donees.

   e. This is an essential exception to Code Sections 2036 and 2038; namely, they do not apply if the transfer was made for bona fide, adequate and full consideration.

2. In the early 2000s, the Service began successfully challenging Family Limited Partnerships at the ownership level on the basis of Section 2036(a).\textsuperscript{156/} A challenge to
Family Limited Partnerships under Section 2036(a) will be successful if it can be found that the decedent either (1) had possession or enjoyment of, or the right to the income from, the transferred property, or (2) had the right, either alone or in conjunction with another, to designate the persons who shall possess or enjoy the property or the income therefrom.

a. Express or Implied Understanding

Most cases have centered around the finding of an “express or implied understanding” between the decedent and his or her family that partnership assets would be available to the decedent as needed.

If such an agreement is found to exist, the decedent is deemed to have retained sufficient enjoyment of the transferred property to cause it to be included in his or her estate under Section 2036(a)(1).157

The finding of an implied agreement depends on the facts and circumstances at the time of or after the transfer. The cases the government won had some or all of the following “bad facts” in common:

1. Decedent transferred almost all of his or her assets to the partnership.
2. Decedent continued to occupy transferred property without paying rent.158
3. Decedent commingled partnership and personal assets.
4. Decedent distributed or used partnership assets in accordance with personal needs.
5. Distributions were made to the limited partners on a non-pro rata basis, contrary to the terms of the partnership agreement.
6. Decedent transferred assets to the partnership in anticipation of his or her impending death.
7. There was no non-tax reason for the partnership; in other words, it lacked a business purpose.

b. Beneficial Enjoyment

Recently, the Service has successfully challenged family limited partnerships by arguing the decedent retained Section 2036(a)(2) control over the beneficial enjoyment of the assets transferred to the entity.

Previously, taxpayers and the Service alike recognized that United States v. Byrum159 served as a protective shield against Section 2036(a)(2) claims.160
Despite the Service's past acknowledgment of Byrum, the government recently challenged transfers to family limited partnerships on Section 2036(a)(2) grounds in two cases, Kimbell Sr. v. United States and Strangi v. Commissioner. Both cases had facts that weighed in the government's favor. Nonetheless, Kimbell was recently reversed by the Fifth Circuit, indicating that the taxpayer may once again be able to rely on the safe harbor of Byrum.

In both Kimbell and Strangi, not only did the courts reject the discounts claimed by the decedents' estates in valuing the limited partner interests, but also they included the date of death values of all the property initially transferred to the partnership in the decedents' estates. Presumably, if the decedents had transferred partnership interests to family members prior to death, those transferred interests would also have been included in the decedents' estates with no discounts.

To protect against inclusion of the partnership assets in the donor's estate, the donor should refrain from serving as general partner or controlling the partnership in any capacity. If the donor does not wish to give up control of the partnership, the following precautions should be considered:

(1) Fiduciary duties should be affirmed in the partnership agreement.

(2) Partners should act consistently with the partnership agreement.

(3) Capital accounts must be respected, under the agreement and in practice.

(4) The distribution power of the manager or general partner, if a donor, should be held by someone other than the donor and, at the very least, should be limited to an ascertainable standard; for example, the partnership agreement could require that all net earnings (or at least enough to cover Federal, state and local income taxes, at an assumed aggregate rate) be distributed currently and on a proportionate basis.

(5) Other family members or unrelated persons should be able to purchase limited partner interests. In the alternative, the donor could gift significant limited partner and/or general partner interests to family members or charitable organizations after creating the partnership.

c. Drafting the Partnership Agreement.

In drafting the partnership agreement, the taxpayer should be mindful of how many estate and gift tax provisions can be implicated by the following partnership characteristics.

(1) If the donor/general partner takes a salary for managing the Family Limited Partnership, the salary should not be keyed to the actual income produced by the
property and it should meet the standard for the industry and not be considered "disproportionate," or inclusion of the gifted partnership interests in the donor's estate under Section 2036 may be raised at the donor's death.

(2) Stock in a closely held corporation owned by the general partner which is transferred to the Family Limited Partnership clearly may cause a Section 2036(b) (retained voting rights) problem.

(3) For nontax reasons, restrictions on transfers are usually imposed in Family Limited Partnership agreements, so this test should not create a problem. Such restrictions likewise should not be an issue under Sections 2036 or 2038 so long as state law allows the transfer of a beneficial interest in the limited partner interest as an assignee, because the donor/general partner does not retain any power to alter the beneficial interest of the donee/limited partner. In order to protect the entity and the other owners, admittance of the assignee to the entity as a limited partner or member, to whom the general partner or manager owes fiduciary duties should only be permitted on the consent of the general partner or manager.

(4) It is not desirable that consent of all partners be required for continuation of the partnership, because the greater the limited partner's ability to get to the underlying property, the smaller the size of the lack of marketability discount available when valuing the gifts of the limited partner interests.

(5) Another issue in Family Limited Partnerships is the shift of income away from the limited partner under the terms of the partnership agreement. Although such income shifting is allowable within the confines of Section 704, an attempt to do so in a Family Limited Partnership context wherein the donor gifts limited partner interests and remains the general partner will run afoul of Section 2036(a). The Service has ruled that, if the donor retains the income of the limited partnership, the value of the entire partnership will be includable in the donor's estate. In this situation, the donor had structured the partnership so as to pull out all of the income in the form of either salary or a disproportionate distributive share. The Tax Court has not agreed with the Service. The safest type of income allocation is a straight pro rata distribution of income based on percentage interests in the partnership, although, as previously noted, reasonable compensation for the general partner who or which manages the partnership property may be desirable-or even necessary.

(6) In Section 2036(a)(2), an issue arises if the donor retains control over the beneficial enjoyment of the transferred property; which in this context means the right to determine the timing of distributions and liquidations (assuming the agreement requires proportionate distributions and liquidations are made pursuant to capital accounts, once the general partner/manager makes the decision to distribute or liquidate). Consideration should be given to creating two classes of general partner/manager. One of which holds this discretion and the donor is not an owner or member of this class. The donor could act as the second class of general partner/manager, who holds all other powers.
VI. REDUCTION IN VALUATION THROUGH RETAINED INTERESTS

A. Gifts of Trust Interests

1. General Rules

a. If real property (or an interest in real property) is placed into a trust for the benefit of one or more persons and the transferor does not retain any interest in the trust, the value of the gift will be the value of the property (or entity interest) passing to the Trust.

b. However, if the donor is a trust beneficiary who retains the right to the income of the trust for a term of years, then the special valuation rules for estate and gift tax purposes set forth in Section 2702 of the Code may apply.

c. Section 2702

The special valuation rules of Section 2702 state that, if the trust interest which is retained does not satisfy strict pay-out requirements defined in the Section, then such retained interest is not to be valued under the normal valuation rules of Section 7520 and the Regulations under Section 664, but, rather, is valued under the rules of Section 2702, the result of which is that the retained interest is valued at zero.168/ Prior to the enactment of Section 2702, making such a transfer into trust and retaining a right in the trust income provided a means through which a donor could reduce the gift tax cost of transferring property to a donee.

1. A reduction in the gift tax cost was achieved because, although the donor transferred the entire asset to the trust, as a result of the retained income interest the donor made a gift of only the remainder interest to the asset, so that only that interest would be subject to gift tax.

2. The value of such remainder interest would be the value of the asset transferred to the trust, minus the value of the retained term interest, which was determined by reference to actuarial tables published by the Service. Thus, although the donee received the asset at the end of the stated term, including any appreciation on the asset that occurred after the date the trust was funded, the donor’s gift tax burden or charge against his or her unified credit was based on only a portion (the remainder interest) of the asset.

3. In order for such a gift to succeed, the donor had to survive the retained term interest. If the donor died during the term, he or she was treated as having transferred the asset while retaining an income interest therein. This resulted in the full value of the asset being included in his or her estate under Section 2036(a).

a. If there was inclusion in the estate and if any of the donor’s unified credit was used at the time of the creation of the trust, such amount of the unified credit would be restored to the grantor’s estate.
If there was inclusion in the estate and any gift tax was paid, such tax would be credited against the estate tax payable, if any, as a result of the inclusion of the asset in the donor’s estate.

2. There are several exceptions to the valuation rule of Section 2702. If the transaction fits within one of these exceptions, then the Service’s tables can be used to value the term interest, with such value subtracted from the value of the property for purposes of the gift tax determination. For example, an exception exists if the remainder interest of the trust is held by individuals other than the “members of the family” of the donor. The definition of “members of the family” includes, for purposes of this exception, the grantor’s spouse, any ancestor or lineal descendant of the grantor or the grantor’s spouse, any brother or sister of the grantor and the spouse of any such described individual.169/6

B. GRATS AND GRUTS

1. Grantor Retained Annuity Trusts and Grantor Retained Unitrusts are two types of trust with retained interests that are qualified interests under section 2702.

   a. A Grantor Retained Annuity Trust (“GRAT”) and a Grantor Retained Unitrust (“GRUT”) are irrevocable trusts.

   b. Each type of trust is established for a fixed term of years and the donor/grantor retains an income right. The income right in a GRAT or a GRUT is a stated amount paid to the donor/grantor each year during the term of the trust. Upon the termination of such trust, the trust fund, which would include any income earned during the trust term that exceeded the stated amount payable to the donor/grantor, is payable to the remainderman.

   c. The difference between a GRAT and a GRUT is based on the determination of the stated amount paid to the donor/grantor, both of which fall within the definition of a qualified interest for purposes of section 2702.

      (1) In a GRAT, the income interest is a fixed sum of dollars determined at the outset of the trust, which is payable each year.

      (2) In a GRUT, the donor/grantor receives an amount equal to a fixed percentage of the fair market value of the trust. The percentage is fixed at the time the GRUT is created; however, the fair market value of the GRUT, on which the percentage is based, is determined each year.

      (3) It is possible to structure the payments under a GRAT to increase as the term continues, although the increase is limited to providing a lower payout at the beginning of the trust recognizes that certain property will not produce the same amount of income in early years as in later years.

   d. Choosing a higher annuity will increase the present value of the donor/grantor’s income interest to a point that the remainder interest (and hence the gift) is worth nothing. Prior to 2003, the Service took the position that GRATs could not be zeroed out, and
the regulations dealing with GRATs and the new regulations dealing with the valuing annuities under §7250 also took this position. In Notice 2003-72, the Service acquiesced to the Tax Court's decision in *Walton v. Commissioner*, which allows taxpayers to create “zeroed out” GRATs, and recently the Service issued new regulations that permit such GRATs.  

e. A GRAT or GRUT will be considered a grantor trust for income tax purposes, so long as the annuity may be paid from income or principal, to the extent income is insufficient. As a result, (i) a GRAT or GRUT is an eligible S corporation shareholder; (ii) all the income is includable in the grantor’s taxable income, whether or not it is paid to him or her; and (iii) any deductible expenses will be deductible by the grantor.

**Example**

60 year old Donor  
Section 7520 is 3.6%  
Value of asset is $1,000,000  
Annual Payout

<table>
<thead>
<tr>
<th>Annuity Amount</th>
<th>Value of Gift</th>
</tr>
</thead>
</table>

**10 year GRAT**

| a. | $50,000 | $586,260 |
| b. | $90,000 | $255,268 |
| c. | $120,848 | -0- |

**8 year GRAT**

| a. | $50,000 | $657,730 |
| b. | $90,000 | $383,914 |
| c. | $146,083 | -0- |

**2 year GRAT**

| a. | $527,148 | -0- |

**10 year GRUT**

| a. | 5% | $632,410 |
| b | 9% | $435,400 |

**8 year GRUT**

| a. | 5% | $687,060 |
| b. | 9% | $504,320 |

f. There are several exceptions to the valuation rule of section 2702. If the transaction fits within one of these exceptions, then the Service’s tables can be used to
value the term interest, even if the donor/grantor retained all of the income for a period of years rather than an annuity or unitrust interest. This value would be subtracted from the value of the property for purposes of the gift tax determination.

C. PRTS AND QPRTS

1. Personal Residence Trusts -- Another exception relates to a trust which holds the personal residence of the holder of the term interest, under section 2702(a)(3)(A)(ii).

   a. The term “personal residence” is defined by the Regulations to be either a residence within the meaning of section 1034 of the Code or one other residence, usually a vacation home, as defined in section 280A(d)(1) (but without regard to section 280A(d)(2)), or a fractional undivided interest in either. The personal residence can also include appurtenant structures and adjacent land used by the term holder for residential purposes and reasonably appropriate for residential purposes.

   b. The term holder, as donor, is limited in the number of personal residence trusts he or she can create. The Regulations state that, if such term holder/grantor already holds term interests in two trusts that are personal residence trusts of which the term holder was the grantor, a third trust will not qualify as a personal residence trust.

   c. A personal residence trust qualifies for the exception from the section 2702(a) valuation rules only if the trust agreement prohibits the trust from holding any asset other than the personal residence of the term holder and “qualified proceeds”.

   d. Qualified proceeds are defined in the Regulations as proceeds payable as a result of damage to or destruction or involuntary conversion of the residence. These qualified proceeds must, however, be reinvested in a personal residence of the term holder within two years from the date the proceeds are received. If the residence is sold or otherwise transferred by the trust, the personal residence trust must terminate.

2. Qualified Personal Residence Trusts -- The Regulations provide a safe harbor in the form of a more flexible personal residence trust called a Qualified Personal Residence Trust (“QPRT”).

   a. Under Reg §25.2702-5(1)(9), the trust agreement must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse at any time during the original retained trust term. In addition, it prohibits such sale or transfer at any time after the original term interest during which the trust is a grantor trust.

   b. Under Reg §25.2702-5(c)(5), the QPRT is permitted to hold other assets, in addition to the personal residence and qualified proceeds, for limited periods of time, and still be eligible for the exception from the section 2702(a) valuation rules.
c. The trust agreement must include language that directs the income of the trust to be distributed to the term holder at least annually, and that assures that principal cannot be distributed to anyone other than the term holder prior to the expiration of the retained term interest.

d. The trust agreement must prohibit the commutation (prepayment) of the term holder’s interest.

e. Under Reg §25.2702-5(c)(5), a QPRT is prohibited from holding any assets other than the personal residence, improvements thereupon, qualified proceeds, policies of insurance on the residence and certain cash additions.

(1) Such cash additions can be made only for the following purposes:

(a) the payment of trust expenses that have been incurred or are reasonably be expected to be incurred within six months of the date the cash addition was made;

(b) improvements to the residence to be paid within six months of the date the cash addition was made;

(c) the purchase of the personal residence within three months of the date the trust is created (the trustee must have entered into a contract to purchase the personal residence prior to such cash addition); and

(d) the replacement of the personal residence with another personal residence (as long as the trustee has entered into a contract to purchase prior to the date the cash addition is made).

(2) The trustee must be required to determine each quarter whether the amounts held in the trust exceed the amounts required for the purposes described above. If the trustee so determines, the excess cash must be distributed to the term holder immediately thereafter.

f. If the QPRT ceases to qualify as such prior to the end of the term holder’s interest, the trust agreement must provide that, within 30 days of such cessation, either the assets must be distributed to the term holder or the trust must be converted to a “qualified annuity” for the remainder of the term holder’s interest. The annuity factor will, under Reg §25.2702-5(c)(8)(C)(2), be determined at the rate used in valuing the retained interest at the time of the original transfer, rather than the time the trust ceased to be a QPRT.

g. If the residence is sold (the Grantor and the Grantor’s spouse cannot buy back the residence), then, unlike the personal residence trust, which would terminate immediately, the QPRT is allowed to hold the sale proceeds until the earlier of:

(1) two years from the date of sale;
(2) the termination of the term holder’s interest in the trust; or
(3) that date on which a new residence is acquired by the trust.

Example

A donor places a residence worth $1,000,000 into a Personal Residence Trust at a time when the section 7520 rate is 3.6%:

<table>
<thead>
<tr>
<th>Terms of the Trust</th>
<th>Value of Gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. If the donor is 75 years old and retains the right to use the residence for 3 years:</td>
<td>$784,110</td>
</tr>
<tr>
<td>B. If the donor is 75 years old and retains the right to use the residence for 5 years:</td>
<td>$652,660</td>
</tr>
<tr>
<td>C. If the 75 year old donor is married to a 65 year old spouse and the residence is divided in half, with each spouse owning one-half:</td>
<td></td>
</tr>
<tr>
<td>1. 75 year old donor transfers his one-half interest in the house to the trust at a value of $450,000 ($500,000 discounted for estimated cost of partition [10%]) and retains the right to use his half for 5 years:</td>
<td>$293,696</td>
</tr>
<tr>
<td>2. 65 year old donor transfers her one-half interest in the house to the trust at a value of $450,000 ($500,000 discounted for estimated cost of partition [10%]) and retains the right to use her half for 15 years:</td>
<td>$156,752</td>
</tr>
<tr>
<td>Total gift for gift tax purposes</td>
<td>$450,448</td>
</tr>
</tbody>
</table>

Revenue Procedure 2003-42 provides a sample declaration of trust for a QPRT. The Service will recognize a trust as a QPRT meeting all the requirements of Section 2702(a)(3)(A) and Regulation § 25.2702-5(c) first, if the trust instrument is substantially similar to the sample in the revenue procedure; and, second, if the trust operates in a manner consistent with the terms of the trust instrument.

VII. FREEZING VALUES FOR ESTATE TAX PURPOSES

A. Intrafamily Sales of Property

The primary goal (and hence advantage) of the intrafamily sale is that such a sale “freezes” the value of the asset being sold at its then value, and removes future appreciation in
such asset from the seller’s estate. In the absence of some disqualifying factor, there is no gift or estate tax on the post-sale appreciation. There may well be income tax payable by the seller; nonetheless, assuming long-term capital gains treatment, the income tax rate will not be greater than 28 percent, whereas the estate tax rate, which would be applied against the property itself as well as those dollars which would have been used to pay the income tax, may be as high as 45 to 49 percent.

1. Assuming that the sale is made at current value, there should be no gift element, or gift tax payable, with respect to the transaction. Furthermore, the discounts discussed above for gift tax purposes, are discounts that recognize the true fair market value of the property that is gifted. Therefore, the same discounts would be applicable when determining the sale price of the asset since the sale amount should be equal to the true fair market value of the property that is being sold to the buyer.

2. The purchaser’s basis in the purchased property will be the amount paid to acquire the same. This may be significantly less than the value of the property at the time of the seller’s death (which would become the property’s basis if the recipient received the property from the seller’s estate). However, one must not overstate the benefit of this basis adjustment on death inasmuch as this appreciation can be taxed at rates up to 45 to 49 percent if included in the seller’s estate, as compared with 28 percent if and when the property is sold by the purchaser.

3. An intrafamily sale may have the added advantage of providing needed liquidity to the seller. Consider the situation where an older generation taxpayer has been acquiring real property throughout his or her lifetime, always anticipating that the income generated by such property would provide sufficient income throughout such person’s “retirement”. Due to the general state of the economy, the real property cannot generate the once anticipated income. This situation is further complicated because there is no market for the property. Assuming that future appreciation is anticipated (once the economy turns around), then, through selling the property to one’s family members, the seller benefits by receiving cash to live on, and the purchaser benefits because the property may be purchased at a price which, it is anticipated, is less than the expected future value of the property.

4. Further, and importantly, on the non-tax side, an intrafamily sale offers the opportunity to retain the asset in one’s family.

5. Finally, a sale transaction allows the family to move assets to younger generations even when the gift tax, if a gift of the same asset had been made, would have been prohibitive, or, in the case of transfers to grandchildren, the generation skipping transfer tax exemption has been fully utilized and any further gifts to would incur not only a gift tax but a generation skipping transfer tax as well.

6. Note Freeze

   a. A donor may sell the fee interest in the real property to a donee in exchange for notes from the donee that have a value equal to the excess of the value of the transferred property over the amount of the allowable annual exclusion for the current year. In
successive years, the donor may forgive an amount of the notes equal to the annual exclusion, so long as there is no pre-existing agreement to do so, as discussed immediately below. Of course, the forgiveness of the notes may trigger recognition of gain by the donor under the installment sales rules. The value of the balance of the note as of the decedent’s date of death will be includable in the donor’s estate under Section 2031.

b. The amount of a gift is the value of the property transferred reduced by the value of notes or consideration received in exchange by the donor.\textsuperscript{171} For income tax purposes, the transfer of property in exchange for a note would be treated as a sale to the extent of the consideration received.

c. A promissory note given to the transferor by the donee may not be recognized by the Service as consideration if it is systematically forgiven in annual increments equal to the annual gift tax exclusion. The Service may argue that the notes must be disregarded ab initio, so that the transfer is treated when made as a gift of the entire value of the property. That result must follow, according to the Service, if the transferor intended from the outset to forgive the notes that he or she received.\textsuperscript{172}

\begin{enumerate}
\item The issue has been most frequently litigated in the Tax Court, which has generally recognized valid, enforceable notes as consideration, particularly when they were secured.\textsuperscript{173}

\item The Service did succeed in Deal v. Commissioner,\textsuperscript{174} where the Court found that the notes executed by the transferee daughters “were not intended to be enforced and were not intended as consideration for the transfer by the petitioner, and that, in substance, the transfer of the property was by gift.”\textsuperscript{175}
\end{enumerate}

7. Installment Sales

a. The fact that younger generation family members do not have currently available resources to purchase an asset from an older generation family member need not preclude using an intrafamily sale for estate planning purposes. The installment sale is a device through which an individual may effectively accomplish the estate planning goals described in the general discussion about intrafamily gifts.

b. An installment sale to family members is attractive for the same reasons as is an installment sale to an outsider, in that, generally, unless the seller elects not to use the installment method of reporting,\textsuperscript{176} any gain on the sale is deferred and taxed ratably as payments are received (or the purchaser’s notes are cancelled). When property is sold for full and adequate consideration, only the value of the installment obligation is includable in the seller’s estate. Thus, as a general rule, as with any outright sale, the installment sale enables a person to remove future asset appreciation from his or her estate.

c. In general, the installment method of reporting gain on the sale of property applies whenever a payment will be received in a year other than the year of disposition.\textsuperscript{177} Under the installment method, the gain recognized for a tax year is “that proportion of the payments received in that year which the gross profit (realized or to be realized
when payment is completed) bears to the total contract price.\textsuperscript{178/} Gain or loss is usually recognized whenever the holder sells, exchanges or otherwise disposes of the installment obligation.\textsuperscript{179/}

d. Upon the decedent's death, his or her estate includes only what remains of the sales proceeds and/or the outstanding installment obligation. This amount, however, is considered income in respect of a decedent, and the estate does not receive a step-up in its basis in the note. Accordingly, any future payments are taxable income to the estate or its beneficiaries, depending on who receives the payments. If the note is cancelled or distributed to its obligor, such a distribution is treated as a disposition under the installment sale rules and all gain will be immediately recognized by the estate.\textsuperscript{180/}

e. For estate tax purposes, the value of an outstanding installment obligation may be discounted if it carries a below-market rate of interest, or there is an extended period of time to maturity.\textsuperscript{181/} On the other hand, if the transferor received less than full and adequate consideration upon the sale of the property when the note was executed, then the full date of death value of the property may be includable in the transferor's estate under Sections 2036 through 2038. The Service could find that the seller gave away a portion of property and, under the terms of the note payments or security interests, retained an interest in the property sufficient to make these Sections applicable. Therefore, in designing any installment sale for estate planning purposes, the transferor must be careful not to retain any interest which may require inclusion under these Sections inasmuch as there is always a possibility that the consideration may be found not to equal the value of the property.

8. Self-Cancelling Installment Notes

a. General Rule

(1) If property is sold and an installment note is taken back by the seller, neither the value of the transferred property nor the balance of the note will be includable in the seller's estate for estate tax purposes where the installment obligation automatically terminates upon the death of the seller, so long as the sale is bona fide and for full and adequate consideration and the provision for termination was bargained for by the parties.\textsuperscript{182/}

(2) A "self-cancelling installment note" is a debt obligation which, by its terms, will be extinguished, with the remaining note balance thereof automatically cancelled, in the event of the death of the seller/creditor. To compensate the seller for this risk of cancellation, the terms of the note must reflect a "risk premium", either in the form of an increased purchase price or an increased interest rate on the note.

(3) Thus, a self-cancelling installment note that terminates by reason of the decedent/noteholder's death not only freezes the estate tax value of the property being sold, but also removes a portion of that value from the seller's estate in the situation where the seller dies before the note is paid in full, thereby adding another substantial estate planning benefit to using an intrafamily installment sale.

b. Income Tax Consequences to the Seller
In Estate of Frane v. Commissioner, the Court addressed the income tax treatment of self-canceling installment notes. The decedent had sold stock in a family business to his children in return for self-canceling installment notes and reported gain on the installment method. At decedent’s death, the installment notes were cancelled. The Court held that the unreported gain on the sale was reportable on the decedent’s final income tax return; however, the Eighth Circuit held that the unreported gain is reportable on the estate’s income tax return.

c. Income Tax Consequences to the Buyer

(1) While the noteholder is alive, the self-canceling installment note is treated the same as any other installment obligation and the note is subject to the rules of Section 453, as well as Sections 483, 1274 and 1274A.

(2) Upon the death of the noteholder, the Court held in Estate of Frane that the obligor’s basis in the assets acquired for the note equals the face amount of the note and not the amount actually paid. The Court quoted from a General Counsel’s Memorandum (which was not cited in the Court’s opinion), which concluded that obligor’s basis is equal to the face value of the note because Section 453B will tax the obligor on that amount of the appreciation so the obligor should get the benefit of the increased basis.

d. The terms of the note should not exceed the seller’s life expectancy or else the parties run the risk that the Service will reclassify the payments as annuity payments and the interest component of the payments will not be deductible by the buyer.

9. Private Annuity Sales

A private annuity accomplishes many of the same estate planning goals as an installment sale. A private annuity offers the opportunity to retain an asset in the family. Any gain on the sale is deferred and taxed proportionately as payments are received. A private annuity will provide the transferor with a fixed retirement income. Future appreciation of the transferred asset is removed from the transferor’s estate and only the payments received (and not consumed) are included in his or her estate.

a. There will be no gift if the private annuity payments are based on the current value of the property sold and the annuity payments are computed based on the methods and values set forth in Service Notice 89-60 and the tables in IRS Publication 1457, there was a real expectation of payment and payments were actually made.

(1) Valuation Issues:

(a) The value of the annuity payments may be calculated under Table S of the Service’s valuation tables, as set forth in Reg. §20.2031-7(d)(6).

(b) Determining the value of the property being sold for purposes of determining the purchase price under a private annuity arrangement is very important. If the property is undervalued, the Service will find a part-sale, part-gift, and, given the annuity interest, the Tax Court has found a retained interest in the gifted property that will
result in the inclusion of the property subject to the private annuity sale in the decedent's estate.186/

(2) Advantages and Disadvantages:

(a) The main disadvantage in a private annuity transaction is that the transferor may outlive his or her actuarial life expectancy. Thus, the estate tax on the annuity payments may exceed the estate tax that would have been attributable to the transferred asset if the private annuity transaction had not taken place.187/

(b) However, if the transferor dies before his or her life expectancy, or if the transferor consumes most or all of the annuity payments, then the asset will pass to a younger generation with little or no estate tax paid on the accumulated annuity payments. Moreover, if the property appreciates substantially in value, that increase in value is out of the decedent’s estate, because the annuity was based on the value at the time of sale.

b. Other Requirements

(1) The annuity payments cannot be either directly or indirectly, tied to the income from the property.

(2) The annuity payments must be limited to or dependent upon the income from the property transferred.

(3) The annuity payments must be the personal, unsecured obligation of the transferee.188

(4) The transferee/obligor must have assets and income that can support the annuity payments from sources other than the property transferred.189

(5) The transferor cannot retain any ownership or control, direct or indirect, as to the property transferred.

(6) The transferor has not retained a security interest in the transferred property.

e. Basis Considerations

(1) The transferee’s basis in the property, at the time of the sale, is the present value of all future payments that will be paid if the transferor lives to his or her life expectancy. In other words, the basis is initially the fair market value of the property transferred.190

(2) This basis is the value used at the outset in computing the transferee’s depreciation deduction. Once the annuity payments exceed the original fair market value of the property transferred, the excess payments will increase the obligor’s adjusted basis, thereby increasing the depreciation deductions. Once the transferor dies, the obligor’s adjusted basis will equal the total sum of the annuity payments minus any depreciation deductions, so
that, if the transferor dies prior to his or her life expectancy, the basis may be required to be reduced (but only prospectively, not retroactively).

d. Income Tax Consequences of Payments

(1) No part of the annuity payments is considered interest; therefore, the obligor is unable currently to deduct any part of the annuity payments, except for any depreciation deductions.\(^{191} \text{I} \)

(2) The income tax consequences to the transferor/annuitant are determined under the annuity rules.\(^{192} \text{I} \) Generally, to calculate the income tax consequences of an annuity, an exclusion ratio must be computed. The exclusion ratio is the percentage of each annuity payment that will be considered as a return of the annuitant’s investment in the annuity contract.

(3) In an unsecured annuity transaction, the transferor’s investment in the annuity contract is his basis in the property transferred. Thus, the exclusion ratio is computed by multiplying the annuity payments by the transferor’s life expectancy and then dividing this amount by the transferor’s adjusted basis in the property transferred.\(^{193} \text{I} \)

(4) If the property transferred is a capital asset, then the difference between the fair market value of the property at the time of the transfer and the transferor’s adjusted basis will be recovered as capital gain ratably over the life of the annuity. The remaining part (if any) of the annuity payment will be ordinary income.

10. Sales to Grantor Trusts

a. Grantor Trusts

(1) A trust can be a completed gift for gift tax purposes but not complete for estate tax purposes and hence includable in the grantor’s estate. A trust can also be complete for estate and gift tax purposes but not effective for income tax purposes, which results in the grantor having to include the trust’s income in his own taxable income regardless of whether or not he receives the income.

(2) The latter alternative described above is usually referred to as a “grantor trust” and can provide the grantor with an estate and gift tax advantage, because the trust can grow without any reduction for its tax burden since the grantor pays the income tax on the income.\(^{194} \text{I} \)

(3) In a grantor trust, the grantor is considered the owner of the trust for income tax purposes, and the Service frequently uses the term “alter ego” when describing such trusts.\(^{195} \text{I} \) As a result, the grantor can put property in such trust and still receive all of the income tax advantages he would have received had the property remained in his name, but without the property being included in the grantor’s estate. These income tax advantages include the $250,000 exclusion ($500,000 for a husband and wife who file a joint Federal income tax return) of gain on property under Section 121.\(^{196} \text{I} \) The Service has ruled that, since such a trust is an alter ego of the grantor, a transfer of a partnership interest to such trust will not
cause the grantor to recognize gain to the extent of his negative capital account. At the grantor’s death, when the trust is no longer a grantor trust but becomes a separate taxpaying entity, then, so long as the gift was complete for estate and gift tax purposes when made, the trust property will not be included in the grantor’s estate, but it also will not receive a step-up in basis under Section 1014.

(4) The status as a grantor trust can be achieved by qualifying as such under the grantor trust rules of Sections 673 through 677.

(5) The grantor of a grantor trust may be considered the owner of the trust with respect to only corpus or only income or both. If a trust is considered a grantor trust with respect to only income, then the trust is a separate taxpaying entity with regard to principal transactions. In order to ensure that such trust is defective for purposes of both income and principal, the applicable provisions and the powers relating thereto should be specifically applicable to both trust principal and trust income.

(6) When the trust loses its status as a grantor trust (either because of the death of the grantor or the grantor's renunciation of the grantor trust powers described above), the trust becomes a separate tax-paying entity. If the grantor is alive, the grantor will be treated upon the termination of the grantor trust, solely for income tax purposes, as though the grantor entered into the transaction at that time. It is unclear what happens if the grantor trust status is terminated as a result of the death of the grantor. It is also unclear under either scenario if the tax consequences that would have arisen if the trust had not been a grantor are brought back and recognized at the termination of the grantor trust or if only future tax consequences are recognized.

(7) All of the sale techniques described above can be accomplished utilizing a grantor trust. None of the income tax consequences described therein will, however, arise, which may alter the economics of the transaction.

(8) Example

$1,000,000 real estate with net return of 6% is transferred into LLC by Grantor. Grantor sells a 40% LLC interest to Grantor Trust.

1. Sale price: $280,000
   ($400,000 (40%) minus an assumed 30% discount)

2. Gift to Grantor Trust: $28,000
   Grantor Trust should not be unfunded when entering into a purchase and 10% of the sale price is generally considered a safe amount. This gift is not eligible for the annual exclusion from gift taxes, since the
annual exclusion requirements are incompatible with the grantor trust provisions.

3. Grantor Trust owns 40% of LLC and a 20 year promissory note payable to Grantor at 8% with a face amount of $280,000.

Year One:

(a) LLC pays Grantor Trust $24,000. (This is 40% of 6% return from real estate).

(b) Grantor Trust pays Grantor $36,400 (note payments: principal $14,000, interest $22,400). Trust must use some of its gift to meet payment, and in less than three years the gift amount will be completely used up.

(c) Grantor pays income tax on $24,000, which is $9,504 (at 39.6% rate) on the LLC distribution to the trust. Grantor pays no income tax on the promissory note payment.

(9) If an individual has liabilities in excess of his or her basis (a negative capital account) in an asset that he or she wants to sell to the family, the sale will usually trigger the negative capital account which will result in taxable income to the seller in the year of the sale. It is possible to defer (but not eliminate) the triggering of such negative capital account by selling such an asset to a grantor trust. The seller, however, would only utilize this technique if he or she feels that the asset to be sold has such a great potential for appreciation that despite the ultimate recognition of income as a result of triggering the negative capital account, it is still better to remove the asset and its appreciation from the seller’s estate, because of the estate tax burden. The reason the seller should be aware of this is because, if the seller had done nothing, upon his or her death, the cost basis of all of the seller’s assets are increased to the fair market value of such assets, determined as of his or her date of death. As a result, upon the seller’s death, the negative capital accounts of such assets disappear and is never subject to income tax, although the asset itself, at its then fair market value, is subject to estate tax.

(10) When the trust is no longer a grantor trust but becomes a separate taxpaying entity, then, so long as the gift was complete for estate and gift tax purposes when made, the trust property will not be included in the seller’s estate, but it also will not receive a step-up in basis under Section 1014. As a result, any negative capital account will then be triggered and recognized. The negative capital account will be probably be triggered in the trust’s income tax return, which would not give the seller’s estate an estate tax deduction, but the seller has succeeded in deferring the triggering of the negative capital account and removed the asset and its appreciation from his or her taxable estate.

(11) If, however, the balance of the note has been reduced through annual payments and the property has appreciated, a portion of the purchased property
(and a portion of the negative capital account) could be used to prepay the note, thereby transferring the negative capital account back into the hands of the original owner where, upon such owner’s death, the trigger of such negative capital account will be offset by the increase in the basis of the asset. A proportionate interest in the asset, and its appreciation, however, will be includible in the owner’s estate. A recapitalization and repayment of the note with the recapitalized interest (and negative capital account) may also be possible, which would freeze the appreciation includible in the owner’s estate.

B. Joint Purchases

1. In the joint purchase arrangement, two or more persons simultaneously purchase a life interest and a remainder interest in the same property. Generally, the older generation purchaser would purchase the life interest in an asset (or assets), while his or her intended beneficiaries would purchase the remainder interest.

2. The advantage of a joint purchase is that when the owner of the life interest dies, nothing is includible in his or her estate and the remainderman receives the entire asset, free of any transfer tax burden. Furthermore, the payment for the life estate reduces the owner’s taxable estate.

3. Section 2702(c)(2), captioned “Joint Purchases”, covers the situation where two or more members of the same family, in the same transaction or series of related transactions, acquire a life interest and a remainder interest, respectively, in the same property. In the estate planning context, often an older generation purchaser acquired a specified income or term interest in an asset (or assets), while his or her intended beneficiaries acquired the remainder interest in such property. This arrangement was used to present the opportunity to freeze the value of or remove assets from the estate of the older generation purchaser.

4. Recently, the Service approved a joint purchase by family members of a commercial facility and found that a partner’s priority distributions that were set at a fixed rate (which interest was purchased by the partner) satisfied the rules of Section 2702 as a qualified annuity interest. In addition, the Service approved a joint purchase through a qualified personal residence trust (“QPRT”) of a residence by family members. In this scenario, the parents contributed cash to the QPRT equal to the parent’s lifetime interest in the house (determined actuarially) and the children contributed the remainder of the cash. The QPRT then purchased the house. No gift under Section 2702 occurred because QPRTs are an exception to Section 2702.

5. It is very important that each party use his or her own funds to acquire the interest, otherwise the Service will apply the step transaction doctrine to collapse the joint purchase.

6. Even if the taxpayer does not qualify for this treatment, the objective of freezing the value or removing assets from the estate can still be achieved, but at a higher gift tax cost.
a. For example, as the Regulations provide, if A purchases a 20-year term interest in an apartment building and A's child purchases the remainder interest, and A and A's child each provide the portion of the purchase price equal to the value of their respective interests in the property under Section 7520, then A is treated as acquiring the entire property and transferring the remainder to A's child in exchange for the portion of the purchase price provided by A's child. This gift of the remainder to the child, if the term interest is expressed (i) in a term for years and (ii) in the form of a qualified annuity, can be valued as a GRAT under the rules of Section 2702, thereby reducing the gift tax consequences, if the life tenant survives the term.

b. Under the Section 2702(a) rules, all the value is held in the remainder interest since A's retained interest is valued at zero, so A made a gift equal to the full market value of the property minus the consideration paid by A's child. When A dies, the property will escape inclusion in A's estate under Section 2036(a) because there was no transfer and retention of an interest. The deemed transfer in trust applies solely for purposes of Section 2702, not for any other Code Section.

C. Partnership Freezes

1. Section 2701 was enacted in 1990 as a part of Chapter 14 and addresses the technique of partnership freezes between family members. On the most basic level, a partnership freeze (prior to 1990) was a technique wherein two classes of partnership interests would be issued; one of which carried a non-cumulative preferred return on what was most often the partner's capital account (but had no rights to participate in the growth of the entity) and the other, a non-preferred interest, carried the remaining value of the entity, taking into account the entity's requirement to pay the preferred return. Prior to 1990, when these interests were valued, the majority of the value was found to be in the preferred interest and the non-preferred interest had no (or little) value. As a result, the non-preferred interest could be gifted at little or no gift tax cost, and the future appreciation in the entity would thereafter be in the donee's hands, while the donor continued to receive a stream of income from the entity, through its payment of the preferred return. Upon the death of the donor, the only asset includible in his or her estate was the value of the preferred return, which was discounted in light of its non-cumulative nature. All of the appreciation in the entity would therefore escape inclusion in the donor's estate because it was in the hands of the donee in the form of the non-preferred interest.

2. Section 2701 provides that if the preferred interest does not meet certain requirements set forth in the Section, then such interest will be valued at zero. Thereafter, if any transfer is made of any non-preferred interest, the value deemed to have been transferred shall be based on the "subtraction method" of valuation, calculated as follows:

   a. The value of all property contributed to the partnership (or the value of all interests in the partnership) is determined (as though it were held by one individual).

   b. The value of the preferred interest is subtracted from the value determined above:
(1) If the preferred interest does not meet the requirements of Section 2701, the value is deemed to be zero.

(2) If the preferred interest meets the requirements of Section 2701, the value is determined based on normal valuation methodology, with the exception that any value attributable to most liquidation, put, call or conversion rights (other than rights that must be exercised at a specific time and at a specific amount) attached to the preferred interest, are valued at zero.

c. The remaining value (after the subtraction) is allocated proportionately among the non-preferred interests (including the non-preferred interests held by holders of preferred interests).

d. In a transfer subject to Section 2701, the value of all non-preferred interests, together, must equal at least 10% of the value of all partnership interests, plus the value of any, indebtedness of such entity to the family. Accordingly, notwithstanding the valuation of preferred interests that meet the requirements of Section 2701, if such interests make up more than 90% of the value of the entire entity, the excess of such value over the 90% amount must be allocated proportionately to the non-preferred "junior" entity interests.

e. If the value allocated to each non-preferred interest is greater than the amount contributed (or the consideration paid) by the owner of the non-preferred interest, a gift has been made.

3. Accordingly, to avoid the gift that would result from the value of the preferred interest to be deemed to have been zero, the preferred interest should either meet the requirements of Section 2701 or the transaction must fit into one of the Section’s exceptions, which are as follows:

a. If market quotations for the preferred interest is readily ascertainable, Section 2701 does not apply.

b. If the transferor transfers interests (i) in the same class or (ii) is proportionately the same as the interests retained by the transferor, Section 2701 does not apply.

c. Section 2701 only applies when (i) there is a transfer, to or for the benefit of a member of the transferor’s family who is in the same or lower generation as the transferor, of an equity (non-preferred) interest in the entity, (ii) after the transfer, the transferor or a family member who is in the same or higher generation as the transferor holds retains a "distribution right" (the payment of which is in the discretion of the entity), and (iii) the entity is controlled by the family (pursuant to the application of certain attribution rules set forth in the Section). For this purpose, “control” means either holding 50% of the capital or profits of the entity or holding the general partner or the manager interest in the entity.

d. Qualified Payments
(1) If the distribution right is deemed to be a “qualified payment” then it will be valued at its fair market value, rather than zero, for purposes of these rules. A qualified payment is one that is paid on a periodic basis that is cumulative and determined at a fixed rate.\(^{213}\)

(2) If the distribution right is deemed not to be a “qualified payment”, the transferor or family member holding the right may elect to treat the right as a qualified payment and the election is irrevocable.\(^{218}\)

(3) Once a payment is deemed (or elected) to be a qualified payment, there is an additional consequence to such characterization. If the payments are in arrears by four years or more, then the payments shall be deemed to have been made when due and such payments shall be deemed to have been reinvested as of such date at the discount rate used in determining the value of interest. Such deemed amount will be a deemed transfer subject to estate or gift taxes, either when the transferor makes a gift (or sells) his or her interest in the entity or at his or her death.\(^{219}\)

e. If the distribution right is a right to receive a guaranteed payment (pursuant to Section 707(c)) of a fixed amount, then such rights are not subject to the rules of Section 2701.

4. See Private Letter Ruling 200114004 for a partnership freeze using a FLLC that was approved by the Service.\(^{220}\)

VIII. PLANNING FOR ESTATE TAX STATUTORY RELIEF

After transfer taxes have been reduced as much as possible and liquidity and wealth replacement has been provided for to the extent feasible, then the final issue that must be addressed is whether one of the estate tax statutory relief provisions can be utilized.

Under the Code, there are provisions that allow a taxpayer to value qualified real estate at less than its highest and best use, thereby reducing the estate tax cost of such property. Furthermore, even if no such relief is possible, the Code nonetheless allows the deferral of the payment of estate taxes under certain circumstances. These Code Sections are discussed below.

A. Section 2032A

As previously stated, real property is generally valued at its fair market value, which is based on the property’s highest and best use. Thus, for example, if a farm is situated near an urban area (assuming that zoning and the necessary utilities were all in place), its value may well be greater if it were subdivided for residential or commercial use than as farm property. As a consequence of valuation based on the highest and best use, substantially higher estate taxes might be imposed; and, in many cases, the greater estate tax burden would make the continuation of farming, or closely held business activities, not feasible because the income potential from these activities would not be sufficient to service extended tax payments or loans obtained to pay
the estate tax. Thus, the heirs could be forced to sell the land for development purposes. For these reasons, among others, Congress added Section 2032A.

1. General Rules of Section 2032A

   a. Assuming certain conditions are met, an executor may elect, under Section 2032A, to value real property used for farming or in a closely held business based on its value as such, rather than on the basis of its potential highest and best use.

   b. In conjunction with the election, under Section 2032A(d)(2), all parties in being having an interest in the real property (whether or not in possession) must sign a written agreement consenting to the imposition of, and personal liability for any taxes assessed in the event that, within 10 years of the decedent’s death, certain events set forth in Section 2032A(c) occur.

2. Consequences of Section 2032A Election

   a. The reduction in the value of the qualified real property resulting from the application of the special use valuation cannot exceed $870,000 (or $485,000 in the case of a community property interest) in the year 2005. If more than one farm is used in electing Section 2032A value and the limitation imposed by Section 2032A(a)(2) is exceeded, the reduction must be allocated ratably among all farms for which the special valuation is elected.

   b. The special use value establishes the basis of the qualified real property for income tax purposes.

3. Requirements of Section 2032A

   a. Real property used in a farm, timberland, woodland, or other closely held business qualifies for special use valuation if the adjusted value of the real and personal property used in connection with the farm or closely held business accounts for at least 50% of the adjusted value of the gross estate.

   b. The adjusted value of the real property must amount to at least 25% of the adjusted value of the gross estate.

   c. The value of a farm for farming purposes is determined as follows: The excess of (1) the average gross cash rental for comparable land used for farming purposes and located in the locality over (2) the average annual state and local real estate taxes for such comparable land is to be divided by the average annual effective interest rate for all new Federal Land Bank loans. However, under Section 2032A(e)(7)(C), the above formula is not to be used where it is established that there is no comparable land from which the average annual gross cash rental may be determined, or the executor elects to have the value of the farm for farming purposes determined in the same manner as other closely held business interests under Section 2032A(e)(8). Each average annual computation is to be made on the basis of the five most recent calendar years ending before the date of the decedent’s death.
d. The value of timberland, standing timber and woodland was established by the taxpayer and accepted by the Service because the taxpayer could provide leases of comparable land for the five years prior to the decedent’s death.7

e. An executor should now be able to use both Section 2032A and a minority discount to reduce the value of a farm. In Estate of Maddox v. Commissioner,222 the decedent owned 35.5% of a family-owned incorporated farm. The Tax Court had not allowed the executors to reduce further the value of the farm as determined by Section 2032A by a minority discount. The Court noted that the election to value the real estate under Section 2032A means that the actual fair market value of the asset is not being used for estate tax valuation purposes. Inasmuch as minority discounts are only relevant in computing an asset’s fair market value, a minority discount may not be used to reduce further the value of a farm valued under Section 2032A. In Hoover v. Commissioner,223 the Tenth Circuit held that to disallow a minority discount suggests that fair market value takes on a different meaning under §2032A than under other circumstances, and permitted the incorporation of a minority interest discount in the determination of value.224

f. On the date of the decedent’s death, the real property must have been in use by the decedent or a family member as a farm or for other business purposes.225 In addition, for at least 5 of the last 8 years preceding the decedent’s death, the decedent or a family member must have (1) owned the real property, and (2) used the real property for farming or other trade or business purposes.226

g. The decedent or a family member must also have materially participated in the operation of the farm or other business for at least 5 of the last 8 years preceding the decedent’s date of death, disability or commencement of Social Security retirement benefits.227

h. Real property owned indirectly through an interest in a partnership, corporation or trust qualifies for special use valuation to the extent it would qualify if it were owned directly.228 However, in order to qualify for the special use valuation in such a situation, the property must be clearly shown as being used in a trade or business, rather than held for mere passive rental. This means that the Service’s interpretation of Section 6166, discussed below, must be carefully analyzed, for only qualification under that Section would permit the use of Section 2032A.

4. Imposition of Additional Estate Tax

a. The disposition (other than by involuntary conversion or the contribution of a qualified conservation easement on the subject property229) of an interest in the qualified real property by a qualified heir (otherwise than to a member of his family230) or the failure of the qualified heir to continue to use the qualified real property for the qualified use, as set forth in Section 2032A(c)(6), results in the imposition of an additional estate tax.241 This additional estate tax may be imposed within 10 years after the decedent’s death.232

b. If such a recapture tax is imposed because of disposition of the qualified real property or cessation of the qualified use, the basis of the qualified real property
may be increased to its fair market value on the estate tax valuation date applicable to decedent’s estate.\textsuperscript{243/} If the qualified heir elects this basis adjustment, interest must be paid at the annually adjusted floating rate of Section 6621 on the amount of the recapture tax from a date 9 months after the decedent’s death until the due date of the recapture tax.\textsuperscript{244/}

5. Disadvantages of Section 2032A Election

Although the special use valuation may provide some estate tax relief for estates which are comprised largely of qualified real property, many planners are reluctant to advise a client to make the election because of the complexity of Section 2032A, the potential for recapture, the personal liability of the qualified heir and the special lien. Where there are multiple qualified heirs, there is also the risk that they may disagree regarding the disposition or use of the property. In addition, the major benefit of special use valuation is the reduction in Federal estate tax due to the lower valuation; however, the property receives a lower basis based on this lower value. Thus, if the property is sold, there may be more gain to be recognized.

6. Relationship between Section 2032A and Section 2056

Special consideration must be given to the interrelationship between special use valuation and the unlimited marital deduction. As a general rule, it appears that the executor and other parties should not elect to make use of special use valuation (with the consequent limitation on basis) where the real property passes to a surviving spouse in a way that qualifies for the unlimited marital deduction. Of course, use of the special use valuation method would increase the amount of property that could be sheltered by the decedent’s unified credit from inclusion in the surviving spouse’s estate. The decision will depend in part on the sizes of the decedent’s and surviving spouse’s estates, the amount of qualified real property included in the estates, and the survivor’s plans for use of the property.

B. Section 6166

1. General Rule

Under Section 6166, an executor may elect to pay all or a portion of the estate tax in two or more equal installments, but not more than 10 installments, if the decedent was a United States citizen or resident and his or her estate includes an interest in a closely held business which exceeds 35% of the decedent’s adjusted gross estate.\textsuperscript{245/} The deferrable portion of the estate tax is that fraction thereof which reflects the ratio that the closely held business bears to the adjusted gross estate.\textsuperscript{246/}

2. Definitions of an Interest in a Closely Held Business

a. An “interest in a closely held business” is (1) an interest in a sole proprietorship carrying on a trade or business;\textsuperscript{247/} (2) an interest in a partnership carrying on a trade or business if 20% or more of the total capital interest in the partnership is included in the decedent’s gross estate, or if there were 15 or fewer partners;\textsuperscript{248/} or (3) stock in a corporation carrying on a trade or business if 20% or more in the value of the voting stock is included in the
decedent’s gross estate, or if there were 15 or fewer shareholders. For estates of decedents dying after December 31, 2001, the number of partners and shareholders allowed in a closely held business has been increased to 45.

b. A great deal of controversy exists over whether the owner of real property, whether a farm or land improved by buildings, should be entitled to relief under Section 6166. Certain rules have emerged. Passive investments do not qualify as a “business”. The “mere grouping together of income-producing assets” from which income is obtained only through ownership of the property, rather than from the conduct of a business, has been held not to be a trade or business. Furthermore, the Service recently issued a Ruling in which active businesses such as manufacturing mercantile or service businesses, in which Section 6166 would apply, were distinguished from the mere management of real estate assets which, under the ruling, was denied the Section 6166 extension.

c. Examples

(1) Ownership of real estate was held not to be a trade or business even though, prior to his death, a decedent maintained a fully equipped business office to collect receivables, negotiated leases, made occasional loans, and by contract directed the maintenance of his properties, and even though the decedent maintained records and kept regular office hours for collection of the amounts involved and the maintenance of his properties. The Service held that “the decedent’s relationship to the various assets described was merely that of an owner managing investment assets to obtain the income ordinarily expected from them.”

(2) The ownership and rental of 8 homes, with regard to which the decedent collected rents, made the mortgage payments and made the necessary repairs and maintenance was also held not to be a trade or business.

(3) The ownership of farm real estate leased to tenant farmers under an agreement whereby the decedent received 40% of the crops and bore 40% of the expenses, and where the decedent participated in important management decisions and made almost daily visits to inspect the farms and discuss operations, although he lived several miles from the farms, was found to be a trade or business. The Service pointed out that: “An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.” Thus, where the decedent rented land to sharecroppers, but took part in farm management decisions, and received a portion of the produce, the business was active and the estate qualified for tax deferral under Section 6166. On the other hand, where the decedent owned property and merely rented it, the decedent was held merely to be managing passive assets.

(4) A trade or business was found from the ownership of stock in an S corporation which built homes on land owned and developed by the decedent. The Service ruled that land owned by the decedent which was held for the purpose of building homes by such corporation qualified as an interest in a closely held business for purposes of Section 6166, as did a business office and warehouse owned by decedent but used by both the decedent
and the corporation in the home building and land-holding operations. Further, the estate could treat the interests in these two businesses as an interest in a single closely held business, under Section 6166(c).

(5) A trade or business was found where the decedent purchased, renovated, actively managed on a day-to-day basis, and leased commercial buildings. A trade or business was also found where the decedent owned a one-third interest in a trust that owned an operating business. The Service ruled that the trustee was the agent of the decedent.

(6) The Service found in one letter ruling that the decedent personally participated in acquiring and renovating real property and in its overall operation and therefore his management rose to the level of a trade and business that is eligible for a Section 6166 deferral. Furthermore, although the day-to-day operations were handled by corporations, these corporations were the decedent’s agents, and their activities were attributed to the decedent. The Service found qualification for Section 6166 treatment because the decedent’s activities “(as assisted) went beyond merely collecting rents, paying taxes, making mortgage payments and making necessary repairs (considered management of investments).”

(7) The decedent owned a one-half interest in a partnership that held no assets but provided bookkeeping services to the decedent’s corporations and to the decedent himself, all of which owned real property. The Service found that all of the entities and the cash reserves, as well as the real property, constituted a trade or business eligible for Section 6166 deferral. The Service reached this result by analyzing what the cash reserves were used for (local property and payroll taxes, insurance, repairs, utilities and legal and accounting fees). The real property held by the decedent, either as tenant in common or through wholly owned S corporations, included apartment buildings and commercial buildings.

(8) The decedent owned tenant-in-common interests in two buildings and a one-third interest in a partnership holding buildings. The decedent’s activities included “tenant relations”, which involved interviewing and selecting prospective tenants and negotiating and enforcing leases; “administrative procedures”, which involved collecting rents, paying expenses, obtaining and reviewing insurance coverage; and “maintenance of property”, which involved making all repairs and improvements, inspecting property and providing services. When the decedent’s health failed, the decedent’s daughter took over these activities. The Service found that these activities involved the management of investment assets and did not rise to the level of an active trade or business and, as a result denied the Section 6166 extension.

(9) The decedent owned a two-thirds interest in a partnership, the operation of which was an active cattle ranching business. Decedent also owned the land on which the business was located; however, the land was not held by the partnership, but by the decedent individually. The Service ruled that since the land was essential to the business, it was eligible for the Section 6166 deferral.

(10) The decedent operated 11 properties and managed all aspects of leasing, management and maintenance. Even though shortly before his death the
decedent gave up his responsibilities as a result of illness, the Service found that the properties were a trade or business for purposes of Section 6166, as a result of the level of the decedent’s activities prior to becoming ill.262/

(11) The decedent was engaged in a commercial real estate development and leasing business. As part of his role in the business, the decedent maintained a business office at one of the properties, reported to the office daily, coordinated the employees’ daily activities, reviewed all invoices, signed all invoice and payroll checks, and negotiated all commercial leases. The Service held that the decedent actively participated in the management and operation of the properties and, thus, was engaged in a trade or business for purposes of Section 6166 of the Code.268/

(12) The decedent owned and materially participated in the operation of automobile dealerships and also owned improved real estate, the improvements of which were specifically for the dealerships. The real estate was leased to the dealerships. The Service found that the improved real estate, being essential to the dealerships, were an active business.269/

3. Election

a. Once it is determined that a decedent’s estate is eligible for Section 6166, an irrevocable election must be made under Section 6166(d), for such deferral on the estate tax return. The first such installment is to be paid at the time the return is required to be filed under Section 6151(a), with the remaining installments paid annually on the anniversary dates thereof.270/ As a practical matter, executors generally elect the longest payment period available, which is a 10-year period beginning on the fifth anniversary of the due date of the decedent’s estate tax return.271/ The estate tax may always be prepaid without penalty. On the other hand, if an alternate payment term has been elected,272/ it may not be extended if the date for making the original election (that is, the due date for filing the return as prescribed by Section 6075,273/ including extensions) has passed.

(1) Interest at the rate of 2% is imposed on the lesser of:

(a) the amount of tax on the first $1,070,000 (for decedents dying in the year 2005) of the taxable value of the business; or

(b) the amount of estate tax deferred under Section 6166.274/

(2) the $1,000,000 amount will be adjusted for inflation; however, only by increments of $10,000.275/

(3) Interest at the rate equal to 45% of the annual rate provided by Section 6601(a) is imposed on the remaining estate tax defined under Section 6166.276/
b. The interest paid under Section 6166 is no longer a deductible expense on the estate tax return. However, the excess interest on any overpayment of tax is deductible.

c. Once the property subject to the Section 6166 election is transferred, the unpaid estate tax will be due, although the Service recently ruled that a transfer of such property to a LLC did not accelerate the payment of the tax.

C. Section 6161

1. Even if an estate does not qualify for deferral of estate tax payments under Section 6166, the executor may request that the Service extend the time for payment of the estate tax due for up to 10 years upon a showing of "reasonable cause." 

2. The Service will look at the following factors in determining whether reasonable cause exists:

   a. the executor's inability to marshal assets to pay the estate tax;

   b. the estate's assets consist largely of the right to receive payments in the future (such as annuities, royalties, contingent fees or accounts receivable);

   c. the substantial assets of the estate cannot be collected without litigation; and

   d. the estate does not have sufficient funds available, after the making of reasonable efforts to convert assets (other than an interest in a closely held business) into cash, with which to pay the tax in a timely fashion.

3. An application containing a request for an extension of time for paying the estate tax must, under Reg. §20.6161-1(b), be in writing; state the period for which the extension is requested; include a declaration made under penalty of perjury; state the reasonable cause for which the extension is requested; and be filed with the appropriate District Director on or before the date prescribed for payment of the tax.

4. The taxpayer usually is required to furnish a bond or other security. Interest will be charged at the current rate of interest, as determined under Section 6621.

IX. CHARITABLE GIVING WITH REAL ESTATE

A. Introduction

When making charitable gifts of real estate (or interests in real estate), either directly or through entities, the taxpayer should be aware of both the opportunities and the pitfalls that arise as a result of the unique nature of real estate. In general, a donation of property
to a charitable organization will give rise to a tax deduction for the donor; however, the amount of the deduction available to the donor, for income and gift tax purposes, or for estate tax purposes, depends upon the nature and value of the property being transferred. Certain sale transactions may also be governed by the rules for charitable contributions if the sale price is less than the fair market value of the property.

B. Substantiation Requirements and Requirement for a Qualified Appraisal

A charitable contribution is deductible only if the contribution is verified in a manner required by Regulations. For taxable years beginning prior to January 1, 1983, and, at the election of the taxpayer, for charitable contributions made on or before December 31, 1984, each taxpayer was required to list on his Federal return the name of each organization to which property was contributed for which a deduction was claimed, as well as the value of each contribution.

In addition, certain information and a qualified appraisal will be required in order to deduct a charitable contribution of property other than cash, inventory, publicly traded securities and certain vehicles valued at more than $5,000, which is required to be attached to the taxpayer’s return.

C. Transfers of Entire Interests in Property - Special Circumstances

1. Transfers of Encumbered Property

In general, when a taxpayer contributes encumbered property to a charitable donee, thereby discharging his outstanding obligation, the amount of the discharged obligation is treated as a cash payment from the charitable organization to the taxpayer.

   a. The amount of the charitable deduction for such a transaction is the fair market value of the property contributed less the amount of the obligation from which the taxpayer was discharged.

   b. When a taxpayer makes a contribution of appreciated encumbered property, the transaction may be treated as if the taxpayer sold the property to the charitable organization for less than its fair market value. For example, in Ebben v. Commissioner, a transfer of encumbered property was recharacterized as a bargain sale.

2. Bargain Sales

   a. A bargain sale is a transfer of property which is partly a sale or exchange of the property and partly a charitable contribution. Typically, a bargain sale occurs when an owner of property sells the property to a charitable organization for less than its fair market value. In the event of a bargain sale, the seller may be entitled to a charitable contribution deduction based on the difference between the purchase price and the fair market value. However, as with any other charitable contribution, the seller must have the proper intent to benefit the buyer.
b. In general, the rules for determining the deductible amount of a contribution which is made through a bargain sale are the same as for any contribution of a partial interest, which are described below. However, since the taxpayer may be recognizing gain on the sale portion of the transfer, a few additional rules apply.

(1) Allocation of Basis.

In the case of a bargain sale, the taxpayer’s adjusted basis in the property is determined according to the rules for contribution of a partial interest. Since the transfer is partly a sale, the taxpayer recognizes ordinary income or gain on the portion of the property sold, based on the taxpayer’s basis in the portion of the property sold. In addition, the portion of the ordinary income or gain which would have been recognized had the contributed property been sold at its fair market value on the date of contribution, but which is not recognized by reason of the bargain sale, is applied against the amount of the charitable contribution in accordance with Section 170(e)(1).

(2) Application of Reduction under Section 170(e)(1).

(a) When property is contributed as part of a bargain sale, Section 170(e)(1) applies to reduce the amount of the contribution by the amount of ordinary income or gain realized on the transfer.

(b) For purposes of making the reduction, the amount of ordinary income or gain realized on the transfer must be calculated, by allocating first the taxpayer’s basis in the property and then the fair market value of the property. The fair market value of the contributed portion of the property is the difference between the fair market value of the entire property and the purchase price of the property. The amount of ordinary income or gain realized for purposes of Section 170(e)(1) is then the difference between the fair market value of the contributed portion of the property and the taxpayer’s basis in such portion of the property.

3. Gift of a Remainder Interest in a Residence or Farm

A charitable contribution of an irrevocable remainder interest in a personal residence or a farm is the only type of remainder interest that is deductible, unless the contribution is in trust, or the remainder interest is the donor’s entire interest in the property.

a. A “personal residence” must be property used as the donor’s personal residence, but need not be his principal residence. A “farm” must be property used by the donor or his tenant for the production of agricultural products or the sustenance of livestock.

b. An inter vivos gift of a remainder interest in a farm requires a reduction for depreciation on the portion of the property given (excluding land).

c. In addition, it may be possible for the donor to retain an easement in gross over the underlying land upon which the residence sits when giving a remainder interest...
to the charity. As long as the residence is used for charitable purposes, the charity is considered to have the use of the underlying land as well. After the donor gives the remainder interest in the personal residence to charity, additions or improvements are also deductible as contributions for the use of the charitable remainderman.

4. Gift of "Qualified Conservation Easement"

Certain partial interests in, and certain rights attaching to, real property contributed after December 17, 1980, are deductible if they constitute "qualified conservation contributions". A contribution is a "qualified conservation contribution" if (1) the interest contributed is a "qualified real property interest", (2) the contribution is made to a "qualified organization", and (3) the contribution is made "exclusively for conservation purposes".

a. Qualified Real Property Interest

A "qualified real property interest" is defined as any of the following interests in real property:

1. The donor's entire interest in the property other than a qualified mineral interest. A donor's "entire interest" in real property includes any interest other than a partial interest. In addition, an interest which is an undivided portion of the donor's entire interest in real property (such as a co-tenancy), is treated as an entire interest as long as any conservation restriction on the property is protected in perpetuity. However, a real property interest is not an entire interest if the property is divided prior to the contribution in order to enable the donor to retain control of more than a mineral interest or to reduce the donation.

2. a remainder interest, or

3. a perpetual conservation restriction. A "perpetual conservation restriction" is defined as a voluntary restriction, granted in perpetuity, on the use, which may be made of real property. Commonly referred to as a "conservation easement", such restriction may be in the form of an easement, a restrictive covenant, an equitable servitude, or any other similar interest in real property under state law.

b. Qualified Organization

The second condition for the qualification of a conservation contribution is that the recipient of the qualified real property interest be a "qualified organization". In order to be a "qualified organization", an organization must be either a Federal, state or local government entity or a certain type of public charity. In addition, the organization must be committed to preserving the conservation purpose of the donation and possesses adequate resources to enforce applicable restrictions. An organization, which is organized or operated primarily or substantially for conservation purposes (as defined below), are considered to be committed to such purposes.

c. Exclusively for Conservation Purposes
The conservation easement must be made exclusively for conservation purposes. Permissible conservation purposes specifically include contributions for (i) the preservation of land area for outdoor recreational or educational use; (ii) the protection of a natural habitat of fish, wildlife or plants or similar ecosystems; (iii) the preservation of open space for the public's scenic enjoyment; or (iv) the preservation of a historically important land area or a certified historic structure.

(1) Preservation for Recreation or Education -- The donation of a qualified real property interest to preserve land areas for the outdoor recreation or education of the general public will qualify as a permissible conservation purpose. Property will not meet this test unless the public's uses are substantial and regular. The Regulations specify donations such as a water area for public boating or fishing or a public nature or hiking trail.

(2) Preservation for Protection of Environment -- The donation of a qualified real property interest for the preservation of a significant, relatively natural habitat for a fish, wildlife or plant community will qualify as a permissible conservation purpose. This type of conservation donation will retain its deductibility despite restrictions on public access.

(3) Preservation of Open Space -- The donation of a qualified real property interest for the preservation of open space will qualify as a permissible conservation purpose if the contribution yields a significant public benefit and is either (1) in accord with a "clearly delineated federal, state or local government conservation policy" or (2) for the scenic enjoyment of the general public.

(a) The requirement that there be "significant public benefit" is satisfied by an analysis of the facts and circumstances of each conservation contribution. For example, significant public benefit might be found in: (1) the preservation of farmland in accordance with a state flood prevention program, (2) the preservation of woodland along a public highway pursuant to a government program to preserve the surrounding area, or (3) the preservation of a stretch of land between a highway and an ocean to maintain the scenic ocean view from the highway.

(b) The requirement that the preservation of open space be pursuant to "clearly delineated" governmental policy is designed to protect property identified by representatives of the general public as worthy of preservation, although the policy need not identify particular lots. Government policy may originate from either a general government declaration or a specific government action supporting the position. For example, a site-specific declaration, a commitment in the form of a monetary grant by the government, or acceptance of an easement by a governmental agency will tend to establish a government policy for the preservation of a particular site. However, a general declaration of conservation goals by a single official or legislative body is not generally considered "clearly delineated policy".

(c) Whether a contribution satisfies the requirements of providing "scenic enjoyment" to the general public depends on the facts and circumstances of the contribution. For example, preservation of land may be for the scenic enjoyment of the public if development of the property would impair the scenic character of the local rural or urban...
landscape or would interfere with a scenic panorama that is enjoyed from a park or other area which is open to or utilized by the public. 338/3

(4) Preservation of Historic Property -- A contribution of property will satisfy the requirement of having a conservation purpose if the purpose of the contribution is to preserve a historically important land area or a certified historic structure. 339/ A historically important land area includes: (a) an independently significant land area that meets the National Register Criteria for Evaluation, (b) any land area within a registered historic district, and (c) any land area adjacent to property listed in the National Register of Historic Places (but which is not itself within a registered historic district) whose features contribute to the historic or cultural integrity of the property. 340/ A certified historic structure includes any building, structure or land area which is (a) listed in the National Register of Historic Places, or (b) located in, a registered historic district (as defined under Section 48(g)(3)(B)) and certified by the United States Secretary of the Interior. 341/ In addition, the terms of any development restrictions imposed by the donor must conform to appropriate federal, state or local standards for construction or rehabilitation within the applicable district. 342/

d. Other Requirements

(1) Perpetuity -- There is a requirement that a donation be exclusively for conservation purposes contemplates the preservation of the conservation purpose in perpetuity. 343/ Consequently, a donor will be denied a charitable deduction if, for example, the terms of an easement to preserve open space permit future development which could interfere with the purpose of the donation. 344/3

(2) Retention of Rights -- Generally, a donation is not disqualified from being made exclusively for conservation purposes if the donor retains certain rights in the property or realizes incidental benefits from the use restrictions imposed, as long as the retention of such rights and/or benefits does not interfere with the donor’s primary conservation objectives, 345/ and as long as the donor has the requisite donative intent. If the donor intends to reserve certain rights which could adversely affect the conservation purpose of the donated property, he is required to notify the donee prior to exercising such rights 346/ and supply the donee with documentation supporting the condition of the property at the time of the donation. 347/

(3) Access -- In order for a qualified conservation contribution to be deductible, there must be adequate public access to the property.

(a) The Regulations impose differing degrees of accessibility upon property, depending upon the conservation purpose underlying the donation. For instance, while real property donated for recreational or educational use requires substantial and regular public access, 348/ property donated to preserve a natural habitat or ecosystem permits substantial limits on public access without jeopardizing the charitable deduction. 349/ Moreover, mere visual access is acceptable for an open space easement. 350/ Finally, the degree and character of public accessibility to historically important property depends on the nature and condition of the property, although, in general, access is sufficient if the public is afforded a regular opportunity to observe the features of the property. 351/ However, if excessive public
access could jeopardize the underlying characteristics and features of the property, restrictions on physical access maybe permissible.  

(b) Factors to be considered in assessing the reasonableness of limitations on public visitation include: (i) the historical significance of the property, (ii) the nature of the features subject to the easement, (iii) the remoteness or accessibility of the site, (iv) the existence of physical hazards to the public, (v) the intrusion on the privacy interests of residents of the property, (vi) the degree to which public access would impair the preservation purpose of the contribution, and (vii) the existence of alternative viewing modes. 

(4) No “inconsistent use.” A deduction for the donation of any easement will be denied if the donation would permit the destruction of significant conservation interests—even if the donation accomplishes one of the conservation purposes enumerated here. 

(e) Valuation of Conservation Easements -- The value of a qualified conservation contribution is based on the fair market value of the property (or property interest) at the time of the contribution. A particular problem encountered in valuing conservation easements, however, is the lack of an established market for the sale of property encumbered by a use restriction. 

(1) In the event that a substantial record of marketplace sales of property comparable to a particular conservation property is available, the fair market value of the contributed easement is determined based on the sales price of such similarly situated properties, which have been recently sold in arm’s-length transactions. 

(a) Factors which are considered significant in assessing the comparability of properties include (i) size, (ii) location, (iii) existing improvements, (iv) the possibility of expansion, and (v) topographical and physical variances. 

(b) Although the comparable sales approach, in theory, represents the most accurate assessment of value, the lack of sales data severely limits its application. 

(2) An alternative to the comparable sales method for assessing the value of a conservation easement is the “before and after” approach, under which a comparison is made between a property’s value prior to the imposition of the easement and its value subsequent to the imposition of the easement. Any decline in value is deemed to be the fair market value of the easement and represents the donor’s charitable deduction with respect to such property. 

(a) For purposes of appraising a conservation easement under the “before and after” approach, the “before” and “after” values must take into account the economic use which will likely yield the highest present value upon sale of the property. 

(b) Generally, the determination of the highest and best use of property when valuing a conservation easement is affected not only by the general
character of the property and its surrounding areas, but also by factors such as road accessibility, utility availability, and the existence of liens, encroachments, life estates and reversions. Furthermore, the “before” value may be greatly affected by existing zoning and land use regulations, which, notwithstanding any donor-imposed conservation restrictions, may limit the property’s value.

(3) For example, property possessing the potential for future development and growth prior to the imposition of an easement may yield a high “before” value and, thus, maximize the donor’s charitable deduction.

(4) Conversely, preexisting zoning restrictions may limit the development and productive use of the property, which, in turn, will tend to lessen the value of the contribution. Thus, while the placement of a conservation easement which greatly exceeds local zoning regulations will reduce the “after” value and thereby increase the appraisal under the before and after approach, an easement containing terms which are consistent with local zoning laws will have only nominal value and result in a lower charitable deduction for the donor.

(5) Another consideration in valuing a conservation easement is its effect on adjacent property owned by the donor or his affiliates. As previously noted, a donor may recognize incidental benefits from the imposition of a property restriction if the donor receives benefits which neither jeopardizes nor interferes with the conservation purpose. However, when the grant of an easement enhances the value of the donor’s adjacent property, the amount of the deduction may be reduced by the amount of financial or economic benefit received or expected to be received by the taxpayer or related person. Thus, while the receipt of secondary or indirect benefits, including, for example, preferred interest on bank loans or zoning concessions, may not disqualify a conservation easement from charitable treatment, such benefits may significantly reduce the donor’s charitable deduction.

f. Tax Considerations

(1) A donor must consider whether the tax benefit of a conservation easement deduction may be offset, in whole or in part, by certain other adverse tax consequences. For example, a donor of a facade easement (that is, the preservation of the facade of a historically important building) should consider whether such donation will result in the recapture of a portion of the rehabilitation tax credit previously recognized by such donor. Under this scenario, the grant of the easement might be considered a partial disposition of the donor’s interest in the property, which might in turn trigger the recapture.

(2) When a taxpayer grants a conservation easement, the basis allocable to the qualified real property interest is calculated based on the ratio that the fair market value of the qualified interest bears to the “before” value of the property.

D. Estate Tax Exclusion for Real Estate Subject to Conservation Easement

1. The 1997 Act provided for an exclusion from the gross estate equal to 40% of the value of any real property located in particular geographical locations in the United States.
States subject to a “qualified conservation easement”. This exclusion is in addition to the estate tax charitable deduction available to the estate for the value of the irrevocable easement itself. The 2001 Act expanded this exclusion to real property located anywhere in the United States or its possessions.

2. The exclusion is equal to the lesser of:
   a. the “applicable percentage” of the value of the land subject to such easement reduced by any estate tax charitable deduction allowed for the easement, or
   b. the “exclusion limitation” is $500,000. This limitation is imposed on each estate and, accordingly, if properly structured, a husband and wife, together, could utilize these limitation amounts and exclude up to $1,000,000 in value of such real property from their joint estates.

3. The exclusion is not available under the following circumstances:
   a. to the extent that the land is “debt-financed property”, but is available to the extent of the decedent’s equity in the property;
   b. any development right retained by the donor/decedent in conveyance of the easement, unless an agreement, acceptable to the Service, is entered into by all parties-in-interest (whether or not in possession) before the estate tax return is filed (and filed with the return), in which such rights are extinguished permanently; or
   c. for the value of any improvements to the land.

4. Qualifications for the exclusion
   a. The land must be located in the United States or its possessions.
   b. The land must have been owned by the decedent or a member of the decedent’s family at all times during the three-year period ending on the date of the decedent’s death.
   c. An election to exclude the land from the estate must be made on the decedent’s estate tax return.
   d. A qualified conservation easement (as defined in Section 170(h)(1)(c), with certain exceptions) has been made as of the date of the election by the decedent, a member of the decedent’s family, the executor of the decedent’s estate, or the trustee of a trust holding the subject land. These exceptions include a prohibition on more than a de minimus use of the property for commercial recreational activities which is more restrictive than what is necessary to qualify as a conservation easement for income tax charitable contribution purposes.
5. The exclusion will allow the exclusion of interests in partnerships, corporations, or trusts, so long as the decedent owned, either directly or indirectly, at least 30% of the entity, as determined under Section 2033A(e)(3).

E. Use of Trusts to Make Charitable Gifts of Real Estate

In general, the value of a partial interest which is transferred in trust is deductible as a charitable contribution only if the trust is a pooled income fund, a charitable remainder trust or a charitable lead trust.

1. Gift of Remainder Interest to Charity: The Charitable Remainder Trust ("CRT")

A CRT is an irrevocable trust, to which an individual gives a certain amount (or asset) and either retains an annuity from the CRT or provides an annuity from the CRT to another person. When the CRT terminates, the remaining assets in the CRT are distributed to charity.

a. Benefits of Creating a CRT

(1) Immediate Income Tax Charitable Deduction. If the CRT is created during lifetime, the donor receives an immediate income tax charitable deduction for the value of the charitable remainder interest, although the donor still has the benefit of the gifted amounts since he or she or his or her designee(s) receives the annuity.

(2) Immediate Estate Tax Charitable Deduction. If the CRT is created at death, the individual's estate receives an immediate estate tax charitable deduction for the value of the charitable remainder interest, even though the charity does not receive the funds until the end of the specified term or the death of the person who is to receive the annuity.

(3) Tax-exempt Entity. A CRT is a tax-exempt entity. Since sales of assets held by CRT do not generate taxable gain to CRT, diversification can be achieved without capital gains cost. However, this is only a deferral of tax because the pay-out to the non-charitable beneficiary is taxed on a tiered system under Section 664. Nonetheless, the pay-out can be based on the full amount of the sale proceeds and not on after-tax dollars. Furthermore, any "phantom income" received by the CRT, as a result of the assets it is holding, can be avoided or deferred.

b. Term

The term of CRT can be a period of years not exceeding twenty years or the life (or lives) of any person or persons.

c. Pay-out Rules
(1) 10% Rule. The annual pay-out to the non-charitable beneficiary cannot be so large that the value of the remainder interest is less than 10% of the initial fair market value of the assets transferred to the CRT. 

(2) 50% Rule. The annual pay-out to the non-charitable beneficiary cannot exceed 50% of the initial fair market value of the assets transferred into the CRT.

(3) Pay-out Options. There are two types of CRT, based on the type of pay-out from the CRT.

(a) A Charitable Remainder Annuity Trust (“CRAT”) pays out an annuity that is a flat dollar amount or percentage of the initial fair market value of the CRT. The consequences of using a CRAT are as follows:

(i) the pay-out amount cannot change;

(ii) the pay-out must be made within certain
defined time periods.

(iii) no future additions to the CRAT are permitted.

(b) A Charitable Remainder Unitrust (“CRUT”) pays out a percentage of the fair market value of CRUT, as re-determined each year. The consequences of using a CRUT are as follows:

(i) the pay-out amount will go up or down depending on performance;

(ii) future additions to the CRUT are permitted;

(iii) there are a number of alternative pay-out options available with a CRUT.

(c) The alternative pay-out provisions that can be used in a CRUT are as follows:

(i) the pay-out of the lesser of a percentage of a fair market value of the CRUT or the annual net income in the CRUT; or

(ii) the pay-out of the lesser of a percentage of the fair market value of the CRUT or the annual net income in the CRUT, with a “make-up”.

aa. A “make-up” provides that, to the extent the net income of the CRUT exceeds the percentage amount in any one year, such excess
income is paid out to “make up” any shortfalls that occurred in prior years, when only the net income and not the percentage amount was paid out to the non-charitable annuitant. A meaningful make-up provision should define “income” in the agreement to include capital gains, and this definition must be permitted under state law.

The Service issued Final Regulations to Section 664 on December 10, 1998, which prohibit the allocation of pre-gift appreciation to income, when using a make-up provision.

If a make-up provision is used, then, to the extent there is a deficiency in a year (the net income is less than the percentage amount), the fair market value of the CRUT must be reduced (but not below the unrealized appreciation in the CRUT) to account for the deficiency when determining the percentage amount.

(iii) Flip Unitrust: This type of pay-out was made effective when the Service issued its Final Regulations to Section 664, on December 10, 1998. The requirements for a “Flip Unitrust” described in the Final Regulations are as follows:

aa. The provision in the CRUT is for the payment of income-only or the lesser of the net income or the percentage of fair market value amount, and, upon the happening of a certain event, the pay-out provision “flips” to a straight percentage pay-out.

bb. The requirements for this type of pay-out are twofold; namely, (1) 90% of CRT assets must be unmarketable securities, and (2) the “flip” event is triggered upon the occurrence of any triggering event, as long as such event is not controlled by the trustee or any other person.

c. Existing income-only CRTs could be reformed to Flip Unitrusts so long as the proceedings were initiated by June 8, 1999.

d. The change in method must take effect in the CRT's tax year immediately following the flip.

(4) Form of Pay-out. Distributions of the pay-out amount may be made in kind. An in-kind distribution is treated as a deemed sale, and the recipient’s basis in the asset received will be its fair market value.

(5) Timing of Pay-out. The pay-out must be made within a reasonable time after the close of the year for which payments are due if the character of the amounts paid is income under the CRT tier system or the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due.

(6) Consequences of failing to satisfy the pay-out obligation may include the following:
(a) the CRT trust may not be considered to function exclusively as a CRT, in which case it loses its tax-exempt status;

(b) the failure could be construed as self-dealing within the meaning of Section 4941, in which case excise taxes will result; and/or

(c) the unpaid pay-out amount could be construed to be debt-financed income within the meaning of Section 514, in which case the CRT loses its tax-exempt status.

d. Miscellaneous Real Estate-Related Issues in a CRT

(1) Valuation -- In a CRT, the assets must be valued each year. If the grantor/beneficiary is acting as trustee, or if the trustee is related or subordinate to the grantor, there may be an inherent conflict in the two roles when valuing “unmarketable assets” to determine the pay-out amount. The solutions to this problem include the following:

(a) use an independent trustee or special trustee to value assets; or

(b) obtain a qualified appraisal (the Regulations mandate that this requirement must be in the agreement).

(2) Depreciation Reserve -- If the pay-out amount is related to the income of the CRT, the CRT must establish a depreciation reserve if the trustee invests in depreciable or depletable property. The reserve must be based on generally accepted accounting principles; and depreciation deductions are allocated between the income and remainder beneficiaries.

e. General Rules

(1) A CRT can be created during the individual’s lifetime or upon the individual’s death.

(2) The non-charitable beneficiary of the CRT can be any person, as defined in Section 7701(a)(1). This includes individuals (so long as the individual is living at the time the CRT is created), trusts (under certain circumstances), estates, partnerships, associations, companies or corporations.

(3) A CRT cannot be a grantor trust within the meaning of Subpart E of Subchapter J.

(4) The trust agreement cannot restrict the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Accordingly, a CRT has been disqualified under the following circumstances:
(a) if there is a provision that restricts the trustee to certain types of investments; or

(b) the CRT's investments are so restricted that, in effect, the trustee is restricted to certain types of investments, such as the retention of a life estate in the assets contributed to CRT, or a contractual obligation to which the Trustee is subject, which forces the trustee to lease the CRT's property.

(5) Recently, the Service issued guidelines providing a safe harbor for CRTs in order to avoid disqualification due to certain spousal election rights that arise in states that have the augmented estate concept set forth under the Uniform Probate Code (“UPC”). This concept allows a spouse to reach property transferred by the decedent during his or her life as part of the spouse’s right to “take against the Will.” Such right, whether or not exercised, would disqualify the CRT. If, the transferor’s spouse irrevocably waives the right to reach the assets of the CRT, in the manner and within the time set forth in the guidelines as part of the augmented estate, the CRT will not be disqualified. Individuals who do not live in a state that has enacted such concept will not have to obtain such spousal waiver unless and until they establish their domicile in a UPC state; at which time they will have to obtain such waiver for any CRT created on or after June 28, 2005, regardless of how much time has passed between the creation of the CRT (in a non UPC state) and the time of the move (to a UPC state).

(6) The Service has issued new sample CRT forms and any CRT agreements that are the same or substantially similar to the forms will ensure qualification under Section 664, so long as the requirements of Section 664 that surround the transaction.

f. CRTs and the Self-Dealing Rules

(1) CRT’s are subject to the self-dealing rules of Section 4941, pursuant to Section 4947.

(2) “Self-dealing” is defined in Section 4941(d) to include, among other activities, any (i) sale, exchange or leasing of property, (ii) loan or other extension of credit, or (iii) furnishing of goods, services or facilities, between the CRT and any disqualified person.

(3) “Disqualified person” is defined in Section 4946 as the person who contributed assets to the CRT; a trustee of the CRT; the owner of more than 20% of (i) the combined voting power of a corporation, (ii) the profits interest in a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise, which was contributed to a CRT; the spouse, ancestors, children, grandchildren, great-grandchildren and spouses of children, grandchildren or great-grandchildren of such contributor.

(4) Furthermore, a disqualified person includes a corporation of which any of the persons described above own more than 35% of the total combined voting power, a partnership in which any such person owns more than 35% of the profits interest or a trust or estate in which such persons hold more than a 35% beneficial interest. The rules of Section 267(c) apply to these ownership rules with certain exceptions.
(5) Acts of self-dealing are subject to excise taxes.

(a) The rate of the excise tax is 5 percent of the amount involved with respect to the act of self-dealing for each year, which shall be paid by the disqualified person. If the act is not corrected within the taxable period, a tax of 200% of the amount involved is imposed on the disqualified person.

(b) There is an additional tax on the trustee equal to 2.5% of the amount involved, unless such participation is not willful and is due to reasonable cause. If the trustee refuses to agree to part, or all, of the correction, there is then imposed a tax equal to 50% of the amount involved, which is to be paid by the trustee.

(6) Exceptions to the self-dealing rules:

(a) The mere transfer of an asset (such as a part-gift part-sale) to a CRT upon the creation of the CRT is not considered self-dealing. However, if such a transfer is made to an already existing CRT, it will be considered an act of self-dealing if the grantor is also acting as a trustee of the CRT.

(b) A transfer of real property subject to a mortgage or similar lien (if the grantor is acting as a trustee) will be treated as a sale or exchange for purposes of the self-dealing rules, unless such mortgage or lien has been in existence for more than 10 years. A refinancing of 10-year old debt will not be considered new debt except to the extent it increases the amount of the outstanding indebtedness.

(7) Possible or actual acts of self-dealing include the following:

(a) the income beneficiary is the general partner of a limited partnership or manager of an LLC, the interest in which is held in a CRT that pays out the lesser of the income or percentage, or lesser of income or percentage with make-up;

(b) the payment of debt service on property in which the grantor is obligated in some manner or has an interest therein;

(c) a disqualified person acting as trustee and taking unreasonable trustee fees; or the disqualified person is taking management fees;

(d) if the CRT pays out the lesser of the income or a percentage, the deferral of a sale to a subsequent tax year by a trustee, thereby ensuring that there is no income tax that year; and

(e) the reformation of a CRT to delete the income-only part of the pay-out.

(8) Recently, the Service found that a CRT that contributed its assets to an FLLC in exchange for an interest in the FLLC was not guilty of self dealing.
g. CRTs and Unrelated Business Taxable Income ("UBTI")

In any year in which a CRT receives one dollar of unrelated business taxable income, as defined in Section 512, the CRT will lose its tax-exempt status and be taxed as a complex trust under the provisions of Sections 661 and 662.406/

(1) "Unrelated business taxable income" is generally defined in Section 512 as the gross income derived from any trade or business regularly carried on by the CRT that is unrelated to its exempt purposes minus any deductions directly related thereto and subject to certain modifications.

(2) One issue raised by transferring encumbered real estate in a CRT or having the CRT incur debt using the real estate as security is that Section 514(a) provides that income earned from debt-financed property shall be considered income derived from an unrelated trade or business for purposes of Section 512.

(a) "Debt-financed property" is defined in Section 514(b) as any property held to produce income with respect to which there is acquisition indebtedness.

(b) "Acquisition indebtedness" is defined in Section 514(c) as the unpaid amount of the indebtedness incurred (i) in acquiring or improving such property; (ii) before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and (iii) after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurring of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

(c) When property is acquired subject to a mortgage, the mortgage will be considered acquisition indebtedness. There are two exceptions in Section 514(c) to this rule:

(i) where property subject to a mortgage is acquired by bequest or devise, the indebtedness will not be treated as acquisition indebtedness during the 10-year period following the date of acquisition; and,

(ii) if property subject to a mortgage is acquired by gift, if the mortgage was placed on the property more than 5 years before the gift, and if the property was held by the donor more than 5 years before the gift, then the indebtedness secured by such mortgage will not be treated as acquisition indebtedness during the 10-year period following the date of the gift. An extension or renewal of the debt will be considered a part of the pre-existing indebtedness for purposes of this exception, to the extent the outstanding principal balance is not increased.407/

(3) UBTI Exit Strategy. Because Section 514(c)(2)(B) provides relief from UBTI rules for only 10 years, the grantor should contemplate an exit
strategy at the time the CRT is created or the encumbered property is contributed. Possible solutions to this problem include the following actions by the CRT:

(a) pay down the debt,
(b) sell the real estate,
(c) enter into a like-kind exchange of real estate with boot from liability relief, or
(d) contribute the real estate to an UPREIT or DownREIT structure.

h. Contribution of Debt-Encumbered Real Estate to a CRT

(1) The Service takes the position that encumbered property cannot be transferred to a charitable remainder trust when the grantor remains personally liable on the debt. Since the CRT may ultimately be forced to pay the grantor’s legal obligation, the following results would occur:

(a) the CRT would be a grantor trust and would therefore be disqualified as a CRT;
(b) the payment of such obligation would be an act of self-dealing, which is a prohibited transaction and would give rise to excise taxes; and
(c) the income would be debt-financed income and the CRT would receive unrelated business taxable income, if an exception did not apply.

(2) If the grantor does not remain personally liable on the debt or if there is non-recourse debt, there is a part-sale/part-gift transaction, pursuant to Section 1001, upon the transfer of the property to the CRT.

i. Contribution of Partnership Interest with Negative Capital Account.

There are four issues that can arise when contributing partnership interests with negative capital account to a CRT, any of which can have substantial tax consequences:

(1) there could be unrelated business taxable income under Section 512, as debt-financed property under Section 514;
(2) there could be recognition of income through the deemed release of liabilities (even if the debt were non-recourse);
(3) there could be self-dealing under Section 4941; and,
(4) it could be deemed a part-sale part-gift transaction under Section 1001.

j. Using a CRT to Sell Appreciated Real Estate.

(1) A taxpayer may have real estate that has appreciated in value which he or she would like to sell, but is deterred by the income tax that will arise as a result of the sale. When such property is placed in a CRT, the sale can take place without the recognition of gain, however; when the taxpayer receives his or her annuity, the annuity payment carries with it a portion of income realized but not recognized by the CRT.

(a) One technique used by the taxpayer prior to 2001 to avoid receiving a taxable annuity was not to sell the real estate once it was contributed to a CRT. Instead, the trustee of the CRT borrowed money from a disinterested lender, using the real estate as security for the loan, and distributed the loan proceeds to the annuitant to satisfy the annuity requirement. Since there are no income tax consequences to a loan, there was no recognized income in the CRT to be carried out to the annuitant when the annuity was paid. If the annuity was really high (but no higher than 50%) and the term short enough to ensure that the remainder interest equaled 10%, then a substantial amount could be distributed to the annuitant, tax-free.

(b) On January 5, 2001, the Service issued a Final Regulation effectively putting a stop to this technique. The Regulations now impose a “deemed sale” treatment on this type of transaction. The CRT will be treated as though it had sold, in the year in which a distribution is made to the annuitant, a pro rata portion of the trust assets to the extent that the distribution to the annuitant would (but for such Regulations) be characterized in the hands of the annuitant as being a distribution of corpus (and hence a tax-free distribution) under Section 664(b)(4).

2. Gift of Income Interest to Charity: The Charitable Lead Trust (“CLT”)

A CLT is an irrevocable trust, to which an individual gifts (or bequeaths) a certain amount and each year the charity receives a “lead” interest, which is either a fixed dollar amount (annuity pay-out) or percentage of the value of the trust (unitrust pay-out). At the end of the CLT’s term, which can be a term of years or for the life or lives of certain individuals, the CLT terminates and the family receives what remains in the trust.

a. Benefits of a CLT:

(1) If made during his lifetime, the donor receives a charitable gift tax deduction; or, if the CLT is created upon the individual’s death, the decedent’s estate receives an estate tax charitable deduction for the present value of the lead interest.

(2) The value of the remainder interest is a taxable gift (or bequest) valued at the time of the transfer. However, on the termination of the trust, any amounts distributed to the family in excess of the value of the remainder interest, determined at the time of the individual’s gift (or death), pass free of any further transfer taxes. Accordingly,
the gift or estate tax charitable deduction leverages the taxable gift or bequest to enable the donor to leave more to the family.

b. Comparison Between the CRT and CLT:

(1) The CLT is not a tax-exempt entity. The taxation of the CLT depends on the type of CLT that is created, which is described below.

(2) The donor may or may not receive a charitable income tax deduction for the value of the charitable annuity, depending on the type of CLT that is created, as described below.

(3) The charitable annuity paid by a CLT may be less than 5% of the fair market value of the CLT, it may exceed 50% of the fair market value of the CLT and the remainder interest in the CLT may be less than 10%.

(4) There are no alternative unitrust pay-out methods in a CLT.

(5) The term for years in a CLT can be longer than 20 years.

(6) A CLT (as is the case with a CRT) is subject to the self-dealing rules of Section 4941, as well as the other private foundation rules to which a CRT is subject. 411/412/413/414/415/ Recently the Service issued a ruling approving a transaction where a CLT received limited partner interests in a limited partnership that held a debt-financed shopping center. The Service held that the transaction did not constitute self-dealing or violate any of the private foundation rules to which the CLT is subject, so long as (i) the CLT did not assume any part of the indebtedness, and (ii) the debt had not been placed on the property by a disqualified person.

c. Taxation of the CLT and the Donor’s Charitable Income Tax Deduction

(1) “Grantor Trust” CLT.

(a) The donor will receive an immediate income tax charitable deduction for the value of the lead interest, subject to the percentage limitations on charitable income tax deductions described above.

(b) The donor will receive a gift tax charitable deduction for the value of the lead interest.

(c) All of the income in the CLT will be includable in the donor’s taxable income.

(2) “Non-grantor Trust” CLT.
(a) The donor will not receive any charitable income tax deduction for the value of the lead interest.

(b) The donor will receive a gift tax charitable deduction for the value of the lead interest.

(c) The CLT is a separate tax paying entity, which is entitled to a more favorable charitable deduction than an individual.

(d) The CLT receives a charitable income tax deduction for all amounts paid to charity, in each year of the CLT.\textsuperscript{416/}

(e) This deduction is not subject to any percentage limitations based on the CLT’s adjusted gross income.

(f) The exception to this rule is that the CLT does not receive a charitable income tax deduction for amounts of UBI distributed to a charity.\textsuperscript{417/}

(3) Uses of a CLT for Real Estate.

(a) A CLT will allow an individual holding real estate to transfer it to his or her family members at a discounted value, since the amount of the gift is only the remainder interest in the trust, after deducting the value of the annuity payable to charity. If the real estate produces enough income to meet the annuity requirement, then the full value of the real estate, and any appreciation thereupon, will pass to the family at a reduced value.

(b) If an interest in an entity is transferred to a CLT, and if the self-dealing and excess business holding excise taxes can be avoided, then using a CLT will enable the taxpayer substantially to leverage his or her estate or gift tax exemptions through funding with a discounted asset (with the discounts available for the interest in the entity) and the further discounts of subtracting the value of the annuity interest from the value of the gift or bequest.

(c) One opportunity that is lost by using a CLAT (in which a fixed dollar annuity is used, based on the initial fair market value of the trust), which is the entity in which the taxpayer can achieve the most leverage because the annuity is fixed, is that such an entity, just as is the case with a GRAT (which is discussed above), cannot be used to make generation-skipping transfers without great difficulty and uncertainty regarding the effectiveness of the generation skipping transfer.
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§2501(a)(1). Unless otherwise noted, all reference to Sections ($) and Regulations in this outline are to Sections of the Internal Revenue Code of 1986, as amended (the "Code"), and the Regulations thereunder.

Reg. §25.2511-1(c)(1).

§2511(a); Reg. §25.2511-1(a). See Ltr. Rul. 200534015 (May 13, 2005). Disclaimer of contingent remainder interest in trust is not a transfer Ltr. Rul. 200516004 (January 6, 2005), but renunciation of a remainder interest is a taxable gift Ltr. Rul. 200530002 (April 19, 2005).

The Economic Growth and Tax Relief Reconciliation Act of 2001, §511(d).

The Economic Growth and Tax Relief Reconciliation Act of 2001, §511(d).

Code §2502(a).


§2503(b)(2), as amended by the 97 Act §501(c)(3).

But see Nordstrom v. U.S., 97-1 USTC ¶60,255, 79 AFTR 2d 612 (N.D. Iowa 1996), where the spouse’s consent was a question of fact.

Reg. §25.2503-3(a). See Estate of Holland v. Comm’r, 73 T.C.M. (CCH) 3236 (1997). See also TAM 9751003 (August 28, 1997), in which the Service ruled that gifts of interests in a family limited partnership did not qualify for the annual exclusion because they constituted gifts of future interests. The interests did not provide for a steady and ascertainable flow of income, which would make the interests gifts of present interests, because the general partner had the ability to retain income for any reason, thereby making it uncertain whether any income would be distributed to the limited partners. But see TAM 199944003 (July 2, 1999), holding that gifts of limited partners interests qualified as annual exclusion gifts. The Service stated that “The Taxpayer [who was the general partner of the family limited partnership] possesses no powers as a general partner that are not otherwise contained in a standard limited partnership agreement.”

§2503(e).

§2503(e)(2)(A).

§2503(e)(2)(B). The term “medical care” is defined in §213(d), but, as set forth in Reg. §25.2503-6(b)(3), includes amounts paid for medical insurance.

Reg. §25.2503-6(a).

§2523(b). See Ltr. Rul. 9139001 (April 30, 1991) and Ltr. Rul. 9147065 (July 12, 1991), where trust was not eligible for marital deduction if a third party had a right to exercise option to purchase closely held shares held in the trust at book value.

§§2523(e) and (f). The spouse’s possible incapacity will not destroy the marital deduction. Ltr. Rul. 9514002 (December 20, 1994).

§§2523(e)(2) and 2523(f)(3).

§2523(e).

§2523(f)(4).

§2044.

When an individual makes an outright gift of real property and retains a right to mine minerals from the gifted real property, if the probability of surface mining is so remote as to be negligible, such retained right will not preclude the charitable deduction. §170(h)(5)(B)(ii), as amended by 97 Act §508(d).

§2522(c)(2).

§2522(d).

§2522(c)(2).

§6019(3), as amended by 97 Act §1301(a).

The unified gift tax credit must be used to reduce a donor’s gift tax liability in the gift tax period when the liability occurs. Gifts are to be reported on a Federal Gift Tax Return (Form 709 or 709-A).

IRC §6018(a)

§2056.

§2055.

§2651(d).
IRC §2631(c), as amended by Pub L No 107-16, §901.

§2651(e)(2), as amended and redesignated by 97 Act §511(a).

§1012.

§1015(a) and (b). See Ltr. Rul. 9430014 (April 28, 1994).

§1015(a); Reg. §1.1015-1(a)(1).

Reg. §1.1015-1(a)(2).

§1015(a); Reg. §1.1015-1(a)(3).

§1015(d).

§643(e)(1).

Reg. §1.267(d)-1(a)(2) and (4).

§2032A.

§2032. See Ltr. Rul. 200518009 (January 13, 2005)

§1014(a)(1), (2) and (3). As to decedents dying after July 18, 1984, the alternate valuation date may be elected only where the election will decrease the value of the gross estate and the estate’s total Federal estate tax liability. §2032(c).

Reg. §1.691(a)-1(b). See Ltr. Rul. 9325029 (March 25, 1993), holding that options granted to decedent during her lifetime, but exercisable after death, are not income in respect of a decedent.

§1014(a)(4), as amended by 97 Act §508(b).

§2040(b)(1) and 1014.

§2040(b)(2).


§754.

Reg. §1.743-1(b).

§743(a).

§754.

§732(b).

§1022, as added by 2001 Act §542(a).

§1022(a)(2), as added by 2001 Act §542(a).

§1022(b)(2)(B), as added by 2001 Act §542(a).

§1022(b)(2)(C), as added by 2001 Act §542(a).

§1022(c)(2)(B), as added by 2001 Act §542(a).

§1022(b)(3)(A), as added by 2001 Act §542(a).

§1022(d)(4), as added by 2001 Act §542(a).

§1022(d)(3), as added by 2001 Act §542(a).

§1022(d)(2), as added by 2001 Act §542(a).

§1022(e), as added by 2001 Act §542(a).

§1022(d)(1)(A), as added by 2001 Act §542(a).
§1022(d)(1)(B)(i)(II), as added by 2001 Act §542(a).
§1022(d)(1)(B)(ii), as added by 2001 Act §542(a).
§1022(d)(1)(B)(iii), as added by 2001 Act §542(a).
§1022(d)(1)(C)(i), as added by 2001 Act §542(a).
§1022(f), as added by 2001 Act §542(a).
§1022(d)(1)(D)(i), as added by 2001 Act §542(a).
§1022(d)(1)(D)(ii), as added by 2001 Act §542(a).
§1022(d)(1)(D)(iii), as added by 2001 Act §542(a).
§1022(d)(1)(D)(iv), as added by 2001 Act §542(a).
§1022(g)(1), as added by 2001 Act §542(d).
§1040(a), as amended by 2001 Act §542(d).
§1022(h)(2), as added by 2001 Act §542(a).

§2001(f), as amended by 97 Act §506(a), and §6501(c)(9), as amended by 97 Act §506(b); see Prop. Reg. 106177-98, 63 Fed. Reg. 707, 701, December 2, 1998.
Reg. §301.6501(c)-1(f)(2).
Reg. §301.6501(c)-1(f)(3).
Reg. §301.6501(a)-1.
Reg. §301.6501(c)-1(f)(4).
§7477(a), as added by 97 Act §506(c)(1).
But see §469(c)(7) and Reg. §1.469(f).
IRC § 705(a)
IRC § 752(b), 731(a).
Caveat: In avoiding gain recognition, out-of-pocket dollars may need to be spent and/or the value of the gift may be increased.
See Shepherd v. Comm’r, 2002 WL 312533 (CA 11 2002), holding that the taxpayer made an indirect gift of land to his two sons rather than a gift of partnership interests. The valuation of the gift was not determined by reference to the sons’ indirect ownership of the land through the partnership after the transfer and so discounting was not permitted.
No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse.
Reg § 301.7701-3(a).
See Juden v. Comm’r, 865 F.2d 960 (8th Cir. 1989).
See Estate of Feuchter v. Comm’r, 63 T.C.M. (CCH) 2104 (1992), increasing land’s value for agricultural use to reflect the potential of certain tracts for residential uses and to reflect the prospect of long-term
speculative development. See also Stanley Works v. Comm’r, 87 T.C. 389 (1986), and Estate of Lloyd v. Comm’r, 71 T.C.M. (CCH) 1963 (1996); but see Estate of Ratcliffe v. Comm’r, 63 T.C.M. (CCH) 3068 (1992), where the Court refused to value a real estate parcel based on highest and best use for multifamily development because obtaining the necessary zoning change for such development was speculative. Further, see Estate of Sirmans v. Comm’r, 73 T.C.M. (CCH) 2846 (1997), where the Court allowed evidence of imminent condemnation proceeding to depress value of land.


105/ See Gettysburg Nat. Bank v. U.S., 806 F. Supp. 511 (M.D. Pa. 1992), holding that real estate appraised at $115,000 at time estate tax return was filed and sold 16 months later to a third party for $84,000 could be revalued at lower price as the discrepancy between the appraisal and sales figures did not result from any material change in the property or the market; but see Proios v. Comm’r, 68 T.C.M. (CCH) 645 (1994). For a discussion of the three methods to value real estate, see Estate of Berg v. Comm’r, 61 T.C.M. (CCH) 2949 (1991), aff’d in relevant part 976 F.2d 1163 (8th Cir. 1992).

106/ See Rev. Proc. 79-24, 1979-1 C.B. 565. See also Estate of Ratcliffe v. Comm’r, 63 T.C.M. (CCH) 3068 (1992), using comparable sales approach with adjustments to account for the subject property’s lack of a sewer connection.

107/ See Rev. Proc. 79-24, 1979-1 C.B. 565. See also Estate of Ratcliffe v. Comm’r, 63 T.C.M. (CCH) 3068 (1992), using comparable sales approach with adjustments to account for the subject property’s lack of a sewer connection.

108/ See Rev. Proc. 79-24, 1979-1 C.B. 565. See also Estate of Ratcliffe v. Comm’r, 63 T.C.M. (CCH) 3068 (1992), using comparable sales approach with adjustments to account for the subject property’s lack of a sewer connection.

109/ See Training Manual for Estate Tax Examiners, at §5.044. See also Smith, Issues and Problems in the Valuation of Real Estate, 30 NYU Inst on Fed Tax’n 209, 229-230 (1972). See also Williams v. Comm’r, 32 T.C.M. (CCH) 291 (1973), noting that the deletion of some items, “particularly income taxes and interest, is a controversial practice”.

110/ See Smith, Issues and Problems in the Valuation of Real Estate, 30 NYU Inst on Fed Tax’n 209, 231 (1972). See also Estate of Bennett v. Comm’r, 65 T.C.M. (CCH) 1816 (1993), increasing discount rate from 11% to 14% in order to reflect the risk that the full amount of ground rents might not be collectible.


112/ Smith, Issues and Problems in the Valuation of Real Estate, 30 NYU Inst on Fed Tax’n 209, 222 (1972). See Rev Proc 66-49, 1966-2 C.B. 1257, indicating there must be a “probative correlation between the costs of reproduction and fair market value”. See also Brigham v. Comm’r, 64 T.C.M. (CCH) 244 (1992), rejecting the replacement cost method of valuation for a water tower and surrounding land on the basis that the water tower was not worth replacing; Estate of Palmer v. Comm’r, 839 F.2d 420 (8th Cir. 1988), rev’g and remanding 86 T.C. 66 (1986).


114/ §7517.

115/ §§7517(a), (b).

116/ §7517(c).


118/ See Knight v. Comm’r, 115 T.C. No. 36 (November 30, 2000).

119/ §6662(g). For returns filed after 1984 and due before January 1, 1990, see repealed Section 6660 for underpayment penalties.

120/ §6662(a). (g).

121/ §6662(b)(1).

122/ §6662(b)(2)(C).


124/ Estate of Baird v. Comm’r, 416 F.3d 442 (2005), rev’g and rem’g 84 T.C.M. (CCH) 620 (2002).

See that compared private-market price of restricted shares of public companies with their public-market price during same period; Estate of Ford v. Comm'r., 53 F.3d 924 (CA8 1995) (allowing a 20% minority interest discount and 10% lack of marketability discount when valuing stock of closely held corporation); Gross v. Comm'r., 78 T.C.M. (CCH) 201 (1999) (allowed 25% lack of marketability discount based on the company's generous dividend policy and the stock's significant marketability restrictions); Estate of Dougherty v. Comm'r., 59 T.C.M. (CCH) 773 (1990), and Estate of Bennett v. Comm'r., 65 T.C.M. (CCH) 1816 (1993); but see Estate of Jephson v. Comm'r., 87 T.C. 297 (1986). See also Pillsbury v. Comm'r., 64 T.C.M. (CCH) 284 (1992), where a 15% discount was allowed although the decedent owned a majority interest (77%) in the entity, and Estate of Gray v. Comm'r., 73 T.C.M. (CCH) 1940 (1997), where a 15% discount was allowed even though decedent owned approximately 82% of the entity; but see Cloutier v. Comm'r., 71 T.C.M. (CCH) 2001 (1996), in which, as a result of poor appraisals, the lack of marketability discount was lost.

These two discounts (the minority interest discount and the lack of marketability discount) generally are found with respect to transfers of stock in closely held corporations, and the following are examples of these types of transfers:

In Ford v. Comm'r., 66 T.C.M. (CCH) 1507 (1993) the Court applied a 20% minority interest discount to the value of two corporations in which the estate had a minority interest, but then applied an additional 10% lack of marketability discount to the value of all corporations, even ones in which the decedent held a controlling interest.

In 1994, the Tax Court approved a 40% discount for lack of marketability of stock held in Joseph Lauder's estate, but also reminded the Service and the taxpayer that (i) if there is a publicly traded company that is in a similar line of business, this must be considered, and (ii) these matters are best resolved outside of litigation. Estate of Lauder v. Comm'r., 68 T.C.M. (CCH) 985 (1994)

In 1995, the Tax Court addressed these discounts a number of times, usually with a favorable result to the taxpayer. In Trenchard v. Comm'r., 69 T.C.M. (CCH) 2164 (1995) the Court applied a control premium to the decedent's stock to reflect his operating and voting control, but also applied a discount for lack of marketability to all the decedent's stock to reflect the absence of an established market for closely held stock. The Court stated that the control premium is separate and apart from any discount that may apply and control does not mean the stock is any more or less marketable. In Mandelbaum v. Comm'r., 69 T.C.M. (CCH) 2852 (1995) the Court applied a 30% lack of marketability discount, based on a list of factors which included (i) an analysis of the corporation's financial statements; (ii) the nature of the corporation's financial statements; (iii) the corporation's dividend paying capacity and its history of paying dividends; (iv) the nature of the corporation and its management; and (v) the cost of going public. Finally, in McCormick v. Comm'r., 70 T.C.M. (CCH) 318 (1995) the Court applied minority interest discounts ranging from 24% to 32% and lack of marketability discounts ranging from 20% to 22%. The three factors the Court considered relevant were the size of the interest, the risks inherent in the business conducted by the entity and the restrictions on transferability.

In 1996, a District Court in the Fifth Circuit allowed a 10% minority discount even though the decedent held 50% of the voting stock of the corporation, since a 50% interest does not allow the decedent to control the management of the company, only to block any proposed action and, as the Tax Court pointed out, a minority discount is based on the lack of control. Wheeler v. U.S., 96-1 USTC 60,226 (W.D. Tex. 1996), reversed on other grounds, 116 F.3d 749 (5th Cir. 1997) The Tax Court also acknowledged in a case decided in 1996 that a marketability discount may be available in cases where decedent owned 100% of the stock of a corporation, but did not grant such a discount because the appraiser failed to establish a basis for such discount. Cloutier v. Comm'r., 71 T.C.M. (CCH) 2001 (1996) Finally, the Tax Court allowed a 19% minority discount and 26% lack of marketability discount. Barudin v. Comm'r., 72 T.C.M. (CCH) 489 (1996)

In 1998, the Tax Court allowed a 40% discount for a minority holding of common stock of a closely held grocery chain, citing a lack of a market for the stock, a restrictive buy-sell agreement, the lack of comparables and the decedent's minority interest. Brookshire Estate v. Comm'r., 76 T.C.M. (CCH) 659 (1998)
The Second Circuit allowed a taxpayer to reduce the value of closely held stock, for Federal gift tax purposes, to take into account potential capital gains tax liabilities if the corporation liquidated, distributed or sold its sole asset, a commercial building, even though no such liquidation, sale or distribution was planned. *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998) The Court reasoned that, because the capital gains tax will in all events ultimately be incurred, the capital gains liability is not too speculative to be valued as of the date of the gift.

In 2000, the Tax Court allowed a 15% lack of marketability discount and a 7.5% lack of control discount (since 2/3 voting majority was needed for control) to an estate that held 63% of a corporation’s outstanding shares. *Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337 (2000)

[As discussed below, the Service has taken the position that the “swing vote” attached to a gifted interest could destroy any possible discount (or, perhaps, result in a premium). Ltr. Rul. 9436005 (May 26, 1994) This Letter Ruling involved a situation in which three 30% blocks of stock were gifted to the donor’s children, which gave each child the ability to control the corporation by voting with one other child. This Service position is unrealistic, and difficult to accept. Among other things, it creates a form of family attribution not present in the Code and specifically rejected in Rev. Rul. 93-12, 1993-1 C.B. 298.]

The following are examples of cases in which a discount was allowed in valuing direct or indirect interests in real property:

* In *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) the decedent died owning certain community real property with his wife. The executrix claimed, and the Court allowed, a 15% valuation discount to account for the relative unmarketability of an undivided fractional interest in the property.
* Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982), involved ownership by the decedent of approximately 20% in four closely held corporations. All four corporations were involved primarily in the ownership, operation and management of commercial real estate. The real estate holdings included warehouses, commercial office space, retail space, factories and apartment buildings. The Court allowed a minority interest discount of 60% based on the lack of control that could be exercised by any purchaser of decedent’s interest, and such purchaser’s inability to sell such shares in the marketplace. The Court concluded that there was no family attribution for purposes of determining whether the decedent did, in fact, hold a minority interest.

* In *Estate of Sels v. Comm'r*, 52 T.C.M. (CCH) 731 (1986), the Court applied a 60% discount to undivided interests ranging from 2% to 25% in 11 different tracts of timberland. Later, the Court applied a 40% valuation discount to a taxpayer’s 20% undivided interest in 1,212.4 acres of farmland (the balance of which was owned by members of his family). *Estate of Wildman v. Comm'r*, 58 T.C.M. (CCH) 1006 (1989) This discount factor reflected a 15% minority interest discount plus a 10% discount to account for the fact that the irrigation facilities relative to this land were not owned by the landowners and plus a 15% discount to account for potential impediments to the sale of the property as well as possible litigation or partition expenses. (See also *Estate of Bennett v. Comm'r*, 65 T.C.M. (CCH) 1816 (1993), allowing a 15% lack of marketability discount even though 100% of the closely held corporation stock was held in a grantor trust; and *Moore v. Comm'r*, 62 T.C.M. (CCH) 1129 (1991), in which the Court held that a 35% discount for a minority partnership interest was appropriate.)

* In *Estate of Berg v. Comm'r*, 61 T.C.M. (CCH) 2949 (1991), aff'd in relevant part 976 F.2d 1163 (8th Cir. 1992), the Eighth Circuit upheld the Tax Court’s determination that decedent’s shares of stock in a closely held real estate holding company, representing 27% of the company, should be discounted by 30% -- representing a 20% discount because decedent owned a minority interest in the corporation plus a 10% discount because of the lack of marketability of such interest. The Berg Estate claimed an aggregate 60% discount, comprised of a 40% minority interest discount and a 20% discount for lack of marketability.

In 1998, the Tax Court allowed a 44% discount for the decedent’s one-half interest in certain parcels of timberland owned at the time of her death. *Williams v. Comm'r*, 75 T.C.M. (CCH) 1758 (1998). The IRS argued that the discount should be limited to 5%, based on its estimate of the cost of partitioning the properties, but did not offer any evidence in support of its valuation. The taxpayer, however, presented four expert witnesses. The Court focused on the following testimony of such experts in allowing the discount: (i) banks will not lend money to an owner of a fractional interest in real property without the consent of the co-owner; (ii) a market discount is appropriate because of a projected nine-month marketing time and 10% real estate commissions; (iii) the holder of a fractional interest cannot unilaterally decide how the property should be managed; (iv) a partition action involves considerable time and expense; and (v) selling an individual fractional interest in real property presents difficulties.

In 1999, the Tax Court allowed discounts of 50% and 65% for gifts of assignee interests (rather than limited partner interests) in a FLP. *Estate of Nowell v. Comm'r*, 77 T.C.M. (CCH) 1239 (1999).
In the same year, the Tax Court allowed an overall discount of 76% for a decedent’s minority interest in two closely held corporations, one of which owned and operated a farm. *Estate of Smith v. Comm'r*, 78 T.C.M. (CCH) 745 (1999). This large discount was awarded despite the provision in the corporate documents that the decedent was entitled to distributions to the extent necessary to meet the shareholder’s income tax burden.

Recently, the Tax Court allowed a 20% lack of marketability discount to a 25% limited partner interest in a partnership holding an apartment building. *Weinberg Estate v. Comm'r*, 79 T.C.M. (CCH) 1507 (2000). What is most interesting about this case is not the size of the discount, but the method by which the Court valued the partnership which, together with the lack of marketability discount, resulted in a discount of almost 50% of the decedent’s percentage interest in the underlying assets.

The following are examples of cases in which a discount was denied in valuing direct or indirect interests in real property:

In *Estate of Young v. Comm'r*, 110 T.C. 297 (1998), the Court denied the fractional interest discount taken by the estate on real property that the decedent owned as a joint tenant with his wife. The estate argued that Section 2033 of the Code, which provides that property in which the decedent had an interest must be included in the gross estate, has been held to allow fractional interest and lack of marketability discounts. The estate further argued that Section 2040 of the Code provides for the inclusion of jointly held property in the gross estate, but does not speak to the valuation of such property. Thus, the IRS cannot construe Section 2040 to deny fractional interest and lack of marketability discounts to the estate. The Court disagreed and stated that the fractional interest discount allowed under Section 2033 is based on the rights of a tenant in common under local law which arise from the unity of interest and the unity of possession. The fractional interest discount is only appropriate when a partial interest in property would sell for its proportionate share and the lack of marketability discount arises from the difference in selling such partial interests. Joint tenancies, however, provide for a right of survivorship; thus, no tenant can devise the property to anyone other than the other joint tenant. Since there are no co-ownership problems at the moment of death, neither fractional nor lack of marketability discounts are appropriate for estate tax purposes.

In *Estate of Fratini v. Comm'r*, 76 T.C.M. (CCH) 342 (1998), the Court held that the estate was not entitled to fractional interest discounts with respect to property held in joint tenancy with the right of survivorship. In determining the amount included in decedent’s estate pursuant to Section 2040, the estate reduced the value of the decedent’s interest in several of the jointly held real properties by fractional interest discounts. The Court, however, disallowed the claimed fractional discounts because, under Section 2040(a), the amount includable in a decedent’s gross estate does not depend on a valuation of property rights actually transferred at death, or on a valuation of the actual interest held by the decedent (legal title). The decedent’s gross estate includes the entire value of property held in a joint tenancy by the decedent and any other person, except to the extent the consideration for the property was furnished by such other person. In addition, Section 2040(a) provides an artificial inclusion of the joint tenancy property: the entire value of the property less any contribution by the surviving joint tenant. Except for the statutory exclusions in Section 2040(a), there is no further allowance to account for the fact that less than the entire interest is being included.

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127/ Reg. §20.2031-2(e); *Estate of Auker v. Comm'r*, 75 T.C.M. (CCH) 2321 (1998); *Estate of Foote v. Comm'r*, 77 T.C.M. (CCH) 1356 (1999). The Service has held, however, that nine gifts of stock, which if given to one donee may have entitled the donor to a blockage discount (given the impact of selling that amount of stock would be on the market), cannot be aggregated in order to obtain this discount, but must be considered separately. Ltr. Rul. 9719001 (November 19, 1996). This is contrary to the Service’s position on the swing vote premium discussed below.


130/ *Estate of Welch v. Comm'r*, 208 F.3d 213 (6th Cir. 2000).


Simplot v. Comm'r, 249 F.3d 1191 (9th Cir. 2001).


Estate of Jelke v. Comm'r., 249 F.3d 1191 (9th Cir. 2001).


Ltr. Rul. 9449001 (March 11, 1994), in which simultaneous gifts to 11 family members of all stock of a closely held corporation were valued separately based on what each donee received, not on what the donor owned. But see Cidulka v. Comm'r, 71 T.C.M. (CCH) 2555 (1996), where a gift of a minority interest in a company to a child, combined with a corporate redemption that took place the same day, which had the effect of making such child a majority holder of the company, was denied any minority discount.


Kerr v. Comm'r, 292 F3d 490 (5 Cir. 2002).

FSA 200049003 (September 1, 2000); FSA 200143004 (July 5, 2001); Strangi v. Comm'r, 115 T.C. 478 (2000)

Reg §25.2703-1(a)(1). Note that a perpetual restriction on the use of real property that qualified for a charitable deduction under either IRC §2522(d) or 2055(f) is not considered a right or restriction.

Reg §25.2703-1(b).

See Regs. §§25.2703-1(a) and (b)(3).

Estate of Gloeckner v. Comm'r, 71 T.C.M. (CCH) 2548 (1996), rev'd, F. Gloeckner Estate, 152 F.3d 208 (2d Cir. 1998), where the Court found that the business associate that was purchasing the stock did not have a familial relationship with the decedent.

Reg. §25.2703-1(b)(4)(i); see also Estate of Gloeckner v. Comm'r, 71 T.C.M. (CCH) 2548 (1996), rev'd, F. Gloeckner Estate, 152 F.3d 208 (2d Cir. 1998), wherein the Appeals Court found a bona fide arrangement that was not a device.

Reg §25.2703-1(b).


Estate of True v. Comm'r, 390 F.3d 1210 (10th Cir. 2004), aff'g 82 T.C.M. (CCH) 27; Blount v. Comm'r, 87 T.C.M. (CCH) 1303, on appeal.

See Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855 (1997). Recently, in TAM 199938005 (June 7, 1999) the Service held that under §2036(b) (if the donor retains the right, directly or indirectly to vote gifted stock in a controlled corporation) such stock that was transferred into a family limited partnership, the limited partner interests of which were gifted by the transferor/general partner, were includible in the general partner's estate.

Regs. §§20.2036-1(a), 20.2037-1(e) and 20.2038-1(a).

Reg § 20.2036-1(a).

Estate of Tehan v. Comm'r, 89 T.C.M. (CCH) 1374 (2005)

States v. Byrum, 408 US 125 (1972)


See Reg § 1.704-1(e).

§2702(b). For a discussion of the zero valuation rule of Section 2702, see Harris, Avoiding Double Taxation on Zero-Valuation Transfers under Section 2702, 12 The Practical Tax Lawyer 25 (Summer 1998).

§§2702(e), 2704(e)(2).


§453(d).

§453(b)(1). See, however, as to installment sales of depreciable property between related persons, §§453(g)(1), 1239(b).

§453(c).

§453B. See also §§453(e), 453C.

§453B(1)(1), 691(a)(1).


98 T.C. 341 (1992), aff'd and rev'd 998 F2d 567 (8th Cir. 1993).

§2512(b); Reg. §25.2512-5. However, a taxpayer may not use the annuity tables if his death was imminent at the time the private annuity agreement was executed. See McLendon v. Comm'r, 66 T.C.M. (CCH) 946 (1993), rev'd in part and remanded 77 F.3d 477 (5th Cir. 1995), modified 71 T.C.M. (CCH) 42 (1996). The Service issued final Regulations effective as of December 13, 1995, which contain the rules as to when the annuity tables may be used to value annuities, interests for life, term of years and remainder interests under §7520. Reg. §25.7520-3.

See Ltr. Rul. 9513001 (November 28, 1994).

See discussion on self-cancelling installment notes wherein a buyer may pay less for the property (in the event of the seller's premature death), but will never pay more for the property than its fair market value at the time of the sale plus the risk premium.

Contrast lack of collateralization on the debt with self-cancelling installment note, where collateralization is permissible.

See Rev. Rul. 68-183, 1968-1 C.B. 308, where the Service ruled that a transferor who transferred stock to a trust in exchange for a private annuity was treated as the owner of the trust because the only source of income to pay the private annuity was the transferred stock.


See Bell v. Comm'r, 76 T.C. 232 (1981), aff'd, 668 F.2d 448 (8th Cir. 1982). See discussion on self-cancelling installment notes, where interest paid on note is deductible.

§72; Reg. §1.72-9.


At one time, the Service took the position that, where the grantor pays the tax on such income that is includable in his or her taxable income, such payment should be considered a gift. Ltr. Rul. 9444033 (August 5, 1994); however, the Service withdrew this ruling and re-released it without this controversial position. Ltr. Rul. 9543049 (August 5, 1995).


The 97 Act repealed the rollover provisions of §1034; however, the Service has not ruled on whether the revised §121 applies to grantor trusts; the Service took the position in Ltr. Ruls. 9321050 (February 25, 1993) and 9309023 (December 3, 1992), that §121 and §1034 apply to the sale of the grantor's residence made by a grantor trust, and there is no reason to believe they would rule otherwise under the revised §121.

Ltr. Rul. 9101065 (December 13, 1989); Ltr. Rul. 9838017 (June 19, 1998).

§1015(b).

Reg. §1.671-3.


The interest rate should be the $7872 rate. Frazee v. Comm'r, 98 T.C. 554 (1992).


See Ltr. Ruls. 200010010, 200010011, 200011005 (March 15, 2000), Reg. § 1.1001-2(c) (Ex. 5).

Reg. §25.2702-4(c).

Ltr. Rul. 9515039 (January 17, 1995).


Reg. §25.2702-4(d), Example 1.

See Ltr. Rul. 9515039 (January 17, 1995).

Reg. §25.2702-4(c); but see Ltr. Rul. 9206006 (October 24, 1991).

§2701(a)(3); see Ltr. Rul. 9933022 (August 1, 1999).

§2701(a)(4).

§2701(a)(2)(A).

§2701(a)(2)(B) and (C).

§2701(b).

§2701(c)(3).

§2701(c)(3).

§2701(d).

Ltr. Rul. 200114004 (November 30, 2000).
General Explanation of the Tax Reform Act of 1976, prepared by the Staff of the Joint Committee on Taxation, at 537.

§2032A(a)(2). Starting in 1998, this amount will be indexed for inflation, but in any year the amount is not a multiple of $10,000, it will be rounded down to the nearest $10,000. §2032A(a)(3)(B), as amended by 97 Act §501(b).

§2032A(a)(10). See also Ltr. Rul. 8023027 (March 7, 1980).

See Ltr. Rul. 8404003 (September 8, 1983).

§1014(a).

FSA 199924019 (March 17, 1999); Estate of Rogers v. Comm'r., 79 T.C.M. (CCH) 1846 (2000).

§2032A(b)(1)(A). Only those assets actually being used for farm purposes may be counted in the numerator of the relevant fraction. For example, a checking account used by the decedent for both farming and personal expenses may not be used in its entirety to meet the 50% requirement. See Estate of Mapes v. Comm'r, 99 T.C. 27 (1992).

§2032A(b)(1)(B).

§2032A(e)(7)(A). In Estate of Klosterman v. Comm'r, 99 T.C. 313 (1992), the taxpayer argued that amounts collected from tenants equal to charges imposed by an irrigation district to operate an irrigation system constituted state or local real estate taxes which would be deductible from gross cash rental. The Court rejected the argument and held that the charges had the effect of increasing the value of the assessed property.

§2032A(e)(7)(A).

§2032A(c)(8), as amended by 97 Act §508(c).

Ltr. Rul. 9642055 (July 24, 1996).

A qualified heir may now lease the farm to a family member on a family land lease basis and not trigger the §2032A recapture. §2032A(c)(7)(E), as amended by 97 Act §504(a). See Ltr. Rul. 9519015 (February 7, 1995), in which a transfer to a revocable trust was not considered a disposition for purposes of §2032A. See also Ltr. Rul. 9503015 (October 21, 1994), where a §1031 exchange of §2032A property is not considered a disposition; and Estate of Hohenstein v. Comm'r, 73 T.C.M. (CCH) 1886 (1997), where leasing property to an unrelated party was considered a cessation of the qualified use.
(February 13, 1996); 9801009 (September 26, 1997), and 9832009 (May 6, 1998). For estates of decedents
dying after December 31, 2001, passive assets do not include stock in a qualifying lending and finance
business. §6166(b)(10), as added by 2001 Act §572(a).

253/ Ltr. Rul. 9621007 (February 13, 1996).
254/ But see Curphey v. Comm'r, 73 T.C. 766 (1980), holding that taxpayer, a dermatologist, who also owned
and managed six rental properties, was engaged in a trade or business under §280A.
255/ Rev. Rul. 75-367, 1975-2 C.B. 472. See Ltr. Rul. 9212001 (June 20, 1991), which held that farm land
removed from commercially productive purposes pursuant to the Federal Conservation Reserve Program
was still part of decedent's active trade or business of farming within the meaning of §6166. Also see Ltr.
Rul. 9214010 (December 23, 1991), which disregarded the decedent's royalty interest in gas and oil
production on his ranch from the determination of the estate's eligibility under §6166.

257/ See Ltr. Rul. 8244003 (May 1, 1982).
260/ See, e.g., Ltr. Ruls. 8829013 (April 15, 1988) and 8452017 (September 17, 1984).
262/ Ltr. Rul. 9309015 (December 1, 1992). See also Ltr. Rul. 925002 (September 11, 1992).
263/ Ltr. Rul. 9309015 (December 1, 1992).
266/ Ltr. Rul. 9635004 (May 15, 1996); see also Ltr. Rul. 200006034 (November 12, 1999).
267/ Ltr. Rul. 9801009 (September 26, 1997).
268/ Ltr. Rul. 9832009 (May 6, 1998); see also Ltr. Rul. 200114005 (December 15, 2000).
269/ Ltr. Rul. 200518011 (May 6, 2005).
270/ §6166(a)(3).
271/ §6166(a)(3); Reg. §20.6166-1(b)(6). Reg. §20.6166-1(b)(4) requires that a proper election must indicate
the number or amounts of installments; however, in Ltr. Rul. 8142014 (May 21, 1981), an election was
deemed valid although such information was not included. The election was presumed to be for the
maximum time, payable in 10 equal installments beginning 5 years after the time fixed for filing the return.

272/ §6166(f)(4).
273/ The estate tax return is due within 9 months after the date of the decedent's death. §6075. Upon a showing
of good cause, an extension of time for filing such return may be granted. However, unless the executor is
out of the country, the extension may not be for more than 6 months. Reg. §20.608-1(a).
(November 19, 2004).
275/ §6601(j)(3), as amended by 97 Act §501(a). The inflation-adjusted figure for 2004 is $1,140,000. Rev.
276/ §6601(j)(1)(B), as amended by 97 Act §503(a).
277/ §2053(c)(1)(D), as amended by 97 Act §503(b)(1).
279/ Ltr. Rul. 200129018 (April 18, 2001).
280/ §6161(a)(2).
281/ Reg. §20.6161-1(a)(1), Examples (1) through (4).
282/ Regs. §§20.6161-1(d) and 20.6165-1(a).
283/ §170(a)(1).
284/ This information included the name and address of the donee, the date of contribution, a description of
the property, the time and manner of acquisition of the property by the donor, the fair market value of the
property and the method utilized in determining such value, the cost or other basis of the property.
(especially for property held less than five years), any reductions under §170(e), the terms of any agreement or understanding between the donor and the donee regarding use or disposition of the property and the total amount claimed as a deduction due to the contribution of the property. Reg. §1.170A-13(d), See American Jobs Creation Act of 2004, Pub. L. 108-357 §§ 682-684, 108\(^{th}\) Cong., 2\(^{nd}\) Sess. (October 22, 2004).

285/ See Estate of Levine v. Comm'r, 72 T.C. 780 (1979), affd 46 AFTR 2d 80-5349 (D.Cal. 1980) (taxpayer recognized taxable gain where contributed property was encumbered beyond taxpayer's adjusted basis).

286/ It is true for all dispositions of property that the amount realized from a disposition includes the amount of liabilities from which the transferor is discharged as a result of the disposition. See Reg. § 1.1001-2, especially Reg. §1.1001-2(a)(4)(iii), which specifically defines a disposition of property for which gain based on discharge of indebtedness is realized to include a transfer of property in satisfaction of liabilities to which it is subject.

287/ See Ebben v. Comm'r, 783 F2d 906 (CA9 1986); and Guest v. Comm'r, 77 T.C. 9 (1981). Pursuant to Reg. §1.1011-2(a)(3), if property is transferred subject to an obligation, the amount of the obligation must be treated as an amount realized for purposes of determining whether there is a bargain sale, whether or not the transferee assumes or pays the obligation. This can be a real problem if an interest in a limited partnership, for example, is given to charity and the partner's share of partnership liabilities exceeds his or her share of partnership assets. Rev. Rul. 75-194, 1975-1 C.B. 80.

288/ See rules pertaining to the deductibility of contributions made pursuant to a bargain sale.

289/ Reg. §1.170A-4(c)(2)(ii).

290/ Although, as described above, a bargain sale may also be deemed to occur when encumbered property is contributed.


293/ See Reg. §1.1011-2(b).

294/ §1011(b) and Reg. §1.1011-2(b). §1011(b) provides that the taxpayer's adjusted basis for purposes of determining the gain recognized from a bargain sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property. In addition, Reg. §1.1011-2(a) stipulates that §1011(b) only applies where a charitable contribution deduction is allowable under §170 (in the year of the transfer or in a subsequent year) by reason of a bargain sale.

295/ Reg. §1.170A-4(c)(2)(i).

296/ Reg. §1.170A-4(c)(1)(i).

297/ Reg. §1.170A-4(c)(3).

298/ §170(f)(3)(B)(i); Reg. §1.170A-7(b)(3), (4). See Ltr. Rul. 9538040 (June 29, 1995) (taxpayer was entitled to deduct the fair market value of the remainder interest in taxpayer's personal residence upon contribution of the remainder interest to a §501(c)(3) organization).

299/ Reg. §1.170A-7(b)(3). For example, stock owned in a cooperative housing corporation is treated as a personal residence if the dwelling which the donor is entitled to occupy is used by him as his personal residence.

300/ Reg. §1.170A-7(b)(4). A farm includes the property and any improvements thereon.

301/ Regs. §§1.170A-7(b)(3), (4); Reg. §1.170A-12.

302/ §170(h)(1)(A).

303/ §170(h)(1)(B)

304/ §170(h)(1)(C)

305/ §170(h)(2)(A). A "qualified mineral interest" is defined as subsurface oil, gas or other minerals, and the right to access such minerals. §170(h)(6).

306/ For example, a contribution of property which is subject to a leasehold interest constitutes a contribution of the donor's entire interest. Ltr. Rul. 8639019 (June 25, 1986).


308/ Reg. §1.170A-14(b)(1)(ii).

309/ §170(h)(2)(B).
§ 170(h)(2)(C). This also applies to subsequent donees to whom the original donee transfers the property. However, in order to protect the conservation restriction, a qualified conservation contribution should either be made subject to a provision prohibiting the donee from transferring the property, or be subject to a provision requiring subsequent donees to carry out the original conservation purposes. See Reg. §1.170A-14(c)(2).

Reg. §1.170A-14(c)(1). Specifically, a qualified organization must be one of the following: (1) a governmental unit described in §170(b)(1)(A)(v); (2) a publicly supported organization described in §170(b)(1)(A)(vi); or (3) a charitable organization described in §501(c)(3) which either meets the public support test of §509(a)(2) or is an affiliated support organization satisfying the requirements of § 5 0 9(a)(3). The fact that qualified organizations must be publicly supported ensures that public purposes will be served when conservation easements are donated. The definition of “qualified organization” was specifically limited by Congress to publicly supported organizations in order to prevent private foundations and other closely held tax-exempt entities from exploiting the conservation easement deduction. Unlike a typical publicly supported organization, a private foundation or closely held tax-exempt organization generally receives its funding from a limited group of contributors. Consequently, such an organization tends to be more attuned to the objectives of its private contributors rather than the goals and desires of general public. Such limited focus contradicts the overall public purpose of conservation contributions. See General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Taxation (1969) (as amended by Pub L. No. 94-81 and Pub L. No. 95-345).

Significant habitats include, but are not limited to, habitats for rare, endangered or threatened species; natural areas that represent high quality examples of a terrestrial or aquatic community; and natural areas which are in or contribute to the ecological viability of a conservation area. Reg. §1.170A-14(d)(3)(ii). Relatively natural does not preclude some alteration by human activity. Reg. §1.170A-14(d)(3)(ii). What level of activity is unclear. The Regulations give examples of lakes or salt ponds formed by man-made dams or dikes which will qualify as long as the lake or pond was a natural feeding area for some rare native species. See also Glass v. Comm’r, 124 T.C. No. 16 (March 25, 2005).

Reg. §1.170A-14(d)(4)(i)(A). See also Ltr. Rul. 8623037 (March 11, 1986) (contribution of agricultural land was consistent with the county’s land use zoning plan). Reg. §1.170A-14(d)(4)(i)(B). See Reg. §1.170A-14(d)(4)(ii)(A) for a listing of relevant factors for determining whether a contribution is considered to be for the “scenic enjoyment” of the general public. Reg. §1.170A-14(d)(4)(iv)(A). There are 11 factors set forth, including the uniqueness of the property, the intensity of surrounding land development, consistency with public and private conservation programs, and the opportunity for the general public to enjoy the property.
See Ltr. Rul. 9052027 (September 28, 1990) (a state statute enacted in order to protect the “natural elements of surviving undisturbed natural ecosystems” is considered a clearly delineated governmental policy) and Ltr. Rul. 9603018 (October 19, 1995) (contribution endorsed by the township and consistent with local, county and state goals regarding the preservation of scenic and undeveloped farmland was found to be pursuant to a clearly delineated governmental policy).

Reg. § § 1.170A-14(d)(4)(iii)(A), (B).

Reg. §1.170A-14(d)(4)(ii). There are eight factors to be considered, including the compatibility of the proposed land use with other land nearby and the nature of the scenic view to be preserved.

Reg. §1.170A-14(d)(5)(i).

§170(h)(5). In general, the conservation purposes are protected if, in the case of retention of a qualified mineral interest, the probability of surface mining occurring on the property is so remote as to be negligible. This special rule was originally limited to property in which the surface and mineral interests were separated before June 13, 1976. 97 Act Section 508(d) eliminated the requirement that the interests be separated before that date for easements granted after December 31, 1997.

Reg. §1.170A-14(d)(4)(v). See McLennan v. U.S., 24 Cl Ct 102 (1991), where retention of the right to build four residential properties did not destroy a scenic easement. The Court recognized that, although a taxpayer must not expect a substantial benefit as quid pro quo for a charitable contribution, the charitable nature of a contribution is not eliminated by the receipt of a benefit incidental to a greater public benefit.

Reg. §1.170A-14(e)(1). See also Reg. §1.170A-14(g)(1), requiring an interest retained by the donor to be subject to legally enforceable restrictions (for example, recordation in land records) which prevent uses inconsistent with the conservation purpose of the donation. Ltr. Rul. 9537018 (June 20, 1995) (reservation of the rights (1) to construct additional residential structures and (2) to continue to use existing structures as a caretaker’s residence and as a facility for business retreats did not create more than an incidental benefit to the donor and, further, the temporary dislocation of wildlife caused by the donor’s timber harvesting activities on the underlying land did not impair significant conservation interests).

Reg. §1.170A-14(g)(5)(ii).

See Reg. §1.170A-14(g)(5)(i), which prescribes the following documentation for establishing the condition of the property at the time of contribution: (1) a United States Geological Survey map; (2) a map drawn to scale indicating manmade improvements, vegetation and identification of flora and fauna, land use history, and distinct natural features; (3) an aerial photograph of the property; and (4) on-site photographs taken at appropriate locations on the property.

Reg. §1.170A-14(d)(2)(ii). See Reg. §1.170A-14(d)(3)(iii). For example, restrictions on public access are permissible to protect the habitat of an endangered animal species which might otherwise be threatened by human contact.


Reg. §1.170A-14(d)(5)(iv)(A). See also Fiske v. Comm’r, 48 T.C.M. (CCH) 1128 (1984) (contribution of property to which access was restricted reduced, but did not eliminate, donor’s charitable deduction).

Treas. Reg. §1.170A-14(e)(i).


Reg. §1.170A-14(h)(3). See also Hilborn v. Comm’r, 85 T.C. 677 (1985) (fair market value determined by applying “before and after” method of valuation). Of course, if there is an increase in the valuation on account of the imposition of the restriction, no deduction is allowed. See also Strasbury v. Comm’r, 79 T.C.M. (CCH) 1697 (March 20, 2000).


See Garrison v. Comm'r, 51 T.C.M. (CCH) 1273 (1986) (the lack of economic feasibility of future development of the contributed property reduced the charitable deduction of the donor).

See Griffin v. Comm'r, 56 T.C.M. (CCH) 1560 (1989) (development restrictions in the French Quarter of New Orleans limited the value of conservation easement); Garrison v. Comm'r, 51 T.C.M. (CCH) 1273 (1986) (the “before” value of the contributed property, which was located in wetlands, was significantly lower than the value claimed by the donor).


Reg. §1.170A-14(e)(1).

Reg. §1.170A-14(h)(3)(ii). See Osborne v. Comm'r, 87 T.C. 575 (1986) (charitable deduction for the grant of a drainage easement to the City of Colorado Springs was reduced by the value added to the donor’s property by the city’s construction of drainage facility).

Ltr. Rul. 200002020 (October 12, 1999); Ltr. Rul. 199952037 (September 30, 1999). Provided, of course, that the requirement of donative intent is satisfied as described above.


§2031(c)(1), as amended by 97 Act §508(a).


The "applicable percentage" is defined to mean 40% reduced (but not below zero) by two percentage points for each percentage point by which the value of the conservation easement is less than 30% of the value of the land (unreduced by the value of the easement, but reduced by the value of any "retained development right"), as of the date of the contribution. §2031(c)(2), as amended by 2001 Act §551(b). The amendments made by 2001 Act apply to estates of decedents dying after December 31, 2000.

§2031(c)(4)(A). “Debt-financed property” means any property on which there is acquisition indebtedness, as defined in §2031(c)(4)(B)(ii), on the date of the decedent’s death.

§2031(c)(3)(A).

§2031(c)(5)(B). Such agreement will be subject to recapture provisions upon the failure to implement the agreement within two years of the decedent’s death or upon the sale of the land, whichever occurs first. §2031(c)(5)(C).


A “member of the decedent’s family” includes the decedent’s ancestors; the decedent’s spouse; a lineal descendant of (i) the decedent, (ii) the decedent’s spouse or (iii) a parent of the decedent; and the spouse of any such lineal descendant. §2031(c)(8)(D).

§2031(c)(8)(A)(ii).

§2031(c)(6).

§2031(c)(9).

§642(c)(5); Reg. §1.642(c)-5.

§664.

Reg. §1.170A-8(a)(2); §170(f)(2)(A); Reg. §1.170A-6(a).
§§664(d)(1)(D) and (2)(D).

§§664(d)(1)(A) and (2)(A).


Reg. §1.664-3(a)(1)(i)(b)(2).


See also Ltr. Rul. 9609009 (November 20, 1995).

Ltr. Ruls. 9511007 (December 12, 1994) and 9511029 (December 16, 1994).

Reg. §1.664-3(c).

Reg. §1.664-1(d)(5).

Reg. §1.664-3(a)(1)(i)(F). In the final Regulations, the Service confirmed and elaborated on Notice 97-68, and provided that, with respect to trusts created prior to December 10, 1998, if the pay-out is 15% or less, such amounts can be paid after the close of the taxable year.

When the trust was judicially reformed ab initio to include improperly allocated post-contribution capital gains to Trust income, the Service ruled it was not an act of self-dealing. Ltr Rul 200535007 (April 13, 2005).

Reg. §1.664-1(a)(7).


Reg. §1.664-1(a)(3).


Reg. 7749034 (September 9, 1977).


Rev. Proc. 97-23, 1997-1 C.B. 654 (April 28, 1997) (amplifying Rev. Proc. 97-3, 1997-1 C.B. 507 (1997)) that it will not rule on the existence of self-dealing in situations where the grantor, a trustee, a beneficiary or a person related to or subordinate to such person, controls the timing of a CRT’s receipt of income from a partnership.


Rev. Proc. 200040347 (July 18, 2000).

Leila G. Newhall Unitrust v. Comm’r, 104 T.C. 236 (1995), aff’d. 105 F.3d 482 (9th Cir. 1997).

Reg. §1.514(c)-1(c)(2).


Reg. §1.664-1(a)(4).


§508(d)(2).


If the debt had been placed by a disqualified person, then, so long as the debt is older than 10 years (pursuant to the discussion on self-dealing contained in the section on CRTs), the debt will not constitute self-dealing.

§170(f)(2)(B).

Ltr. Rul. 200537020 (June 2, 2005).

§642(c).

§681.