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Aligning the Stars -- Estate Planning for Entrepreneurs in Interesting Times

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ALIGNING THE STARS --
ESTATE PLANNING FOR ENTREPRENEURS
IN INTERESTING TIMES

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I. INTRODUCTION

A. Scope

This outline will provide a summary of the main features of estate, gift and generation-skipping transfer American Taxpayer Relief Act, P.L. 112-240, that was signed into law on January 2, 2013 (the “2012 Tax Relief Act”). The goal of this outline is to assist the practitioner in recognizing estate planning opportunities for his or her client; it is not intended to provide an exhaustive analysis of Federal estate or gift taxation or estate planning. This outline only addresses estate planning for citizens of the United States.

B. Overview and Goals of Estate Planning for Entrepreneurs

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

Furthermore, we are in the midst of very volatile times. The stagnant economy, coupled with a current President with an ambitious and ambiguous agenda, has resulted in looking to the wealthy to provide raised tax revenue, in the process eliminating perceived “loopholes” in transferring wealth. Another factor is low interest rates. A third factor has been the drop in value of most types of assets held by clients, including real estate in particular (until the last few years), but also broad categories of other assets, both tangibles and intangibles.

II. FEDERAL ESTATE AND GIFT TAX SYSTEM PRIOR TO 2013 AND BEYOND

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

Generally, if an individual wishes to make a lifetime gift, the amount of the gift is the fair market value of the transferred property at the time of the gift. Under the 2012 Tax Relief Act, the gift tax rate is now unified with the estate tax rate, so that the top gift rate for gifts made in 2015 is 40% on transfers in excess of the applicable exclusion amount (discussed below).\xspace

Typically, 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.

4. Exceptions

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

a. Annual Exclusion

(1) The Federal gift tax law provides, under Section 2503(b), for an annual exclusion for gifts of $14,000 per donee in 2015. Accordingly, a donor may give any number of people up to $14,000 per year and pay no gift tax on the total amount given by the donor.

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

(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 $28,000 per donee each year, which will be treated as given one-half by each consenting spouse if so elected on a timely-filed gift tax return.\xspace

(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.”\xspace

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.\xspace Such amounts, if paid to an educational organization described in Section 170(b)(1)(A)(ii)\xspace 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 can anyone other than the spouse 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:

(a) remainder interests in a farm or residence (despite the transferor's retained life estate);

(b) irrevocable qualified easements in real property;

and

(c) remainder interests in qualified charitable remainder trusts, pooled income funds and charitable gift annuities.

(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.23/

e. Applicable Exclusion Amount (Lifetime Exemption)

The fifth and final exception to the requirement that transfers without consideration are subject to gift and estate taxation is the applicable exclusion amount. Section 2505 provides a unified tax credit24/ against the Federal gift tax liability.

(1) The 2012 Tax Relief Act permanently established an exemption amount of $5 million per person, as adjusted for inflation.25 The exemption amount is $5,430,000 in 2015.

(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, with the exception of 2010 (as to which the estate of a decedent had the choice of no estate tax or an estate tax with a $5,000,000 exemption equivalent), in 2013 and beyond an estate tax will be imposed on the value of the property held by a decedent at the time of his or her death.

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 1976.26/ A tentative estate tax is computed on that aggregate amount. For decedents dying in calendar year 2014 (and beyond), the estate tax rate is 40%.

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.

4. Portability:

(3) The 2012 Tax Relief Act provides that, for estates of decedents dying in 2013 and thereafter, the applicable exclusion amount is the sum of (1) the “applicable exclusion amount” and (2) in the case of a surviving spouse, the “deceased spousal unused exclusion amount.”27/ The applicable exclusion amount is $5,430,000 in 2015. The ability for a surviving spouse to use the deceased spouse’s unused estate tax exclusion amount is referred to as “portability”. Portability is presently applicable where both spouses die after December 31, 2010. A surviving spouse may use the deceased spousal unused exclusion amount in addition to the surviving spouse’s own unified credit amount for transfers during life or at death.28/ An estate will be considered to have made a portability election only if a Form 706,
“United States Estate (and Generation-Skipping Transfer) Tax Return” is filed (even if the gross estate does not have a value in excess of the exclusion amount).  

5. With the exception of those decedents dying in 2010 as to whom the decision was made for the Federal estate tax not to apply, all Federal estate taxes are in fact due within nine months of the decedent’s death. This rule presents two key areas of concern:
   a. how will assets in the estate be valued for estate tax purposes?
   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, if there is an estate tax in existence at the time of the decedent’s death, 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.
   b. The marital deduction allows the decedent to transfer property to the surviving spouse without incurring any Federal estate tax liability on the transfer.
   c. 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, if there is an estate tax in existence at the time of the decedent’s death, 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 in 2015 to a grandchild or grandchild’s trust that results in the transferred property 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 been includable in the child’s estate. The GST tax is a substitute for the estate tax that is not imposed at the child’s death. As with the estate tax, the GST tax was effectively eliminated for 2010 by reducing the tax rate on generation-skipping transfers to zero percent.

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 descendent (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. 35/

   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 from GST tax. For transfers after December 31, 2006 (with the exception of 2010), the GST tax exemption amount equals the estate tax applicable exclusion amount under Section 2010(c).\(^{36}\) Thus, the GST tax exemption is $5,430,000 in 2015.

(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 and will be automatically allocated in certain circumstances.

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.\(^{371}\)

D. The State Estate Tax

Prior to the enactment of EGTRRA, 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.

EGTRRA eliminated the state death credit as of 2005 and death taxes imposed by a state were treated as a deduction rather than a credit on the Federal estate tax return. In 2010, if so decided by the decedent’s estate, there was no Federal estate tax due; in 2010 (if the decedent’s estate elected to incur the Federal estate tax) and forward, state death taxes continue to be treated as a deduction.

In response to the elimination of the state death tax credit in 2005, many states enacted their own estate or inheritance tax, or a combination of both, including a separate exemption from the state estate tax. As a result, even though an estate did not have any Federal estate tax due for a decedent dying in 2010, there could still have been a state estate tax due upon the decedent’s death. Furthermore, many states, such as Florida, eliminated their estate tax by not changing their law; accordingly, because there was no estate tax credit after 2005, and the state estate tax was, under the applicable state law, equal to the estate tax credit, there was no
state estate tax. Other states, such as Virginia, simply eliminated their estate tax, and the change in Federal law will not have an impact on the estate tax in those states.

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.

Illustratively, assume a decedent from Virginia (which has no estate tax) who owns real property located in Maryland. Although there is no Virginia estate tax, if the real property located in Maryland exceeds $1,500,000 in value (the 2015 Maryland exemption amount), there will be an estate tax payable to Maryland.38

Although some states may be moving to enact an estate tax, few, if any, are considering imposing a gift tax. As a result, death bed gifts (so long as the state does not pull the gifted asset back into estate on a contemplation of death theory) should be considered. Such gift will have no Federal estate tax consequences but the donees will lose the basis step-up at death. That loss should be compared to the state estate tax savings.

E. Basis Rules

1. If the decedent’s estate determined not to incur the Federal estate tax for 2010, there was a special set of rules.

2. Otherwise, the general basis rules are as follows:

   a. Where property is acquired by purchase, the basis for such property is its cost.39

   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.40

      (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.41 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.42 If neither the donee nor the District 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.43

      (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.44 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, adjusted for any gain or loss recognized to the estate or trust on the distribution.\footnote{45}

(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, so that the beneficiary takes 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.\footnote{46}

(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. In general, the basis of property acquired by inheritance generally will, under Section 1014, be its fair market value (or its special use value,\footnote{47} if applicable) at the date of death or, if the alternate valuation date\footnote{48} is used for Federal estate tax purposes, the fair market value at such date.\footnote{49} Under prior law, there was no requirement that the same value be used for Federal estate tax and income tax purposes. However, for property with respect to which an estate tax return is filed after July 31, 2015, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41 (the "Transportation and Veterans Health Act"), imposes certain new basis consistency standards which generally provide that the basis of property acquired by reason of death under Section 1014 must equal the value of such property for estate tax purposes. Specifically, the Transportation and Veterans Health Act adds a new Section 1041(f), which states that the basis of property acquired from a decedent cannot exceed the value finally determined for estate tax purposes. In addition, the Transportation and Veterans Health Act adds a new Section 6035 which generally requires that the executor of an estate file an estate tax return to provide to the Service and each person acquiring an interest in property included in the decedent’s gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on the estate tax return. With respect to penalties for failing to comply with the new provisions, Section 6662 was amended to include inconsistent basis reporting to the list of actions for which a 20 percent accuracy related penalty can be imposed, and Section 6724 was amended to include the new Section 6035 information reporting statements to the list of information returns and payee
statements for which a penalty for failing to comply with information reporting requirements can be imposed.

c. Exceptions to Stepped-up Basis at Death

(1) 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) 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.

(a) Although Section 1014(e) denies a basis step-up when appreciated property acquired by a decedent by gift passes to the donor of the gift on account of the decedent’s death within one year of the gift, this does not mean that substantial basis step-ups cannot be obtained through the making of gifts to a dying spouse.

(b) Note that the limitation does not apply if the transferred property is bequeathed to someone other than the original transferor (or his or her spouse). Query, would Section 1014(e) apply if the property was distributed to a GPOA marital trust under the decedent’s Will? What about a QTIP Trust? What about a credit shelter trust where the spouse is the sole trustee and sole beneficiary? Would the same rules for not aggregating assets held in a marital trust with the spouse’s own assets for valuation purposes, apply here as well? Under those rules, so long as the marital trust is drafted to assure that the spouse does not have too much control over the trust fund (such as, for example, holding a general power of appointment over the trust fund), then the entity interests held in the marital trust will be valued without aggregating such interests with any of the entity interests held by the spouse directly.

(c) If the spouse of a terminally ill individual has substantial appreciated assets, and the individual has at least some chance of living for at least a year, the spouse should give appreciated assets to the individual, so that he or she may pass them back to the spouse at death. This is basically a no-lose situation. If the donee spouse lives at least one year, they are home free with a basis step-up; if he or she fails to live at least one year, the property comes back to the donor spouse with the original basis, and no harm has been done. The only downside is that there is always a possibility that the “healthy” spouse could die first.

(d) It is important that the transfer of appreciated property from one spouse to the other is a gift with no strings attached, and with no agreement that the property will be returned at death. However, if an outright gift is inadvisable because,
e.g., the terminally ill spouse does not have the capacity to execute an appropriate will to return
the property to the donor spouse, the original gift can be made in the form of a QTIP trust for the
ill spouse, with the remainder coming back to the donor spouse at the ill spouse's death.

(e) Even if the donee spouse is not expected to, or in
fact does not, survive at least one year after receiving the gift, it may be possible to obtain at
least a partial basis step-up for the property. In the context of a very complex fact pattern, the
Service ruled in PLR 9026036 that where property was to be returned at the donee spouse’s
death to the donor spouse in the form of a life income trust, only the portion of the trust allocable
to the life income interest would be affected by Section 1014(e), and the remainder interest in the
trust would not be deemed to pass back to the donor spouse and would thus qualify for a basis
step-up. This ruling was partially reversed as to other issues and reissued as PLR 9321050, but
there was no change to the provisions of the ruling relating to Section 1014.

(f) Although these rulings cannot be relied on as
precedent, they certainly provide enough support to take the position that the property
bequeathed back to the donor spouse in a QTIP trust (without the possibility of principal
distributions to the spouse) will receive a partial step-up proportionate to the fraction of the trust
actuarially attributable to the remainder interest.

(g) If the family’s financial situation is such that a
bequest back from the dying spouse can go to the next generation without including any interest
to the surviving spouse, the appreciated property in an amount equal to the dying spouse’s
available applicable exclusion amount can be transferred to the dying spouse and indisputably
receive a full basis step-up when transferred to the next generation at the death of the dying
spouse.53/

(3) 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.54/ These types of property interests are referred to as “qualified joint interests”.55/ 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.56/

(4) There is an exception to the general rules discussed above
where a decedent spouse contributed to a pre-1977 joint tenancy. 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 1977.57/ 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 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. 58/ 

(2) In the absence of a pre-existing or timely Section 754 election 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. 59/ 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. (Note that, in 2004, Section 743(a) was amended by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §833(b)(2) (2004), to insert the words “or which has a substantial built-in loss immediately after such transfer.” This new language means that the death of a partner could result in a downward adjustment to the partnership’s inside basis if, immediately after the partner’s death, the partnership has substantial built-in loss.)

(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. 60/ 

(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. 61/ 

(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. 62/ 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.63/

III. ISSUES, BENEFITS AND DRAWBACKS OF LIFETIME GIFTS AS COMPARED TO TESTAMENTARY BEQUESTS

A. Revaluation of Prior Taxable Gifts

1. Adequate Disclosure Requirements.

   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.64/

(1) Final Regulations on what is an adequate disclosure of gifts were issued on December 3, 1999.65/

   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;66/ or

      (ii) an appraisal prepared by a qualified appraiser that contains a description of the property, the appraisal process, the method of valuation used and any assumptions made.67/

   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.68/

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

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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.

(d) Disclosure of Transfers Not Considered to be Gifts.

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.69/

(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.70/

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.

2. Intentionally omitted.

B. 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 at least 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. The Fourth Circuit held that when the estate was unable to pay the estate taxes on the prior gift, the donees of the gifted property are personally liable for the estate tax owed on the gifted property in the amount of the value of the gift received. 71/

C. 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.

D. Reduction in Size of Financial Statement

As gifts are made, the entrepreneur/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. For example, many times, an entrepreneur or
entity’s ability to operate requires loans, which will be based on the personal financial statement of the entrepreneur. Reducing the size of the financial statement through gifting will impede his or her ability to borrow or guarantee.

E. Uncertainty about Future

1. 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.

2. 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 bust for the benefit of the donee may not protect those assets.

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

Entrepreneurs use entities such as Limited Partnerships or Family Limited Partnerships (“FLPs”) and Limited Liability Companies (“LLCs”) and corporations 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 assets and establish a plan for the succession of that management, no matter who the limited partners, members or shareholders may be. Furthermore, the entities protect the assets from creditor claims that are made against any of the entity’s owners or against any other assets owned by the owners of the entity. 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 nor 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. The result is similar in states which have enacted versions of the Revised Uniform Limited Partnership Act. 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 an 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 an ongoing 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 an 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 or a series LLC should be considered for the following reasons:

a. Claims against an entity’s property 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.\[75\]

d. In 2010, the Service issued Prop. Regs. §§ 301.7701-1(a)(5) and -1(f)(3), which provide that a series is treated as an entity formed under local law. Whether such series is treated as a separate entity for Federal tax purposes is determined under the general tax principles of Reg. § 301.7701-1(b). The Proposed Regulations do not address the entity status of the series LLC for Federal tax purposes.\[76\]

B. Avoidance of Probate and Other Benefits

1. Estate Planning Benefits of Entities

a. A family can pool together its individual holdings. Once pooled together in a common ownership, the development and management of the various assets become much easier and more cost-efficient.

b. 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.

c. Use of FLPs and LLCs in Estate Planning

The use of an FLP or 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 an 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 an 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.

(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, then 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 an FLP, certain assets are transferred to the FLP 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 FLP. Nonetheless, the transfer of the property to the entity may be subject to local transfer and recordation taxes.

(b) Section 704(e)

(i) In forming a FLP 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 “check-the-box” Regulations provide that an entity with two members will be treated as a partnership, unless the entity elects to be treated as 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, an 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 an LLC is the lack of case law with regard to creditor rights against a debtor’s limited liability company interest.\(^{29}\)

2. Advantages:

   a. An LLC is much easier to form than is an 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 an 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.

   d. It is possible to create a non-member manager position in an LLC, which allows the owners to go outside of the family for management expertise.

V. VALUATION ISSUES ARISING FROM ENTITY OWNERSHIP

A. Difficulty of Valuation of Assets Without a Readily AscertAINable Market

1. 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.\(^{80}\) 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.\(^{81}\) The statement is for the purpose of providing full information to the parties involved, and it is not binding on the Service.\(^{82}\)

2. Litigation of Value

   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.\(^{83}\) 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.\(^{84}\) The Court is not obligated to accept the taxpayer’s valuation if it rejects the Service’s valuation, even where the Service bears the burden of proof under 26 U.S.C. § 7491.\(^{85}\) A recent Tax Court Memorandum decision\(^{86}\) illustrates how closely the Court reviews an appraiser’s work and how the appraiser
should approach a valuation and the assumptions that the appraiser makes to reach his or her valuation. What is evident in the case is that the Tax Court is not accepting an appraisal as provided, but instead, reviewing the appraiser’s methodology and whether it is reasonable under the circumstances at hand. This makes a detailed appraisal report even more important, in light of the explanation it provides for how the appraiser arrived at his or her conclusions.871

To prevent unanticipated gift tax consequences based upon a retroactive readjustment of the value of an entity (whose interests have been gifted) by the Service or a court of law, some practitioners have used a defined value formula clause to fix the gifts at a specific dollar amount (i.e., the applicable exclusion amount); instead of gifting a certain percentage of partner interests or number of member units. An adjustment to the value of the entity would cause a reallocation of the percentage of partner interests or specific number of member units “gifted” but would not increase the dollar amount of the gifts, thereby avoiding the imposition of any gift tax as a result of the valuation adjustment. The Service has asserted that a defined value formula clause is an impermissible transfer clause because it contains a condition subsequent to the taxpayer’s gifts. However, the Tax Court and certain Circuit Courts have upheld the use of such a clause.88

3. 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, 1989.89 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 65% or less of the amount determined to be correct and (ii) the amount of the underpayment exceeds $5,000.90 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%.91 A gross valuation misstatement occurs if the asset value claimed on an estate or gift tax return is 40% or less of the value ultimately determined to be the correct value for such asset.92

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.

4. Tax Return Preparer Penalties

The Small Business and Work Opportunity Act of 2007 (the “2007 Act”) amended Section 6694, the tax return preparer penalties provision of the Internal Revenue Code. The 2007 Act: (1) expanded the definition of tax return preparer; (2) broadened the scope of penalties to include returns other than just income tax returns; (3) revised the standard of preparer conduct necessary to avoid penalties; and (4) changed the computation of penalties.
The IRS issued interpretive guidelines of the 2007 Act in January of 2008; and in June 2008, the IRS issued proposed rules (the “2008 proposed rules”), which further amended Section 6694.

a. The tax preparer penalty provisions of the Code, as amended by the 2007 Act, are found in Section 6694, which states, in Section 6694(a)(1):

“If a tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of-- (A) $5,000, or (B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.”

(1) A “position described in paragraph (2)” of the Section is defined as follows:

“A position is described in this paragraph if: (A) the tax return preparer knew (or reasonably should have known) of the position, (B) there was not a reasonable belief that the position would more likely than not be sustained on its merits, and (C)(i) the position was not disclosed as provided in Section 6662(d)(2)(B)(ii)23, or (ii) there was no reasonable basis for the position. (Emphasis added).”

(2) However, even if a position is considered an unreasonable position for purposes of this Section, no preparer penalty will be imposed if it is shown that the preparer acted in good faith and there was reasonable cause for the understatement.

(3) The 2007 Act had caused some concern among tax return preparers, because it raised the standard applicable to tax return preparers above that applicable to taxpayers, and because it provided tax return preparers no means of addressing the conflict that was raised by advising taxpayers so that the taxpayer could avoid penalties without making any disclosure on the return when that advice would subject the preparer to penalties under Section 6694. Under the 2007 Act, the standard for taxpayers to report tax positions and avoid penalties imposed under Section 6662 is one of “substantial authority,” if there is not adequate disclosure of their position on the return.

Accordingly, if the taxpayer had substantial authority for his or her position, even if the IRS found the position to be incorrect, no penalty would be assessed against the taxpayer. The lower standard for taxpayers put tax preparers in a difficult situation, since the preparer would need to reach a higher standard of comfort if the taxpayer were not willing to adequately disclose the position on his or her return than the taxpayer needed to reach in order to avoid the taxpayer penalties.

b. However, Section 506 of the Emergency Economic Stabilization Act of 2008, signed by the President on October 3, 2008 (P.L. 110-343) (“EESA”) addressed this concern by reducing the level of confidence required for a tax return preparer to reach for non-tax shelter transactions from a more likely than not standard to a substantial authority standard.
Prior to EESA, a tax return preparer advising a client as to a position on any type of tax return (so long as the tax return preparer knew or reasonably should have known of the position) could have avoided the imposition of preparer penalties in any of the following ways:

(a) If the tax return preparer had a reasonable belief that there was a greater than 50% chance that the position will be sustained on the merits.

(i) If the tax return preparer did not have a reasonable believe that there is a greater than 50% chance that the position will be sustained on its merits, but there was a reasonable basis for the position; and “adequately disclosure” is made to the taxpayer.

(ii) If the tax return preparer did not have a reasonable believe that there is a greater than 50% chance that the position will be sustained on its merits, and the position was not adequately disclosed to the taxpayer, but reasonable cause for the understatement could be shown and the tax return preparer acted in good faith.

Now, under EESA, a tax return preparer advising a client as to a position on any type of tax return addressing a non-tax shelter transaction (so long as the tax return preparer knew or reasonably should have known of the position) can avoid the imposition of preparer penalties in any of the following ways:

(a) If the tax return preparer has based the position on substantial authority,

(b) If the tax return preparer does not have substantial authority for the position, but there is a reasonable basis for the position and “adequate disclosure” is made to the taxpayer.

(c) If the tax return preparer does not have such a belief, there is not a reasonable basis for the position and the position is not adequately disclosed, but reasonable cause for the understatement can be shown and the tax return preparer acted in good faith.

In December 2008, the IRS issued final Regulations (the “final Regulations”) reflecting changes made by the 2007 Act, and simultaneously issued Notice 2009-5, reserving Reg. § 1.6694-2(c) in the final Regulations, providing interim guidance regarding implementation of the Section 6694 penalty as changed by EESA and requesting comments. Tax return preparers may rely on the interim guidance in Notice 2009-5 with respect to issues covered until further guidance is issued. All other issues are governed by the final Regulations, which apply to returns and claims for refund filed (and advice given) after December 31, 2008.94
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. 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).951

2. 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.961

3. Blockage Discount

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 Tax Court Memoranda it was concluded that blockage discounts ranging from 3.3% to 6.2% were appropriate.971

4. Built-in Gain Discount

Cases in both 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.981

4a. In 2001, the Tax Court held that the built-in gain discount would not be available in valuing interests in a partnership, but did not dismiss such a discount for all partnerships.991 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. 109

b. The Tax Court has also held 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. 110 If the liquidation is unlikely or will not take place for several years, this discount will be reduced.

c. The Tax Court rejected an appraiser’s attempt to tax-affect a valuation. 112 In that case, the company was an S corporation, and one of the taxpayer’s appraisers took a 15% discount for “tax affecting”. The two appraisers hired by the taxpayer reduced projected profits on a sale of the company by 35% and 40%, respectively, based on the assumption that after the sale the corporation would lose its S corporation status. The Court found that there was no evidence in the record that the company expected to cease to qualify as an S corporation. Furthermore, the company had a history of distributing enough earnings for shareholders to pay their individual income tax liabilities and there was no evidence that the company intended to change its practice. The Court did not reject tax affecting a valuation; however, it said that, based on the evidence, there was insufficient evidence on the record to support tax affecting.

d. In a recent case, the Revenue Agent did not provide a built-in gain discount in the notice of deficiency. The Service did not “defend” this position in Tax Court. Instead, it relied on an expert who provided a 15% discount for built-in gain tax. Although the Tax Court did not agree with the Service’s expert’s appraisal methodology, it did find the discount appropriate. 113

5. 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. 114

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. 115 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. 116

c. The Tax Court has also held 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. 117 If the liquidation is unlikely or will not take place for several years, this discount will be reduced.
6. 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.\textsuperscript{108/}

7. 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.\textsuperscript{109/} 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. Accordingly, if the owner is married, then a very effective technique to reduce the owner’s estate is to gift and/or bequeath to a marital trust for the benefit of the owner’s spouse, one-half (or however much is necessary to reduce the ownership interest in the donor’s/decedent’s estate to a minority interest) of such entity. So long as the marital trust is drafted to assure that the spouse does not have too much control over the trust fund (such as, for example, holding a general power of appointment over the trust fund), then the entity interests held in the marital trust will be valued without aggregating such interests with any of the entity interests held by the spouse directly.\textsuperscript{110/}

d. 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.\textsuperscript{111/}

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

1. Certain Lapsing Rights under Section 2704(a)

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.

b. 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.

c. 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 has 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

a. 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 consideration. The Tax Court has rejected the Section 2703 argument, although the Service continues to advance it.

b. 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.

c. 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.

d. 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. 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; \(^{120/}\) 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.\(^{121/}\)

e. 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.

f. Section 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).\(^{122/}\) 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 Section 2703 is, under Reg. § 25.2703-1(b), an agreement that meets the following requirements:

1. It must be a 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.\(^{123/}\) 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.\(^{124/}\)

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; and (iv) if a business is unique, comparables from similar businesses may be used.

g. These types of agreements, even if they do not meet the requirements of Section 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 carry forward may be created.\(^{125/}\)
h. 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.\textsuperscript{126} 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.

i. 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.

j. 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.

k. 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 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{127}

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{128} 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.\textsuperscript{129}

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{130}
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) 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 interests are transferred to donees.

e. Code Sections 2036 and 2038 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 FLPs at the ownership level on the basis of Section 2036(a). A challenge to FLPs 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). 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.

   (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

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 U.S. v. Byrum served as a protective shield against Section 2036(a)(2) claims. Despite the Service’s past acknowledgment of Byrum, the government challenged transfers to family limited partnerships on Section 2036(a)(2) grounds in two cases, Kimbell v. U.S. and Strangi v. Comm’r. Both cases had facts that weighed in the government’s favor. Nonetheless, Kimbell was reversed by the Fifth Circuit, indicating that the taxpayer may 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 and in practice.

(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.143/

(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 (presuming 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 class should hold this discretion and the donor should not be an owner or member of such class. The donor could be an owner or member of the second class of general partner/manager, which holds all other powers.

d. There are now a significant number of cases in various courts where the IRS and the taxpayer have argued about the existence and extent of the discount in value that is achieved by the use of FLPs and LLCs, 14 of which were handed down in 2009 alone, and there is still no clear consensus in this area.145 Furthermore, there is the threat of future legislation that will eliminate these discounts in valuation altogether. However, until such time as such legislation is enacted into law, a careful review of the case law, a proper non-tax purpose for the entity, a careful funding of the entity and sufficient time between funding and gifting of entity interests (that is, sufficient to avoid the application of the step transaction) and no retention of the rights and powers (directly, or indirectly) set forth in the discussion above, should serve to preserve the entity and obtain a significant discount in the value of interests in the entity.

VI. REDUCTION IN VALUATION THROUGH RETAINED INTERESTS

A. Gifts of Trust Interests

1. General Rules

a. If an asset 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.146/
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.

(b) 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.147/

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, so long as the individual who is the measuring life is not terminally ill at the inception of the trust.

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.

(4) The annuity must be paid out each year and the trustee cannot use notes as a substitute for distributing cash or property.

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 because mortality experience cannot be ignored, and the regulations dealing with GRATs and the new regulations dealing with the valuing annuities under Section 7250 also took this position. In Notice 2003-72, the Service acquiesced to the Tax Court’s decision in Walton v. Comm'r, which allows taxpayers to create “zeroed out” GRATs (so long as the GRAT continues notwithstanding the death of the individual who is the measuring life), and the Service issued Regulations that permit such GRATs.148/

e. A GRAT or GRUT should be considered a grantor trust for income tax purposes, so long as the annuity (payable in cash or assets, but not in the form of a promissory note) may be paid from income, or principal to the extent income is insufficient. To ensure grantor trust status other grantor trust powers should be included in the trust agreement. As a result of grantor trust status, (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 1.00%  
Value of asset is $1,000,000 

Annual Payout

<table>
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<tr>
<th>Annuity Amount</th>
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<td>b. $90,000</td>
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<tr>
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<tr>
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<td></td>
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<tr>
<td>a. $507,519</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>10 year GRUT</strong></td>
<td></td>
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<tr>
<td>a. 5%</td>
<td>$623,160</td>
</tr>
<tr>
<td>b. 9%</td>
<td>$423,380</td>
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<tr>
<td><strong>8 year GRUT</strong></td>
<td></td>
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<tr>
<td>a. 5%</td>
<td>$679,560</td>
</tr>
<tr>
<td>b. 9%</td>
<td>$493,940</td>
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</tbody>
</table>

2. A grantor’s retention of an annuity or unitrust or other interest in a causes the application of Section 2036 due to the grantor’s retention of possession or enjoyment of, or the right to the income from, the trust property. For Federal estate tax purposes, the “portion of the trust corpus necessary to provide the retained use or retained annuity, unitrust, or other payment (without reducing or invading principal)” is the portion of the trust corpus included in the grantor’s gross estate; provided, however, that the amount included in the grantor’s estate “shall not exceed the fair market value of the trust’s corpus at the decedent’s date of death.”

3. Estate planners use these types of trusts, along with GRITS discussed below, to leverage the gift. The leveraging is achieved if the income/growth of the gifted property over the retained term will exceed the Section 7520 rate in effect at the inception of the trust.
C. Common-law GRITs

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. These trusts are referred to as Grantor Retained Income Trusts (“GRITS”) and are most often used when the remaindermen are not “members of the family” which are defined above. The value of the income interest (based on current Federal interest rates) would be subtracted from the value of the property for purposes of the gift tax determination.

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 28.8 percent (25% on unrecaptured depreciation plus the 3.8% Medicare contribution tax in 2015), 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 40 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 of 40 percent or more if included in the seller’s estate, as compared with 15 to 28.8 percent (25% on unrecaptured depreciation plus the 3.8% Medicare contribution tax), 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 grandchildren would incur not only a
gift tax but a generation skipping transfer tax as well.

6. Note Freeze

a. An individual (or entity) may sell an asset in exchange for notes
from the buyer 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 seller
may forgive an amount of the notes equal to the annual exclusion, so long as there is no pre­
xisting agreement to do so, as discussed immediately below. Of course, the forgiveness of the
notes may trigger recognition of gain by the seller under the installment sale rules. The value of
the balance of the note as of the decedent’s date of death will be includable in the seller’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 seller. 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 buyer 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.

(1) 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.

(2) The Service did succeed in Deal v. Comm'r, 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.”

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

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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, 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. 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." Gain or loss is usually recognized whenever the holder sells, exchanges or otherwise disposes of the installment obligation.

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.

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. 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{161/}

(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 \textit{Estate of Frane v. Comm’r},\textsuperscript{162/} 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 \textit{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 taxed in the initial year of the sale, but in future years a private annuity will provide the transferor with a fixed retirement income that is not subject to tax upon receipt.
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, the annuity payments are computed based on the methods and values set forth in IRS Notice 89-60 and the tables in IRS Publication 1457,165 and there was a real expectation of payment and payments were actually made.164

(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.165

(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.166

(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 tied either directly or indirectly 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.167

(4) The transferee/obligor must have assets and income that can support the annuity payments from sources other than the property transferred.168
(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.

(7) The trust must have enough assets so that, if the assets produce income at the Section 7520 rate, the trust can pay the annuity payments through age 110. Substantial value in the trust may be required to satisfy that test.

c. 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.169/

(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.170/

(2) Prior Private Annuity Rules.

The income tax consequences to the transferor/annuitant were determined under the annuity rules.171/ Generally, to calculate the income tax consequences of an annuity, an exclusion ratio would 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. 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.172/

If the property transferred was 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 would have been recovered as capital gain ratably over the life of the annuity. The remaining part (if any) of the annuity payment will be ordinary income.

IRS News Release IR-2006-161 describes Proposed Regulations changing the income tax treatment of private annuities under Section 72. Private annuities will be taxed the same, whether secured or unsecured, and result in immediate gain recognition. For income tax purposes, if the value of the annuity is same as the value of property exchanged, the value of the annuity becomes the “investment in the contract” for purposes of Section 72.

(a) Prop. Treas. Reg. § 1.1001-1(j), provides, generally, that, if an annuity contract (other than a debt instrument subject to Sections 1271-1275 or a bargain sale charitable annuity) is received in exchange for property, “receipt of the contract shall be treated as a receipt of property in an amount equal to the fair market value of the contract, whether or not the contract is the equivalent of cash.” The Proposed Regulation applies (after issuance as a final regulation) to any exchanges after October 18, 2006; however, there was a delayed 6 month effective date to April 18, 2007 for certain private annuity transactions. Also, charitable gift annuities are not affected, since they are covered by existing Reg. § 1.1011-2.

(b) If the exchange is between a grantor and his or her grantor trust (see below), the Regulation should not apply to the transaction (although the Proposed Regulations do not specifically address that issue).

(c) A private annuity sale could also be characterized as an installment sale, as recognized by the Preamble to the Proposed Regulations:

“property is sometimes exchanged for an annuity contract, including a private annuity contract, for valid, non-tax reasons related to estate planning and succession planning for closely held businesses. The proposed regulations are not intended to frustrate these transactions but will ensure that income from the transactions is accounted for in the appropriate periods. In section 453, Congress set forth rules permitting the deferral of income from a transaction that qualifies as an installment sale. Taxpayers retain the ability to structure transactions as installment sales within the meaning of section 453(b), provided the other requirements of section 453 are met. The Treasury Department and IRS request comments as to the circumstances, if any, in which an exchange of property for an annuity contract should be treated as an installment sale, and as to any changes to the regulations under section 453 that might be advisable with regard to those circumstances.” 173/

(d) If the seller has a shortened life expectancy (but a greater than 50% chance of living at least one year so that the Treasury valuation tables may be used), a private annuity transaction may still be advantageous notwithstanding the immediate gain recognition. Even though there is immediate gain recognition, private annuity transactions may still be appealing after the death of the first spouse. Because of stepped up basis, there would be no gain to recognize.
(4) Private Annuity Sale Disregarded as Sham Transaction

In Melnik v. Comm'r,\textsuperscript{174} the Tax Court found that a private annuity transaction lacked economic substance. The Court found the timing of the transaction to be suspicious, as was the lack of any participation in negotiating the sale by a holding company which was the seller. The Court found the testimony as to the business purpose of the entities or the private annuity itself was not convincing or credible and found a lack of any arm's-length dealings between the various parties.\textsuperscript{175}

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.\textsuperscript{176}

   (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.\textsuperscript{177} 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.\textsuperscript{178} 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.\textsuperscript{179} 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.\textsuperscript{180}

   (4) The status as a grantor trust can be achieved by qualifying as such under the grantor trust rules of Sections 673 through 677.\textsuperscript{181}

   (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.\textsuperscript{182} 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.

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(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.

(a) As discussed below, on termination of the trust’s grantor status during the grantor’s lifetime, if the trust then has any outstanding liabilities (to the grantor or to a third party), the termination of that status will be treated as a sale of the policy by the grantor for the liability. That deemed sale would generate gain, to the extent the outstanding liability exceeded the grantor’s basis in the policy. For that reason, consideration should be given to creating the trust as a non-grantor trust.

(b) There is less certainty about the income tax consequences of termination of grantor trust status as a result of the death of the grantor, where the trust has outstanding liabilities (to the grantor or to a third party). As discussed below, some commentators believe that the grantor’s death has no tax consequences; under that analysis, death is not an event that triggers gain recognition. Another possible result, and the one which the Service would likely endorse, is that the income tax consequences on the death of the grantor follow those that are deemed to occur when grantor trust status is terminated during the grantor’s life, as set forth in the regulations under Section 1001 and other authorities, discussed below. Under that analysis, the income tax consequences would be the same whether termination of grantor trust status is a result of the grantor’s death or a termination of the applicable grantor trust power(s) during the grantor’s life.

(c) On termination of the trust’s grantor trust status during the grantor’s life, the grantor will be deemed to have transferred to the trust for income tax (but not for gift or GST tax) purposes: (i) the assets in the trust, and (ii) the liabilities of the trust.

(d) Under the Section 1001 Regulations, there may be immediate income tax consequences to the grantor when grantor trust status is terminated, if the trust has any outstanding liabilities (whether to the grantor or to a third party) and those liabilities exceed the grantor’s basis in the assets deemed transferred to the trust; however, as in any other capital asset sale context, the grantor will recognize gain only to the extent the liabilities of the trust exceed the grantor’s basis in the assets deemed transferred to the trust. Under the general rule of Reg. § 1.1001-2(a)(1), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such sale or disposition; in this case, the trust’s deemed assumption of the grantor’s liabilities will be treated as a discharge of the grantor’s liabilities in consideration for the assets (the policy) that the grantor is deemed to have transferred to the trust.
(e) However, Reg. § 1.1001-2(a)(3) provides an exception to this rule when a liability is incurred for purposes of acquiring property and is not taken into account in determining the transferor’s basis in such property (for example, where the loan is between the grantor and the trust and thus is ignored for income tax purposes under Rev. Rul. 85-13, above). Under these circumstances, the assumed liability will not be included in the amount realized by the transferor and therefore will not cause recognition of gain. Note that the exception does not, by its terms, apply to liabilities disregarded for income tax purposes because of the relationship of the lender and the borrower and the implications of Rev. Rul. 85-13. It may be that it was intended to apply to liabilities that were too contingent to be an adjustment to basis.

(f) Example 5 of Reg. § 1.1001-2(c) illustrates what is deemed to occur on termination of grantor trust status during the grantor’s life. In the Example, a grantor was considered to be the partner of a partnership in which the grantor trust held an interest. Upon termination of grantor trust status on the renunciation of a grantor trust power, a constructive transfer of the partnership interest to the trust was deemed to occur. The Example concludes that the grantor is required to recognize gain to the extent the allocable share of partnership liabilities assumed by the trust exceeds the grantor’s basis in the partnership interest. Similarly, in Madorin v. Commissioner, above, a grantor transferred to a grantor trust an interest in a partnership that held encumbered assets. The grantor deducted the net losses from the partnership until the trustee renounced a power that had caused the trust to be a grantor trust. The court held that the grantor was released from his share of the underlying liabilities and recognized a gain to the extent that these liabilities exceeded the basis of the partnership interest.

(g) In applying the general rule of Reg. § 1.1001-2(a)(1) to a premium financing transaction, on the termination in status of the trust as a grantor trust, the grantor will be deemed to have transferred the life insurance policy to the trust in exchange for the trust’s assumption of the loan incurred in connection with the trust’s acquisition of the policy. Under the general rule, the grantor will realize income to the extent the liability (i.e., the amount of the loan on termination of the trust’s grantor trust status) assumed by the trust exceeds the grantor’s basis in the policy. Normally, the grantor’s basis in the policy would be the total of the premiums paid on the policy, less any non-taxable dividends received (in the case of a participating, whole life policy), perhaps less the cost of the insurance protection provided.185

(h) If the exception of Reg. § 1.1001-2(a)(3) applies, because the liability (the loan) was incurred in connection with the acquisition of the policy and is not taken into account in determining the grantor’s basis in the policy – which would be true of a loan between a grantor and his or her grantor trust – then no income will be realized by the grantor on termination of the trust’s grantor trust status, even if the liability deemed assumed by the trust exceeds the grantor’s basis in the policy.

(i) It should be noted that at least one article has suggested that this exception does not apply to exclude liabilities that were originally incurred by the trust, rather than the grantor, to acquire assets.186 Citing TAM 200011005, the article concludes that in order to fall within the exception of Reg. § 1.1001-2(a)(3), the liability must have been incurred as a result of the grantor’s acquisition of an asset, rather than the trust’s.
seems, however, that the factual background described in TAM 200011005 may require a narrower application of the ultimate conclusion reached by the Service than the article suggests.

(j) In TAM 200011005, the grantor transferred appreciated stock to a grantor trust that was administered as two separate GRATs for a short period, with the grantor trust making annuity payments to the grantor. In order to make the required annuity payments to the grantor, the trustee borrowed money from another trust. On termination of the grantor trust status, the trust disposed of the appreciated stock to remainder trusts for the benefit of the grantor's nephews. The Service believed that under Reg. § 1.1001-2(a), the debts incurred by the grantor trust for purposes of making the annuity payments and secured by the trust assets should be treated as amounts realized by the grantor when the trust ceased to be a grantor trust. The taxpayer argued, in relevant part, that the exception provided by Reg. § 1.1001-2(a)(3) should apply, because the debt was incurred by reason of the trust's acquisition of the stock. The Service disagreed, stating that language of the exception can only be reasonably read to refer to indebtedness incurred in connection with the grantor's acquisition of the stock. In essence, the debt under these facts was not acquisition indebtedness because neither the grantor nor the trust incurred the debt in order to acquire the stock. Rather, the trust incurred the indebtedness because it held the stock.

(k) The article correctly summarizes the conclusion of TAM 200011005 that the liabilities must have been incurred as a result of the grantor's acquisition of the stock in order to fall within the intended application of the exception; however, the article fails to discuss the specific facts which lead the Service to this conclusion in the TAM. Arguably, if the trust had incurred the liabilities in connection with acquiring the stock, the exception would have applied. Applying this reasoning, the liability incurred by the insurance trust for purposes of acquiring the life insurance policy could be the type of acquisition indebtedness contemplated by Reg. § 1.1001-2(a)(3), and, therefore, under that reasoning, any discharge of that indebtedness resulting from termination of the trust's grantor trust status would fall within the exception and would therefore not be included in the amount realized by the grantor for income tax purposes.

(l) However, even if the exception contained in Reg. § 1.1001-2(a)(3) does not apply in the insurance trust situation, the termination of the trust's grantor trust status still should not result in a recognition of gain by the grantor, as long as the liability incurred by the trust to acquire the policy does not exceed the grantor's basis in the policy. Subject to the Service' position on basis of a policy, discussed above, the trust's basis in the policy should equal the premiums it paid to acquire the policy (regardless of the fact that it financed those premium payments) and because the trust is treated as a grantor trust and therefore considered a disregarded entity for income tax purposes, under Rev. Rul. 85-13, above, the grantor's basis in the policy should be the same as the trust's basis in the policy. Assuming that the loan proceeds (the liability) equal the premiums paid for the policy (the basis in the policy), the liability associated with the policy and deemed assumed by the trust will be offset by the grantor's basis in the policy (again, perhaps adjusted, as discussed above); therefore no income should be recognized by the grantor on termination of the trust's grantor trust status during the grantor's life.
As discussed above, there is substantial uncertainty and debate among commentators regarding the income tax consequences on termination of grantor trust status as a result of the grantor’s death, where the trust has outstanding liabilities at that time. As discussed above, the authorities dealing with the income tax consequences on termination of grantor trust status where the trust has outstanding liabilities only pertain to termination during the grantor’s life.

Some commentators view the transfer of assets that is deemed to occur on the grantor’s death as tantamount to a testamentary transfer of the assets to the trust. Under this theory, a gain-on-death rule is contrary to the rule of Section 1001 and, accordingly, no gain should be triggered on the deemed transfer of the assets to the trust upon the death of the grantor.

On the other hand, the Service will likely argue, and other commentators believe, that when grantor trust status is terminated by the grantor’s death, the deemed transfer of the assets to the trust triggers gain to the extent any assumed liability exceeds the grantor’s basis in the assets transferred, just as in the case of termination of grantor trust status during the grantor’s life.

Thus, under this analysis, as discussed above, on the grantor’s death and the corresponding termination of grantor trust status of the trust, the grantor will be deemed to have transferred the life insurance policy to the trust in exchange for the assumption by the trust of the loan incurred in connection with the acquisition of the policy. Under the general rule of Reg. § 1.1001-2(a)(1), the grantor will recognize gain to the extent the liability assumed by the trust exceeds the grantor’s basis in the policy. However, if it is determined that the exception of Reg. § 1.1001-2(a)(3) applies, because the liability was incurred in connection with the acquisition of the life insurance policy and was not taken into account in determining the transferor’s basis, then no gain will be recognized by the grantor (or his or her estate) on termination of the trust’s grantor trust status, even if the liability deemed assumed exceeds the grantor’s basis in the policy.

If the exception contained in Reg. § 1.1001-2(a)(3) does not apply in the insurance trust situation, because of the conclusion reached in TAM 20011005, termination of the trust’s grantor trust status should still not result in a recognition of gain by the grantor because the liability (the loan proceeds) should equal the grantor’s basis in the insurance policy (the premiums paid by the trust to acquire the policy), again, potentially adjusted as discussed above. Consequently, the liability associated with the policy and deemed assumed by the trust will be offset by the grantor’s basis in the policy, and no gain should be recognized on the termination of the trust’s grantor trust status as a result of the grantor’s death.

b. 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.

c. 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%190/ with a face amount of $280,000.

Year One:

(4) LLC pays Grantor Trust $24,000.
    (This is 40% of 6% return from the asset).

(5) 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.

(6) 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.

d. At the seller’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 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,191/ 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.

e. 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.

f. President's Proposal Effectively to Eliminate Grantor Trusts

One of the most interesting transfer tax proposals made in the President’s Budgets for the last four years is designed to coordinate certain income and transfer tax rules applicable to grantor trusts. For the three prior years (the President’s Budgets for 2013 through 2015), the proposal for grantor trusts was separate from the proposal for grantor retained annuity trusts (“GRATs”). However, in 2016, the GRATs and grantor trust proposals were combined into a single proposal. The Administration’s FY2016 Budget Tax Proposals Fact Sheet indicates that the proposal is designed to make certain “overly generous outcomes more difficult to achieve”.

(1) The 2013 proposal provides that:

(a) “To the extent that” the income tax rules treat a settlor of a trust as the owner of the trust for income tax purposes:

i. The assets of the trust would be includable in the gross estate of the settlor for estate tax purposes;

ii. Any distribution from the trust to a beneficiary during the settlor's life would be subject to gift tax; and

iii. When the trust ceases being a grantor trust during the settlor's life, any assets in the trust would be treated as having been transferred to the trust at such time (at their then-value).

(2) The 2016 proposal (as applicable to grantor trusts) generally is identical to the 2015 proposal. However, this proposal is narrower than the 2013 proposal and would not apply to all the assets of any grantor trust. Instead, the 2016 proposal applies if a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange or comparable transaction that is disregarded for income tax purposes by reason of the person’s treatment as a deemed owner of the trust. In such an event, the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon and reinvestments thereof, net of the amount of the consideration received by the person in that transaction):

i. Will be subject to estate tax as part of the gross estate of the deemed owner;

ii. Will be subject to gift tax at any time during the deemed owner’s life when his or her treatment as a deemed owner of the trust is
terminated; and

iii. Will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner.

(a) In effect, the 2016 proposal, if adopted, would treat a transfer to an irrevocable grantor trust as an incomplete gift transaction completed for transfer tax purposes only when grantor trust status ends (during the settlor's life or at his or her death), or when (and to the extent that) any trust property is distributed to trust beneficiaries.

(b) The 2016 proposal would not change the treatment of any trust which is a grantor trust and which "is already includable" in the grantor's gross estate (presumably meaning "could be includable" or "could be partially includable"), such as GRATs and QPRTs.

(c) The 2016 proposal would be effective for trusts created on or after the date of enactment and, with respect to the 2013 proposal, any portion of a pre-enactment trust attributable to a contribution made after date of enactment.

(d) The 2016 proposal provides that regulatory authority would be granted, including the ability to create exceptions to the provision. The 2013 proposal provides that regulatory authority would be granted to create transition relief for, among other things, "certain types of automatic, periodic contributions to existing grantor trusts" (presumably referring to irrevocable life insurance trusts which are grantor trusts and which require on-going contributions); but query as to what the word "automatic" means here — are recurring gifts to pay premiums automatic in any sense?

(1) As noted, the proposals on traditional grantor trusts seems to convert any irrevocable grantor trust or applicable portion thereof (other than trusts like GRATs or QPRTs) into an incomplete gift trust (such as an irrevocable trust in which the grantor retains a power of appointment) — includable in the grantor's estate for estate tax purposes, with any distributions to anyone other than the grantor treated as gifts for gift tax purposes, and (unlike traditional incomplete gift trusts) termination of grantor trust status during life treated as completing the gift.

(2) Some initial planning thoughts, if any of the proposals were to be enacted:

(a) Every grantor trust, not just those created as intentional (intentionally defective) grantor trusts, would be affected by the proposal. For instance, every foreign trust, which is automatically a grantor trust, would be treated as an incomplete gift trust, includable in the grantor's estate for estate tax purposes, as would any trust in which the grantor's spouse is a beneficiary (such as a lifetime QTIP, or a trust that allowed distributions to the grantor's spouse during the grantor's life without the consent of an adverse party).
Subject to the possible meaning, adoption and application of the regulatory exception discussed in the proposal, pre-existing irrevocable life insurance trusts which were grantor trusts (because of the ubiquitous power to use income to pay premiums, without the consent of an adverse party) would become partially subject to the new rules as new gifts are made to pay premiums.

Would the exception apply to recurring annual exclusion gifts to pre-existing Crummey trusts? Could they be considered “automatic” under the 2013 proposal?

Presumably, clients will want the ability to create irrevocable trusts which will not be includable in their estates for estate tax purposes, and therefore would be willing to forego grantor trust treatment.

That will increase the cost of doing installment sales to those trusts and/or lending money to those trusts, eliminate the ability of the grantor to exchange assets with that trust without an income tax, and would eliminate the "tax burn" of having the grantor pay the income tax on trust assets, reducing his or her estate, without a transfer tax.

In order to be certain to create a non-grantor irrevocable life insurance trust, the power to use income to pay premiums would have to be discretionary and would have to require the consent of an adverse party (a trust beneficiary).

Although the proposals are focused on the interplay between the income tax, grantor trust rules and the gift tax and the estate tax, some aspects of the proposal will have GST implications in many other cases as well, since many irrevocable grantor trusts are designed as multi-generational (dynasty) trusts.

Query – in the 2013 proposal, what does the phrase "to the extent that" the trust is treated as a grantor trust mean? If only a portion of the trust is treated as a grantor trust, would only that portion be subject to the proposal? What if only the ordinary income portion were so treated?

Also, it should be remembered that the grantor trust status of some trusts "comes and goes" — a domestic trust becomes a foreign trust, an insurance trust surrenders or sells its policies, the grantor's spouse is added or deleted as a trust beneficiary, etc.

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 property.
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. 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 having been 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 are readily ascertainable, Section 2701 does not apply. 202/

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. 203/

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. 204/

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. 205/

(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. 206/

(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 of (or sells) his or her interest in the entity or at his or her death. 207/

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 PLR 200114004 for a partnership freeze using a FLLC that was approved by the Service.208/

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 certain assets 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

1. Generally assets are valued for estate tax purposes at their highest and best use. 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.209/ For these reasons, among others, Congress added Section 2032A.

a. General Rules of Section 2032A

(1) 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.

(2) 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.

b. Consequences of Section 2032A Election

(1) The reduction in the value of the qualified real property resulting from the application of the special use valuation cannot exceed $1,100,000210/ in 2015.211/ 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.212/

(2) In general, the special use value establishes the basis of the qualified real property for income tax purposes.213/
2. Requirements of Section 2032A

a. The decedent must be a US citizen or resident at the time of his or her death and the real property must be located in the United States.

b. Real property was used by the decedent or a member of the decedent’s family in a farming, timberland, woodland, or other closely held trade or business or was rented for such use either by the surviving spouse or lineal descendant of the decedent to a family member of the decedent’s on a net cash basis.

c. 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, and the adjusted value of the real property must amount to at least 25% of the adjusted value of the gross estate. “Adjusted value” is the value without the Section 2032A reduction.

   (1) 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.

   (2) 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.

   (3) 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.

   (4) 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, 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, the Tenth Circuit held that to disallow a minority discount suggests that fair market value takes on a different meaning under Section 2032A than under other circumstances, and permitted the incorporation of a minority interest discount in the determination of value.

   d. 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 qualified business
purposes. 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.

(e) 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.

(f) At death, the real property will pass from the decedent to a "qualified heir".

(g) 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. 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.

3. Imposition of Additional Estate Tax

(a) The disposition (other than by involuntary conversion or the contribution of a qualified conservation easement on the subject property) of an interest in the qualified real property by a qualified heir (otherwise than to a member of his family) 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. This additional estate tax may be imposed within 10 years after the decedent's death.

(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. 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.

4. 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.
5. 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. 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.

2. Definitions of an Interest in a Closely Held Business

An “interest in a closely held business” is (1) an interest in a sole proprietorship carrying on a trade or business; (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; 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.

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.

b. The date chosen for the payment of the first installment of tax is not required to be on an annual anniversary of the original due date of the tax. However, it must be on the date within any month which corresponds to the day of the month of the original due date. (Example: If the payment was originally due on August 12th the first payment must be paid on the 12th day of any month). Succeeding installments must then be paid annually on or before the same date until all installments are paid.
c. 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. The estate tax may always be prepaid without penalty. On the other hand, if an alternate payment term has been elected, 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, including extensions) has passed.

d. Interest payments

(1) Section 6601(j) provides:

“(1) In general—If the time for payment of an amount of tax imposed by chapter 11 is extended as provided in section 6166, then in lieu of the annual rate provided by subsection (a)—

(A) interest on the 2-percent portion of such amount shall be paid at the rate of 2 percent, and

(B) interest on so much of such amount as exceeds the 2-percent portion shall be paid at a rate equal to 45 percent of the annual rate provided by subsection (a).

(2) For purposes of this subsection, the term “2-percent portion means the lesser of—

(A)(i) The amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the sum of $1,000,000 and the applicable exclusion amount of effect under section 2010(c), reduced by (ii) the applicable credit amount in effect under section 2010(c), or

(B) the amount of tax imposed by Chapter 11 which is extended as provided in section 6166.

(3) Inflation adjustment—In the case of estates dying in a calendar year after 1998, the $1,000,000 amount contained by paragraph (2)(A) shall be increased by an amount equal to-

(A) $1,000,000, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar by substituting “calendar year 1997” for “calendar year 1992” in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the next lowest multiple of $10,000.
For estates of decedents dying in 2015, the two percent (2%) portion is $1,470,000.248

(2) The payments for interest are not deductible on the estate tax return or the estate's fiduciary income tax returns. However, the excess interest on any overpayment of tax is deductible.249/

(3) The interest payable during the first five (5) years after the estate tax return was to be filed is paid annually. Interest attributable to any period after the first five (5) years is paid annually at the same time as, and as part of, each installment payment of the estate tax.250

e. Generally, if the estate fails to pay principle or interest under Section 6166, on or before the date fixed for its payment (including any extension of time) the balance of the estate tax payable in installments is required to be paid upon notice and demand from the Service.251

(1) If the estate makes the payment within six (6) months of the due date, the Service cannot issue a demand for the remainder of the estate tax payment. However, a penalty equal to five percent (5%) of the payment originally due multiplied by the number of months (including fractions thereof) from the original due date to the date of actual payment will be accessed.252

(2) Estate tax payments are allocated in the following order: 1) first to the non-deferred portion of the estate, 2) next to the interest accrued on both the non-deferred and deferred taxes; and 3) finally to the tax deferred under Section 6166. Once installment payments on the deferred tax begin, the Service proportionately allocates the payments in the following order: 1) first to the required installments of deferred tax, 2) next to the interest on the deferred tax; and 3) finally to any unpaid balance of the deferred tax.253

(3) If the Estate makes an overpayment, that overpayment will be credited against the unpaid installments, if any. If the amount already paid, whether or not on the basis of installments, exceeds the amount of the correct amount of the tax, the excess will be credited or refunded as in the case of other overpayments.254

4. What actions lead to the loss of a Section 6166 election.

a. Section 6166 (g)(1)(A) provides that if:

“(i)(I) any portion of an interest in a closely held business which qualifies under subsection (a)(1) is distributed, sold, exchanged, or otherwise disposed of, or

(II) money and other property attributable to such an interest is withdrawn from such trade or business, and
(ii) the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds fifty (50)% of the value of such interest,

then the extension of time for payment of tax provided in subsection (a) shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.255

b. For purposes of determining whether acceleration of payments is triggered, the phrase “distributed, sold, exchanged, or otherwise disposed of” is broad in scope and comprehends all possible ways by which an interest in a closely held business ceases to form a part of the gross estate. As a general rule, however, the phrase does not encompass transactions which are mere changes in form.256 Also, it is generally held that if the reason for a disposition is to generate funds to keep the business in operation and the proceeds of the dispositions are returned to the company instead of being distributed to the owners because the purpose behind Section 6601 is kept intact.

c. The following actions are not considered to be dispositions:

(1) Certain redemptions of stock to pay death tax under Section 303.257 As long as the payment of the first installment of estate tax and interest after the date of distribution is not less than the amount of money and other property distributed under Section 303, the redemption will not be counted towards the fifty percent test contained Section 6166(g)(1)(A). The Service uses two approaches to determine whether the redemptions will trigger an acceleration of payments. The first is the cumulative approach. This method compares the cumulative estate tax payments with the cumulative Section 303 and says that only the portion of cumulative redemptions that exceed the cumulative estate tax payments are counted towards the fifty percent withdrawal test. Under the redemption approach, redemptions made in the years immediately following the decedent’s death could cause acceleration of the deferred tax if the redemptions exceed the amount of the estate tax due on the next installment payment.258

(2) Changes in form of doing business.259 For example, in PLR 8131030, the Service ruled that the transfer of the decedent’s interest in a closely held business into a limited partnership would not constitute a disposition leading to acceleration because the transfer did not materially alter the business and the interest of the estate in the business did not change.260

(3) Certain tax-free exchanges of stock in connection with transfers to controlled corporations, namely, recapitalizations, mere changes in identity, form or place of organizations and certain tax-free spin-offs and split-ups, under Section 368(a)(1)(D), (E) and (F) and Section 355.261

(4) A transfer of property of the decedent to a person entitled by reason of the decedent’s death to receive such property under the decedent’s will, the applicable law of descent and distribution, or a trust created by the decedent, will not constitute a distribution of the interest that will lead to Section 6166 acceleration. Subsequent transfers of
property by reason of death, so long as each transferee is a member of the family, as defined in Section 267(c)(4), of the transferor in such transfer is also permissible and will not trigger acceleration.\textsuperscript{263} In PLR 9202017, the Service, citing Section 6166(g)(1)(D), ruled that an estate’s distribution of closely held stock to a family trust and the subsequent distribution of stock from the family trust to decedent’s sons was not a disposition that would lead to acceleration of payments because the sons were authorized under the decedent’s will to withdraw any of their shares from the trust.\textsuperscript{264} However, in PLR 8730006, the Service ruled that the cash sale of real property forming part of a closely held business from one heir to another was a disposition leading to acceleration of payments. Although the reshuffling of business property between heirs was normally not a disposition, the cash used to pay for the property was coming from outside of the estate, which made it a disposition.\textsuperscript{265}

(5) A partial sale of the assets of a closely held business to prevent foreclosure on mortgages on business properties where the proceeds were used to reduced the mortgage debt on encumbered assets of the ongoing business. However, if sales proceeds exceed the mortgage and accrued interest, removal from the business of any excess funds is treated as a withdrawal.\textsuperscript{266} Additionally, in PLR 8841006, the Service ruled that the sale of property from a partnership to repay the debts of the partnership was permissible and would not constitute a disposition. However, it was noted that if the funds had been used to pay the estate tax it would have constituted a withdrawal of funds.\textsuperscript{267}

(6) Additionally, the Service has issued a number of private letter rulings on what actions constitute a disposition that will lead to a Section 6166(g) acceleration. In PLR 7825029 the Service ruled that, where an estate proposed to transfer stock to trusts for the decedent’s children, and that transfer would be followed by the trusts’ transfer of the stock to a limited partnership, the partnership’s liquidation of the corporation and distribution of the corporation’s assets to itself was a step in the process of changing from a corporate to an unincorporated form and did not trigger a Section 6166 acceleration.

5. Reporting Obligations Re: Section 6166(g)(1)(A).

On the date fixed for each installment other than the final installment (and without regard to extensions), the executor must advise the district director in writing either of all withdrawals or dispositions known to him and not previously reported by him, or that to the best of his knowledge the withdrawals or dispositions that have occurred were not large enough to trigger the acceleration of payments under Section 6166(g)(1)(A). Additionally, if an executor acquires knowledge of any withdrawals or dispositions which alone or together with other transactions would result in acceleration of installment payments, he must notify the district director in writing within thirty (30) days of acquiring that knowledge.\textsuperscript{268}

6. Caution About Undistributed Income of Estate

Section 6166(g)(2) provides:

"(A) If an election is made under this section and the estate has distributed net income for any taxable year ending on or after the due date for the first installment, the executor shall, on or before the date prescribed by law for
filing the income tax for such taxable year (including extensions thereof), pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installment.

(B) For purposes of subparagraph (A), the undistributed net income of the estate for any taxable year is the amount by which the distributable net income of the estate for such taxable year (as defined in section 643) exceeds the sum of—

(i) the amounts for such taxable year specified in paragraphs (1) and (2) of section 661(a)(relating to deductions for distributions, etc);

(ii) the amount of tax imposed for the taxable year on the estate under chapter 1; and

(iii) the amount of the tax imposed by section 2001 (including interested) paid by the executor during the taxable year (other than any amount paid pursuant to this paragraph).”


a. Under Section 6324A, a special lien for estate taxes may be elected in lieu of the regular estate tax lien. If payment of a portion of the estate tax is deferred under Section 6166, an executor of a decedent’s estate who wishes to be discharged from personal liability may elect a lien in favor of the United States by applying to the Service office where the estate tax return is filed. The application is a notice of election requesting the special lien and must be accompanied by an agreement consenting to the creation of the lien, which must be signed by each person who has an interest in any property designated in the agreement.

b. The agreement must contain:

(1) The decedent’s name and taxpayer identification number as they appear on the estate tax return;

(2) The amount of the lien;

(3) The fair market value of the property subject to the lien as of the date of the decedent’s death and the date of the election;

(4) The amount of all encumbrances on the property as of the date of decedent’s death and the date of the election;

(5) A clear description of the property and a statement of its estimated remaining useful life, in the case of property other than land; and

(6) The designation of an agent, including the agent’s address, for the beneficiaries of the estate and the consenting parties to the lien for all dealings with the Service.
c. The value of property that the Service may place under this special lien may not exceed the sum of the deferred principal amount of taxes plus the aggregate amount of interest payable over the fifteen year period. 271

d. Under this section, if at any time the value of the property secured by the lien is less than the amount of unpaid portion of the deferred taxes plus interest, the Service may request additional security. If such security is not furnished within ninety (90) days following notice and demand for it, the remaining installments due are accelerated under Section 6166(g). 272

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”. 273

2. The Service will look at the following factors in determining whether reasonable cause exists: 274

   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. 275

Interest will be charged at the current rate of interest, as determined under Section 6621.

IX. PROVIDING LIQUIDITY AT DEATH: CORPORATE REDEMPTIONS; SHAREHOLDER SALES AND OTHER SOURCES OF LIQUIDITY 276

A. Buy-Sell Agreements

Arrangements to sell the decedent’s stock are usually found in Buy-Sell agreements, which are generally characterized as either “cross-purchase” or “redemption” agreements.
1. In a cross-purchase arrangement, the other owners are the purchasers; in a redemption arrangement, the business itself is the purchaser.

2. If the arrangement is insured, in a redemption the business would own one policy on each owner’s life, and in a cross-purchase each owner would own a policy on the life of each other owner (or perhaps, collectively through a partnership or an LLC, one policy on each owner).

3. The determination of the type of arrangement to use depends on an assessment by the business owners and the planner of the advantages and disadvantages of each.

a. If the arrangement is to be funded with life insurance, a redemption arrangement may be advantageous where there is a large number of owners.

   (1) With a large number of owners, if a cross-purchase agreement is funded with insurance on the life of each owner, the number of policies required to fund the agreement could be unmanageable. Moreover, at the death of an owner who is a party to a cross-purchase agreement, the policies which he owned on the lives of the survivors (now owned by the decedent’s estate or revocable trust) will need to be transferred to the remaining owners, by purchase.

   (2) The transfer for value problem of those transfers must be considered, since co-shareholders are not exempt transferees for transfer for value purposes; accordingly, some part of the death proceeds of the transferred policies at each later death would lose their Section 101(a) income tax exclusion.

      (a) However, if the co-shareholders are also partners in an existing (or even a newly created) partnership, the transfer for value exception for transfers among partners will apply – so long as the partnership is valid under state law, regardless of whether it has to do with the insurance or not.277

      (b) Ownership of a single policy on each owner by a partnership made up of all of the owners should solve both of these issues; the transfer for value implications of using a trust arrangement for this purpose instead of a partnership (as is sometimes suggested) are not clear.

      (c) Also note the possible use of a single, first-to-die policy insuring all of the owners. The estate tax implications of these policies at each insured’s death are not clear.

(3) On the other hand, there are some disadvantages of using a redemption agreement funded with life insurance, including:

   (a) The policies insuring the lives of the owners will be owned by the business, subjecting them to corporate creditors on an on-going basis.

   (b) Section 101(j), added by the COLI Best Practices Act of 2006 (a part of the Pension Protection Act of 2006), could impact the death benefit
exclusion of the policy proceeds collected by the corporation, unless its qualification, notice and consent requirements are complied with; it also imposes record-keeping requirements on the employer for such policies.

(c) In addition, the insurance proceeds, when collected by the business, will be corporate assets for all purposes (including claims of creditors). This may thus entail obtaining the prior consent of any lenders to the use of the insurance death proceeds to carry out the redemption.

(d) The insurance proceeds will increase the value of the business at the death of an owner.

(i) Since those insurance proceeds (in excess of the cash values) will not have been carried on the books of the business, depending upon the valuation method utilized, an adjustment to the purchase price of the business for such excess proceeds may need to be considered.

(ii) In addition, those proceeds will affect the valuation of the business for estate tax purposes (although, depending on the valuation method used, perhaps not on a dollar-for-dollar basis). If the buy-sell agreement ignores the proceeds or the valuation technique used to value the shares does not take the proceeds into account, in either case there is a potential Section 2703 issue where family members are involved.\textsuperscript{278/}

(e) TRA 86 limits the deductibility of interest on such policies to loans not in excess of $50,000 per insured; HIPAA 1996 further restricted the deductibility of any such interest. Section 264(f), added by TRA 97, limits the deductibility of general corporate interest, based on the existence of unborrowed policy cash values (similar to the proportional interest deduction limits of Section 265, for carrying tax-exempt bonds).

(f) The increase in the cash surrender value in excess of premiums and the death proceeds in excess of cash values will be subject to the accumulated current earnings (formerly the book income) preference rules of the corporate alternative minimum tax (as added by TRA 86), if – and only if – the corporation is a C corporation; the corporate AMT does not apply to S corporations.

(i) This may result in a flat 20%\textsuperscript{279} tax on those excess proceeds in the year of death (after a small exemption, which phases out at $310,000 of minimum taxable income), depending on the business’ regular tax-AMT posture in that year.

(ii) However, under RRA 89, any AMT paid can be carried forward indefinitely and used to offset future regular tax (but not AMT).

(iii) TRA 97 exempts from the AMT any “small business corporation”, defined as one with less than $5 million in gross income.

(4) If a cross-purchase agreement is used where the owners’ ages, percentage interests in the business or financial abilities are very different, the younger,
less wealthy owner will be at a disadvantage in trying to purchase insurance for or assume the
obligation for the purchase of the older (and often wealthier) owner’s interest in the business.

(a) As discussed below, the use of a split-dollar arrangement to “fund” the cross-purchase using the business’ money may be a possible solution to this problem.

(b) The “cost” to the policy owner will be a tax on the “economic benefit” of the arrangement, measured by what amounts to the term cost of the policy(ies) he or she owns on the lives of the co-owners, plus, depending on whether the arrangement is governed by Notice 2002-8 or the Regulations, a tax on policy cash values, either on termination of the arrangement during the insured’s lifetime or currently, or by the imputed interest of what is, in effect, an interest-free loan.

(c) A similar result could be obtained using a premium finance agreement – a loan by the corporation to the policy owners, with interest paid or accrued at the AFR.

(5) Basis Rules

(a) Under a cross-purchase agreement, the survivor’s basis for the interest acquired from the estate of a deceased owner will be the price paid for the interest – an important advantage to this type of arrangement where the surviving owners plan to sell their interests during life (and obviously less of an advantage where that is not contemplated).

(i) Note the effect of the interest classification rules of TRA 86 on interest paid on cross-owned financed policies and on any allowed deferred payment of the non-funded purchase price.

(ii) The interest may be considered investment interest, rather than trade or business interest, with more restrictive deductibility.

(b) In an S Corporation redemption arrangement funded with life insurance, the income tax-free receipt of the death proceeds will proportionally increase the survivors’ bases in their shares. However, a portion of the insurance proceeds will increase the basis of the decedent’s shares – which will already have received a stepped-up basis at death – wasting that part of the step-up.

(6) In a redemption agreement, the business is the purchaser, and so the relative proportion of each remaining owner’s interest in the business will remain the same before and after redemption in such an arrangement. This is an important consideration where there are minority owners; a cross-purchase arrangement in which the minority owners are not purchasers is an alternative to consider.

(7) Because each form of buy-sell agreement has its advantages and disadvantages, sometimes such agreements are drafted as “either-or” or “wait-
and-see” buy-sell agreements, in which the decision as to the form of the agreement is not determined until a purchase is to be carried out.

(a) Under such an arrangement, the business is ultimately the required purchaser; the business and then the other owners are given options to purchase before the business must purchase.

(b) In funding such an arrangement with insurance, the shareholders should be the owners of the policies; they could contribute the policies or their proceeds to the business on a tax-free basis, if a redemption turned out to be advantageous (going the other way, a transfer by the corporation to the owners could be a taxable event and would raise transfer for value concerns).

(8) Dividend issues for surviving shareholders in a corporate redemption --

(a) If the corporation, in redeeming the interest of the decedent, is satisfying a personal obligation of the surviving shareholders, the amounts distributed in redemption would be treated as dividends to those surviving shareholders.

(i) If the business is to effect the purchase, the obligation to purchase must be that of the business, not that of the survivors. Note this issue in planning a wait-and-see agreement.

(ii) In a C corporation with no earnings and profits or in an S corporation with no pre-S earnings and profits, this will not be an issue in any event.

(b) Dividend issues for redeemed shareholder --

There is a dividend risk for the redeemed shareholder’s estate (or revocable trust), especially where the shareholders are related within the meaning of Section 318.

(i) In a C corporation with no earnings and profits or in an S corporation with no pre-S earnings and profits, this will not be an issue. Accordingly, in such a family-owned S corporation, the choice of the form of a buy-sell agreement can be made without regard to this concern.

(ii) If the redemption is treated as a dividend, it is fully taxable as ordinary income to the recipient (to the extent of earnings and profits); any available basis is “lost” – it “disappears”. This is especially critical for redemptions at death, because the loss of the stepped-up basis will convert a totally non-taxable capital sale (if done at estate tax values) into a fully taxable dividend (with no offset for the stepped-up basis) – assuming the decedent died in a year in which the stepped-up basis at death rule was in effect. However, the maximum tax rate on dividends (20% plus the 3.8% Medicare contribution tax in 2015) may lessen this concern to some extent (although any stepped-up basis would still be wasted).
Redemptions are treated as a dividend to the redeemed shareholder unless: (a) the redemption is not essentially equivalent to a dividend, under Section 302(b)(1); (b) the redemption is substantially disproportionate with respect to the shareholder, under Section 302(b)(2); or (c) the redemption is a complete redemption of all of the interest of the business owned by the shareholder, under Section 302(b)(3). In addition, as discussed below, there is independent protection from the dividend rules provided by Section 303 to redemptions at death which qualify under its provisions (subject to its dollar limitations).

In determining the tax consequences of redemptions under Section 302, the constructive ownership provisions of Section 318 must be considered.

A redeeming shareholder is treated under Section 318 as owning interests in the corporation which are actually owned by related people (under the family attribution rules), as well as interests owned by related entities (under the entity attribution rules). As discussed below, while the family attribution rules can, in appropriate circumstances, be waived, the entity rules cannot. “Family” in this context does not include siblings.

Of particular importance in redemption arrangements at death is the rule that an estate (or trust) is deemed to own the interest owned directly or indirectly by a beneficiary. The selling estate or trust will therefore be considered as constructively owning shares owned by any beneficiary (in addition, of course, to the shares it owns directly).

As a result, it is extremely difficult to eliminate the constructive ownership of interest by an estate or a trust where there are other members of a decedent’s family who are shareholders, who are the decedent’s natural beneficiaries, and who are going to continue being shareholders after the redemption.

Unless those shareholders can be (and are willing to be) eliminated as beneficiaries of the estate or trust – not a practical alternative in most situations.

The first test for avoiding dividend treatment – that the redemption is not essentially equivalent to a dividend under Section 302(b)(1) – is a subjective test. The Supreme Court, in United States v. Davis, 307 U.S. 301 (1970), held that, in order for a redemption to qualify for this exception, it must “result in a meaningful reduction of the shareholder’s proportionate interest in the business”, taking into account the constructive ownership rules of Section 318.

The second test, the “substantially disproportionate” exception of Section 302(b)(2), as opposed to the “not essentially equivalent to a dividend” exception, is, on the other hand, an objective test.
(i) To meet this objective test, immediately after the redemption: (a) the redeeming shareholder must own less than 50% of the total combined voting power of all classes of interest entitled to vote; and (b) the ratio of the voting interest and common stock of the business owned by the shareholder immediately after the redemption to all voting stock and common stock of the business must be less than 80% of the ratio immediately before the redemption.

(ii) Note again that the attribution rules of Section 318 must be considered in these tests, and can create genuine traps for both the wary and the unwary.

(c) Under the “complete redemption” exception of Section 302(b)(3), a distribution in redemption of interest will be taxed as a capital transaction whenever there is a complete termination of the shareholder’s interest in the business, again taking into account the attribution rules of Section 318.

(i) This exception is the one most commonly applicable in buy-sell agreements.

(ii) It applies to lifetime buy-outs even among family members, because Section 302(c)(2)(A) allows a waiver of the family attribution rules of Section 318, in some circumstances.

(iii) The waiver requires compliance with the restrictive ten year “walk-away” rules – the shareholder must sever all ties with the business, except that of a creditor.281

(iv) Special restrictions must be considered and complied with when either the redeemed interest or the interest of other family member(s) was acquired from the redeemed shareholder within ten years of the redemption; an advance ruling is usually suggested.

(10) Section 303 provides another permissible safety zone for a redemption of stock by a corporation at a shareholder’s death without dividend treatment, subject to its dollar amount limitations, if its requirements are met. Because of the estate’s stepped-up basis at death (other than where decedent’s estate elected out of estate tax for 2010), its effect is to eliminate any income tax consequences as a result of the redemption (if carried out at estate tax values).

(a) Under Section 303, corporate stock which qualifies can be redeemed in an amount equal to the sum of the Federal and state death taxes payable as a result of the deceased shareholder’s death, plus the amount of funeral and administration expenses of the estate allowable as estate tax deductions (whether or not such administration expenses are so claimed); many business owner’s estates would likely meet this test.

(b) Note that using the unlimited marital deduction means that Section 303 will effectively not be available until the survivor dies. Planning will therefore require a focus on qualification of the survivor’s estate for Section 303.
In order to qualify for Section 303 treatment, the stock must have been includible in the deceased shareholder’s gross estate and its value must exceed 35% of the gross estate, less the amounts of allowable deductions under Sections 2053 and 2054 (whether or not so claimed); many business owners’ estates would likely meet this test, without special planning.

(i) In determining whether an estate qualifies under the 35% test, gifts made by the decedent within three years of death are included in the gross estate. This rule would prevent immediate pre-death gifts of non-stock assets to meet the 35% threshold test. There does not appear to be anything which would prevent a stock acquisition in contemplation of death to increase the stock’s proportion of the estate.

(ii) Stock must be redeemed from a shareholder whose interest in the estate is reduced directly (at least through a binding obligation) by the payment of death taxes and funeral and administration expenses. Note, however, that there is no requirement that the redemption proceeds actually be used to pay taxes and expenses or that the estate be illiquid. Note also that the estate would qualify, but the surviving spouse or a marital trust would not (since either would normally be exonerated from liability for the tax by the tax clause in the decedent’s Will).

(iii) Section 303 redemptions are also permitted for stock included in generation-skipping transfers which occur after the death of the transferor.

(d) Although the rationale for Section 303 is to provide liquidity for the estate of a closely-held corporation’s shareholder, it can be used even where the estate has sufficient liquidity – so long as its tests are met.

(e) There are strict time limits on redemptions imposed by Section 303 which must be complied with; although, as discussed below, where the estate also qualifies for Section 6166 treatment – the threshold tests are the same – the two can be combined and the redemption done in installments (matching the Section 6166 payments).

6. Cross Purchase Agreements.

As also noted above, in a cross-purchase agreement, each owner owns a policy on each of the other owners’ lives (unless a master partnership arrangement is used to own the policies). With a cross-purchase arrangement, since the obligation to purchase is that of each of the surviving owners, in many cross-purchase agreements insurance funding is provided individually by each owner.

(a) In some cases, the business pays the owner-employees additional compensation – a bonus – to enable them to pay the premiums.

(b) In other cases, the cross-purchase agreement is funded with policies on the lives of the owners which are arranged under split-dollar agreements with the business. This technique allows the business to bear the premium costs of the cross-purchase...
arrangement, so that, like the redemption agreement, the business is providing the funding for the insurance premiums.

(1) However, unlike a funded redemption agreement, the owner has income from the arrangement (measured by the economic benefit of having the business provide the insurance he or she owns on the other owners’ lives, less his or her contribution if any, to the arrangement, which for post-final regulation arrangements, will be income to the corporation); since it will recover its premium advances at the death of each owner, the business gets no deduction for those advances.\footnote{285}

(a) The “economic benefit” is measured by the lower of the so-called Table 2001 rate or the insurer’s published, generally available annual term insurance cost.

(b) Under Notice 2002-8, post-1/28/02 arrangements will be subject to additional requirements as to the use of alternative term costs after 1/1/04.

(c) For pre-final Regulation arrangements, Notice 2002-8 only taxes the excess of cash values over premiums on termination of the arrangement during the insured’s lifetime, subject to the so-called “no inference” rule, and provided safe harbors for pre-1/28/02 arrangements terminated before 1/1/04.

(d) Notice 2007-34, applying Section 409A to compensatory split-dollar arrangements, also applies on termination, without any “no inference” provision, potentially changing the effect of Notice 2002-8.

(e) It also allows pre-final Regulation arrangements to be treated as interest-free loans, governed by Section 7872, measuring the income to the policy owner by the foregone interest, rather than the term cost, and avoiding any tax consequences relating to those excess cash values.

(f) For post-final Regulation arrangements, most collateral assignment arrangements will be treated as interest-free loans (other than those employment or gift arrangements providing only a death benefit) and require endorsement arrangements to be treated under the economic benefit regime (with taxation based on a combination of term costs and current taxation of any excess policy values when the non-owner of the policy has “access” – as broadly defined – to those values.).

(g) The final Regulations only apply to arrangements entered into, or materially modified, after September 17, 2003.

(h) Where the corporation has elected S status, the arrangement should be contributory to avoid any issue relating to creating a second class of stock.\footnote{286}

(2) As an alternative, the corporation could lend the shareholders the premiums on each other’s policies, under a premium finance arrangement, with interest paid or accrued at a market rate of interest, but not less than the AFR.

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B. Life Insurance

The traditional role of life insurance as a source of the liquidity needed at death to pay estate taxes and other costs should be considered in the estate of the business owner.

1. As noted above, given the potential impact of Section 2703 on the ability of family buy-sell agreements to “fix” estate tax values, not requiring a purchase at death under such an agreement may make sense, eliminating the need for insurance funding of the agreement and “freeing up” insurance to be used outside the business to provide liquidity.

2. From an estate planning point of view, the identity of the insured(s), the ownership and beneficiary designation provisions of the policy, as well as the source of premium payments are all issues to be dealt with.

   a. Ownership.

      (1) If the insured owns the policy, names his or her spouse as the beneficiary (and the spouse survives the insured), although the policy proceeds will be includible in the insured’s estate for estate tax purposes, there will be no tax on the proceeds at the insured’s death, because of the unlimited marital deduction provided by Section 2056, so long as the spouse is a U.S. citizen.\textsuperscript{287}

      (a) The policy proceeds, to the extent not spent or given away, will, however, be includible in the surviving spouse’s estate for estate tax purposes.

      (b) Accordingly, in larger estates, consideration should be given to having neither the insured nor his or her spouse own the policy.

      (c) That may mean having the insured transfer ownership of an existing policy to the children (or a partnership of the children), having the children apply for new insurance on his or her life as the initial owners, having the insured transfer existing insurance to an irrevocable insurance trust, or having such a trust apply for the insurance on his or her life.\textsuperscript{288}

         (i) An initial acquisition by a third party owner would avoid a Section 2035 three-year risk for the insured.

         (ii) In addition, note the impact of the generation-skipping transfer tax on this planning, where beneficiaries two or more generations below the insured are involved.

         (iii) Such a trust could use the proceeds to lend to the insured’s estate or to acquire assets (perhaps interests in the family business) from the estate and would then become the focal point of the decedent’s plan for the disposition of the family business.

         (iv) Which will mean the terms of the trust and the identity of the trustee(s) will be critical issues in planning for control of and ultimate ownership of the business.
b. Source of Premiums.

(1) The issue of the source of paying premiums needs to be explored, especially in light of the availability of the insured’s closely held business as a possibility.

(2) Consideration should be given to a bonus arrangement as a way of funding such policies.

(3) Or, in the right situation, using a split-dollar arrangement to provide premium funding and to reduce the gift tax consequences of transferring the policy proceeds to the ultimate beneficiary(ies) – from the full premium to the “economic benefit” of the arrangement.

(a) But note that split-dollar is likely to be a temporary financing device, requiring consideration of a lifetime exit strategy.

(b) And also note the effect of Notice 2002-8 on pre-final Regulation arrangements and the final Regulations on post-final Regulation arrangements.

(4) Or, perhaps, using premium financing (by the corporation or a third party lender) – reducing any gift to the interest required to be paid the lender in any year.

c. Beneficiary.

(1) The beneficiary designation provisions of the policy need to be reviewed, to be sure that the insurance proceeds and the liquidity they represent will be available to the insured’s estate for the payment of debts and taxes and will either be paid to (or at least available to) the surviving spouse to provide a source of continued income.

(2) Again, third party ownership by an irrevocable trust, which would also be the policy beneficiary, may make sense.

d. Insured(s).

(1) Finally, consideration should be given to use of a joint, second-to-die policy, to provide the needed liquidity at the survivor’s death (where the unlimited marital deduction is planned for) and to reduce the premium cost.

(2) In most cases, owned by and payable to an irrevocable insurance trust and in many cases arranged under a split-dollar agreement.

(3) If the owner is not insurable, consideration should be given to insuring the spouse, again using an irrevocable insurance trust as owner and beneficiary or using a survivorship policy, in which the insurability of either insured is not usually an insurmountable issue.
X. COMPARISON OR COMBINATION OF TECHNIQUES

When considering what technique or combination of techniques would work best for the real estate owner, the advantages and disadvantages of the techniques, the nature of the asset that is being transferred and the nature of the asset must all be considered.

A. The Client

Consider an entrepreneur’s personality, which means a controlling personality with little confidence in the ability of the family or advisors to manage the assets as well as the owner, who also happens to be a “deal junkie”; with very little liquidity and who lives off the cash flow from the property. The owner usually takes great pride in the owner’s financial statement as an affirmation of what the owner has accomplished, as well as using the financial statement as the basis for borrowing in order to enter into the next venture, usually with personal guarantees.

Accordingly, in order to enter into any of these techniques, the owner must be convinced that he or she can maintain control, at least indirectly, the owner’s after-tax cash flow must be maintained and the assets transferred must still be available for borrowing purposes. An advantage of the owner’s need to enter into new deals is that, if the owner can be convinced, the new entities/owners should be included in the new deals, thereby transferring the appreciation potential from these new deals to the owner’s family.

B. The Assets

Closely held businesses always raises a valuation issue due to the expense of the appraisals as well as the valuation itself, in light of the issues with discounts arising from the use of entities to hold the assets. Therefore, keeping the number of appraisals to a minimum is desirable.

Transferring entity interests can be a problem if the donor is not in control of the entity.

Finally, such assets can range from producing no cash flow (such as a startup business with great appreciation potential) to negative cash flow (the costs of supporting a young business or developing it) to a steady and reliable stream of income.

C. Techniques

1. Transfer Tax-Free Restructuring.
   
   a. Transfers between spouses will produce minority interests held by each spouse. To prevent the surviving spouse from receiving one hundred percent of the interest at the death of the first spouse to pass away, the Wills or Revocable Trusts should utilize QTIP trusts to hold the interests in a way that utilizes the marital deduction but if the QTIP is property drafted, prevent the assets in the trust from being aggregated with the assets held by the surviving spouse.
b. Separate management from ownership with the use of non-member LLCs. This will ensure that the asset can be managed by the most appropriate persons or group without an estate or gift tax consequence.

c. Move assets into second tier entities based on the technique that is most appropriate for the assets. For example, if the client has decided to enter into a sale transaction with a note or enter into a private annuity sale, then the assets that produce cash flow should be held in one entity that will be sold, to enable the purchaser to use the cash flow to meet the promissory note payments or annuity obligations. If the client has decided to make gifts, then property with appreciation potential, whether or not it produces cash flow, should be moved in to another entity which can be gifted. Assets that will be retained by the client should be held in a separate entity, the ownership of which is split between the client and the client's spouse (with QTIP trust provisions in the estate plan) and the client should be convinced to give up management and control over this entity, in order to produce maximum discounts for estate tax purposes as the client's death.

2. Transfer Tax Planning: GRATs, GRUTs, Sales, Annuities, Grantor Trusts, a very brief (and therefore incomplete) checklist of techniques.

There are no home runs in this area and no perfect technique, but a combination of techniques could be what works best.

a. Outright gifts are simple, but they are expensive if the gift tax exemption is exceeded. The donor has the annual exclusion available to shield a portion of the gift, in most cases, and can utilize GST planning.

b. GRATs and GRUTS. The annual exclusion and general GST planning are not available for these techniques. These techniques can provide for leveraging opportunities and there is the availability of zeroing out the gift, thereby reducing the expense of the gift. The biggest drawback to these gifts is the possibility of the death of the donor before the end of the retained interest, which will collapse the transaction. The second drawback is the requirement that the annuity be paid every year, which will require either cash flow or portions of the gifted asset or the entity to be distributed, necessitating valuations to determine the correct amount of the transfer. This technique cannot be used by a client with a terminal condition.

c. Partnership Freeze. There is a reason this technique is called a "leaky freeze"; in order for the retained preferred interest to be respected, pay-out must be cumulative and deemed to be paid after a period of years, even if the entity has not performed well enough to make the payment, which causes the client's estate to increase in value. In light of the requirement that the junior interest has to equal at least 10% of the value of the entity, there is usually a gift tax consequence to the technique. GST planning and annual exclusions can be utilized with the partnership freeze.

d. Installment Sales With a Promissory Note. These only freeze the client's estate, removing future appreciation. In light of the requirement of a source independent of the purchased assets from which to make payments on the note, there is usually a taxable gift or the expense of letters of credit or other guarantees when using this technique. The property...
must produce cash flow to enable the purchaser to make payments on the note. The interest rate on these notes must be equal or higher than the Section 1274 AFR. Increasing the interest rate, amortizing the note for principal payments, or using interest-only balloon notes gives the client the greatest flexibility on determining the cash flow the client will receive from the note. This flexibility does not exist with GRATs, GRUTs, or Private Annuity sales, all of which have to use the Section 7520 rate.

e. SCINs. These are freezes with a potential for elimination of the asset from the estate if the client dies during the term, but they can also be somewhat leaky due to the premium that must be paid for the cancellation feature, if the client survives. If the client should die, there will be an income tax consequence to the client’s estate. This technique cannot be used by a client with a terminal condition. All other advantages and disadvantages set forth above for notes apply for SCINs. The term of the note cannot exceed the seller’s life expectancy or the SCIN could be reclassified as a private annuity, which is a problem for older clients.

f. Private Annuity Sales. These are leaky freezes if the client lives beyond his or her life expectancy with the potential for elimination of the asset from the estate if the client dies prior to his life expectancy. If the Section 7520 rate is lower than the Section 1274 AFR, this technique can make it easier for the purchaser to make the annuity payments, however, since the rate cannot be changed, the seller’s annuity may be too low to satisfy the seller’s cash flow needs. One possible means to address this problem is to use the life expectancy of a person older than the client, on which to base the annuity payments. Sellers like these transactions because they know that they will never run out of money, purchasers don’t like these transactions because they don’t know how much they paid for the property until the death of the seller and it is only at that time that they know their true tax-cost basis in the property. A grantor trust must be the purchaser, or immediate recognition of gain will result.

g. A Grantor Trust should be considered for any of these techniques (and must be used for the Private Annuity Sale), and oftentimes taking the income tax consequences out of the equation is the only way the technique will work.

XI. SOME QUESTIONS THE PRACTITIONER SHOULD BE ASKING:

A. Should the Marital Deduction Always Be Taken?

1. Transfer Tax-Effect of Marital Deduction

A marital deduction does not eliminate estate tax; it defers it. Are we moving from a period of low valuation to increasing appreciation over the long term?

2. The Better Marital Trust Is Not Always a Marital Deduction Trust

Even though the marital deduction requires that the spouse be the sole beneficiary of the asset, a non-marital trust may provide that the spouse is the sole beneficiary to protect the spouse from claims by other beneficiaries.

3. State Law Effect of Marital Deduction
The marital deduction requirement that the surviving spouse receive all income at a reasonable rate of return on the assets for which a marital deduction is claimed exposes such amounts (or the right to such amounts) to creditor claims of the surviving spouse.

4. Income Tax Effect of Marital Deduction

The distribution of income required in marital deduction trusts means that most, if not all (in the case of QTIP and other marital trusts), of the income will be distributed to the surviving spouse, to be taxed at his or her rate. With the possibility of higher income tax rates for higher bracket taxpayers (over $250,000 of income), pushing income down to lower brackets will become popular again.

B. Should the Charitable Deduction Always Be Taken?

A charitable estate and/or gift tax deduction eliminates gift and estate tax, but at a cost to the family. In addition, the charitable income tax deduction is phased out to a great extent for high income tax bracket taxpayers and often is not that useful due to the impact of the AMT.
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Section 2501(a)(1). Unless otherwise noted, all reference to Sections (Sec.) 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).

Section 2511(a); Reg. § 25.2511-1(a). See Priv. Ltr. Rul. 200534015 (May 13, 2005). Disclaimer of contingent remainder interest in trust is not a transfer, see Priv. Ltr. Rul. 200516004 (January 6, 2005), but renunciation of a remainder interest is a taxable gift, Priv. Ltr. Rul. 200530002 (April 19, 2005). Also see Priv. Ltr. Rul. 201119003 (January 12, 2011), holding that an exchange between legatees pursuant to a settlement agreement for full and adequate consideration was not a disposition under Section 2519 or a gift under Section 2511.

2012 Tax Relief Act §101(c)(1).

Section 2503(b)(2), as amended by the Taxpayer Relief Act of 1997 (the “1997 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. 3236 (1997). See also Tech. Adv. Mem. 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. See also Price v. Comm’r, T.C. Memo 2010-2 and Chief Counsel Advice 201208026 (Feb. 24, 2012). But see Estate of Wimmer v. Comm’r, T.C. Memo 2012-157, holding that gifts of limited partnership interests qualified as annual exclusion gifts. The partnership held dividend-paying stock at the time of the gifts; the partnership agreement and applicable state law imposed fiduciary obligations on the general partners to distribute some portion of the partnership income to the limited partners; and the dividend-paying stock was publicly traded, so the limited partners could estimate their allocations of quarterly dividends based on the stock’s dividend history. See also Tech. Adv. Mem. 199944003 (July 2, 1999), holding that gifts of limited partner 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.”

Reg. § 25.2503-6(a).

Section 2523(b). See Priv. Ltr. Rul. 9139001 (April 30, 1991) and Priv. 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.

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

Sections 2523(e)(2) and 2523(f)(3).

Section 2523(e).
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. Section 170(h)(5)(B)(ii), as amended by the 1997 Act §508(d).

Section 2522(c)(2).
Section 2522(d).

Section 6019(a)(3), as amended by the 1997 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).

Section 2505(a)(1), which refers to Section 2010(c) (which was amended by 2012 Tax Relief Act) §§101(a)(1), 101(a)(2) and 101(c)(2). Rev. Proc. 2014-61, 2014-47 I.R.B. 860.

Section 6018(a).

Section 2010(c)(2), as amended by 2012 Tax Relief Act §101(c)(2). Recently, Final Regulations were issued, with an effective date of June 12, 2015.

Notice 2011-82, 2011-42 I.R.B. 516, and News Release 2011-97. Reg. §§ 20.2010-3 and Reg. §25.2505-2 clarify that, if the decedent is the last deceased spouse of the surviving spouse on the date of a transfer by the surviving spouse that is subject to gift or estate tax, the surviving spouse (or the estate of the surviving spouse) of that decedent may take into account that decedent’s spouse’s unused exclusion (“DSUE”) amount in determining the applicable exclusion amount of the surviving spouse when computing the surviving spouse’s gift or estate tax liability on that transfer. The Regulations also provide that a surviving spouse may use the DSUE amount of a predeceased spouse as long as, for each transfer, such DSUE amount is from the surviving spouse’s last deceased spouse at the time of that transfer. Thus, a spouse who has surviving multiple spouses may use each last deceased spouse’s DSUE amount before the death of that spouse’s next spouse, and thereby may apply the DSUE amount of multiple deceased spouses in succession. In Rev. Proc. 2014-18, 2014-7 I.R.B. 513, the Service provided a simplified procedure for requesting an extension to file a portability election for certain decedents dying prior to 2014.

Notice 2011-82, 2011-42 I.R.B. 516, and News Release 2011-97. The executors of the estate do not need to make an affirmative election on the Form 706. Qualifying estates of decedents dying in the first six months of 2011 will be allowed a six-month extension to file Form 706 in order to make a portability election. This extension applies if the executor of the estate did not file a Form 4768, “Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes”, within nine months after the decedent’s death. To receive the extension, the executor of the estate must file a Form 4768 within 15 months after the decedent’s date of death. Notice 2012-21, 2012-10 I.R.B. 450, and News Release 2012-24. See also Reg. § 20.2010-2(a)(7), which provides that executors of estates that are not otherwise required to file an estate tax return under Section 6018(a) do not have to report the value of certain property that qualifies for the marital or charitable deduction, but must estimate the total value of the gross estate (including the values of the property that do not have to be reported on the estate tax return under this provision), based on a determination made in good faith and with due diligence regarding the assets includible in the estate. The instructions issued with respect to the estate tax return (Form 706) will provide ranges of dollar values, and the executor must identify on the estate tax return the particular range within which falls the executor’s best estimate of the total gross estate.

As a result of the 2010 Tax Relief Act, the estate of a decedent dying in 2010 may elect the retroactive applicability of the estate tax, in which case there is a period of nine months after the date of enactment (December 17, 2010) to pay the Federal estate tax. It should also be noted that in Rev. Proc. 2011-41, 2011-35 I.R.B. 188, and Notices 2011-66, 2011-35 I.R.B. 179 and 2011-76, 2011-40 I.R.B., the Service provided guidance for an executor of an estate of a decedent who died in 2010 and elected out of the estate tax regime and instead embraced the modified carry-over basis rules of Section 1022. The Notices provide that an executor may make a Section 1022 election by filing an IRS Form 8939, “Allocation of Increase in Basis for Property Acquired from a Decedent”, on or before January 17, 2012. The Revenue Procedure
provides that the Service will not challenge the basis of the property, if the executor follows certain conditions.

But see Section 6166 for rules for extension of time for payment of estate tax where an estate consists largely of interests in closely held businesses.

Section 2056. See Estate of Turner v. Comm'r, 138 T.C. No. 14 (2012) (holding that even though certain gifts of partner interests were included in decedent’s gross estate under Section 2036, the partner interests (and the assets attributable to the partner interests) were not considered to have “passed” to decedent’s spouse and, therefore, the estate was not entitled to claim the marital deduction with respect to such property).

See U.S. v. Windsor, 111 AFTR 2d 2013-2385 (S. Ct. 2013) (holding that the §3 of the Defense of Marriage Act was unconstitutional, thereby allowing same sex couples to qualify for the marital deduction).

Section 2055. See Estate of Palumbo v. Comm'r, 107 AFTR 2d 2011-1274 (D.C. Pa. 2011), aff’d 109 AFTR 2d 2012-1594 (3rd Cir. 2012) (holding that an estate is entitled to a charitable deduction for a payment made to charitable trust pursuant to a settlement agreement, resulting from a dispute over whether the charitable trust was a remainder beneficiary under decedent’s will due to a scrivener’s error).

Maryland increased the amount exempt from Maryland estate taxes from $1 million in 2014 to $1.5 million in 2015, $2 million in 2016, $3 million in 2017 and $4 million in 2018. In 2019, the State estate tax exemption will match the Federal exemption.

to reduce the value of the marital trust by transferring the surviving spouse’s interest in the marital trust (rather than the assets of the marital trust) into a family limited partnership.

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Section 2040(b)(1) and 1014.

Section 2040(b)(2).


Section 1014(a). See Strauss, Real Estate Ownership Raises Estate Planning Complications, 27 Tax’n for Lawyers 25 (July/Aug. 1998). However, for property with respect to which an estate tax return is filed after January 31, 2015, the Transportation and Veterans Health Act imposes certain new basis consistency standards which generally provide that the basis of property acquired by reason of death under Section 1014(a) must equal the value of such property for estate tax purposes.

Section 743(a). Note that, in 2004, §743(a) was amended by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §833(b)(2) (2004), to insert the words “or unless the partnership has a substantial built-in loss immediately after such transfer.” This language means that the death of a partner could result in a downward adjustment to the partnership’s inside basis if, immediately after the partner’s death, the partnership has substantial built-in loss.

Reg. § 1.743-1(b).

Reg. § 743(a).

Section 754.

Section 732(b).

Section 2001(f), as amended by the 1997 Act §506(a), and Section 6501(c)(9), as amended by the 1997 Act §506(b); see Adequate Disclosure of Gifts, 63 Fed. Reg. 70,701 (proposed December 2, 1998).


Reg. § 301.6501(c)-1(f)(2). See CCA 200916022, where the IRS Chief Counsel analyzed whether transactions involving sales of interests in a family LLC in exchange for annuities were adequately disclosed on decedent’s gift tax return under 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).

Section 7477, as added by the 1997 Act §506(c)(1).

Reg. § 301.7701-1(a)(5).

Reg. § 301.7701-3.

Section 705(a).

Reg. § 301.7701-3.

While it does not yet appear to be common practice, there are cases where the court has “reverse pierced” the LLC veil and used LLC assets to satisfy the debts of an LLC member. See, e.g., Devan Lowe, Inc. v.
Stephens, 842 So.2d 703 (Ala. Civ. App. 2002) (holding that a debtor could garnish payments made to an LLC in satisfaction of the debt of an LLC member because the LLC was a sham); Litchfield Asset Management Corp. v. Howell, 799 A.2d 298 (Conn. App. 2002) (holding that an LLC member had so controlled the business that justice required that LLC assets to be used to pay the debts of the LLC member); Great Neck Plaza, L.P. v. Le Peep Restaurants, LLC, 37 P.3d 485 (Colo. App. 2001) (holding that a judgment creditor was permitted to garnish the bank account of an LLC after it had obtained judgments from corporations affiliated with the LLC because the LLC and the corporations were alter egos of one another).

There are also cases which proscribe a creditor's ability to seek payment of its debt by seizing the actual LLC interest. See Zokaites v. Pittsburgh Irish Pubs, LLC, 962 A.2d 1120 (Pa. Super. Ct. 2008) (holding that a member's interest in an LLC may not be transferred to a judgment creditor without the unanimous approval of the other members); Dowling v. Chicago Options Associates, Inc., 847 N.E.2d 741 (Ill. App. Ct. 2006) (holding that the trial court did not have the authority to order the debtor to convey to the creditor the debtor's membership interests in various LLCs); Brant v. Krilich, 835 N.E.2d 582 (Ind. Ct. App. 2005) (holding that a charging order is a judgment creditor's only remedy against a judgment debtor's membership interest in an LLC); Herring v. Keasler, 563 S.E.2d 614 (N.C. Ct. App. 2002) (holding that a judgment creditor could not have his judgment satisfied by the seizure and forced sale of the judgment debtor's membership interests in various LLCs).

Section 7517. Section 7517(a), (b).

Estate of Lenheim v. Comm'r, 60 T.C.M. 356 (1990). See Estate of Thompson v. Comm'r, 499 F.3d 129 (2d Cir. 2007) for comments regarding an appraiser's lack of qualifications. See also Estate of Mitchell v. Comm'r, T.C. Memo 2011-94, where the Tax Court found in favor of taxpayer because taxpayer's appraiser was better qualified, had performed more research, and provided a more understandable report. See Estate of Deputy v. Comm'r, T.C. Memo 2003-176; Knight v. Comm'r, 115 T.C. 506 (2000); Estate of Elkins v. Comm'r, 114 AFTR 2d 2014-5249 (5th Cir. 2014).

Estate of Thompson v. Comm'r, 499 F.3d 129 (2d Cir. 2007). See also Estate of Giovacchini v. Comm'r, T.C. Memo 2013-27.


See also Bolstar, LLC v. Comm'r, 136 T.C. No. 14 (2011) (holding that a taxpayer's expert's appraisal report was not admissible, because it was not the product of a reliable method, resulting from the fact that it assumed scenarios that were unrealistic). See also Mohamed v. Comm'r, T.C. Memo 2012-152 (holding that taxpayers were not entitled to any charitable deduction, even though they may have undervalued their contribution, because appraisals were not independent and Form 8283 was missing key information). See Estate of Evenchik v. Comm'r, T.C. Memo 2013-34 (holding that taxpayers failed to provide qualified appraisals because appraisals valued underlying assets of corporation, instead of the stock in corporation which was donated) and Estate of Richmond v. Comm'r, T.C. Memo 2014-26 (holding that the taxpayer was liable for accuracy-related penalties because it failed to show that it acted reasonably and with good faith when it relied on an unsigned draft appraisal report prepared by its accountant, who was not a certified appraiser).

Wandry v. Comm'r, T.C. Memo 2012-88. On November 13, 2012, the Service issued Action on Decision 2012-004, 2012-46 I.R.B., stating that it believed the Court erred in Wandry in determining that the property transferred for gift tax purposes was anything other than a fixed percentage membership interest transferred on the date of the gift to each donor. As a result, the Service stated that it will not acquiesce in the Wandry decision. See also Estate of Petter v. Comm'r, T.C. Memo 2009-280, aff'd 108 AFTR 2d 2011-5593 (9th Cir. 2011); Estate of Christiansen v. Comm'r, 130 T.C. 1 (2008), aff'd, 104 AFTR 2d 2009-7352 (8th Cir. 2009); Hendrix v. Comm'r, T.C. Memo 2011-133; and McCord v. Comm'r, 120 T.C. 358, rev'd and remanded 98 AFTR 2d 2006-6147 (5th Cir. 2006).

Section 6662(g). For returns filed after 1984 and due before January 1, 1990, see repealed Section 6660 for underpayment penalties.
Disclosure under Section 6662(d)(2)(B)(ii) entails adequate disclosure of the relevant facts affecting the item's tax treatment in the return or in a statement attached to the return, and existence of a reasonable basis for the tax treatment of such item by the taxpayer.

Notice 2009-5 discusses (1) the effect of EESA on Notice 2007-54 and Notice 2008-13; (2) the definition of substantial authority for purposes of Code Sec. 6694(a)(2)(A); and (3) the interim penalty compliance rules for "tax shelter" transactions as defined in Code Sec. 6694(d)(2)(C)(ii).

Notice 2008-13 provided interim guidance on the standards of conduct applicable to tax return preparers under section 6694(a) and interim penalty compliance obligations applicable to tax return preparers. Notice 2008-13 is effective for all returns and claims for refund (other than employment and excise tax returns) filed, as well as advice provided, on or after January 1, 2008, and before January 1, 2009 (the effective date of the final regulations under section 6694(a)); and all 2007 employment and excise tax returns filed on or after January 1, 2008, and before January 1, 2009.

EESA's special rule for tax shelters (as defined in section 6662(d)(2)(C)(ii)) and reportable transactions to which section 6662A applies does not apply retroactively, so the provisions of Notice 2008-13 will apply to positions on returns or claims for refund for tax years ending prior to the date of enactment of EESA and otherwise covered by Notice 2008-13, as set forth above. The interim guidance provided in Notice 2009-5 with regard to such transactions is effective for returns or claims for refund for tax years ending after the date of enactment of EESA.

See Ward v. Comm'r, 87 T.C. 78 (1986); LeFrak v. Comm'r, 66 T.C.M. 1297 (1993) (allowing a 20% minority interest discount). See also Estate of Trenchard v. Comm'r, 69 T.C.M. 2164 (1995); Estate of Wheeler v. U.S., 96-1 USTC 60,226, 77 AFTR 2d 96-1411 (W.D. Tex. 1996), where a gift of a 50% interest was entitled to a 10% minority discount to reflect lack of control. But see Godley v. Comm'r, 286 F.3d 210 (4th Cir. 2002).

See Estate of Giustina v. Comm'r, 114 AFTR 2d 2014-6848 (9th Cir. 2014) (applying a 25% lack of marketability discount to a $0.28% limited partner interest); Estate of Richmond v. Comm'r, T.C. Memo 2014-26 (applying 32.1% lack of marketability discount to a 23.44% interest in a family owned investment holding company, the portfolio of which consisted primarily of publicly traded stock); Estate of Koons v. Comm'r, T.C. Memo 2013-94 (applying 7.5% lack of marketability discount to 50.5% interest held through decedent's trust in family-controlled LLC, which had millions of dollars of highly liquid assets); Dallas v. Comm'r, 92 T.C.M. 313 (2006) (applying 20% lack of marketability discount); McCord v. Comm'r, 120 T.C. 358 (2003) (holding lack of marketability discount of 20% appropriate to determine fair market value of gifted interests in family limited partnership based on studies 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 F3d 924 (8th Cir. 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. 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. 772 (1990); Estate of Bennett v. Comm'r, 65 T.C.M. 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. 284 (1992) (15% discount allowed although the decedent owned a majority interest (77%) in the entity); and Estate of Gray v. Comm'r, 73 T.C.M. 1940 (1997)(15% discount allowed even though decedent owned approximately 82% of the entity); but see Cloutier v. Comm'r, 71 T.C.M. 2001 (1996) (lack of marketability discount lost as a result of poor appraisals).
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. 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. 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. 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. 2882 (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. 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, 77 AFTR 2d 96-1411 (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. 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. 488 (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. 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. 1337 (2000), rev'd on other grounds, 301 F.3d 339 (5th Cir. 2002).

In 2009, in Pierre v. Comm'r, 133 T.C. No. 2 (2009), the Tax Court held that a taxpayer’s single-member LLC was not disregarded for Federal gift tax valuation purposes and thus was subject to discounts
for lack of control and marketability. However, in Pierre v. Comm'r, T.C. Memo 2010-106, the Tax Court reduced the lack of control discount because of step transaction issues.

In 2011, in Estate of Gallagher v. Comm'r, T.C. Memo 2011-148, the Tax Court allowed both a 23% minority discount to the equity value (computed on a 30% controlling interest basis) and a 31% lack of marketability on stock in a print media company where there were not adequate comparable companies.

[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). Priv. 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. 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. 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. 1816 (1993) (allowing a 15% lack of marketability discount even though 100% of the closely held corporation stock was held in a grantor trust); Moore v. Comm'r, 62 T.C.M. 1128 (1991) (holding that a 35% discount for a minority partnership interest was appropriate)).

In Estate of Berg v. Comm'r, 61 T.C.M. 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. 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. 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. 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.

In 2000, 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. 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, 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 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 or lack of marketability discounts are appropriate for estate tax purposes.

In Estate of Fratini v. Comm’r, 76 T.C.M. 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.

In Rev. Rul. 2008-35, 2008-29 I.R.B. 116, the Service held that an interest in a restricted management account ("RMA") would not be reduced or discounted for estate or gift tax purposes for restrictions imposed under the RMA agreement. Under the facts presented, B, an investor, deposited cash and marketable securities into an RMA with M, a bank. The RMA was for a term of five years, during which time B could not withdraw the assets. B gifted a portion of the RMA to a child, C, subject to the terms of the RMA agreement. A subsequently died during the RMA term. The Service found that the restrictions in the RMA agreement were not substantive restrictions on the assets and did not affect the value of the assets in the RMA.

Reg. § 20.2031-2(e); Estate of Auker v. Comm’r, 75 T.C.M. 2321 (1998); Estate of Foote v. Comm’r, 77 T.C.M. 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. Priv. Ltr. Rul. 9719001 (November 19, 1996). This is contrary to the Service’s position on the swing vote premium discussed below.


Estate of Jelke v. Comm’r, 89 T.C.M. 1397 (2005). In November 2007, the Eleventh Circuit vacated the Tax Court’s decision in Jelke and remanded the case, finding that the Tax Court used an inappropriate valuation method and should have allowed 100% of the C corporation’s unpaid built-in tax as a dollar-for-dollar reduction to the value of the stock as a matter of law pursuant to the Fifth Circuit’s decision in Estate of Dunn, 301 F.3d 339 (5th Cir. 2002). The 11th Circuit held that “... we are in accord with the simple yet logical analysis of the tax discount valuation issue set forth by the Fifth Circuit in Estate of Dunn, providing practical certainty to tax practitioners, appraisers and financial planners alike.”


Estate of Jelke v. Comm’r, 89 T.C.M. 1397 (2005) (See above. The case was vacated by the Eleventh Circuit.) See also Estate of Richmond v. Comm’r, T.C. Memo 2014-26 (applying 7.75% lack of control discount to a 23.44% interest in a family owned investment holding company, the portfolio of which consisted primarily of publicly traded stock).


See Tech. Adv. Mem. 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 Estate of Cidulka v. Comm’r, 71 T.C.M. 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. See Kerr v. Comm’r, 113 T.C. 449 (1999); Knight v. Comm’r, 115 T.C. 506 (2000); Harper v. Comm’r, 79 T.C.M. 2232 (2000).

But see Rev. Rul. 79-7, 1979-1 C.B. 294, where the IRS found that the decedent had so much control over the trust fund that aggregation was appropriate.


See Kerr v. Comm’r, 113 T.C. 449 (1999), where the Court held that a term for years was not an applicable restriction. See also FSA 199919009 (May 12, 1999), where the Service ignored the term for years in the agreement because it was not a definite term (50 years or until the general partner and majority of limited partner interests agreed to terminate).

Kerr v. Comm'r, 292 F.3d 490 (5th Cir. 2002).

FSA 200049003 (September 1, 2000); FSA 200143004 (July 5, 2001); but see Strangi v. Comm'r, 115 T.C. 478 (2000), aff'd in relevant part, 293 F.3d 279 (5th Cir. 2002).

But see Blount v. Comm'r, 87 T.C.M. 1303 (2004), aff'd in relevant part and rev'd in part, 428 F.3d 1338 (11th Cir. 2005) (holding that the buy-sell agreement should be disregarded in determining the estate tax value of the stock subject to such agreement).

Reg. § 25.2703-1. Note that a perpetual restriction on the use of real property that qualified for a charitable deduction under either Section 2522(d) or 2055(f) is not considered a right or restriction. See also Holman v. Comm'r, 130 T.C. No. 12 (2008), aff'd 105 AFTR 2d 2010-1802 (8th Cir. 2010) (disregarding restrictions on transfer of family limited partnership interests in determining the value of gifts).

See Estate of Blount v. Comm'r, 87 T.C.M. 1303 (2004), aff'd in relevant part and rev'd in part, 428 F.3d 1338 (11th Cir. 2005) (holding that certain modifications to a buy-sell agreement caused the agreement to be subject to the strict rules of Section 2703). See also Estate of Elkins v. Comm'r, 114 AFTR 2d 2014-5249 (5th Cir. 2014) (holding that an agreement in which the decedent waived his right to institute a partition action with respect to certain artworks had to be disregarded under Section 2703(a)(2)).

See Estate of True v. Comm'r, 390 F.3d 1210 (10th Cir. 2004), aff'd in relevant part and rev'd in part, 428 F.3d 1338 (11th Cir. 2005) (holding that, in order to qualify for the "arms' length negotiation" exception to Section 2703, taxpayer must produce evidence of agreements actually negotiated by persons at arms' length, under similar circumstances and in similar businesses, that are comparable to the terms of the challenged agreement).

See Reg. § 25.2703-1(a) and (b)(3).

Estate of Gloeckner v. Comm'r, 71 T.C.M. 2548 (1996), rev'd, 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. 2548 (1996), rev'd, 152 F.3d 208 (2d Cir. 1998), wherein the Appeals Court found a bona fide arrangement that was not a device.


Estate of Blount v. Comm'r, 428 F.3d 1338 (11th Cir. 2005), aff'd 87 T.C.M. 1303 (2004); Estate of True v. Comm'r, 390 F.3d 1210 (10th Cir. 2004), aff'd 82 T.C.M. 27 (2001).

See Estate of Schauerhamer v. Comm'r, 73 T.C.M. 2855 (1997). In Tech. Adv. Mem. 199938005 (June 7, 1999), the Service held that under Section 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. See also Estate of Adler v. Comm'r, T.C. Memo 2011-28; Estate of Van v. Comm'r, T.C. Memo 2011-22, and Estate of Turner v. Comm'r, 138 T.C. No. 14 (2012). For a pro-taxpayer decision, see Estate of Riese v. Comm'r, T.C. Memo 2011-60.

In addition, even if the "gift" is included in decedent's gross estate under Section 2036, the estate may not be able to claim the marital deduction under Section 2056 as the "gifted" assets would not be considered to have "passed" to decedent spouse. See Estate of Turner v. Comm'r, 138 T.C. No. 14 (2012).

Regs. §§20.2036-1(c)(2)(i) and 20.2038-1(a). But see Reg. § 20.2036-1(c)(2) regarding inclusion of retained income interests in Charitable Remainder Trusts and Grantor Retained Income Trusts under Section 2036 and valuation of such interests.

The cases include: Strangi v. Comm'r, 85 T.C.M. 1331 (2003), aff'd, 417 F.3d 468 (5th Cir. 2005); Kimbell v. U.S., 244 F.Supp.2d 700 (N.D. Tex. 2003), vacated and remanded, 371 F.3d 257 (5th Cir. 2004); Estate of Thompson v. Comm'r, 84 T.C.M. 374 (2002); Estate of Harper v. Comm'r, 83 T.C.M. 1641 (2002); Estate of Schauerhamer v. Comm'r, 73 T.C.M. 2855 (1997); Estate of Reichardt v. Comm'r, 114 T.C. 144 (2000).

Estate of Tehan v. Comm’r, 89 T.C.M. 1374 (2005); Estate of Disbrow v. Comm’r, 91 T.C.M. 794 (2006.)

U.S. v. Byrum, 408 U.S. 125 (1972)


Kimbell v. U.S., 408 u.s. 125 (1972)


Kimbell v. U.S., 408 u.s. 125 (1972)


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Kimbell v. U.S., 408 u.s. 125 (1972)


Kimbell v. U.S., 408 u.s. 125 (1972)
Section 453(d).

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

Section 453(c).

Section 453B. See also Sections 453(e) and 453C.

Sections 453B(f)(1) and 691(a)(2).


98 T.C. 341 (1992), aff'd in part and rev'd in part, 998 F.2d 567 (8th Cir. 1993).

Section 2512(b); Reg. § 25.2512-5(d). However, a taxpayer may not use the annuity tables if his death was imminent at the time the private annuity agreement was executed. See Estate of McLendon v. Comm'r, 66 T.C.M. 946 (1993), rev'd in part and remanded, 77 F.3d 477 (5th Cir. 1995), modified 71 T.C.M. 42 (1996) and Estate of Kite v. Comm'r, T.C. Memo 2013-43. See Reg. § 25.7520-3 for rules as to when the annuity tables may be used to value annuities, interests for life, term of years and remainder interests under §7520.


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.

Section 72; Reg. § 1.72-9.


Preamble to Prop. Regs., 71 Fed. Reg. 61,441 (October 18, 2006).

T.C.M. 2006-25 (February 15, 2006).

This is also a case where there were many “bad facts”. The Melnik brothers had been approached to sell their shares in a company engaged in the scrap metal business to a roll-up company. One of the brothers had just been through a bitter divorce where the value of the brother’s interest in the business was disputed. A business associate of the brothers created two foreign trusts in early November, 1996, based in Bermuda (the dates of the creation of the trusts were unclear, as were many dates set forth in the facts of the case). The beneficiaries of each trust were the business associate, the brother, the descendants of the brother, the spouses of any beneficiary, certain charities and any other trust that existed for the benefit of the beneficiaries. The brothers were the trust protectors of their respective trusts, and the trustee was Bermuda Trust. Each brother had “special testamentary limited powers of appointment” (although the facts state that, under these powers, the brothers could appoint to any person or entity). The Trusts then acquired a British Virgin Islands holding company which had not previously conducted business and had been created by a trust company in March, 1995. The holding company agreed to purchase stock from the brothers in exchange for private annuities, effective as of November 8, 1996. There was no corporate resolution (in fact no shareholders or directors meeting had been held as of yet) for the holding company approving this
transaction, and the company did not participate in any negotiations regarding the terms of the sale. Sometime during 1996, the sale of the company to the roll-up company was negotiated by one of the brothers and a merger agreement was worked out, which was executed on December 10, 1996. The brothers later borrowed money from the holding company, which was not repaid.

The Tax Court found that the record was incomplete since certain dates could not be established, which, in turn, meant the Court could not evaluate the legitimacy of the petitioner’s contentions. Furthermore, there was admitted backdating of documents, which the Court found established a “willingness to manipulate the relevant chronology in a way that does not enhance the credibility of the petitioner’s evidence”.

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. Priv. Ltr. Rul. 9444033 (August 5, 1994); however, the Service withdrew this ruling and re-released it without this controversial position. Priv. Ltr. Rul. 9543049 (August 3, 1995).


The Service has not ruled on whether the revised Section 121 applies to grantor trusts. The Service took the position in Priv. Ltr. Ruls. 9321050 (February 25, 1993) and 9309023 (December 3, 1992), that Section 121 applies 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 Section 121.


Reg. § 1.671-3.


Compare the IRS position contained in Priv. Ltr. Rul. 9443020 with the holding of Gallun v. Comm’r, 327 F.2d 809 (7th Cir. 1964); in the Letter Ruling and in CCA 200501004, the IRS held basis was reduced by the value of the insurance protection provided, while in Gallun, basis was held to be premiums paid, less non-taxable dividends.


See Reg. § 1.1001-2(c) Example 5; Madorin v. Commissioner, above; Rev. Rul. 77-402; TAM 200011005.

See Reg. § 1.1001-2(c) Example 5; Madorin v. Commissioner, above; Deborah v. Dunn & David A. Handler, Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates, above; Fred Nicholson, Sale to a Grantor Controlled Trust: Better Than a GRAT, 37 Tax Management Memorandum 99 (1996), in which the author acknowledges that the reasoning in Reg. § 1.1001-2(c) and the Madorin case may cause the recognition of gain on the grantor’s death to the extent the deemed transfer of assets subject to a liability exceeds the grantor’s basis in those assets. See also Blattmachr, Gans and Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death, 97 JTAX 149 (September 2002).


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


Reg. § 25.2702-4(c).


Reg. § 25.2702-4(d), Example 1.


Reg. § 25.2702-4(c); but see Priv. Ltr. Rul. 9206006 (July 23, 1991).

Section 2701(a)(3); see Priv. Ltr. Rul. 9933022 (April 12, 1999).

Reg. § 25.2701-3(b).

Section 2701(a)(4).

Section 2701(a)(2)(A).

Section 2701(a)(2)(B) and (C).

Section 2701(b).

Section 2701(c)(3).

Section 2701(c)(3)(c).

Section 2701(d); Reg. § 25.2701-4(c).


General Explanation of the Tax Reform Act of 1976, prepared by the Staff of the Joint Committee on Taxation, at 537.


§2032A(a)(3)(B), as amended by 97 Act §501(b).

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

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

§1014(a). However, for property with respect to which an estate tax return is filed after July 31, 2015, the Transporation and Veterans Health Act, imposes certain new basis consistency standards which generally provide that the basis of property acquired by reason of death under Section 1014(a) must equal the value of such property for estate tax purposes.

§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(b)(1)(C).

§2032A(e)(7)(A).


§2032A(a)(3)(B), as amended by 97 Act §501(b).

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


§§2032A(b)(1)(C) and (4).

§2032A(a).

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

§2032A(c). A qualified heir may now lease the farm to a family member on a net cash lease basis and not trigger the §2032A recapture. §2032A(c)(7)(E), as amended by 97 Act §504(a). See Priv. 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 Priv. 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.

Van Alen v. Comm'r, T.C. Memo 2013-235 (holding that trust beneficiaries who inherited an interest in ranch property that had been valued for estate tax purposes under Section 2032A were required to compute capital gain on the subsequent sale of a conservation easement on property under Section 2032A).

§6166(a)(1). Unlike what constitutes qualified property for purposes of §2032A, cash has been held to be includable in the decedent's trade or business for purposes of §6166. Priv. Ltr. Rul. 9250022 (September 11, 1992).

The Service has ruled that a late return prevented a qualified election under Section 6166. Priv. Ltr. Rul. 201015003 (Apr. 16, 2010).

The estate tax return is due within 9 months after the date of the decedent's death. Section 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. § 20.6081-1(a).


Madden, Tax Planning for Highly Compensated Individuals, § 10.07, Installment Payment of Estate Taxes—Section 6166.
rev. rul. 89-4, 1989-1 c.b. 298.
priv. ltr. rul. 88-41006 (july 6, 1988).
reg § 20.6166a-3(f).
section 6166(g)(2).
reg. § 301.6324(a)-1(b)(1).
section 6324(a)(b)(2).
section 6166(g)(4).
section 6161(a)(2).
reg. § 20.6161-1(a)(1), examples (1) through (4).
regs. §§ 20.6161-1(d) and 20.6165-1(a).
this section is adapted from an outline prepared by lawrence brody, "estate planning for owners of closely-held businesses", 2008
see ltr. ruls. 90-42023 and 93-09-021; the latter approved, for transfer for value purposes, a partnership which was formed to "hold and manage" the insurance policies funding the arrangement – its holding seems unreliably broad on that point. see also priv. ltr. rul. 96-25013, reaching the same result for members of an llc taxed as a partnership.
but see blount v. comm'r, below, allowing the insurance proceeds to be disregarded in determining the value of the entity, in a family business subject to section 2703.
section 531, as amended by 2012 tax relief act §102(c)(1)(a). for tax years beginning before january 1, 2013, the accumulated earnings tax rate was 15%.
section 318(a)(3)(a).
section 303(b)(3).
section 303(d).
see notice 2002-8, and the final split-dollar regulations, reg. §§ 1.61-22 and 1.7872-15.
see priv. ltr. ruls. 93-18007 (jan. 29, 1993) and 93-31009 (may 5, 1993).
see chief counsel advice 2013-28030 (march 18, 2013), stating that, if a decedent only held a right to receive policy dividends, the insurance proceeds were not includible in the decedent's gross estate.
see priv. ltr. rul. 2013-27010 (march 27, 2013).