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RECENT DEVELOPMENTS 2013:

SELECTED FEDERAL AND ILLINOIS CASES, RULINGS AND STATUTES

Chicago Estate Planning Council

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SELECTED FEDERAL RECENT DEVELOPMENTS

I. ADMINISTRATIVE ISSUES.

A. Rev. Proc. 2013-35, 2013-47 I.R.B. at 537 (November 18, 2013) sets forth the inflation-adjusted figures for exclusions, deductions and credits for 2014. In the estate and gift tax area these figures are the following:

• Applicable Exclusion Amount	Increases to 5,340,000
• Annual Exclusion:	Remains at $14,000
• Foreign Spouse Annual Exclusion:	Increases to $145,000
• §2032A Aggregate Decrease:	Increases to $1,090,000
• §6601(j) 2% Amount:	Increases to $1,450,000
• §6039F Gifts From Foreign Persons	Increases to $15,358
• 39.6% Bracket for Trusts and Estates	Income over $12,150

B. 2013-14 Priority Guidance Plan.

On August 9, 2014, Treasury and the Internal Revenue Service released their joint priority guidance plan for 2013-2014. The plan includes the following initiatives:

GIFTS AND ESTATES AND TRUSTS:

1. Final regulations under §67 regarding miscellaneous itemized deductions of a trust or estate. Proposed regulations were published on September 7, 2011.

   COMMENT: The proposed regulations provided that when final regulations are ssued, they will apply to taxable years beginning on or after the date that they are published in the Federal Register. Since the regulations were not final as of January 1, 2014, the earliest they could apply to calendar year taxpayers would be 2015.

2. Guidance concerning adjustments to sample charitable remainder trust forms under §664.

3. Guidance concerning private trust companies under §§671, 2036, 2038, 2041, 2042, 2511, and 2601.

   COMMENT: On June 22, 2011 the Securities and Exchange Commission published a rule regarding the "family office" exception to registration as an investment adviser under the 1940 Investment Advisers Act. See Release No. IA-3220; File No. S7-25-10. The new rule was prompted by the Dodd-Frank Wall Street Reform and Consumer Protection Act’s repeal of the private adviser exemption from registration contained in section 203(b)(3) of the Advisers Act, effective July 21, 2011, upon which many family offices had relied for exemption from registration. The text of the rule is at 17 CFR 275.202(a)(11)(G)-1.

4. Regulations under §1014 regarding uniform basis of charitable remainder trusts.
5. Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.

   COMMENT: This provision is new and arises out of concern that if a QTIP election is made but is not necessary to reduce federal estate tax, it may not be effectively recognized. See, *e.g.* Rev. Proc. 2001-38, 2001-2 C.B. 24, and PLRs 201345006 and 201338003.
6. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
7. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
8. Regulations under §2642 regarding the allocation of GST exemption to a pour-over trust at the end of an ETIP.
9. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.
10. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.
11. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

<u>EXEMPT ORGANIZATIONS</u>:

1. Revenue Procedures updating grantor and contributor reliance criteria under §§170 and 509.
2. Revenue Procedure to update Revenue Procedure 2011-33 for EO Select Check.
3. Guidance under §501(c)(4) relating to measurement of an organization's primary activity and whether it is operated primarily for the promotion of social welfare, including guidance relating to political campaign intervention.

   COMMENT: This is a newly added initiative, arising from potential political campaign intervention by social welfare organizations following the Supreme Court's decision in <u>Citizens United v. Federal Election Commission</u>, 558 U.S. 310 (2010). Under Code Section 501(c)(4) and its regulations, an organization that is operated exclusively for the promotion of social welfare may operate as a tax-exempt entity. Contributions to a 501(c)(4) organization are not tax deductible, and the organizations are not required to disclose the identities of their contributors.

   An organization operates for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. Existing regulations, which date from 1959, further provide that "[t]he promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office." Treas. Reg. §1.501(c)(4)–1(a)(2)(ii). The Regulations under Section 501(c)(4) overlap with those of Sections 501(c)(3) and 527, both of which also deal with political campaign activity by tax-exempt organizations, but the concepts of the several sections are not synonymous. There is confusion within the IRS, and the public, over how to distinguish between campaign intervention and social welfare activity, and how to measure an organization's social welfare activities relative to its total activities. In order to more clearly define these concepts, the Service has published Proposed Regulations and invited public comment by February 27, 2014. 2013-52 I.R.B. at 856 (December 23, 2013).

4. Final regulations under §§501(r) and 6033 on additional requirements for charitable hospitals as added by §9007 of the ACA. Proposed regulations were published on June 26, 2012 and April 5, 2013.
5. Additional guidance on §509(a)(3) supporting organizations (SOs).
6. Guidance under §4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners.
7. Final regulations under §4944 on program-related investments. Proposed regulations were published on April 19, 2012.
8. Guidance regarding the new excise taxes on donor advised funds and fund management as added by §1231 of the Pension Protection Act of 2006.
9. Regulations under §§6011 and 6071 regarding the return and filing requirements for the §4959 excise tax for community health needs assessments failures by charitable hospitals as added by §9007 of the ACA.
10. Guidance under §6033 on returns of exempt organizations.
11. Final regulations under §6104(c). Proposed regulations were published on March 15, 2011.
12. Final regulations under §7611 relating to church tax inquiries and examinations. Proposed regulations were published on August 5, 2009.

C. President's Greenbook Proposals.

[Reserved -- at the date this outline was prepared the President's 2015 Greenbook Proposals had not yet been released].

II. REGULATIONS

T.D.9644, 2013-51 I.R.B. 676 (Novebmer 26, 2013).

Final regulations for the 3.8% net investment tax under Code Section 1411 have been published. The final regulations are effective as of December 2, 2013.

In the case of an estate or trust, section 1411(a)(2) imposes the 3.8 percent tax on the lesser of: (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of: (i) the estate's or trust's adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Section 1.1411-3 of the final regulations provides guidance on the computation of the net investment income tax for estates and trusts.

Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Sections 1.1411-4 and 1.1411-10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).

Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is a passive activity (within the meaning of section 469) with respect to the taxpayer, or a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

Since income from a trade or business that is considered a passive activity as to the taxpayer is subject to the tax, taxpayers who derive income from a business activity will be highly motivated to establish their material participation in the activity.

What constitutes material participation by a trustee is controversial. In Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex., 2003) the trustee of the trust managed all of the assets of the trust, including the Carter Ranch. The Carter Ranch covered approximately 15,000 acres, on which several thousand head of cattle grazed. The trustee employed a full-time ranch manager and some part-time employees who performed essentially all of the activities for the ranch. The manager was charged with overall management of livestock production and the management and conservation of pasture lands, as well as the supervision and direction of the other employees of the Trust involved in the ranch operations. The day-to-day management of the ranch was subject to the trustee's approval. The trustee reviewed and approved all financial and operation proposals for the ranch and the trust, budget and budgeting for the ranch, all investment decisions for the trust, asset acquisitions and sales, supervising all employees and agents of the trust and the trust's service providers, reviewing all financial information and responsibility for all banking relationships of the trust.

The ranch sustained significant operating losses in 1994 and 1995 which it sought to deduct. The Service issued notices of deficiency on the basis of the losses being disallowed losses from a passive activity. The trustee paid the deficiencies and sued for refunds. In the litigation the Service filed a motion for partial summary judgment on the basis that only the activities of the trustee, in his capacity as such, could determine whether the trust materially participated in a trade or business under Section 469(h)(1). The taxpayer filed a motion for summary judgment on the basis that for purposes of determining material participation, one looks to activities of the trust, through its fiduciaries, employees and agents. The Texas Court noted that Section 469(a)(2)(A) identifies the trust, not the trustee, as the taxpayer, and then reasoned: "Common sense dictates that the participation of the Carter Trust in the ranch operations should be scrutinized by reference to the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of the Carter Trust." According to the Court, it was clear that the activities of the persons who conducted the business of the ranch on the Carter Trust's behalf were regular, continuous, and substantial so as to constitute material participation. Alternatively, the Court also found that the trustee's activities, standing alone, were regular, continuous and substantial so as to constitute material participation by him. The Service's motion was denied and that of the taxpayer granted.

In Technical Advice Memorandum 200733023 the trustee appointed persons labeled "special trustees" to help manage a business. Declining to agree with the decision in Mattie K. Carter Trust, the IRS held that sole means for the rust to establish material participation was if its fiduciaries were involved in the business operations on a regular, continuous, and substantial basis. Applying the related tests, the IRS held that the special trustees were not fiduciaries of the trust for purposes of § 469 and even if they were, many of the duties they performed had a questionable nexus to LLC's business and did not constitute "material participation" under Treas. Reg. § 1.469-5T(f)(2)(ii). See also PLR 201029014.

National Office TAM 201317010 involved a question of whether certain research and experimental expenditures had to be capitalized for purposes of the alternative minimum tax. Section 56(b)(2)(D) provides that the requirements of paragraph (2) will not apply if the taxpayer materially participates in the activity, within the meaning of Section 469(h).

Under the facts of the ruling, A was a "special trustee" of complex trusts that owned an interest in "X", an S company, which owned an S subsidiary company, "Y". As the "special trustee" A controlled all decisions regarding the sale and retention of the two companies and the voting of the stock of the two companies. A owned the interests in the companies not owned by the trust; he was a beneficiary of both trusts, and he was the president of the subsidiary company. The TAM provided:

1. "Notwithstanding the decision in Mattie K. Carter, the Service believes that the standard annunciated in the legislative history is the property standard to apply to trusts for purposes of §469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis."
2. "As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company y under §469(h)(1). Trust A and Trust B represent that B [the individual trustee of both trusts], acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of §469(h) for purposes of §56(b)(2)(D) for the tax years at issue."

All of this has relevance for the 3.8% tax on net investment income, since the income of a partnership or S company held in trust will be considered passive unless there is material participation by the trust within the meaning of Section 469(h). When the proposed regulations were issued, commentators raised these concerns. The preamble to the final regulations indicates that Treasury and the Service believe that these issues really belong under Section 469:

> The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to

> include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

The proposed regulation under §1.1411-3(b)(1) excluded from the application of section 1411 a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170 (c) (2) (B) (referred to as "Charitable Purpose Trusts"). In response to comments, the final regulations under §1.1411-3 (b) (1) have been expanded to exclude from the application of section 1411 not only Charitable Purpose Trusts, but also estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170 (c) (2) (B).

The final regulations preserve the special rule for determining the net investment income of an electing small business trust ("ESBT"). The regulations treats the ESBT as two separate trusts for computational purposes but consolidates the ESBT into a single trust for determining the adjusted gross income threshold in section 1411(a)(2)(B)(ii). This is consistent with the chapter 1 treatment of ESBTs, which are entitled to only a single personal exemption, rather than one per ESBT portion, notwithstanding the fact that the income for each portion is computed separately. This rule also puts ESBTs on the same footing as other taxable trusts by applying a single section 1(e) threshold to ESBTs similar to other taxable trusts. In order to determine its tax base, the ESBT first must separately calculate the undistributed net investment income of the S portion and non-S portion in accordance with the general rules for trusts under chapter 1, and then must combine the undistributed net investment income of the S portion and the non-S portion. The ESBT then determines its adjusted gross income, solely for purposes of section 1411, by adding the net income or net loss from the S portion to the adjusted gross income of the non-S portion as a single item of income or loss. Finally, to determine whether the ESBT is subject to section 1411, the ESBT compares the combined undistributed net investment income with the excess of its adjusted gross income over the section 1(e) threshold. In the preamble to the final regulations, Treasury admitted that the foregoing method of computation means that net investment income in one portion of the ESBT cannot be offset with net investment losses in the other part, but observed that the computational method was consistent with the chapter 1 treatment of ESBTs as consisting of two portions.

Section 1.1411-3(b)(1)(ix) of the final regulations provides that the 3.8% tax does not apply to foreign estates, but does not exempt U.S. beneficiaries of foreign estates from the application of the tax to distributions from foreign estates. The taxation under section 1411 of United States beneficiaries receiving distributions of net investment income from a foreign estate will be consistent with the general operation of subparts A through D of part I of subchapter J and will be subject to section 1411. See §§1.1411-3(e)(3)(ii) and 1.1411-4(e)(1).

The final regulations reserve the issue of whether accumulation distributions from foreign trusts will be subject to the tax. Comments on the proposed regulations recommended that section 1411 should not apply to foreign trusts that accumulate income for the benefit of United States beneficiaries, but rather, that United States beneficiaries should be subject to section 1411 upon the receipt of an accumulation distribution from a foreign trust.

The government agrees that section 1411 should apply to U.S. beneficiaries that receive distributions of accumulated net investment income from a foreign trust but not to the foreign trust itself. Treasury and the Service continue to study how section 1411 should apply to accumulation distributions from foreign trusts to United States beneficiaries, and intend to issue subsequent guidance on this issue. Pending the issuance of such guidance, section 1411 will not apply to distributions of accumulated income from a foreign trust to a United States beneficiary. Therefore, §1.1411-4(e)(1)(ii) of the final regulations is reserved.

The final regulations state that Treasury and the Service request additional comments concerning this issue, including recommendations on methods by which to identify accumulation distributions as net investment income. In particular, the Treasury Department and the IRS are interested in possible methods by which to determine the “additional tax” imposed under section 667(b) when the distribution is “thrown back” to the relevant past tax year, possible methods by which to identify and exclude the “additional tax” imposed under section 667(b) from years prior to the effective date of section 1411, whether a default rule similar to that contained in Notice 97-34 may be a viable approach for section 1411 purposes, and other specific technical recommendations (accompanied by numerical examples, if possible) for applying section 1411 to accumulation distributions.

III. CASES AND RULINGS.

A. Basis and Section 2032A

Van Alen v. Commissioner, T.C. Memo 2013-235 (October 21, 2013) concerned whether taxpayers who had benefitted from a Section 2032A election could later assert that the property had a basis higher than the Section 2032A value for purposes of determining gain when a conservation easement was sold. In Van Alen, the decedent died in 1994, leaving his 78.32% interest in ranch property ("ranch interest") in trust to a daughter and son of his second marriage, which was to a woman named Virginia. At the time of the decedent's death the daughter was 18 and the son was 14, but decedent and Virginia had divorced, and the decedent was survived by this third wife, Bonnie. Bonnie was the executor of the estate and responsible for filing the estate tax return. A deputy probate referee in California reviewed the property and communicated his notes to the probate referee. The notes indicated that the ranch interest was worth $1,963,000. In the estate tax return Bonnie, the stepmother-executor, claimed that the fair market value of the ranch interest was $427,500, but after valuing the interest at its special use (farming), reported a value of $144,823. The Service audited the estate tax return and after some adjustments to other property accepted a Section 2032A value of the interest of $98,735. The required Section 2032A agreement was signed by Bonnie, the adult daughter, and by Virginia acting as trustee and guardian *ad litem* for the son, a minor. After the audit adjustments an amended Section 2032A agreement was apparently (the record did not include it but the Court believed it was filed) submitted to the Service, signed again by Bonnie, the adult daughter and Virginia as trustee and guardian *ad litem* for the son. Because the decedent's will did not apportion taxes, California law provided for equitable apportionment, which meant that the daughter and son received in part the benefit of reduced taxes on account of the election.

In 2007 the ranch sold a conservation easement to the California Rangeland Trust. The trust that held the 78.32% interest for the son and daughter received proceeds of $910,000. The trust filed an income tax return for 2007, reporting substantial gain, a basis for the interest of about $100,000, and issuing K-1s to the son and daughter for $360,000 each. The trust subsequently filed an amended return in which the interest's basis was essentially doubled, and issuing amended K-1s reporting gain to each beneficiary of $310,000. The son filed his 2007 income tax return before, and the daughter filed her 2007 return after, the amended trust return. Neither one of them reported any gain from the K-1s. The Service issued a notice indicating a mismatch between income reported from a payor and income reported from the payee. Notice of deficiencies followed, along with accuracy-related penalty notices.

The siblings then looked into whether they could claim a different basis for income tax purposes than their step-mother had claimed for estate tax purposes. They argued that based on the deputy probate referee's notes they had clear and convincing evidence that the ranch property was worth $1,963,000 as of the date of death and that since they were not responsible for filing the estate tax return they should not be bound by the election made by Bonnie, the stepmother.

Section 1014(a)(1) generally provides that the basis of property acquired from a decedent is its fair market value. The problem for the siblings in this case is that basis of Section 2032A property is not governed by Section 1014(a)(1); it is governed by Section 1014(a)(3), which flatly says that the basis of property for which a Section 2032A election has been made is the value reported on the estate tax return. The siblings argued that the principles of Rev. Rul. 54-97, 1954-1 C.B. 113, should apply to permit them to claim a higher basis. Rev. Rul. 54-97 provides that for purposes of deterring basis of property acquired from a decedent under Section 113(a)(5) (a predecessor of 1014(a)(1)), the value reported on an estate tax return establishes a presumption as to such value, but when the taxpayer is not estopped by previous actions or statements, the presumption is not conclusive and may be rebutted by clear and convincing evidence. Their argument was essentially that the correct fair market value of the entire ranch property was $1,963,000, that Section 2032A limited the valuation reduction to $750,000, 78.32% of which their interest was entitled, and that the Section 2032A value should have been about $1,375,000.

Whether Rev. Rul. 54-97 could be applied in such a manner was not determined by the Court. Rather, it believed that well-established principles of the duty of consistency trumped the Revenue Ruling. The duty of consistency requires that there be a representation or report by the taxpayer, reliance by the Commissioner, and an attempt by the taxpayer after the statute of limitations had run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. The principle issue the Court examined was whether a representation was made by the "taxpayer." The Court first observed that the duty of consistency is usually understood to encompass both the taxpayer and parties with sufficiently identical economic interests. The Court found that because the siblings benefitted from the election (lowered tax that was apportioned to their interests) their interests were sufficiently identical to those of the executor.

The siblings argued that even if they had sufficiently identical economic interests with the taxpayer, they not have sufficient privity of interest. The Tax Court noted that the daughter, and the son through his guardian *ad litem*, both signed Section 2032A agreements twice; these facts distinguished them from a mere heir of the estate.

Finally, the Court upheld the accuracy-related penalties, noting that the siblings both had filed their 2007 income tax returns reporting no income before they sought advice about whether the basis of the property could be increased based on the $1,963,000 valuation notes.

B. Section 2035(b) Gross Up; Net Net Gifts

1. Estate of Sommers v. Commissioner, T.C. Memo 2013-8 (January 10, 2013).

Sommers is a complicated case that is somewhat unremarkable except for the general principle that in gift cases careful attention needs to be paid to the burden of estate taxes. Sheldon Sommers had been married twice and divorced twice, and was childless, when he decided that he should give an art collection to his three nieces. At the time he had moved to Indiana from New Jersey. The plan was for Mr. Sommers to transfer the art collection to the nieces free of any tax payment, and it was hoped he could do this through use of annual exclusions and his basic exclusion amount, which in 2001 was $675,000 (eventually increasing to $1,000,000 in 2002 as a result of EGTRRA). Since the art collection turned out to be worth more than Mr. Sommers and his nieces realized, the decedent formed an LLC to hold the art, and planned to give away LLC interests subject to discounts. The plan was to make the first series of gifts in late December, 2001, but limit the amount of the gifts to the basic exclusion amount plus annual exclusions. The balance of the gifts would be made in early January, 2002, and, it was ultimately decided, would be net gifts, with the nieces agreeing to pay the gift tax. The net gift aspect addressed the nieces' concern that they receive all of the LLC interests prior to their uncle's death. It turned out that Mr. Sommers decided to remarry his second wife, and in April, 2002, he executed a new will that left the residue of his estate to his fiancee.

The gift documents were duly drafted and signed, but blanks were left for the number of LLC units that were to be transferred. The numbers were not determined until April, 2002, after Mr. Sommers had executed a new will. The blanks were filled in and the assignments were modified in various ways, but not on the signature pages. Mr. Sommers remarried in June, 2002 and died in November, 2002. He died a resident of New Jersey. Gift tax returns were filed reporting the 2001 and 2002 gifts. The nieces paid the gift tax associated with the 2002 net gift.

In June, 2002, prior to his remarriage, Mr. Sommers commenced an action in Indiana seeking a determination that there had been no effective gift and demanding return of the artwork. Pursuant to the LLC operating agreement the issue was referred to arbitration and ultimately the arbitrator held that there was an effective gift. While the arbitration was proceeding, Bernice, the widow and executor of the estate, filed the decedent's estate tax return. On audit the Service assessed gift tax for both the 2001 and 2002 gifts, claiming undervaluation. Since both gifts were made within three years of death, the gift tax paid was also an asset of the gross estate. The problem here was that the inclusion of the "phantom" estate tax under Section 2035(b), as well as the assessment of additional taxes, substantially increased the burden of federal estate taxes, thereby reducing the residuary disposition, which was intended to qualify for the marital deduction. The result was an interrelated "tax-on-tax" computation that diminished what Bernice would receive under the will.

When the arbitration was completed, Bernice brought an action in the New Jersey courts, seeking apportionment of the estate tax or, in the alternative, a number of remedies grounded on rescission, reformation and estoppel. The New Jersey court dismissed with prejudice all but the issue of apportionment, which it dismissed without prejudice on the grounds that the issue was not yet ripe for determination. The New Jersey court believed that the federal estate tax issue of whether the 2001 and 2002 gifts were includible in the decedent's estate should first be determined before it could decide on apportionment.

With this as a background, the Tax Court was presented with partial motions for summary judgment from both the taxpayer and the government. The taxpayer argued that because the operative agreements contained blanks, the purported assignment of LLC units were incomplete "revocable" gifts and that the right to revoke was relinquished in April, 2002, when the blanks were filled in. Thus, Bernice argued, the gifts were includible in the estate under Sections 2035 and 2038 (and therefore presumably subject to estate tax apportionment under New Jersey law). Alternatively, Bernice argued that if a gift occurred in 2001, it was limited by a defined value clause, and that all potential gift tax would occur in 2002, at the expense of the nieces because of the net gift arrangement. Bernice also asked the Tax Court to apportion the estate taxes under the New Jersey statute against the nieces. The government and the nieces argued that the Indiana arbitration and the New Jersey court had already determined that a gift was made in 2001 and the Tax Court was bound to that determination under principles of collateral estoppel.

The Tax Court granted the government's motion for partial summary judgment on the issue of whether the gifts were revocable. It believed that the prior proceedings in Indiana and New Jersey precluded a redetermination with respect to the issue of whether the 2001 transfers were completed gifts. They had been found to be so twice, and the Tax Court followed those determinations. The Court also found that even if collateral estoppel did not apply, it would agree with the prior determinations that the transfers were completed gifts. The Tax Court found it was premature to rule on the apportionment issue, because it had not yet considered (1) whether the government's revaluation of the gifts was proper and (2) the amount of tax to be included in the decedent's estate under Section 2035(b).

2. <u>Steinberg v. Commissioner</u>, 2013 Tax Court Lexis 39 (141 T.C. No. 8, September 30, 2013)

<u>Steinberg</u> is a gift tax in involving what the Tax Court referred to as a "net, net gift" situation. Mrs. Steinberg, a New York resident, made a net gift to her four daughters. By written contractual agreement, the daughters promised to pay the gift tax on the gift, and any estate tax that would be payable with respect to the gift tax includible in Mrs. Steinberg's estate under Code Section 2035(b) should she die within 3 years of the gift. The contractual agreement was the result of several months of negotiation between Mrs. Steinberg and her daughters. Mrs. Steinberg and the daughters were represented by separate counsel. An

appraiser determined that the actuarial value of the consideration for the assumption of the potential Section 2035(b) liability was $5,838,540. The donor reported taxable gifts of $71,598,056 and total gift tax of $32,034,311. The Service audited the gift tax return and issued a notice of deficiency for a gift tax increase of $1,804,908.

At issue was whether the value of the gift should be reduced by the actuarial value of the donees' assumption of the potential Section 2035(b) liability. The Service filed a motion for summary judgment, arguing that under the Tax Court decision in McCord v. Commissioner, 120 T.C. 358 (2003), rev'd and remanded *sub. nom*. Succession of McCord v. Commissioner, 461 F. 3d 614 (5th Cir. 2006), the agreement to pay the potential Section 2035(b) liability did not result in any benefit to the donor and therefore must be disregarded. Steinberg is appealable to the Second Circuit while McCord was appealed to the Fifth; for that reason the Service argued that the Tax Court could stick with its reasoning in the earlier case.

In McCord the Tax Court had held that in advance of the death of a person, no recognized method exists for the approximating the burden of the estate tax with a sufficient degree of certitude to be effective for Federal gift tax purposes. This was referred to as the "too speculative" theory. The Court also held that any benefit from the donees' assumption of the potential Section 2035(b) tax would accrue to the benefit of the donor's estate rather than the donor, which might provide peace of mind but would not yield the type of tangible benefit required to invoke net gift principles. This was referred to as the "estate depletion" theory. In Steinberg the Service reserved argument on the "too speculative" theory and concentrated on the "estate depletion" theory.

The Tax Court denied the Service's motion for summary judgment. The majority opinion was written by Judge Kerrigan, who was joined by Judges Colvin, Foley, Vasquez, Wherry, Homes, Paris and Buch. Judges Gale, Goeke, Kroupa, Gustafson, Morrison and Lauber concurred in the result only. Judge Halpern dissented.

The majority reviewed its reasoning in McCord, in light of the Fifth Circuit's reversal, and concluded that a willing buyer and a willing seller in appropriate circumstances may take into account a donee's assumption of potential Section 2035(b) estate tax liability in arriving at a sale price. In reaching its conclusion, the majority observed that the contingency of a three-year survival is a relatively simple matter that does not depend on multiple occurrences. Whether it is too speculative or highly remote is a factual issue and therefore not proper for summary judgment. The majority also reasoned that even if estate tax exemptions and rates are subject to change, the Court could not foreclose the possibility that an appropriate method may exist to fix the potential Section 2035 estate tax liability assumed by the donees.

Regarding the "estate depletion" theory, the majority admitted that its distinction between a benefit to the donor's estate and a benefit to the donor was incorrect. For purposes of the estate depletion theory, ". . . the donor and the donor's estate are inextricably bound. According to the estate depletion theory, whether a donor receives consideration is measured by the extent to which the donor's estate is replenished by the consideration." Note that in denying the government's motion, the Tax Court did not find that there was a benefit to the donor or her estate; it simply found that the assumption of the potential estate tax liability *could be* consideration in money or money's worth within the meaning of Code Section 2512(b).

Finally, the majority also rejected the Service's argument that the contractual agreement to pay the estate tax was a gift because it was not in the "ordinary course of business." Whether a transfer that is or is not in the ordinary course of business is irrelevant if there is full and adequate consideration in money or money's worth for the transfer.

Judge Goeke wrote a concurring opinion to point out a potential valuation issue, with which Judge Lauber agreed. Judge Goeke stated:

> The Code is clear that "[t]he value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." Sec. 2031(a). Petitioner recognized that the donor's legal right to have the donees pay any section 2035(b) estate tax liability is a new asset of the donor that must be included in her gross estate like any other contract right, indemnity right, or similar claim she owned at death. Petitioner's position presumes the value of this obligation at death is the same as the calculated value at the time the asset is created. This presumption is illogical.
>
> The estate tax liability, and therefore the indemnity right, is going to depend on the facts and circumstances. If the donor dies after three years have passed since the date of the gift transaction, then the value of that "new asset" will be zero (i.e., no estate tax liability arises by virtue of section 2035(b)). If, however, the donor dies within that three-year period, then the indemnity right will be equal to whatever the estate tax liability actually is. This is in contrast to the value petitioner estimates with mortality table calculations. Consequently, the donees either could get a windfall (i.e., getting a gift tax discount and not paying any estate tax) or may end up suffering some serious repercussions necessitated by finding consideration (i.e., potentially paying a lot more in estate tax than is in accord with the discount they received). This issue is not before us now, but we should recognize the issue we create in finding the present promise to pay contingent estate tax may be consideration to the donor.

Judge Lauber wrote a separate opinion concurring in the result, but pointing out that the Service did not advance the "too speculative" theory in its motion for summary judgment, and therefore this theory could still be advanced in post trial briefs. For this reason, Judge Lauber believed that the majority's discussion of the "too speculative" theory was unnecessary to resolve the summary judgment motion, and that it would be improper to consider overruling the Tax Court decision in McCord, insofar as it embraces the "too speculative" theory, until a party has squarely presented the issue for resolution.

As to the "estate depletion" theory, Judge Lauber attempted to clarify the majority opinion by pointing out the government's argument that New York statutory law would apportion the Federal estate tax attributable to the Section 2035(b) gross up to the persons benefitted by the gifts, so that the contractual agreement between Mrs. Steinberg and her daughters did nothing more than memorialize an obligation that already existed. Whether memorializing an existing obligation could constitute consideration would depend on many factual issues that make the case inappropriate for resolution by summary judgment:

> I agree that respondent's motion for summary judgment should be denied because the proper disposition of his "apportionment clause" argument hinges on resolution of disputed issues of material fact. See op. Ct. p. 42. These facts may include the following: (1) whether petitioner's daughters, at the time of the gifts, were beneficiaries under her will; (2) whether petitioner's daughters, if not then beneficiaries under her will, should be regarded as such because they were the natural objects of her affection and bounty; (3) whether petitioner, a New York resident when she made the gifts, should be deemed a New York domiciliary for purposes of applying the New York apportionment statute; (4) whether the net gift agreement, as petitioner contends, "provides an effective enforcement mechanism that does not exist under the [New York] statute"; (5) whether the bulk of petitioner's assets will be subject to probate or will pass by trust or other nonprobate mechanism, which might affect ease of enforcement; and (6) whether any incremental enforcement benefit is substantial enough to constitute "consideration" within the meaning of section 2512(b).
>
> The Court appears to recognize that respondent, while not entitled to summary judgment on his "estate depletion" theory, could prevail on this theory at trial if the requisite facts are resolved in his favor. Indeed, the proper disposition at trial of respondent's "apportionment clause" argument may determine not only whether the donees' agreement to pay the section 2035(b) tax constitutes "consideration," but also the nature and outcome of the valuation exercise. If the only benefit accruing to petitioner and her estate from the donees' agreement to pay the section 2035(b) tax is the incremental benefit the executor derives from having a contractual as well as a statutory enforcement mechanism against the daughters, the actuarial value of their assumption of the contingent section 2035(b) liability becomes essentially irrelevant. The thing to be valued in that event--the "consideration" received by petitioner's estate--will be this incremental enforcement capacity enjoyed by the executor. As Judge Raum noted 50 years ago, we should be cautious in treating as statutory "consideration" obligations assumed in "an intrafamily transaction" under "'colorable family contracts.'" Estate of Woody v. Commissioner,

> 36 T.C. 900, 903 (1961) (quoting Carney v. Benz, 90 F.2d 747, 749 (1st Cir. 1937)). Assuming arguendo that the actuarial value of the daughters' assumption of the contingent section 2035(b) liability is $5,838,540, as petitioner contends, the value of the incremental enforcement capacity enjoyed by the executor may be substantially less than that.
>
> In sum, the Court properly leaves the evaluation and disposition of respondent's "apportionment clause" argument for a post trial opinion after all the evidence in this case has been heard. Respondent's motion for summary judgment should be denied, not because his "estate depletion" theory is wrong, but because the proper resolution of the "apportionment clause" argument underlying his "estate depletion" theory hinges on disputed issues of material fact. Because respondent could ultimately prevail on his "estate depletion" theory if the trial establishes the requisite facts in his favor, it would clearly be premature to overrule this aspect of McCord at the present stage of this case. That is a question for another day.

Judges Gale, Goeke, Kroupa, Gustafson and Morrison agreed with the concurring opinion.

Finally, Judge Halpern dissented, on the basis that according consideration to the assumption of potential estate tax for the Section 2035(b) gross up is a subversion of Congress' purpose in enacting Section 2035(b) in the first place. Judge Halpern pointed out that under the unitary system of gift and estate taxation, when a transferor dies within three years of making a taxable gift, the estate tax is the same whether or not the donor pays the gift tax or shifts the liability to the donee via a net gift. He did not believe that Congress intended a donor to derive any benefit from making deathbed transfers.

C. Section 2036 Inclusion

Estate of Trombetta v. Commissioner, T.C. Memo 2013-234 (October 21, 2013).

Trombetta involved the estate tax treatment of two trusts created by the decedent in 1993. One trust was a grantor trust with a term of 15 years, subject to the grantor’s right to shorten the term. The decedent was a co-trustee with three of her four children, and under the terms of the trust the decedent held 50% of the trust voting rights and the remaining 50% was shared by the co-trustees. The decisions of the trustees were by “majority vote of all trustees.” The decedent was entitled to an annual sum of $75,000 for the first 12- month period of the annuity term, to be paid in quarterly installments; thereafter the payment for each successive 12-month period would be 4% higher than the previous period’s payment. The grantor intended these payments to be treated as “qualified payments” under Code Section 2702. If the income of the trust exceeded the annual annuity payment, the trustees could distribute the income to the decedent, or accumulate the income. At the later of the termination of the decedent’s term interest, or the decedent’s death, the annuity trust property would pass to the decedent’s surviving children or grandchildren; however, if the decedent outlived the term, there could be no distributions made to the decedent. If the annuity trust lacked sufficient assets to make a periodic payment, Decedent's three children who were co-trustees agreed that they would be jointly and severally liable for the shortfall. The grantor (decedent) transferred two rental real estate properties to the trust, both of which were subject to mortgages for which the grantor was personally liable. The decedent filed a gift tax return, reporting that the properties had a net value of $1,425,803, subject to her retained interest of $921,809, resulting in a taxable gift of $503,993.

The second trust was intended to be a QPRT. Mrs. Trombetta named herself as the sole trustee and transferred her principal residence in Modesto, California to the trust. Again the trust term was 15 years, subject to decedent's retained right to shorten the term. On termination, the trust property would pass to the grantor's children if the grantor were living, or to the grantor's estate if the grantor were then deceased. On her 1993 gift tax return Mrs. Trombetta claimed that the residence was worth $150,000, subject to her retained interest of $92,491,resulting in a taxable gift of $57,509.

Over the course of the next 12 years the decedent received annuity payments that in the main varied from, and were less than, the scheduled amounts. The decedent also caused the annuity trust to issue a note to a family limited partnership she had established. The note provided that the annuity trust and the decedent were borrowing $721,801.27 from the family partnership. The decedent was personally liable for the note and the annuity trust secured the note with its two properties.

In March 2005 the decedent was diagnosed with cancer. Because she thought that she would not live until the termination of the trusts in 2008, she amended the trusts by providing that the annuity trust term would end as of July 31, 2006, and the residence trust term would be the number of months, not greater than 180, determined by making the month of her death the last month preceding the termination date.

She further amended the residence trust, and her will, to instruct the trustee to transfer her home in Modesto, as the Court described it, to:

> . . . a "charitable remainder unitary trust" for a term of years with "a unitary payout percentage that will target the present value (as determined under applicable Regulations) of the interests of the charitable beneficiaries to and among whom the [charitable remainder unitary trust's] corpus is to be distribution [sic] following the [charitable remainder unitary trust's] term of years to equal about $250,000." Decedent provided that her estate would be the sole beneficiary entitled to the unitrust payments during the term of years. Decedent intended that the "charitable remainder unitary trust" would allow her estate a charitable contribution deduction of $250,000.

Mrs. Trombetta died on September 16, 2006. When she died the annuity trust term had ended, but the annuity trust still owed her $121,979.28 and the mortgage debt on the annuity trust property, for which she was personally liable, was $2,194,245.50. After the decedent's death her executor petitioned the local court to reform the amendment to the residence trust. According the executor, the decedent had intended to remove the assets of the residence trust from her estate, and that she had erroneously amended the residence trust to provide for a termination in the month after her death rather than in the month before. The court entered an order modifying the residence trust that effectively terminated it as of August 31, 2006.

Note that by virtue of this amendment the assets of the residence trust would not be distributed as if the decedent was living at the termination of the trust. In its estate tax return the estate included only the unpaid annuity trust payments and the remainder value of the Modesto home. In a subsequent claim for refund the estate claimed a charitable deduction of $250,000 and a deduction for mortgages on the annuity trust properties, for which the decedent was personally liable. The Service challenged these and issued a notice of deficiency claiming that the value of the two properties in the annuity trust was $14,177,325, that the Modesto house had a value of $750,000, and disallowing the deductions for charity and the unpaid mortgages.

The Tax Court found that the assets of the annuity trust were includible in the decedent's estate under Section 2036. It rejected the taxpayer's argument that Section 2036 did not apply because of the exception for a *bona fide* sale for full and adequate consideration. The very filing the decedent's gift tax return established that there was not full consideration; moreover, there was no *bona fide* sale. Regarding the decedent's retained interest, the Court reviewed the history of the trust administration and concluded:

> Given decedent's continued control over the transferred properties, her right to the excess income from the properties, and the use of the income from the properties to discharge her personal legal obligations, we are unable to find that decedent "absolutely, unequivocally, irrevocably, and without possible reservations" parted with all of her title, possession, and enjoyment of the transferred properties. Commissioner v. Estate of Church, 335 U.S. at 645. We conclude that decedent retained an interest in the entirety of the transferred properties.

The Court also rejected two other taxpayer arguments with respect to the annuity trust. One argument was that the annuity trust operated as a private annuity transaction rather than a transfer with a retained life estate. There was scant factual basis for this argument. The other argument was that the amendment to the trust which shortened the term was an exercise of a power rather than the relinquishment of an interest, and therefore at the time of death the decedent had no interest in the property and there was no relinquishment of a power that would cause includibility under the 3-year rule. The Court found the 2006 amendment to be a relinquishment of her power with respect to her right to receive periodic payments and to distribute excess income from the transferred properties. The two properties were includible at their full value, which the Court found to be $4,300,000 on account of a stipulated net lease value (the properties had been leased prior to the decedent's death).

With respect to the residence trust, the taxpayer argued that only the rental value of the Modesto home should be includible in the estate. The Court correctly found that that the decedent had retained the right to occupy the property for a period up to and including her death, and that therefore the entire property was includible in her estate under Code Section 2036(a)(1).

The Court ruled that the decedent's estate could deduct the full mortgage indebtedness on the properties of the annuity trust that were includible in the decedent's estate. The Court also denied a charitable deduction, because under the terms of the decedent's residence trust, as modified by the executor, the decedent was living at the time the trust terminated; therefore the house should have passed to the decedent's children rather than to the "unitary" trust.

D. Valuation Issues

1. <u>Estate of Kite</u>, T.C. Memo 2013-43 Tax Ct. Memo Lexis 43 (February 7, 2013),

Mrs. Kite was the beneficiary of numerous trusts, including the following:

1. A lifetime QTIP Trust (QTIP # 1) that she had created for her husband, who died before her. When her husband died, a second QTIP election was made in his estate to qualify the trust as a QTIP in her estate.

2. A GST-exempt QTIP Trust (QTIP # 2) created by her husband at death.

3. A general power of appointment trust ("GPA Trust") created by her husband at death.

4. A GST-exempt residuary trust ("Residuary Trust") created by her husband at death.

5. Her own revocable trust ("Revocable Trust").

Mr. Kite died in 1995 and the various trusts under the estate plan were funded. In 1996 the trusts participated in the formation of a family limited partnership, called "Brentwood Limited Partnership", organized under Oklahoma law. The general partner of the partnership was Easterly Corporation, an Oklahoma corporation, which was owned by Mrs. Kite and her children, Mrs. Kite owning a majority interest. Beginning with the formation of Brentwood, the Kite family and the trusts entered into a series of transactions which culminated in the termination of the marital trusts, the distribution of assets to Mrs. Kite, and her sale of these assets in 2001 to her children for a deferred annuity. The notes provided that there would be no payment whatsoever under the notes for 10 years; after 10 years the 3 children were obliged to make annual payments of $1,900,679.34 each until Mrs. Kite's death. At the time of the annuity arrangement, Mrs. Kite was 74 years old. Her doctor examined her and stated in writing that her longevity and health outlook was good for the next several years. The doctor also stated that she was not terminally ill and did not have an incurable illness or other deteriorating physical condition that would cause her to die within one year, and that there was at least a 50% probability that she would survive for 18 months or longer. The letter was important because Mrs. Kite intended to rely on the 7520 tables to value the annuity payments.

The series of transactions that began with the formation of Brentwood and ended with the annuity transaction is summarized as follows:

A. Dec. 1996: The trusts contributed their assets to Brentwood in exchange for limited partner interests.

B. Jan. 1997: Mrs. Kite caused about 1/3 of the Brentwood interests that are owned by her or the trusts to be given to her children. She filed a gift tax return, reported a gift, and paid a tax of $1,485,132. The underlying assets of Brentwood were discounted by 34.354% for purposes of the gift. The Tax Court opinion did not explain what portion of the gift (if any) came from the QTIP trusts, nor how a direct transfer from the QTIP to a third party could be made. Perhaps the Brentwood assets were first distributed to Mrs. Kite; the opinion simply does not deal with this issue

C. Feb. 1998: The family reorganized the partnership under Texas law. Brentwood was merged into Baldwin Limited Partnership and Easterly Corporation, the Oklahoma general partner, was merged into Easterly (Texas). The partners now owned interests in Baldwin.

D. May 1998: All trusts sold their remaining Baldwin LP interests to the Kite children or their trusts in exchange for promissory notes. The sole assets of the two QTIP Trusts and the GPA Trust were then only the promissory notes of the Kite children and their trusts. The notes were secured, recourse obligations of the purchasers. As a result of this transaction, the Kite children and their trusts owned all 99% LP interests in Baldwin, and the marital deduction trusts owned promissory notes with quarterly payments of interest and principal due over 15 years at 5.81% interest. The record was unclear whether the Residuary Trust ever received any Baldwin interests and from this point forward the intra-family dealings with the notes only concerned the three marital deduction trusts and Mrs. Kite's Revocable Trust.

E. Dec. 2000: The trusts contributed their notes to Kite Family Investment Co ("KIC") a Texas general partnership. As a result, the marital trusts only owned interests in KIC. The three marital trusts and the Revocable Trust collectively owned a 99% interest in KIC. The other 1% was owned by Easterly (Texas), which was the managing general partner. Although the Revocable Trust owned KIC interests, Mrs. Kite, as trustee of the Revocable Trust, did not sign the agreement transferring the notes to KIC.

F. Mar. 2001: Mrs. Kite replaced the trustees of all three marital trusts with her children. This was done on March 28, 2001, effective as of January 1 of that year. On the same day, and subsequent to being appointed co-trustees, the three children terminated the three marital trusts by distributing their assets (consisting solely of KIC interests) to the Revocable Trust. This was also done effective January 1, 2001. As a result Mrs. Kite, through the Revocable Trust, owned 99% of the general partnership interests in KIC. The documents allowed the marital trusts to be terminated "when, in the judgment of the trustees, the trust estate is too small to justify management as a trust, or the trust otherwise should be terminated." On March 29, 2001, the Kite children, who controlled Baldwin, caused Baldwin to contribute over $13 million to KIC. As a result of the recapitalization of KIC, the interests of Mrs. Kite's Revocable Trust, formerly 99%, were reduced to 43.7367%. Baldwin and Easterly signed an amended and restated partnership agreement for KIC. Although the Revocable Trust owned KIC interests, Mrs. Kite, as trustee of the Revocable Trust, did not sign the restated KIC partnership agreement. On March 30, 2001, Mrs. Kite caused the Revocable Trust to sell the 43.7367% KIC interests to the three children for three unsecured annuity agreements. Each of the three Kite children agreed to pay $1,900,679.34 to Mrs. Kite annually for life on each March 30, beginning in 2011.

G. Apr. 2004: Mrs. Kite died, never having received any annuity payments.

In auditing the estate tax return, the Service took alternate positions for gift and estate tax purposes. The Service claimed that Mrs. Kite made a gift in 2001, for which gift tax was payable. In the alternative, if there was no gift in 2001, the Service asserted a notice of deficiency for estate tax. The Tax Court opinion dealt only with the gift tax issues.

The Service argued that the annuity arrangements were not full and adequate consideration for the transfer of KIC partnership interests. This issue really revolved around whether Mrs. Kite was permitted to value the annuity arrangements under Section 7520. The Service argued that the Section 7520 factors could not be used because (1) Mrs. Kite's deteriorating health condition made her death within 10 years foreseeable, and (2) the unsecured nature of the annuities, among other factors, demonstrated that the parties had no real expectation of repayment.

Under the 7520 tables, Mrs. Kite's life expectancy was 12.5 years. After citing the physician's statement, the Court noted the following with respect to Mrs. Kite's condition in 2001:

> Respondent did not challenge the physician's letter or present evidence contradicting the physician. Instead, respondent relied on Mrs. Kite's 24-hour medical care at home, which began in 2001, and her increased medical costs from 2001 through 2003 to conclude that her death within the next 10 years was foreseeable. Mrs. Kite's increased medical costs, however, were due primarily to the cost of home health care. Mrs. Kite's Federal income tax returns filed for 2001 through 2003 claimed medical expense deductions of $131,100, $142,136, and $176,982, respectively, of which $115,780, $114,587, and $170,845, respectively, were attributed to home health care. although the increased medical costs and home health care indicate that Mrs. Kite's health was in decline, they alone do not suggest, let alone prove, that Mrs. Kite had a terminal illness or an incurable disease. Rather, Mrs. Kite's increased medical costs merely demonstrate that Mrs. Kite was a wealthy, 75-year-old woman who, when faced with certain health problems, decided to employ health care aids at her home. Her decision to hire home health care was not unusual for a woman who was accustomed to hiring personal assistants. Moreover, as exemplified in <u>Estate of McLendon</u>, increased medical costs and home health care do not prove a terminal illness or other incurable disease for purposes of section 7520. Accordingly, Mrs. Kite was not precluded from relying on IRS actuarial tables to value the annuity transaction. The annuity agreements therefore constituted adequate and full consideration and consequently were not subject to Federal gift tax.

Regarding the expectation of repayment, the Tax Court observed that the annuity arrangements were legally enforceable and that the children, through their ownership of KIC, the assets of which were enhanced by the Baldwin contribution, had sufficient assets available to them to effect repayment. Further, the Court stated that Mrs. Kite demonstrated an expectation of repayment, and that if she only survived to her life expectancy (12.5 years) she would have received approximately $800,000 more in annuity payments than the value of the KIC interests she sold. Finally, Mrs. Kite also had access to financial assets so that she did not need to retain an income flow for 10 years from KIC. In conclusion, the Tax Court found the annuity sale to be a *bona fide* sale for adequate and full consideration.

The Tax Court also rejected the Service's argument that the annuity arrangement should be disregarded and the KIC interests included in Mrs. Kite's estate under Section 2033. The Court summarily rejected a substance over form argument on the same basis as it found that the transaction was for adequate and full consideration. It also considered whether the failure of the Revocable Trust to sign the amended and restated partnership agreement after the Baldwin recapitalization caused Mrs. Kite to retain an indirect ownership in KIC. The Court cited Logan v. Logan, 138 Tex. 40, the Texas case that holds that the legal consequences of partnership transfers is controlled by the parties' intent. Logan was the basis for the surprising partnership decisions in Church and Keller, two Section 2036 cases. Although Mrs. Kite failed to have her Revocable Trust sign the amended partnership agreement, she manifested an intent to sell the restated interest (47.7367%) and this was good enough for the Tax Court to find no retention under Section 2033.

The last issue dealt with whether the annuity transaction involved a gift by virtue of the termination of the QTIP trusts and the GPA Trust.

The Court analyzed the QTIP Trusts under Section 2519 -- whether any of the events involved a disposition of the income interest of the trusts. In the sequence of events set forth above, the Court made the following statements:

A. 1996 Contribution to Brentwood: Not a disposition. The Court stated:

> As the lifetime income beneficiary of these trusts, Mrs. Kite continued to receive the income interest from the QTIP trust assets that now passed from Brentwood to Mrs. Kite's trusts. Thus, under section 25.2519-1(f), Gift Tax Regs., Mrs. Kite did not dispose of her qualifying income interest because she continued to have a qualifying income interest for life in the QTIP trusts after reinvestment of the trust assets.

Note that the Brentwood formation involved a reduction in value of assets due to the partnership discount.

B. 1997 Gift of Brentwood Interests: Again, the Court found no disposition. There was no analysis of how these gifts were made. Nevertheless, the Court found that reporting the transferred property on a gift tax return did not involve a disposition for purposes of Section 2519:

> In 1997 Mrs. Kite, through her trusts, transferred limited partnership interests in Brentwood to her children and filed a Federal gift tax return reporting the transfers.[35] Although it is not clear from Mrs. Kite's 1997 Federal gift tax return whether she viewed, in part, her transfers as taxable gifts under sections 2519 and 2511, her payment of gift tax preserved the integrity of the QTIP election for the QTIP

trust assets underlying the Brentwood limited partnership interests. The QTIP trust assets, which avoided tax when transferred to the QTIP trusts upon Mr. Kite's death and later reinvested in Brentwood, was now taxable when transferred by Mrs. Kite in its reinvested form, *i.e.,* as Brentwood limited partnership interests, to her children.

35 The Court notes that Mrs. Kite was able to reduce the taxable value of the assets underlying the Brentwood limited partnership interests by applying a 34.354% lack of marketability and minority interest discount to the limited partnership interests themselves. According to her 1997 Federal gift tax return, the adjusted basis of Brentwood limited partnership interests transferred to her children and grandchildren were reduced from $4,054,701 and $68,630, respectively, to a fair market value of $2,954,067 and $50,000, respectively.

C: 1998 and 2000 Transactions: Held not to be a disposition because Mrs. Kite "maintained a qualifying interest in the converted property." These transaction involved Brentwood's merger into Baldwin, the sale of Baldwin interests for notes, and the contribution of the notes to KIC. The Court stated:

> Thus, from 1996 through 2000 Mrs. Kite's transfers and reinvestments of the QTIP trust assets satisfied the requirements of the QTIP rules because she either continued to have a qualifying income interest in the reinvested property or, upon the [**46] transfer of the reinvested property to her children, she reported and paid Federal gift tax.

The problem arose with the termination of the QTIP Trusts and the sale of Mrs. Kite's interests in the QTIP Trusts. The Court stated:

> The liquidation of the QTIP trusts and subsequent sale of Mrs. Kite's interests in KIC, however, disregarded the QTIP rules. In 2001 Mrs. Kite appointed the Kite children as trustees of the marital trusts, and the Kite children, as trustees, contemporaneously terminated the marital trusts.[36] The marital trust assets were transferred to Mrs. Kite's lifetime revocable trust.[37] Two days later Mrs. Kite's lifetime revocable trust sold its entire interest in KIC to the Kite children for three unsecured private annuity agreements with a value of $10,605,278. The first annuity payments were due 10 years later, in 2011, and would continue every year until Mrs. Kite's death.

36 Respondent argues that the Kite children's termination of the marital trusts and subsequent transfer of trust assets to Mrs. Kite's lifetime revocable trust was a breach of a fiduciary duty. However, without more information regarding the Kite children's decision to terminate the trusts, the Court is reluctant to question the Kite children's discretion, as trustees, to terminate the trusts pursuant to the terms of the trust agreements.

37 Respondent does not raise the issue of whether the Kite children's termination of the QTIP trusts, and the subsequent liquidation of QTIP trust assets, was a gift from the remainder beneficiaries, i.e., the Kite children, to the lifetime income beneficiary, i.e., Mrs. Kite.

Discussion of such a liquidation can be found in Priv. Ltr. Rul. 9908033 (Feb. 26, 1999). Because the Court finds below that the termination of the marital trusts immediately followed by the sale of the marital trust assets is a single transaction for purposes of sec. 2519, the Court does not address the possibility of a gift of the remaindermen interest in the QTIP trusts. See also Rev. Rul. 98-8, 1998-1 C.B. 541 (regarding the gift tax consequences of the disposition of a qualifying income interest).

Respondent asks the Court to view the termination of the marital trusts and the annuity transaction as an integrated transaction. Respondent argues that "[i]n substance . . . [Mrs. Kite] has disposed of her income interest in the Q-TIP trusts in exchange for the deferred annuity." Courts use substance over form and its related judicial doctrines to determine the true meaning of a transaction disguised by mere formalisms, which exist solely to alter tax liabilities. See United States v. R.F. Ball Constr. Co., 355 U.S. 587, 78 S. Ct. 442, 2 L. Ed. 2d 510 (1958); Commissioner v. Court Holding Co., 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 981, 1945 C.B. 58 (1945) . In such instances the substance of a transaction, rather than its form, will be given effect.

According to the record, which included testimony regarding the family attorney's presentation of the annuity transaction to the Kite children and subsequent negotiations of the annuity transaction with Mrs. Kite, the termination of the QTIP trusts was part of a prearranged and simultaneous transfer of the QTIP trust assets, i.e., Mrs. Kite's ownership interests in KIC. Although the QTIP trust agreements authorized the Kite children, as trustees, to terminate the QTIP trusts in their discretion, the estate has presented no explanation of why the QTIP trusts were terminated immediately before the transfer of the QTIP trust assets. Instead, by creating an intermediary step in the annuity transaction, i.e., terminating the QTIP trusts before selling the QTIP trust assets to the Kite children, Mrs. Kite's transfer of her ownership interests in KIC would circumvent the QTIP regime and avoid any transfer tax imposed by section 2519. Accordingly, the Court finds that the termination of the QTIP trusts and the following immediate transfer of the QTIP trust assets to the Kite children are treated as a single transaction for purposes of section 2519.

As discussed above, the sale of QTIP assets, followed by the payment to the surviving spouse of a portion of the proceeds equal to the value of the surviving spouse's income interest, is considered a disposition of the qualifying income interest. See sec. 25.2519-1(f), Gift Tax Regs. The Court held in Part II, above, that Mrs. Kite received adequate and full consideration for her interest in KIC. Accordingly, Mrs. Kite made a disposition of her qualifying income interest, which can be traced from KIC to the QTIP trusts.[38]

38 The QTIP trusts contributed the Baldwin notes to KIC in exchange for an interest in KIC. When the QTIP trusts were terminated, their interest in KIC was transferred to Mrs. Kite's lifetime revocable trust. Mrs. Kite's lifetime revocable trust then sold its interest in KIC for the annuities.

A surviving spouse who makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) is treated as transferring all interests in property other than the qualifying income interest. See sec. 25.2519-1(a), Gift Tax Regs. The amount treated as a transfer under section 2519 is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition, less the value of the qualifying income interest in the property on the date of the disposition. Sec. 25.2519-1(c)(1), Gift Tax Regs. The gift tax consequences of the disposition of the qualifying income interest are determined separately under section 2511. Id.

As a result, the sale of Mrs. Kite's interest in KIC that can be traced to the QTIP trusts was subject to Federal gift tax under section 2519 to the extent of the fair market value[39] of the entire property subject to Mrs. Kite's qualifying income interest, determined on the date of the annuity transaction, less the value of her qualifying income interest. However, because Mrs. Kite received adequate and full consideration for her income interest in KIC, she did not make a gift of her qualifying income interest under section 2511.[40]

39 According to Mr. Kite's estate tax return the fair market value of the QTIP trusts on the date of his death in 1995 was $4,291,327 for QTIP trust-1 and $825,213 for QTIP trust-2. See supra note 9. In 1997 Mrs. Kite, as trustee of her trusts, transferred $4.5 million of the Brentwood limited partnership interests held by her trusts, which included the QTIP trusts, to her children and filed a gift tax return reporting the transfer. See supra note 12. After subsequent transfers and reinvestments of her trust assets, including the QTIP trusts, Mrs. Kite's lifetime revocable trust held a 43.7367% interest in KIC, which had a liquidation value of $10,605,278. See supra note 26.

40 Like surviving spouse described in sec. 25.2519-1(g), Example (2), Gift Tax Regs., Mrs. Kite received consideration for her income interest in the annuity transaction.

Finally, the Service argued that the termination of the GPA Trust constituted a relinquishment of Mrs. Kite's general power of appointment, and was therefore taxable under Section 2514. The Tax Court rejected this argument:

> A "transfer of property" is defined as "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or the devise employed". Sec. 25.2511-1(c), Gift Tax Regs. The transfer of the trust assets to

> Mrs. Kite's lifetime revocable trust was not a transfer of property for gift tax purposes because Mrs. Kite did not transfer an interest in the property to another. See, e.g., Estate of Robinson v. Commissioner, 101 T.C. 499, 508-509 (1993). Instead, Mrs. Kite maintained her interest in the property as the grantor and the sole income beneficiary of her lifetime revocable trust. Therefore, Mrs. Kite did not make a taxable transfer of the marital deduction trust assets under section 2514.

COMMENT: The Section 2519 transfer is the entire value of the QTIP trusts, less the value of the income interests. In Kite what was the amount of the actual gift? Judge Paris had already ruled that all of the interests held by the QTIP Trusts (the KIC interests) were exchanged for full and adequate consideration. Does this mean that there was no gift at all? No, according to the Court. In a subsequently issued Rule 155 Order the Tax Court clarified that when a QTIP income interest is disposed of under Section 2519, the result is a gift of the remainder interest for which the spouse cannot receive full and adequate consideration, or any consideration, in exchange. This reasoning stands traditional gift tax principles on their head, since the Court is simultaneously admitting that there has been an exchange for full and adequate consideration which is not estate depleting, but that the consideration will not count under Section 2519 for the value of the remainder interest. Undoubtedly what must have bothered the Court was the back-end loading of the annuity structure, and the fact that absent the Court's holding the children would have received a significant transfer tax windfall, although the benefit would be offset, at least partially, by the lack of basis in the purchased assets. In the last analysis the stumbling block for the taxpayer, if there was one, seems to have been the failure to pass the "smell test" with respect to the sale of the KIC interests for a deferred annuity that terminated before any payments were required.

An encouraging aspect of Kite is that the back-end loading would apparently be successful in a non-QTIP situation. Of course, there is always a risk that the annuitant could outlive his or her life expectancy, resulting in potential aggrandizement of the taxpayer's estate. Back-end loading an annuity also puts pressure on the family (or the trust) to make the payments. The requirements for a *bona fide* transaction include not only an expectation of repayment, but an ability to repay. The family, or the trust, may have to meet heightened net worth requirements in order to have an ability to repay.

Another encouraging factor was the Tax Court's observation that the QTIP trusts' participation in the formation of a family partnership (Brentwood) did not involve a disposition of income interests. The concern here is that a QTIP's contribution of income-producing assets to an entity that does not normally guarantee a right to income, and that usually has no effective means of exit, might itself be a disposition of the income interest as to those assets. The Service concluded in FSA 199920016 that a QTIP Trust's participation in the formation of a limited partnership was not a disposition of the income interest, but observed that in this particular case the partnership had continued to make income distributions. In deciding to concede the argument that a disposition under Section 2519 had occurred, the FSA stated:

> As applied to the facts of our case, petitioner's conversion of the trust assets into FLP interests is not the typical disposal of the

> income interest envisioned under the provisions of section 2519. By converting the trust assets into FLP interests, she has disposed of the corpus rather than the qualifying income interest. Facially this appears to be a permissible conversion. Thus, in order to invoke 2519, the conversion of the trust assets must work such a limitation on her right to the income as to amount to a disposition of that income. Although the conversion to partnership interests could yield this result, it does not necessarily follow. An investment in a partnership, despite possible restrictions on distribution, could be, under the right circumstances, a very lucrative investment.
>
> Moreover, although the managing partner of the FLP had the right to accrue and not distribute the partnership income, the facts show that such has not been the case. Petitioner has continued to receive her income unabated since the formation of the FLP. No action of Petitioner's has affected her right to income from the trust; that right still exists. The fact that she might not, in a hypothetical world, actually receive income does not destroy her right to any income, if such income exists. Moreover, QTIPs can be originally funded with partnership interests or, for that matter, closely held stock. Both of these investments could distribute no income in any given year. The right to annual income is not tantamount to a fixed right to yearly income, rather it is a right to any income to the extent it exists, on at least an annual basis.

A field service advice, like a private letter ruling, cannot be cited for precedent. The nature of the qualifying language quoted above, referring to the fact that an investment in a FLP "could yield this result" (i.e., constitute a disposition), and that in this particular case income did continue to flow, suggested that a cautious practitioner would try to distribute QTIP assets to the spouse and allow the spouse to engage in estate planning, which is what the family tried to do in Kite. Perhaps a longer "cure" period between the termination of the marital trusts and the gift would have produced a different result.

In Kite the QTIP trust permitted the trustee to terminate the trust at any time when, in the judgment of the trustee, the trust corpus was too small to justify management as a trust, or "the trust otherwise should be terminated." The termination and distribution to the spouse presumably was made under the "otherwise should be terminated" standard. The opinion noted that the Service did not argue, nor did the Court have to consider, whether the failure of the children to object to the termination constituted a gift. One should not count on the Service not raising this argument in future cases. Moreover, if the termination of the trust, followed by a disposition of the assets, is considered an integrated transaction that triggers Section 2519, what about a partial distribution of principal to a spouse, under a stated standard, that the spouse then employs in a gift program?

2. Chief Counsel Advice 201330033.

CCA 201330033 addresses a situation that is closely related to the private annuity transaction in Kite: a sale for a self-cancelling installment note ("SCIN") that is also back-end loaded. It appears that the CCA was issued in connection with a docketed but not yet decided case in the Tax Court entitled Estate of Davidson v. Commissioner (Tax Court Docket 13748-13). In the CCA the taxpayer engaged in a series of transactions that involved the sale of assets to grantor trusts in return for notes. In some transactions, the notes represented face value of the appraised value of the stock transferred to the trusts, with interest at AFR. Interest only was payable annually, with a balloon payment of all principal at the end of the term. In other transactions, the notes were self cancelling if the taxpayer died before the maturity date. One transaction involved a SCIN where the face value of the note was equal to the appraised value of the property sold, but the risk premium was built into the interest rate. Another transaction involved a SCIN where the interest rate was AFR but the risk premium was built into the face value of the note, which the CCA noted was almost twice the value of the property sold. Both versions of the SCINs provided for interest-only payments, with a balloon payment of all principal at the end of the term. The taxpayer valued the SCINs under Section 7520. In the Davidson case, the taxpayer was 86 when he entered into the SCIN transaction, and the notes had a term of 5 years, slightly less than his normal life expectancy. Shortly after the SCIN transactions (December 2008 and January 2009) he was diagnosed with a terminal illness and he died on March 13, 2009 before any interest or principal was received under the notes. The CCA posed the following questions:

1. Does all or any portion of the transfers of stock from the decedent to the grantor trusts in exchange for the notes with the self-cancelling feature constitute a gift?
2. How should the fair market value of the notes with the self-cancelling feature be determined?
3. If the Date 1 transfers do not constitute a gift, what are the estate tax consequences of the cancellation of the notes with the self-cancelling feature upon the decedent's death?

In Estate of Constanza v. Commissioner, 320 F. 3d 595 (6th Cir., 2003), the Sixth Circuit stated that a SCIN transaction entered into by family members is presumed to be a gift and not a *bona fide* transaction. In Constanza the Court held that the taxpayer had rebutted the presumption of gift based on the taxpayer's need for a steady stream of retirement income, the expectation of repayment, and the intent to enforce repayment. The Chief Counsel contrasted this holding with a Court of Claims holding in Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995), involving a loan from a seriously ill father to his son in return for a note to be cancelled at death. In Musgrove the loan was for $251,540 in return for a note of $300,000. In granting summary judgment to the government, the Court of Claims observed that there was no repayment schedule to follow, no interest was established on the note, there were no payments to the decedent before his death, and the son was uncertain as to whether he could repay the loan.

The CCA reasoned that the notes were structured as interest only solely for estate planning purposes because of the back-end loading and the fact that the decedent had sufficient other assets for his daily living expenses. It characterized them as a device to transfer stock to other family members at less than fair market value. The CCA also reasoned that the grantor trusts may not have had the ability to repay, given the principal risk premium built into the one set of notes (close to 2X value), although it conceded that there may have been sufficient seed money to support the higher payments needed at the back end.

The answer to the first question posed, then, was that there was a deemed gift to the extent that the value of the notes was less than the fair market value of the property transferred. This seems obvious enough and leads to the second issue -- how to value the notes. The taxpayer probably valued the notes using Section 7520, since the essence of a SCIN is that it has a mortality feature (payments will stop when the person dies - hence life expectancy is a factor). Here the Service disagreed with the use of the Section 7520 Tables:

> We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

If a SCIN cannot be valued under Section 7520, then the taxpayer who suffers from an illness or deteriorating physical condition would be unable to rely on Treas. Reg. §20.7520-3(b)(3)(i), which presumes that a person who survives for 18 months was not terminally ill. The Regulations state that a person with a terminal illness or deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the person will die within 1 year. This implies that if there is a greater than 50% probability that the person will survive for at least one year, the person is not terminally ill. The CCA would discard these standards, and the taxpayer would be left with a high degree of uncertainty in how to properly value notes where repayment is tied to mortality. Rather than using a standard set of tables, the appraiser would need to examine the medical history and possibly the family genetics of each individual taxpayer.

Finally, on the third question, the Chief Counsel concluded that there was no estate tax consequence associated with the cancellation of the notes (i.e., the notes were part of the gross estate). After reciting the facts of Musgrove, the Chief Counsel concluded:

> There are similarities between the decedent in the subject case and the decedent in Estate of Musgrove. In each case, the decedent who received a promissory note with a self cancelling feature was in very poor health and died shortly after the note was issued. In addition, there is a legitimate question as to whether the note would be repaid in each case.

3. Koons v. Commissioner, T.C. Memo 2013-94 (April 8, 2013).

Koons involved failed attempts to (1) support a substantial lack of marketability discount and (2) deduct interest on a Graegin loan arrangement. In

Koons the decedent's Company ("CIC") agreed to the sale of its Pepsi-Cola distribution business to a Pepsi bottling company for $340 million, plus a $50 million payment from Pepsi to settle a lawsuit, minus certain closing obligations, which included an obligation of the seller to remediate elevated levels of carbon dioxide in a Florida production facility. At the time the sale was negotiated, the decedent owned 49.5% of the voting stock of CIC, and 51.5% of its non-voting stock. The sale was structured so that the surviving company would be a limited liability company ("CI LLC") that would be owned in the same proportion among its members as the stock of CIC had been owned. The stock purchase agreement required the seller to maintain a net worth of $40 million, including liquid assets of $10 million, until January 10, 2012. Another term of the stock sale obliged CI LLC to offer to the decedent's four children, or trusts holding interests for their benefit, the opportunity to redeem their interests for each holder's proportionate share of CI LLC's assets minus liabilities. The decedent died on March 3, 2005, after the sale had closed, and after the four children (or trusts for their benefit) had accepted a written offer to redeem their interests, but before the redemptions had been consummated. At the date of death, the total assets of CI LLC were approximately $351 million, of which approximately $322 million was cash. Its liabilities were approximately $33 million, of which $20 million was a note payable to the decedent. When he died, the decedent's revocable trust owned 46.94% of the voting membership interests in CI LLC, and 51.59% of the non-voting membership interests, or a total over-all ownership interest of 50.50%. Following the redemptions of the interests held directly or indirectly by the four children, the decedent's revocable trust owned 70.42% of the CI LLC voting interests, and 71.07% of the CI LLC non-voting interests. The redemptions closed on April 30, 2005, but final payments were not made until on or about July 1, 2005.

The operating agreement of CI LLC was amended, prior to the decedent's death, to provide for management by a Board of Directors who were required to make distributions to members to cover their federal and state income taxes, and were permitted to make other distributions in the Board's discretion. The operating agreement could be amended by majority vote of the members; a majority vote was also required for the company's consolidation, merger, the sale of all or substantially all of its assets, liquidation, dissolution or winding up.

In February, 2006, the decedent's estate borrowed $10,750,000 from CI LLC on a Graegin note. The note provided for an interest rate of 9.5% (note: long-term AFR for February, 2006, annual compounding, was 4.61%) and prohibited prepayment. Interest would accrue on the loan until payments began, which would not occur until August, 2024, at which time 14 equal installments of principal and interest would be made until the loan was paid off in full by February, 2031. Interest on the back-end loaded arrangement was $71,419,497. The interest deduction helped reduce the over-all estate tax liability reported to the IRS to approximately $21 million. There was also a generation-skipping transfer tax liability of approximately $5 million. These liabilities were based on a valuation of the estate's interest in CI LLC at $117,197,442.72. The taxpayer claimed a 27% discount for lack of marketability on the return, but in the Tax Court asserted a 31.7% discount. There was no claim of discount for lack of control. The Service argued that the discount for lack of marketability should be limited to 7.5%. The issue, of course, was whether at the date of death the decedent's stock should be valued taking into account the effect of the redemptions that had been agreed to prior to death but not consummated until after.

The Tax Court agreed with the Service that under the willing buyer/willing seller test only a modest discount should be allowed. The Court noted that at the time of decedent's death the redemption offers had been accepted, and although a stated price had not been established, the redemption offers were for net asset value of a company that consisted almost exclusively of cash. Under these circumstances, a local court (Ohio) would enforce the agreements, and there was only a slim possibility that they would not occur. The Court also noted that other factors, such as the remediation obligation, the obligation to maintain a $40 million (12.6% of the company's assets) and a nephew's lawsuit filed after the decedent's death but ultimately barred by the statute of limitations, were factors that supported a 7.5% discount but not a deeper one. Other factors, such as transferability restrictions and the fact that the Board controlled discretionary distributions, became irrelevant in light of the control position attributed to the decedent.

The decedent's control position also rendered the Graegin loan provisions ineffective. Since the decedent's estate could amend the company's operating agreement to provide for a cash distribution to pay the tax, the loan was not necessary. In denying the deduction for this reason, the Court cited Estate of Black v. Commissioner, 133 T.C. 340 (2009), and Estate of Stick v. Commissioner, T.C. Memo 2010-92. The Court also noted that the decedent's revocable trust had no way to repay the loan except for distributions from the company.

COMMENT: As a final reason for denying the deduction, the Court stated:

> Furthermore, the Estate must remain active long enough for the loan to be repaid. The loan repayments are due 18 to 25 years after the death of Koons. Keeping the Estate open that long hinders the "proper settlement" of the Estate. See 26 C.F.R. sec. 20.2053-3(a) (2009).

This statement suggests that planners should be wary of structures which are so back-end loaded that they take on aspects of gaming the system. With a Graegin situation, the estate claims a deduction for aggregate future interest payments that are not discounted to present value – a real advantage where the lender and the borrower are essentially the same family group so that the interest payments are being recycled. But the loan ought to bear some reasonable relationship to what a sensible borrower would agree to.

4. Estate of Giovacchini, T.C. Memo 2013-7 (January 23, 2013).

Giovacchini was a valuation dispute in which the Tax Court considered a sale that occurred 2 years and 7 months after the decedent's gift, and 16 months after the decedent's date of death, in arriving at gift and estate tax values. The valuation dispute was over approximately 2,356 acres of real property located in the mountainous region near the California-Nevada border just south of Lake Tahoe ("High Meadows"). The property ranged in altitude from a mile above sea level to almost two miles above sea level, which made the property hard to accurately survey or measure. There were several appraisals of the property (including its timber) in the 1990s, one for $3,800,000 in 1990, another

$4,100,000 in 1991, and another for $5,375,000 in connection with the estate tax proceedings for Mrs. Giovacchini's husband, who predeceased her in 1997. His estate tax return valued the real property at $3,837,000 and the timber at $743,750. In 1999 the decedent transferred the property to a trust, and then on June 27, 2000 the trust sold a 50% interest to a family LLC for $2,500,000. There was no appraisal performed at the time; the value was arrived at by the family's CPA, who advised the family on tax matters, based on the estate tax appraisal of the property, with annual increases based on the consumer price index.

The American Land Conservancy was interested in acquiring a portion of the land for conservation purposes, and immediately reselling it to a public agency. In September, 2001, the trust and LLC signed a contract to sell 1,730 acres of land to ALC. ALC accepted the contract on October 4, 2001, four days before Mrs. Giovacchini's death. The purchase price would be 95% of the fair market value of the property as determined in an appraisal approved by seller, buyer and the agency to which the land would be resold. At the time of the contract ALC did not have an agency buyer committed; later the United States Forest Service ("USFS") became the repurchasing agency. ALC commissioned an appraisal of the land, which on completion estimated the purchased acres (by agreement between the parties increased to 1,790) to have a value of $25 million as of October 10, 2001. In March, 2002, ALC contacted USFS regarding its possible repurchase of the land. USFS then engaged the same person who had appraised the property at $25 million to appraise the acreage, taking care to ensure that the appraisal met the Uniform Appraisal Standards for Land Acquisition and the Uniform Standards of Professional Appraisal Practice, with the latter to control in the event of a conflict. The new appraisal valued the acreage at $29.5 million as of September 2, 2002. In December, 2002, the USFS approved the $29.5 appraisal. The sale eventually closed on January 31, 2003 for $29.5 million. Meanwhile, Mrs. Giovacchini's estate reported its 50% interest in the entire property at $2,800,000 for the land and $453,117 for the timber. The value was derived from the value in Mrs. Giovacchini's predeceased husband's estate, by the same appraiser who had prepared that valuation. He was aware of the ongoing negotiations for the sale of 1.790 acres but had not been provided with a copy of the purchase agreement. In the ensuing estate tax audit the Service issued two notices of deficiency, one for gift tax, claiming that the sale of the 50% interest in the property to the LLC was part gift, part sale, and the other for estate tax. The notices of deficiency included undervaluation penalty notices. The Service claimed that the 50% interest held by the estate was worth $16,059,000 rather than the $3,253,117 reported on the estate tax return.

The taxpayer's essential argument was that the $29.5 million value was not reflective of fair market value because the USFS appraisal did not take into account certain conditions peculiar to the land and required in the standards for land appraisal, particularly the Uniform Standards of Professional Appraisal Practice. In addition, the taxpayer argued that a subsequent sale was not relevant to fair market value at death. The Tax Court found serious flaws with the USFS appraisal, but still believed it was relevant:

> Although this Court has observed that subsequent events are generally irrelevant (and therefore inadmissible) in determining a

property's fair market value as of a relevant valuation date, that observation is generally inapplicable when the subsequent event is a sale of the subject property itself within a reasonable time of the relevant valuation date. See Estate of Spruill v. Commissioner, 88 T.C. at 1228, 1233; see also Saltzman v. Commissioner, 131 F.3d 87, 93 (2d Cir. 1997), *rev'g* T.C. Memo. 1994-641. Indeed, evidence of actual price received for property in the estate after the date of death is generally admitted without any discussion of the rule against admission of post-valuation date events." First Nat'l Bank of Kenosha, 763 F.2d at 894; see Estate of Kaplin v. Commissioner, 748 F.2d at 1111 (reversing a Tax Court decision because the Tax Court failed to consider a sale of the subject parcel itself two years after the donation of the parcel); Estate of Hillebrandt v. Commissioner, T.C. Memo. 1986-560 (admitting evidence of sales of the various parcels of the subject property that occurred five years after the decedent's death); see also Estate of Jung v. Commissioner, 101 T.C. 412, 431 (1993); Trout Ranch LLC v. Commissioner, T.C. Memo. 2010-283; Estate of Brown v. Commissioner, T.C. Memo. 1969-91, aff'd, 425 F.2d 1406 (5th Cir. 1970).

However, there is an exception where "a material change in circumstances occurs between the valuation date and the date of sale." Estate of Keitel v. Commissioner, T.C. Memo. 1990-416. In short, we will not consider subsequent events that affect a property's value, but we will consider subsequent events which merely serve as evidence of a property's fair market value as of the relevant valuation date. See Estate of Jung v. Commissioner, 101 T.C. at 432 ("When viewed in this light—as evidence of value rather than as something that affects value—later-occurring events are no more to be ignored than earlier-occurring events.").

Citing an aforementioned case, on July 11, 2008, we denied the estate's March 25, 2008, amended motion to strike from the record evidence of the January 31, 2003, sale of High Meadows. We concluded that evidence of the January 2003 sale is admissible on the issue of that property's fair market values on June 27, 2000—2-1/2 years earlier—and on October 8, 2001—16 months earlier. See First Nat'l Bank of Kenosha, 763 F.2d at 894; Estate of Kaplin v. Commissioner, 748 F.2d at 1111.

We reiterate that the sale of most of High Meadows to ALC 2 years and 7 months after the date of the gift and about 16 months after the date of Shirley's death was reasonably close to both relevant valuation dates. Nothing that could not have been foreseen, other than the result of Mr. Harrison's appraisal, using extraordinary assumptions as directed by USFS, occurred between the relevant valuation dates and January 31, 2003, that drastically or materially affected High Meadows' intrinsic value so as to render the sale irrelevant. [footnotes omitted].

Having observed that the sale of the 1,790 acres to USFS was the only true "comparable sale", the Tax Court then admitted that the appraisal on which that sale turned was seriously flawed, negotiated by parties not truly adverse, and in any case undertaken well after the gift and estate tax valuation dates. Those factors warranted "considerable adjustment and discount" for the estate and gift tax values at issue in the case. After adjusting for access and other issues, the Tax Court found that the entire property had a rounded value of $18.5 million for gift tax purposes and $21.3 million for estate tax purposes. The Court excused the taxpayer from penalties, finding that it had engaged competent professionals, provided them with information needed to determine value, and reasonably relied on that determination. The government argued that the taxpayer's reliance on the low appraisal for estate tax purposes was unreasonable because the first appraisal undertaken after the agreement with ALC indicated a value of about $25 million. The Court characterized this value as something "thrown" at the estate, which the estate had no reason to believe reflected reality, especially in light of its earlier appraisals. The Court pointed out that at the time of the $25 million appraisal, ALC had no ability to fund that price by itself, so that any deal was wholly dependent on identifying an agency that would buy the property at that price. In short, there was justifiable skepticism that the transaction would ever close. As to the gift tax appraisal, even though it was prepared by a CPA who was not qualified to value real estate, and adjusted an earlier appraisal for CPI increases, the taxpayer was not required to second guess the advice given.

5. <u>Tanenblatt v. Commissioner</u>, 2013 Tax Ct. Lexis 273 (November 18, 2013).

<u>Tanenblatt</u> concerned the valuation of a 16.667% LLC interest in a decedent's gross estate. The taxpayer submitted an appraisal with the estate tax return that valued the interest $1,788,000 (the "MPI Appraisal"). The LLC consisted of a commercial property located in New York City, some cash and other assets, and some liabilities. The MPI Appraisal concluded that the net asset value of the LLC was $20,628,221 and applied, sequentially, discounts of 20% for lack of control and 35% for lack of marketability. In the estate tax audit the Service accepted the MPI Appraisal's net asset value but applied corresponding discounts of 10% and 20%, resulting in a value of $2,475,882.

The taxpayer then retained another appraiser, who valued the decedent's interest at $1,037,796 (the "Tindall Appraisal"). The taxpayer attached a copy of the Tindall Appraisal to its Tax Court petition and averred that the Tindall Appraisal was correct in blending the net asset and income approaches to value, and considering the interest to be an assignee's interest rather than a membership interest. In its answer to the averment, the Service admitted that the taxpayer had attached a new appraisal to the petition, denied for lack of sufficient information that taxpayer obtained the appraisal, and denied the remaining allegations. At trial the government's expert (Mr. Thomson) testified, and concluded that the rounded fair market value of the interest was $2,303,000.

The problem for the taxpayer is that the estate became embroiled in a fee dispute with the appraiser, and could not get the appraiser to testify at trial. The taxpayer argued that because the Tindall Appraisal was attached to its Tax Court petition, and because the parties had stipulated to the copies of the petition and answer that were filed, the appraisal was part of the evidence before the Court. The stipulation of the parties, however, stated that the stipulations ". . . show the parties' pleadings in this case and are not admitted in evidence."

Rule 143(c) of the Tax Court governs the use of expert testimony at trial. It provides in part that ex parte affidavits or declarations, statements in briefs and unadmitted allegations in pleadings do not constitute evidence. The Tax Court explained its rules for the admission of expert testimony:

> Petitioner's path for attempting to introduce the Tindall appraisal into evidence as expert testimony is, to say the least, unusual. Generally, a party obtains the testimony of an expert witness by calling that witness to testify. See Rule 143(g)(1). Pursuant to that Rule, the expert witness must prepare a written report, which is marked as an exhibit and, after having been identified by the witness and adopted by him, received into evidence as his direct testimony unless the Court determines that the witness is not qualified as an expert. The Rule further provides that, not less than 30 days before the call of the trial calendar on which a case appears, a party calling an expert witness shall serve on each other party and submit to the Court a copy of the expert's report. Finally, the Rule also provides that, generally, we will exclude an expert witness' testimony altogether for failure to comply with the Rule. Those requirements are echoed in our standing pretrial order, which was served on petitioner.

The Tax Court observed that a stipulation that a document is attached to a pleading establishes the authenticity of the document, but if the document is then offered by a party for the truth of the matters asserted in the pleading, both the pleading and the attachment constitute hearsay, and may or may not be admissible. The Tax Court concluded that the Tindall Appraisal had to be excluded from the evidence:

> Petitioner did not call Dr. Tindall as a witness but asks us to rely on her report (which, under our Rules, would serve as her direct testimony) as her expert opinion. Petitioner has neither qualified Dr. Tindall as an expert entitled pursuant to rule 702 of the Federal Rules of Evidence to give her opinion on technical matters nor has he satisfied our procedural rules for expert testimony, found in Rule 143(g) and in our standing pretrial order. In other words, petitioner has failed to satisfy the preconditions for our receiving Dr. Tindall's opinion into evidence. Because her report (i.e., the Tindall appraisal) is not in evidence, we may not consider her opinion.

With the Tindall Appraisal being excluded, the Court was left with the MPI Appraisal, and the testimony from the expert offered by the Service, both of which started with the same net asset value of the LLC and different applied discounts. The taxpayer argued that it was improper to start with net asset value, and that the interest should be valued as an assignee interest rather than a membership interest.

In finding that there was no error in both appraisers referring to the interest as a "member's" interest, the Court stated:

> We must determine whether respondent and Mr. Thomson erred in classifying the subject interest as a member's interest rather than classifying it as an assignee's interest. A member's

interest is more valuable than an equivalent percentage interest of an assignee because the member's interest can participate in management and control of the LLC. We think respondent and Mr. Thomson did not err. Decedent was a member of the LLC when she transferred the subject interest to the trust. We assume, therefore, that, until she made the transfer, she enjoyed all of the benefits and was saddled with all of the burdens attendant upon being a "member" of the LLC. The term "member's interest" (or the term "membership interest", which the parties use, but which we do not, because it is a term defined in the operating agreement to mean a member's proportional interest in capital) is both a convenient and an accurate classification for indicating that decedent's interest in the LLC was of the fullest kind; i.e., she shared in management and control and did not merely share in profits and losses. For the same reasons, the term is a convenient and accurate classification for the subject interest in the hands of the trust, which also was a member of the LLC. Moreover, there is no evidence that, on or before the valuation date, the trust distributed, sold, exchanged, or otherwise disposed of the subject interest, so that, possibly, on that date, it could more accurately be described as an assignee's interest. Therefore, because the term "member's interest" conveniently and accurately describes the rights inherent to a subject interest on the date decedent transferred it, on the date she died, and on the valuation date, neither respondent nor Mr. Thomson erred in classifying it as such (or, in their terms, classifying it as a "membership interest").

The fair market value of the subject interest on the valuation date is determined under the objective willing buyer-willing seller standard discussed *supra*. The willing buyer and willing seller are purely hypothetical persons, and their characteristics are not necessarily the same as the personal characteristics of the actual seller or a particular buyer. E.g., <u>Chapman Glen Ltd. v. Commissioner</u>, 140 T.C. No. 15 (May 28, 2013). Certainly, in applying the willing buyer-willing seller standard to determine the value of the subject interest, it would be appropriate to take into consideration limitations in the operating agreement on the rights of a nonfamily member transferee to participate in control and management of the LLC and limitations on the transferee's rights otherwise to be treated as a member. Petitioner, however, seeks to collapse the two steps of the valuation process—i.e., (1) identify the property to be valued and its nature and character, and (2) objectively determine its value—into a single step. Petitioner would expand section 20.2031-1(b), Estate Tax Regs., beyond its intended scope by using the provision to redefine the character of the subject interest as an assignee's interest. See <u>Kerr v. Commissioner</u>, 113 T.C. 449, 469 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002). As discussed in the immediately preceding paragraph of this report, on the valuation date the subject interest was a member's interest. The holder of that interest, at that time,

> enjoyed fully the benefits and burdens of being a member of the LLC, including his or her inability to transfer all of those benefits and burdens to a nonfamily member transferee. The hypothetical willing buyer and hypothetical willing seller—"both having reasonable knowledge of relevant facts", sec. 20.2031-1(b), Estate Tax Regs.—would understand a member's interest to be so restricted, and would take that restriction into account in their negotiations of what a member's interest was worth. Mr. Thomson considered restrictions imposed on transferability of an interest in the LLC as a factor in his marketability discount analysis.

The Court also found no error in the net asset approach that was used by both the MPI Appraisal and the government's expert. In fact, they both started from the same number. The Tax Court also pointed out that the primary asset of the LLC -- a building appraised at $19,960,000 -- was itself valued exclusively on an income approach using a discounted cash flow analysis. Finally, regarding the discounts, the Court observed that while the taxpayer criticized the methodology of the Service's expert for determining the discounts for lack of control and lack of marketability, he provided no expert testimony from which the Court could draw different, greater values in those technical areas of analysis. The Court found the value to be that established by Mr. Thomson -- $2,303,000.

6. <u>Estate of Elkins v. Commissioner</u>, 140 T.C. No. 5 (March 11, 2013).

Mr. Elkins and his wife had owned 64 works of art. After wife's death, as a result of three works of art having been transferred to 10-year GRITs created by Mr. Elkins and his wife, the wife's estate plan, and Mr. Elkin's disclaimers with respect to portions of wife's interest in 61 works, Mr. Elkins owned 73.055% interests in 61 works of art and 50% interests in the three that had been in the two GRITs. The remaining interests were owned by the Elkins' three children.

There were separate agreements regarding 2 pieces formerly held in the GRITs (the "GRIT Art") and the other 62 pieces. The agreement for the GRIT Art was a lease arrangement between Mr. Elkins and his children. Although the lease was entered into in 2000, rent was not established until after Mr. Elkins' death. The lease agreement restricted the transfer of each party's fractional interest in the GRIT Art, and at trial it was conceded by both the taxpayer and the government that the restriction violated Section 2703.

The agreement with regard to the remaining 62 pieces of art was a co-tenancy agreement, by which the parties agreed not to sell the underlying pieces of art without unanimous consent, but arguably did not restrict the ability of a party to sell his or her fractional interest in the art. The taxpayer argued that Section 2703 did not apply to the co-tenancy agreement, because there was no restriction as to the property included in the decedent's estate (the fractional interest). The Service argued that the restriction on sale was essentially a restriction designed to depress the value of the interest in the estate and should be disregarded. In the estate tax return the taxpayer claimed a substantial discount for the art (44.75%) while the Service argued that no discount at all was appropriate. At trial the parties stipulated to the undiscounted value of the art. The estate called three expert witnesses to support its argument that substantial discounts were appropriate. The Service stuck to its argument that no discounts were available.

The Tax Court first found that under Section 2703 the restriction on sale without unanimous consent should be disregarded to the extent that the co-tenancy agreement waived a fractional owner's right of partition under Texas law:

> We think that both petitioners' and respondent's analyses miss the mark. During trial, we queried Mr. Miller, petitioners' expert on partition, about paragraph 7 of the cotenants' agreement. We pointed out to him that, for a sale of any of the jointly owned properties (i.e., works of art) to occur, all of the cotenants would have to agree, and that would be so independent of the language of paragraph 7 of the cotenants' agreement. He agreed. We added: "So that the statement that an item of property may only be sold with the unanimous consent of all of the cotenants is a rather unremarkable statement of the obvious." He responded: "I do agree." With respect to what the language of paragraph 7 accomplished, he testified: "If this language was not in the co-tenancy agreement, any individual interest owner would have the right to commence a partition action." That is in accord with his direct, written testimony, wherein he states that the right to partition is absolute, although cotenants may expressly or impliedly agree not to partition, and that he has "assumed that Provision 7 . . . is, in essence, an agreement by the Co-Owners not to partition." With exceptions not here relevant, section 2703(a)(2) instructs that "the value of any property shall be determined without regard to . . . any restriction on the right to sell or use such property." Whether paragraph 7 of the cotenants' agreement is a restriction on decedent's right to sell the cotenant art or is a restriction on his right to use the cotenant art is not important. It is clear that, pursuant to paragraph 7 of the cotenants' agreement, decedent, in effect, waived his right to institute a partition action, and, in so doing, he relinquished an important use of his fractional interests in the cotenant art. While, as we shall explain, it makes little or no difference to our conclusion as to the value of the art, we shall, in determining the value of each of the items of cotenant art, disregard any restriction on decedent's right to partition.

Having thus concluded that the fractional interests in the art must be determined without regard to restrictions on partition, the Tax Court then considered whether, and to what extent, a discount should apply.

The estate's strategy at trial included establishing, through testimony of the Elkins children, that they considered the art to be a family legacy and would be adverse to any sale unless agreed to by all of the owners. Presumably this factor would support a deep discount, since the hypothetical willing buyer would not pay anywhere near pro-rata value for an interest that would not likely be sold. Ironically, the Tax Court used the same testimony to reason that the Elkins family would probably go to great lengths to purchase the fractional interest. Note, however, that the Court did not posit the Elkins children as the "willing buyer" for purposes of determining valuation. To do so would violate the requirement that the willing buyer be a hypothetical person. Rather, the Court reasoned that the hypothetical willing buyer would be aware of the desire of the Elkins children to purchase the fractional interest:

> The overriding flaw in Mr. Nash's and (derivatively) Mr. Mitchell's analyses is their failure to consider not only the Elkins children's opposition to selling any of the art but also their ownership position vis-a-vis that of the hypothetical willing buyer and the impact that the 73.055-26.945 or 50-50 ownership split would have on the negotiations between seller and buyer. Both experts should have considered the fact that the Elkins children, cumulatively, were entitled to possession of 61 works of cotenant art for a little over three months each year, and to possession of the three works of GRIT art for six months of each year. The relatively brief period of annual possession and the expense and inconvenience of annually moving the art from the hypothetical buyer's premises back to Houston most likely would have caused the Elkins children to reassess their professed desire to cling, at all costs, to the ownership status quo existing after decedent's death. Thus, the hypothetical buyer would be in an excellent position to persuade the Elkins children, who, together, had the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art. Neither Mr. Nash nor Mr. Mitchell considered that possibility.
>
> Ms. Sasser testified that, in the light of a relatively short period of possession of the art to which she and her siblings would be entitled vis-a-vis a hypothetical buyer, and considering that the buyer would, most likely, not reside in the Houston area, she "would be willing to pay . . . a fair price" to purchase the hypothetical buyer's 73.055% or 50% interests in the art. Her testimony confirms what both the hypothetical willing buyer and seller would reasonably suspect during their negotiations: that the Elkins children's strong desire to retain possession of the art in place would motivate them to purchase the hypothetical buyer's interests, most likely in each case for an amount equal or close to the undiscounted fair market value of the interest. It defies logic to assume that, as 27% or 50% owners and possessors of the art, the Elkins children would spend millions of dollars to retain their status as such, perhaps as defendants in multiple partition actions that could drag on for many years, when they would be able to acquire 100% ownership and possession of the art, which, after all, is what they really want.
>
> * * * * * * * * * * * *
>
> In short, we find petitioners' experts' analyses and conclusions to be unreliable because they are based, in large part, on the false or at least highly dubious assumption that the Elkins children would mount an unrelenting defense of the status quo, ignoring the very high probability that, instead, the children would seek to purchase the hypothetical buyer's interests in the art. Because we

> reject that assumption, we find Mr. Mitchell's discounted values for the art to be unrealistically low.[footnotes omitted]

The Court rejected the Service's argument that no discount was appropriate, allowing a 10% discount, which it described as "nominal", because the hypothetical buyer could not be certain that the Elkins children would buy the decedent's fractional interests or that, if they did, that they would agree to pay full pro rata full market value. A 10% discount would "enable a hypothetical buyer to assure himself or herself of a reasonable profit on a resale of [the decedent's] interests to the Elkins children."

COMMENT: The primary problem with establishing discounts for fractional interests in art is that there is virtually no data for such interests. Fractional interests are sometimes purchased by museums that have a shared interest in acquiring a work and rotating its display. In other situations investors may jointly purchase a work with a view toward a sale to divide the proceeds. In the absence of data to support substantial discounts, the Tax Court appears to allow only nominal discounts for fractional interests. See, *e.g.*, Estate of Stone, 2009 U.S. Appeals Lexis 6347,in which the Ninth Circuit affirmed the Tax Court's determination of a 5% discount.

E. Same Sex Marriage

1. Windsor v. United States, 133 S. Ct. 2675 (2013).

Windsor considered whether Section 3 of the federal Defense of Marriage Act ("DOMA") violated the equal protection clause of the United States Constitution when it was applied to deprive the surviving spouse of a same-sex marriage of a federal estate tax marital deduction. The absence of a marital deduction resulted in $363,053 of federal estate taxes that could have been avoided had a marital deduction been granted.

Edith Windsor was legally married to her same-sex partner, Thea Spyer, in Canada in 2007. Edith was a New York resident at the time of Thea's death in 2009. The death occurred two years before New York recognized same-sex marriages, but after at least two New York intermediate appellate courts had ruled that New York would be likely to recognize the marriage of same-sex persons who were legally married under the laws of another jurisdiction as valid under New York law.

Edith filed suit to challenge Section 3 of DOMA, which provides that in determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

While the case was pending, and before the District Court issued its opinion, the President determined that Section 3 of DOMA was unconstitutional and instructed the Department of Justice not to enforce DOMA in the Federal courts. However, the President continued to enforce the law by denying Windsor any estate tax refund. The decision of the Executive Branch not to enforce the law but simultaneously deny the refund resulted in a very odd situation. When the

District Court granted summary judgment for Windsor, the Department of Justice appealed, but, like Windsor, asked the Second Circuit to affirm the District's Court's ruling. Similarly, when the Second Circuit affirmed, the Department of Justice asked the Supreme Court to hear an appeal, but again agreed with Windsor that both lower courts had gotten the case right. When Justice announced that it would not enforce the law, the Bipartisan Legal Advisory Group (‘BLAG”) of the U.S. House of Representatives sought, and was granted, leave to intervene. BLAG argued that there were “unique” federal interests underlying DOMA: maintaining a consistent federal definition of marriage, protecting the fisc, and avoiding "the unknown consequences of a novel redefinition of a foundational social institution." BLAG also argued that Congress enacted the statute to encourage "responsible procreation."

The Supreme Court affirmed the Second Circuit in a 5-4 decision. Justice Kennedy, writing for the majority, devoted several pages of his opinion to the historic function of the States, rather than the Federal government, to define marriage, but ultimately said that the case did not rest on principles of federalism. Rather, Justice Kennedy found that Section 3 of DOMA was an unconstitutional deprivation of liberty under the Fifth Amendment. Justice Kennedy went on to say that while the Fifth Amendment ". . . itself withdraws from Government the power to degrade or demean in the way this law does, the equal protection guarantee of the Fourteenth Amendment makes the Fifth Amendment right all the more specific and all the better understood and preserved." In discussing equal protection, Justice Kennedy observed that "no legitimate purpose" overcomes the purpose and effect of Section 3 of DOMA "to disparage and to injure those whom the State, by its marriage laws, sought to protect in personhood and dignity." The majority opinion's penultimate sentence was "This opinion and its holding are confined to those lawful marriages", referring to marriages that States choose to recognize. Implied by this statement is that the opinion does not affect Section 2 of DOMA, which permits States to refuse to recognize same-sex marriages performed under the laws of other States.

COMMENT: There were three separate dissents filed, by Justices Roberts, Scalia and Alito, in portions of which Justice Thomas joined. Roberts, Scalia and Thomas did not believe that either the Second Circuit or the Supreme Court had jurisdiction to hear the case once the Department of Justice refused to enforce the law in court. Since the Government and Windsor were both asking, on appeal, for the prior decision to be affirmed, there was no Article III case or controversy, and in the words of Justice Scalia, "What, then, are we *doing* here?" Alito believed that BLAG had standing because the U.S. House of Representatives had suffered an injury by virtue of a law not being enforced. All the dissenters believed that that the Constitution neither permitted nor prohibited same-sex marriage.

Scalia's dissent was lengthy and particularly pointed. He criticized the majority opinion for what he considered a "scatter-shot" analysis that discussed federalism, "substantive" due process under the Fifth Amendment and equal protection in the context of demonizing the motives behind DOMA (". . . the real rationale of today's opinion, whatever disappearing trail of its legalistic argle-bargle one chooses to follow, is that DOMA is motivated by 'bare . . . desire to harm' couples in same-sex marriage."). He predicted that despite the majority's statement that its ruling was limited to Section 3 of DOMA, the majority's characterization of the motives behind DOMA would surely result in challenges to Section 2 of DOMA, regarding a State's refusal to recognize same-sex marriages performed under the laws of other States: "As far as this Court is concerned, no one should be fooled; it is just a matter of listening and waiting for the other shoe."

The other shoe is dropping rather quickly. In **Obergefell v. Whymslo**, 2010 U.S. Dist. LEXIS 156934 (S.D. Ohio, 2013), the question before the District Court was whether Ohio was required to recognize a valid out-of-state marriage between a same-sex couple for the purpose of listing a party to the marriage as a surviving spouse on an Ohio death certificate. The Ohio statutes were amended in 2004 to prohibit same-sex marriages in Ohio and to prohibit recognition of same-sex marriages from other states. Mr. Obergefell and his partner, John Arthur, were Ohio residents who had lived together for 20 years. Arthur was diagnosed with a terminal illness and after Windsor was decided the couple boarded a medically-equipped plane to travel to Maryland, where same-sex marriages were recognized. They were married in the plane as it sat on the tarmac in Maryland. After the couple returned to Ohio, the Ohio District Court granted declaratory and temporary relief, directing that after Arthur's death his death certificate should be issued showing Obergefell as his surviving spouse. When Arthur died Obergefell needed to obtain a permanent injunction to prevent the death certificate from being changed. The surviving spouse of another same-sex couple was also involved in the case. David Michener and William Herbert Ives were validly married in Delaware. When Ives died unexpectedly Michener sought a death certificate naming himself as the surviving spouse. In deciding the case on equal protection grounds, the Ohio Court applied the "heuristic" (to use Justice Alito's term in Windsor) of intermediate scrutiny, balancing the state interests advanced by the legislation and the extent to which they are served against the harm done to the affected group). The District Court found that the state interest in refusing to recognize a valid, out-of-state same-sex marriage was not sufficient to overcome the harm to the parties. The Court stated:

> Defendants advance a number of interests in support of Ohio's marriage recognition bans. (Doc. 56 at 33-40). Defendants cite "Ohioans' desire to retain the right to define marriage through the democratic process," "avoiding judicial intrusion upon a historically legislative function," "Ohio's interest in approaching social change with deliberation and due care," "the desire not to alter the definition of marriage without evaluating steps to safeguard the religious rights and beliefs of others," and "[p]reserving the traditional definition of marriage," although they raise these interests in the context of a rational basis equal protection analysis. (Id.)
>
> In the intermediate scrutiny context, however, these vague, speculative, and unsubstantiated state interests do not rise anywhere near the level necessary to counterbalance the specific, quantifiable, and particularized injuries evidenced here and suffered by same-sex couples when their existing legal marriages and the attendant protections and benefits are taken from them by the state.

In **Kitchen v. Herbert**, 2013 U.S. Dist. LEXIS 179331 (District Court, C.D. Utah, 2013), the District Court for the Central District of Utah held Utah's constitutional enactment (called "Amendment 3") banning same-sex marriage to be a violation of the Fourteenth Amendment. The Court framed the issue as follows:

> The Plaintiffs in this lawsuit are three gay and lesbian couples who wish to marry, but are currently unable to do so because the Utah Constitution prohibits same-sex marriage. The Plaintiffs argue that this prohibition infringes their rights to due process and equal protection under the Fourteenth Amendment of the United States Constitution. The State of Utah defends its laws and maintains that a state has the right to define marriage according to the judgment of its citizens. Both parties have submitted motions for summary judgment.
>
> The court agrees with Utah that regulation of marriage has traditionally been the province of the states, and remains so today. But any regulation adopted by a state, whether related to marriage or any other interest, must comply with the Constitution of the United States. The issue the court must address in this case is therefore not who should define marriage, but the narrow question of whether Utah's current definition of marriage is permissible under the Constitution.

The Court believed that the right to marry is a fundamental right but did not decide the case on the basis of strict scrutiny. Instead, the Court found that there was no rational basis for Utah's constitutional ban on same-sex marriage. Utah had advanced the following reasons for the legislation:

1. Promoting responsible procreation within marriage;
2. Promote optimal child-rearing;
3. Proceeding with caution;
4. Preserving tradition.

The District Court observed:

> In its briefing and at oral argument, the State was unable to articulate a specific connection between its prohibition of same-sex marriage and any of its stated legitimate interests. At most, the State asserted: "We just simply don't know." (Hr'g Tr., at 94, 97, Dec. 4, 2013, Dkt. 88.) This argument is not persuasive. The State's position appears to be based on an assumption that the availability of same-sex marriage will somehow cause opposite-sex couples to forego marriage. But the State has not presented any evidence that heterosexual individuals will be any less inclined to enter into an opposite-sex marriage simply because their gay and lesbian fellow citizens are able to enter into a same-sex union. Similarly, the State has not shown any effect of the availability of same-sex marriage on the number of children raised by either opposite-sex or same-sex partners.

> In contrast to the State's speculative concerns, the harm experienced by same-sex couples in Utah as a result of their inability to marry is undisputed. To apply the Supreme Court's reasoning in Windsor, Amendment 3 "tells those couples, and all the world, that their otherwise valid [relationships] are unworthy of [state] recognition. This places same-sex couples in an unstable position of being in a second-tier [relationship]. The differentiation demeans the couple, whose moral and sexual choices the Constitution protects." Windsor, 133 S. Ct. at 2694; see also id. at 2710 (Scalia, J., dissenting) (suggesting that the majority's reasoning could be applied to the state-law context in precisely this way). And while Amendment 3 does not offer any additional protection to children being raised by opposite-sex couples, it demeans the children of same-sex couples who are told that their families are less worthy of protection than other families.

In **Griego v. Oliver**, 2013 N. Mex. Lexis 414 (S.C. N. Mex., 2013) the New Mexico Supreme Court considered whether New Mexico laws, as a whole, prohibited same-sex marriage and, if so, whether such prohibition was unconstitutional. In New Mexico some county clerks were issuing marriage licenses to same-sex couples while others were not. The Court summarized its decision in the case as follows:

> We conclude that although none of New Mexico's marriage statutes specifically prohibit same-gender marriages, when read as a whole, the statutes have the effect of precluding same-gender couples from marrying and benefitting from the rights, protections, and responsibilities that flow from a civil marriage. Same-gender couples who wish to enter into a civil marriage with another person of their choice and to the exclusion of all others are similarly situated to opposite-gender couples who want to do the same, yet they are treated differently. Because same-gender couples (whether lesbian, gay, bisexual, or transgender, hereinafter "LGBT") are a discrete group which has been subjected to a history of discrimination and violence, and which has inadequate political power to protect itself from such treatment, the classification at issue must withstand intermediate scrutiny to be constitutional. Accordingly, New Mexico may neither constitutionally deny same-gender couples the right to marry nor deprive them of the rights, protections, and responsibilities of marriage laws, unless the proponents of the legislation—the opponents of same-gender marriage—prove that the discrimination caused by the legislation is "substantially related to an important government interest." Breen v. Carlsbad Mun. Sch., 2005-NMSC-028, ¶ 13, 138 N.M. 331, 120 P.3d 413 (internal quotation marks and citation omitted).
>
> The opponents of same-gender marriage assert that defining marriage to prohibit same-gender marriages is related to the important, overriding governmental interests of "responsible procreation and childrearing" and preventing the deinstitutionalization of marriage. However, the purported

> governmental interest of "responsible procreation and childrearing" is not reflected in the history of the development of New Mexico's marriage laws. Procreation has never been a condition of marriage under New Mexico law, as evidenced by the fact that the aged, the infertile, and those who choose not to have children are not precluded from marrying. In addition, New Mexico law recognizes the right of same-gender couples to raise children. NMSA 1978, § 32A-5-11 (1993) (recognizing parties who are eligible to adopt children); see also Chatterjee v. King, 2012-NMSC-019, ¶ 84, 280 P.3d 283 (Bosson , J., specially concurring) (recognizing the right of a former same-gender partner who supported both the child and her former partner to have standing to seek custody of the child). Finally, legislation must advance a state interest that is separate and apart from the classification itself. It is inappropriate to define the governmental interest as maintaining only opposite-gender marriages, just as it was inappropriate to define the governmental interest as maintaining same-race marriages in Loving. Therefore, the purported governmental interest of preventing the deinstitutionalization of marriage, which is nothing more than an argument to maintain only opposite-gender marriages, cannot be an important governmental interest under the Constitution.
>
> We conclude that the purpose of New Mexico marriage laws is to bring stability and order to the legal relationship of committed couples by defining their rights and responsibilities as to one another, their children if they choose to raise children together, and their property. Prohibiting same-gender marriages is not substantially related to the governmental interests advanced by the parties opposing same-gender marriage or to the purposes we have identified. Therefore, barring individuals from marrying and depriving them of the rights, protections, and responsibilities of civil marriage solely because of their sexual orientation violates the Equal Protection Clause under Article II, Section 18 of the New Mexico Constitution. We hold that the State of New Mexico is constitutionally required to allow same-gender couples to marry and must extend to them the rights, protections, and responsibilities that derive from civil marriage under New Mexico law.

COMMENT: On January 6, 2014, the United States Supreme Court stayed the District Court's decision in Kitchen pending the State of Utah's appeal to the 10th Circuit. 187 L. Ed. 2d 699 (2014).

See also **O'Connor v. Tobits**, 2013 U.S. Dist. Lexis 105507 (E.D. Pa., 2013), which considered whether a party to a same-sex marriage in Canada would be considered a "spouse" for purposes of claiming death benefits under an ERISA-controlled retirement plan. The dispute in O'Connor was between the decedent's surviving spouse, Jean Tobits, and the decedent's parents, David and Joan Farley. The couple was domiciled in Illinois and the decedent died before IIllinois enacted its civil union act. After Farley's death the Circuit Court of Cook County entered an order declaring Tobits as a party to a civil union and Farley's sole heir. The District Court concluded that under the ERISA plan Tobits was a surviving spouse. The case had been brought in Pennsylvania by the firm that maintained the ERISA plan because the firm was headquartered in Pennsylvania.

As of February, 2014, 17 states recognized same-sex marriage and 33 banned it. Of the 17 states recognizing same-sex marriage:

6 recognize it by court decision (not counting Utah):

> California (June 28, 2013), Connecticut (Nov. 12, 2008), Iowa (Apr. 24, 2009), Massachusetts (May 17, 2004), New Jersey (Oct. 21, 2013), and New Mexico (Dec. 19, 2013)

8 by state legislation:

> Delaware (July 1, 2013), Hawaii (Dec. 2, 2013), Illinois (law will take effect June 1, 2014), Minnesota (Aug. 1, 2013), New Hampshire (Jan. 1, 2010), New York (July 24, 2011), Rhode Island (Aug. 1, 2013), Vermont (Sep. 1, 2009);

and 3 by popular vote:

> Maine (Dec. 29, 2012), Maryland (Jan. 1, 2013), Washington (Dec. 9, 2012)

In addition, Washington, DC legalized same-sex marriage on Mar. 3, 2010. The remaining 33 states do not recognize same-sex marriage.

2. Rev. Rul. 2013-17. 2013 I.R.B. at 201 (August 29, 2013.

Following the Supreme Court's decision in Windsor, the Service issued Rev. Rul. 2013-17, which provides that for Federal tax purposes, the terms "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if they were lawfully married in a state whose laws authorize the marriage of two individuals of the same sex, and the term "marriage" includes such marriages of individuals of the same sex. The Service also determined to interpret the Code as incorporating a general rule, for Federal tax purposes, that recognizes the validity of a same-sex marriage that was valid in the state where it was entered into, regardless of the married couple's place of domicile. The Rev. Rul. Explained:

> Under this rule, individuals of the same sex will be considered to be lawfully married under the Code as long as they were married in a state whose laws authorize the marriage of two individuals of the same sex, even if they are domiciled in a state that does not recognize the validity of same-sex marriages. For over half a century, for Federal income tax purposes, the Service has recognized marriages based on the laws of the state in which they were entered into, without regard to subsequent changes in domicile, to achieve uniformity, stability, and efficiency in the application and administration of the Code. Given our increasingly mobile society, it is important to have a uniform rule of recognition that can be applied with certainty by the Service and taxpayers alike for all Federal tax purposes. Those overriding tax

administration policy goals generally apply with equal force in the context of same-sex marriages.

* * * * * * * * * * * * *

For Federal tax purposes, the term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law, and the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals who have entered into such a formal relationship. This conclusion applies regardless of whether individuals who have entered into such relationships are of the opposite sex or the same sex.

Windsor, declarative of existing law, implicates prior tax filings. Recognizing this, Rev. Rul. 2013-17 provides:

The holdings of this ruling will be applied prospectively as of September 16, 2013.

Except as provided below, affected taxpayers also may rely on this revenue ruling for the purpose of filing original returns, amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from these holdings, provided the applicable limitations period for filing such claim under section 6511 has not expired. If an affected taxpayer files an original return, amended return, adjusted return, or claim for credit or refund in reliance on this revenue ruling, all items required to be reported on the return or claim that are affected by the marital status of the taxpayer must be adjusted to be consistent with the marital status reported on the return or claim.

Taxpayers may rely (subject to the conditions in the preceding paragraph regarding the applicable limitations period and consistency within the return or claim) on this revenue ruling retroactively with respect to any employee benefit plan or arrangement or any benefit provided thereunder only for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under sections 106, 117 (d), 119, 129, or 132 based on an individual's marital status. For purposes of the preceding sentence, if an employee made a pre-tax salary-reduction election for health coverage under a section 125 cafeteria plan sponsored by an employer and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by that employer, an affected taxpayer may treat the amounts that were paid by the employee for the coverage of the same-sex spouse on an after-tax basis as pre-tax salary reduction amounts.

> The Service intends to issue further guidance on the retroactive application of the Supreme Court's opinion in Windsor to other employee benefits and employee benefit plans and arrangements. Such guidance will take into account the potential consequences of retroactive application to all taxpayers involved, including the plan sponsor, the plan or arrangement, employers, affected employees and beneficiaries. The Service anticipates that the future guidance will provide sufficient time for plan amendments and any necessary corrections so that the plan and benefits will retain favorable tax treatment for which they otherwise qualify.

COMMENT: Windsor raises issues of whether persons who were legally married can recover use of their gift tax exemptions for gifts made to the same-sex partner prior to federal recognition of the spouse. Rev. Rul. 76-451, 1976-2 C.B. 304, permitted a taxpayer who erroneously failed to claim a marital deduction for gifts in 1961-62 to recover a portion of the $30,000 specific exemption then in effect. In the facts of the Revenue Ruling the taxpayer had reported taxable gifts to his spouse and paid a gift tax; no recovery of a taxable gift was possible after the statute had run. After the unification of the gift and estate tax regimes in 1976, taxable gifts were sometimes revalued for purpose of computing the estate tax, but in 1997 the law changed, and Treas. Reg. § 25.2504-2(b) now provides as follows:

> (b) *Gifts made or section 2701(d) taxable events occurring after August 5, 1997.* If the time has expired under section 6501 within which a gift tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) on the transfer of property by gift made during a preceding calendar period, as defined in § 25.2502-1(c)(2), or with respect to an increase in taxable gifts required under section 2701(d) and § 25.2701-4, and the gift was made, or the section 2701(d) taxable event occurred, after August 5, 1997, the amount of the taxable gift or the amount of the increase in taxable gifts, for purposes of determining the correct amount of taxable gifts for the preceding calendar periods (as defined in § 25.2504-1(a)), is the amount that is finally determined for gift tax purposes (within the meaning of § 20.2001-1(c) of this chapter) ***and such amount may not be thereafter adjusted.*** The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift including valuation issues and legal issues involving the interpretation of the gift tax law. For purposes of determining if the time has expired within which a gift tax may be assessed, see § 301.6501(c)-1(e) and (f) of this chapter. [emphasis added].

In light of the Windsor decision, one might expect a constitutional challenge to the regulation as it applies to transfers between persons who were legally married at the time but not so recognized under the federal tax laws.

3. Notice 2013-61, 2013-44 I.R.B. at 432 (October 28, 2013).

The Service then published Notice 2013-61, to permit optional simplified methods for employers and employees to make claims for refund or adjustments of overpayments of Federal Insurance Contributions Act (FICA) taxes and Federal income tax withholding (employment taxes) with respect to certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses resulting from the decision in Windsor.

For overpayments of employment taxes for 2013 and prior years with respect to certain same-sex spouse benefits and certain remuneration paid to same-sex spouses, there are alternative special administrative procedures. Under the first alternative, employers may use the fourth quarter 2013 Form 941, Employer's Quarterly Federal Tax Return, to correct overpayments of employment taxes for the first three quarters of 2013. To have used this first alternative, the employer must have correct the overpayment for 2013 on or before December 31, 2013. Under the second alternative, employers may file one Form 941-X, Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund, for the fourth quarter of 2013 to correct the overpayments of FICA taxes for all quarters of 2013.

For overpayment of FICA taxes for years before 2013, employers can make a claim or adjustment for all four calendar quarters of a calendar year on one Form 941-X filed for the fourth quarter of such year if the period of limitations on refunds under section 6511 of the Internal Revenue Code (Code) has not expired and, in the case of adjustments, the period of limitations will not expire within 90 days of filing the adjusted return. Under normal procedures, employers are required to file a Form 941-X for each calendar quarter for which a refund claim or adjustment is made.

The special administrative procedures provided in the notice are optional. Employers that prefer to use the regular procedures for correcting employment tax overpayments related to same-sex spouse benefits and remuneration paid to same-sex spouses, instead of the special administrative procedures, may do so.

4. <u>Hollingsworth v. Perry</u>, 133 S. Ct. 2652 (2013).

<u>Hollingsworth</u> arose out of the California Supreme Court deciding that same sex couples had the right to marry under the California constitution. After the California Supreme Court holding, state voters passed a ballot initiative known as Proposition 8, amending the State Constitution to define marriage as a union between a man and a woman. The ballot passed, and two same-sex couples who wished to marry brought suit in Federal District Court challenging the law as a violation of due process and equal protection under the U.S. Constitution. The state officials refused to defend the case, although they continued to enforce the law throughout the litigation. The District Court allowed the proponents of the legislation to intervene in order to defend the ballot initiative; after a bench trial the District Court ruled that Proposition 8 was unconstitutional. The State of California did not appeal, but the intervenors did. The Ninth Circuit certified a question to the California Supreme Court as to whether the intervenors in this case had either a particularized interest in the validity of Proposition 8 or the authority to assert the State’s interest in its validity, which would enable them to defend its constitutionality upon its adoption, or appeal a judgment invalidating it, when the public officials charged with that duty refuse to do so. After the California Supreme Court answered "yes," the Ninth Circuit affirmed the District Court ruling. The appeal to the Supreme Court followed. Justice Roberts wrote

the opinion in a 5 - 4 decision. He summarized the majority's position in the case as follows:

> Federal courts have authority under the Constitution to answer such questions only if necessary to do so in the course of deciding an actual "case" or "controversy." As used in the Constitution, those words do not include every sort of dispute, but only those "historically viewed as capable of resolution through the judicial process." Flast v. Cohen, 392 U. S. 83, 95, 88 S. Ct. 1942, 20 L. Ed. 2d 947 (1968). This is an essential limit on our power: It ensures that we act as judges, and do not engage in policymaking properly left to elected representatives.
>
> For there to be such a case or controversy, it is not enough that the party invoking the power of the court have a keen interest in the issue. That party must also have "standing," which requires, among other things, that it have suffered a concrete and particularized injury. Because we find that petitioners do not have standing, we have no authority to decide this case on the merits, and neither did the Ninth Circuit.

The majority found that the intervenors suffered no personal injury, and that they were not agents of the state, either formally or under the general principles of agency law. Therefore, they could not represent the state in the litigation. The majority vacated the decision of the Ninth Circuit.

Justice Kennedy wrote the dissent. He believed that the California referendum process permitted private parties to represent the State under California law, and in this case it was clear that the California Supreme Court considered the intervenors to fill that role, even if there was no formal designation of agency. He stated:

> In the end, what the Court fails to grasp or accept is the basic premise of the initiative process. And it is this. The essence of democracy is that the right to make law rests in the people and flows to the government, not the other way around. Freedom resides first in the people without need of a grant from government. The California initiative process embodies these principles and has done so for over a century. "Through the structure of its government, and the character of those who exercise government authority, a State defines itself as sovereign." Gregory v. Ashcroft, 501 U. S. 452, 460, 111 S. Ct. 2395, 115 L. Ed. 2d 410 (1991). In California and the 26 other States that permit initiatives and popular referendums, the people have exercised their own inherent sovereign right to govern themselves. The Court today frustrates that choice by nullifying, for failure to comply with the Restatement of Agency, a State Supreme Court decision holding that state law authorizes an enacted initiative's proponents to defend the law if and when the State's usual legal advocates decline to do so. The Court's opinion fails to abide by precedent and misapplies basic principles of justiciability. Those errors necessitate this respectful dissent.

F. GST Rulings

1. PLR 201314017

The PLR concerned a rare situation involving 9100 relief in connection with the application of the GST transition rules to a person who was mentally incompetent on and at all times after October 22, 1986. Under Treas. Reg. §26.2601-1(b)(3)(i)(A), the generation-skipping tax does not apply to a GST transfer under a trust of a person who was mentally incompetent on and at all times after the effective date of the tax (October 22, 1986), ". . . to the extent such trust consists of property, the value of which was included in the gross estate of the individual (other than property transferred by or on behalf of an individual during the individual's life after October 22,1986); . . . ." Under Treas. Reg. §26.2601-1(b)(3)(iii), if there has not been a court adjudication that the decedent was mentally incompetent as of October 22, 1986, the executor must file, with the form 706, either a physician's certification that the person was mentally incompetent on and at all times after the effective date and did not regain sufficient competence to modify or revoke the terms of the person's estate planning instruments, or sufficient other evidence regarding the person's incompetence and an explanation of why no certificate is available from a physician. The PLR describes the facts as follows:

Under the facts of the ruling, the husband created a recvocable trust which he later amended prior to October 22, 1986. Husband later died. Upon Husband's death, his revocable trust funded a marital trust for for the lifetime benefit of his wife. The marital trust provided that, upon the death of the wife, the property in the trust would be distributed outright to the children of the husband and wife, subject to the exercise by wife of a power of appointment given to her over the trust. The wife in fact exercised her special power of appointment by will so as to create three equal generation-skipping trusts. In the ruling request the taxpayer represented that no additions were made to revocable trust from and after October 22, 1986.

No physician's certification was submitted with the husband's estate tax return. The ruling does not indicate when the husband died, or how many years intervened before the wife's death. One might surmise that the period was engthy. The co-executors of husband's estate asked for an extension of time to file one or more physician's certifications to establish the decedent's mental incompetency. Treas. Reg. § 301.9100-3 provides the standards used to determine whether to grant an extension of time to make an election whose date is prescribed by a regulation (and not expressly provided by statute). Requests for relief under § 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. Section 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election. The ruling does not state the circumstances of why no physician's statement was submitted, but ruled that on the basis of the facts submitted and representations made, relief would be granted. The co-executors were directed to attach the physician's certification to a supplemental estate tax return.

2. PLR 201320004

The ruling concerned the modification of an exempt, but not a grandfathered trust. Under the facts of the ruling beneficiaries of GST trusts who were entitled to net income wished to modify the trusts to provide that income could be paid or accumulated, but that any accumulated income would be segregated into a separate account and paid to the estate of the income beneficiary on her death. The GST portion of ruling serves as a reminder that although the grandfather rules for modifications to trusts do not apply to trusts made exempt by allocation, nevertheless the Service continues to analyze the effect of the modification under the same principles. The PLR states:

> No guidance has been issued concerning the modification of a trust that may affect the status of a trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.
>
> Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. Under the regulation, unless specifically provided otherwise, these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (unless specifically noted), the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of § 1001.
>
> Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.
>
> Section 26.2601-1(b)(4)(i)(D)(2) provides that a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an

irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification.

In this case, the proposed agreement to modify Trust provides that the trustees have no duty to distribute income annually to the primary beneficiary of each separate trust share but will have the discretion to pay or apply the income for the benefit of each beneficiary. In addition, the proposed agreement to modify Trust provides that any accumulated income not distributed prior to the death of the beneficiary will be paid and distributed to the estate of the deceased beneficiary. Accordingly, the accumulated income will be included in the beneficiary's gross estate for estate tax purposes and the beneficiary will be treated as the transferor of the accumulated income for GST tax purposes. The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, based upon the facts submitted and the representations made, we conclude that the proposed agreement to modify Trust pursuant to Court Order will not cause Trust, as modified, to lose its GST exempt status as a result of allocating Settlor's GST exemption to Trust.

3. PLR 201322025

This PLR involved a judicial construction of a document that was executed prior to the current version of the generation-skipping transfer tax but where the decedent died after the effective date. The document was drafted so as to take advantage of the $250,000 exclusion under the now repealed Section 2613(b)(6) for gifts to grandchildren. When the decedent died, the estate plan created several trusts, one of which was a marital trust for which QTIP was elected and the Section 2652(a)(3) "reverse election" was made for GST purposes to make it wholly exempt (the "Exempt Trust"). Under the terms of the decedent's estate plan, when the surviving spouse died, $250,000 would be placed into a trust for the son ("Son's Trust) and the balance would pass outright to the son. The decedent's will provided, however, that if an amount other than $250,000 was specified in Code Section 2613(b)(6) as then in effect, the amount so specified in the Code would be substituted.

After the surviving spouse died the trustees sought a judicial construction of the document. The trial court found that the decedent's reference to a repealed section of the Internal Revenue Code created an ambiguity, and construed the trust to find that the decedent had intended to take advantage of generation-skipping planning; therefore the full amount of the Exempt Trust (which was more than $250,000) should be allocated to the Son's Trust. The Son's Trust provided that income could be distributed to the son and his issue or accumulated during Son's lifetime, as the trustees deem wise. Trust principal could be distributed as the trustees (other than the son) deem wise to the son for purposes of purchasing a home, starting a business, or providing for emergency needs of the son or his issue. Upon Son's death, the principal and undistributed income then remaining in Son's Trust would be distributed to or for the benefit of the son's children as the son would appoint in his will, provided, however, that the son's power of appointment could be exercised only in such manner as to cause the trust property to be includible in the gross estates of one or more of the son's children.

The Service ruled that: (a) the distribution of the Exempt Trust assets to Son's Trust will not cause the inclusion ratio of that trust to be greater than zero under Code Section 2642; (b) the distribution of the Exempt Trust assets to the Son's Trust will not be deemed to be a transfer by the son that will be subject to federal gift tax under Code Section 2501; and (c) the distribution of the Exempt Trust assets to the Son's Trust will not cause any property of Exempt Trust or the son's trust to be includible in the son's estate under Code Sections 2036 or 2038.

4. PLR 201311004.

The ruling considered whether a distribution from a trust established by a non-resident alien, and a distribution from the NRA's estate, to a resident alien skip person would be subject to the generation-skipping tax. Under the facts of the ruling the property of the trust and estate were not U.S. situs property and were not subject to the U.S. gift or estate tax when the NRA established the trust or died. The Service ruled that the distribution was not subject to the generation-skipping tax:

> When Trust 1 and Trust 2 were established, Decedent was a citizen and resident of Country 1. For purposes of §§ 2511(a) and 2101, Decedent was a nonresident not a citizen of the United States. The residence and cash transferred to the trusts and the cash in the estate were not situated in the United States. Accordingly, the transfers to the trusts were not subject to the federal gift tax, and the residue of the estate was not subject to the federal estate tax. For purposes of the GST tax, Decedent was a NRA transferor with respect to these transfers. Further, Taxpayer is a skip person, as defined in §§ 2651(d) and 2613. However, under § 26.2663-2, the GST tax does not apply to taxable distributions or taxable terminations to the extent the initial transfer of property to the trust by a NRA transferor was not subject to the federal estate or gift tax. As noted above, the transfers to the trusts were not subject to federal gift tax and the residue of Decedent's estate was not subject to federal estate tax. Therefore, the distributions from the estate and terminating distributions from Trust 2 are not subject to GST tax. Accordingly, based on the facts submitted and the representations made, we conclude that the GST tax does not apply to the distributions received by Taxpayer from Trust 2 and Decedent's estate.

5. PLR 201345005

This PLR also concerned the modification of a grandfathered trust. Here a charitable lead trust provided that on termination of the lead interest would divide into separate trusts for the grantor's grandchildren on a *per capita* basis. The trust contained the following provision regarding adopted children:

> t]he terms "children" and "issue" as used in this Trust shall be construed to include an adopted child or children . . . , provided, however, that if any person adopts more than two (2) children who would qualify as "children" or "issue" as used herein, the adopted children of such person in excess of two (2) adopted children (in the order of date of adoption) shall not be construed to be "children" or "issue" as used herein.

The grantor had six children, one of whom simultaneously adopted his four step children. In order to avoid family controversy, the four adopted children entered into a written agreement that the two shares of the trust that the adopted children would be entitled to, if living upon termination of the trust, would be divided equally among all four of the adopted children who were living on termination, or their issue if deceased. The family submitted the matter to the local court, which approved the agreement subject to obtaining a favorable ruling on the tax issues.

Treas. Reg. §26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a *bona fide* controversy regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) the settlement is the product of arm's length negotiations, and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. The regulations further provide that a settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement within the range of reasonable outcomes. In ruling that the settlement would not affect the grandfathered status of the trust, the PLR stated:

> In this case, Trust was irrevocable on September 25, 1985, and the trustees have represented that there have been no additions to Trust after September 25, 1985. The factual situation presented, that is the simultaneous adoption of four children by Son, creates a *bona fide* issue regarding the administration of Trust and the construction of the terms of Trust. The Date 3 Agreement between Adopted Children and the subsequent Date 6 Court order resolve the issue. The Date 3 Agreement is a product of arm's length negotiations representing a compromise that reflects the parties' assessments of the relative strengths of the positions of the various parties, and is within the range of reasonable outcomes under the governing instrument and applicable state law. Based on the facts presented and the representations made, we conclude that the requirements of § 26.2601-1(b)(4)(i)(B) are satisfied and Trust will not lose its GST exempt status.

COMMENT: The settlement did not increase or decrease the amount of property passing to the adopting son's children; it simply allocated the same property four ways instead of two.

G. Creditors Rights and Asset Protection

1. In re Heffron-Clark, 714 F.3d 559 (7th Cir. 2013) (April 23, 2013).

In this case, the Seventh Circuit Court of Appeals ruled that a non-spousal inherited individual retirement account ("inherited IRA" for short) is not exempt from creditors' claims in bankruptcy.

The bankruptcy code exempts from creditor's claims any "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under sections 401, 403, 408, 408A, 414, 457, or 501(a) of the [Code]." The Court viewed this language as requiring both that the funds be (1) "retirement funds" and (2) exempt from taxation under the foregoing Code provisions.

With respect to spousal rollovers, the IRA remains a "retirement fund" because the surviving spouse's IRA is subject to the same restrictions placed upon the original owner, specifically that funds cannot be withdrawn before age 59½ without paying a penalty. However, as the court detailed, different rules govern inherited IRAs. For example, the inherited IRA cannot be combined with another IRA, no new contributions can be made to the account, and, importantly, instead of being dedicated to the beneficiary's retirement years, the inherited IRA must begin distributing its assets within one year of the original owner's death. Although the inherited IRA remains sheltered from taxation until funds are withdrawn, an inherited IRA is "not a place to hold wealth for use after the new owner's retirement."

The court held that the inherited IRA was not exempt from bankruptcy creditors. "To treat this account as exempt … would be to shelter from creditors a pot of money that can be freely used for current consumption." Although the money was "retirement funds" for the debtor's mother, it is no longer "retirement funds" in the hands of the daughter.

This decision creates a split in the circuits as to this issue. See Chilton v. Moser, 674 F.3d 486 (5th Cir. 2012), In re Nessa, 426 B.R. 312 (8th Cir. BAP 2010) and Mullen v. Hamlin, 465 B.R. 863 (9th Cir. BAP 2012), which held inherited IRAs to be exempt as retirement funds.

2. In re Donald G. Huber, 493 B.R. 798 (W. Dist. Wash., 2013) (May 17, 2013).

Mr. Huber was a real estate developer in the State of Washington. In the period of 2007-2009 his projects were beginning to run into the same problems that plagued most developers – declining values and cash flow issues – so Huber consulted with a Washington attorney about asset protection. He ended up with a self-settled asset protection trust that named the Alaska Trust Company as trustee and which provided that Alaska law would control. He transferred about 70% of his assets to the trust. The attorney who did the planning was a Washington attorney and all of the beneficiaries of the self-settled trust lived in Washington. Most of the assets transferred to the trust were equity interests in entities owning real estate assets in Washington. The Alaska Trust Company held a $10,000 CD in addition to these other interests.

After Huber filed for bankruptcy the bankruptcy trustee filed a motion for summary judgment to set aside the asset protection trust in favor of the creditors. The Bankruptcy Court granted the motion on three different grounds, any one of which was sufficient to set aside the transfers:

1. First, the Court found the transfers to the trust void as to creditors because they violated Washington's long-held state law rule not allowing self-settled trusts to avoid creditors' claims. To reach this conclusion, the court had to determine whether it would apply Alaska law, or Washington law, to the trust. Because choice of law here was a federal issue (Bankruptcy Court) the Court applied the rule of the 9th Circuit, which in turn followed the Restatement (Second), Section 270. Section 270 provides that an *inter vivos* trust of movables is valid if (a) the trust is valid under the local law of the state designated by the Settlor to govern the validity of the trust, provided that such state has a substantial relation to the trust and (b) the application of that state's law does not violate a strong public policy of the sates where the trust has its most significant relationship. The Court found that Alaska did not have a substantial relation to the trust, and also found that the self-settled nature of the trust violated a strong public policy of the State of Washington, embodied by a statute (RCW 19.36.020) that declared all conveyances made in trust for the use of the person making the same void as against existing or future creditors of the person.
2. Second, the court found that the transfers into trust should be avoided because of 11 U.S.C. 548(e)(1), the federal "fraudulent transfer" portion of the Bankruptcy Act. The well-worn "badges of fraud" (transfer when there is actual or threatened litigation; transfer of substantially all assets; insolvency or unmanageable indebtedness when the transfer is made; retention by transferor) were used to presume actual intent to hinder or defraud creditors. The debtor had no evidence of a legitimate supervening purpose for the transfers.
3. Finally, the court also found that the transfers could be voided because in violation of state fraudulent transfer laws. Again, the debtor had no evidence to overcome the "badges of fraud" that are contained within most fraudulent transfer statutes.

COMMENT: One could view this as a "bad facts" asset protection case, because Huber sought asset protections at a time when the real estate industry was tanking and he was unable to meet his obligations. But the analysis of the choice of law provisions could apply in any situation where the real contact with the asset protection trustee is minimal. In the course of its opinion, the Court stated: "The record indicates that AUSA did absolutely nothing to become involved with the preservation or protection of the Trust assets but merely acted as a straw man." Whether this minimal contact was because of the nature of the assets, or the nature of the trust itself, will be an interesting question going forward. At the 2014 Miami Institute, Jeffrey Pennell observed that virtually every case that concerns these arrangements winds up invalidating them or, as an extreme case illustrated by <u>FTC v. Affordable Media</u>, LLC, 179 F.3d 1228 (9th

Cir. 1999), finding settlors in contempt of court for failure to have assets in the Cook Islands repatriated even when they did not control the trustee.

H. Procedural Issues

1. Revenue Procedure 2014-18, 2014-7 I.R.B. at 513 (January 29, 2014)

The Revenue Procedure provides a simplified procedure for certain taxpayers to obtain 9100 relief for failure to have filed a timely estate tax return to elect portability.

Treas. Reg. §301.9100-3 provides the standards that apply to extensions of time to make an election when the due date is prescribed by a regulation or other regulatory guidance and not by statute. If an estate is not large enough to meet the filing requirements for an estate tax return, there is no statutory due date; instead, Treas. Reg. § 20.2010-2T(a), provides that such an estate filing a return to elect portability will be considered as having the same filing due date as an estate that meets the filing threshold. In these cases the executor who failed to timely file a return may seek an extension of time under § 301.9100-3 to elect portability.

In general, relief will be granted under 201.9100-3 if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. The Service has received many requests for 9100 relief, including relief in same-sex marriages after the Supreme Court's Windsor decision.

The simplified procedure applies only if:

1. The taxpayer is the executor (see § 20.2010-2T(6)) of the estate of a decedent who:
    a. has a surviving spouse;
    b. died after December 31, 2010, and on or before December 31, 2013; and
    c. was a citizen or resident of the United States on the date of death.
2. The taxpayer is not required to file an estate tax return under § 6018(a) (as determined based on the value of the gross estate and adjusted taxable gifts, without regard to § 20.2010-2T(a)(1));
3. The taxpayer did not file an estate tax return within the time prescribed by § 20.2010-2T(a)(1) for filing an estate tax return required to elect portability; and
4. The following requirements are satisfied:
    a. The person permitted to make the election on behalf of a decedent, pursuant to § 20.2010-2T(a)(6), must file a complete and properly-prepared Form 706 on or before December 31, 2014. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2T(a)(7).
    b. The person filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED

PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

.If it is determined that the requirements for granting relief, as provided in sections 3.01 and 4.01 of this revenue procedure, have been satisfied, the taxpayer will be deemed to meet the requirements for relief under § 301.9100-3 and relief is granted under the provisions of § 301.9100-3 to extend the time to elect portability under § 2010(c)(5)(A). Accordingly, for purposes of electing portability, the taxpayer's Form 706 will be considered to have been timely filed in accordance with § 20.2010-2T(a)(1). The taxpayer will receive an estate tax closing letter acknowledging receipt of the taxpayer's Form 706.

Taxpayers that are not eligible for relief under the revenue procedure, or are outside the scope of the revenue procedure because the decedent died after December 31, 2013, may request an extension of time to make the portability election by requesting a letter ruling under the provisions of § 301.9100-3.

The Revenue Procedure also states that to obtain a credit or refund of an overpayment of tax by reason of a portability election made pursuant to a grant of relief under the revenue procedure, the surviving spouse (or the executor of the estate of the surviving spouse) of the decedent must file a claim for credit or refund of tax before the expiration of the limitations period in § 6511(a) (generally within three years from the date of filing the tax return, or within two years from the date of payment of the tax, whichever period expires later).

2. **Syring v. United States, 2013 U.S. Dist. LEXIS 111712 (W. Dist. Wis.) (August 8, 2013).**

An estate was not entitled to an estate tax refund because its remittance to the IRS was a "payment" and not a "deposit," which caused the estate's claim to fall outside the three-year recovery period, the U.S. district court for the Western District of Wisconsin has held.

After the decedent's death, the estate's personal representative was advised by the accountant retained to complete the estate tax return to make a payment of $170,000 to the IRS prior to the due date of the return. The accountant surmised that the personal representative did not need to pay the full amount of the estimated estate tax prior to the deadline because the estate qualified to pay the estate tax over a period of 10 years (presumably under § 6166 but this is not stated). When the return was finally filed over three years after the extended deadline, it reported that no estate tax was due. Because the IRS had treated the remittance as a partial payment, not a deposit, and because the payment fell outside the three-year period of limitations, the estate's request for a refund was denied.

The court noted that when the estate's personal representative made the payment to the IRS, she failed to provide the IRS with a written statement designating the remittance as a deposit as required by Rev. Proc. 2005-18, 2005-1 CB 798 and Code Sec. 6603. Moreover, the personal representative neglected to provide an affidavit, declaration, or other testimony clarifying her intent to make a deposit when the payment was made. The court also observed that the accountant only requested an extension of time to file, but not to pay the estate tax. If he had intended that the remittance was to be treated as a deposit, the court found that he would have likely requested an extension of time to pay. Further, the accountant's recommendation to the representative that she make a partial payment of the federal estate tax due suggested that the remittance was not meant to be a deposit. In addition, the court determined that the representative's intent to stop interest and penalties did not exclude the possibility that she intended to make a tax payment when remitting the funds. Finally, when the IRS received the funds from the estate, it treated the funds as a payment pursuant to Rev. Proc. 2005-18.

I. Miscellaneous

Morse v. Kraft, 992 N.E.2d 1021 (S.C. MA, 2013), considered whether a trustee held a power to decant a trust when there was no express language permitting decanting. The Florida Supreme Court, in Phipps v. Palm Beach Trust Company, 196 So. 299 (1940), and the New Jersey Supreme Court, in Wiedenmayer v. Johnson, 106 N.J. Super. 161, 164-165, 254 A.2d 534 (App. Div.), *aff'd sub nom*. Wiedenmayer v. Villanueva, 55 N.J. 81, 259 A.2d 465 (1969) had found that broad discretionary language in a trust permitted the trustee's distribution in further trust.

In Morse the trusts in question were all exempt from the generation-skipping tax. The trustee wished to decant the trusts to allow the sons of the grantor -- who were all income beneficiaries -- to also serve as trustees under ascertainable standards for principal distributions. Treas. Reg. §26.2601-1(b)(4)(i)(A)(1) provides that a distribution of property from an exempt trust to a new trust will not cause the new trust to be subject to the GST tax if the terms of the new trust essentially do not extend the time the vesting of interests, and the distribution to the new trust is either authorized by the terms of the exempt trust, or by state law at the time the exempt trust became irrevocable, without the consent or approval of any beneficiary or court. In Morse the trustee petitioned the Court for a determination under the common law of Massachusetts, as applied to the specific language of the trusts, the trustee could make a distribution from the old trust to the new trust without the approval of any beneficiary or any court.

The language of the trust included the following:

> *Article III.B.* The Trustees shall pay to [the] child [for whose benefit a subtrust is held] from time to time such portion or portions of the net income and principal thereof as the Disinterested Trustee shall deem desirable for the benefit of such child. . . .
>
> *Article VI.A.* Whenever provision is made hereunder for payment of principal or income to a beneficiary, the same may instead be applied for his or her benefit. . . .
>
> *Article VII.* The Trustees shall have full power to take any steps and do any acts which they may deem necessary or proper in connection with the due care, management and disposition of the property and income of the trusts hereunder . . . in their discretion, without order or license of court.

Analyzing this language, the Court stated:

> We conclude that the terms of the 1982 Trust authorize the plaintiff to transfer property in the subtrusts to new subtrusts without the consent of the beneficiaries or a court. As did the trust in Wiedenmayer, supra, 9 arts. III and VI give the disinterested trustee discretion to distribute property directly to, or applied for the benefit of, the trust beneficiaries, limited only in that such distributions must be "for the benefit of" such beneficiaries. We regard this broad grant of almost unlimited discretion as evidence of the settlor's intent that the disinterested trustee has the authority to distribute assets in further trust for the beneficiaries' benefit. Such interpretation is in keeping with the reading of similar trust language in Phipps, *supra*, and Wiedenmayer, *supra,* and our comparable holding in Loring, supra, all of which preceded the drafting of the 1982 Trust. Indeed, the principal draftsman of the 1982 Trust stated in his affidavit that he intended the broad distribution authority to allow the disinterested trustee to distribute the income and principal of the 1982 Trust to another trust for the benefit of the beneficiaries. See Walker v. Walker, *supra* at 587-588 (evidence of intent from draftsman); Zeydel, *supra* at 289. Moreover, here, we have affirmative evidence of the settlor's intent that the terms of the 1982 Trust give the plaintiff decanting power in the form of affidavits from the settlor, draftsman, and trustee. See Restatement (Third) of Property: Wills and Other Donative Transfers § 10.2 comment g, at 285 (2003) (postexecution indications of donor intent). What is more, art. VII makes express that the trustee may exercise his "full power" and "discretion," "without order or license of court," and as we stated previously, the 1982 Trust expressly excludes beneficiaries from participation in distribution decisions. For these reasons, the terms of the 1982 Trust authorize distributions to the new trust for the benefit of the 1982 trust beneficiaries without the approval of any beneficiary or court. See 26 C.F.R. § 26.2601-1(b)(4)(i)(A)(1)(i) (2012). See also Walker v. Walker, supra at 588.

The Court noted that there is now increased awareness of decanting issues, and that many newly drafted trusts (including the new trusts in this case) expressly permit decanting. The Court observed:

> In light of the increased awareness, and indeed practice, of decanting, we expect that settlors in the future who wish to give trustees a decanting power will do so expressly. We will then consider whether the failure to expressly grant this power suggests an intent to preclude decanting.

SELECTED ILLINOIS DEVELOPMENTS

A. Legislation

The Religious Freedom and Marriage Fairness Act, P.A. 98-0597, takes effect on June 1, 2014. The new law recognizes same-sex marriages in Illinois, and also generally provides that a marriage, whether of the same sex or different sexes and providing that it is not a common law marriage, legally entered into in another jurisdiction, shall be recognized in Illinois as a marriage in accordance with the provisions of the Illinois Marriage and Dissolution of Marriage Act. A civil union, or a substantially similar legal relationship other than common law marriage, legally entered into in another jurisdiction, shall be recognized in Illinois as a civil union.

To what extent should estate planning documents conform to the definition of a "spouse" or provide benefits to a party to a civil union as if the party were a spouse. In the former case the federal estate tax marital deduction would apply; not so, however, in the case of a civil union.

In Illinois a definition of "spouse" that refers to state law will now include a same sex spouse. In older documents one may logically expect the filing of construction proceedings to determine whether a reference to a person's "spouse" was intended to include a same-sex spouse. More subtle issues will surely arise, such as a power of appointment exercisable in favor of a person's "spouse" where the law governing the construction of the document does not recognize same-sex marriage but the law where the holder of the power resides does. Although under Illinois law a party to a civil union has all the rights of a spouse, an estate planning instrument that does not define that person as a spouse for purposes of the documents may exclude the person from benefits. One definition of spouse, that would include parties to a civil union, is the following:

> The “spouse” of any person, other than me, means the individual (a) to whom such person is married and from whom such person is not legally separated on the date in question or (b) to whom such person was married and from whom such person was legally separated at such person’s earlier death whether or not he or she has remarried. The determination of whether a person is married shall be made under the laws of the jurisdiction in which the ceremony occurred. For purposes of the preceding sentence, parties to a civil union which is valid under the law of the jurisdiction in which the civil union was entered shall be treated as married.

B. Cases

<u>Linn v. Department of Revenue</u>, ___ Ill. App. 3d ___ (Fourth District, 2013). In <u>Linn</u> the Illinois Appellate Court for the Fourth District held that the United States constitution prevented the Illinois Department of Revenue from assessing Illinois income tax on a trust which met the definition of an Illinois resident trust but which no longer had significant connections with Illinois.

Section 1501(a)(20)(D) of the Illinois Income Tax Act defines an Illinois resident, in relevant part, as follows:

> (B) The estate of a decedent who at his or her death was domiciled in this State;

(C) A trust created by a will of a decedent who at his death was domiciled in this State; and,

(D) An irrevocable trust, the grantor of which was domiciled in this State at the time such trust became irrevocable. For purpose of this subparagraph, a trust shall be considered irrevocable to the extent that the grantor is not treated as the owner thereof under Sections 671 through 678 of the Internal Revenue Code.

The trust in Linn was one of 20 established in 1961 when the grantor was an Illinois resident. At the time the trust was established, the trustee was also an Illinois resident, and the trust assets were deposited in Illinois. The trust instrument provided that Illinois law would govern the validity, construction and administration of the trust. The beneficiary of the trust was a granddaughter of the grantor ("Linda").

The terms of the trust permitted the trustee to distribute the trust assets to a different trustee to hold in further trust for the benefit of the original beneficiary – what would now be called a decanting power. The original trustee in 1975 sought a court determination in Illinois that an appointment to trusts created by the beneficiaries themselves was a valid exercise of the power. In 1977 the Illinois court granted the relief requested, retaining jurisdiction of the cause and the parties for the purpose of paying the fees, costs and expenses of the proceedings and for any further orders necessary to interpret or implement the provisions of its order. In January, 2002 the successor trustees of the trust, who included two Illinois residents and one non-resident, exercised their limited power of appointment to distribute the trust assets to another trust ("Autonomy Trust 3" or "AT3") for the exclusive benefit of Linda, the beneficiary of the original trust.

AT3 was created by the trustees of the original trust, along with a trustee of AT3 who was a non-resident of Illinois. The terms of AT3 referenced the same measuring lives for the perpetuities savings clause as those contained in the original trust, but provided that the trust was to be construed and regulated under Texas law, except that under provision 15 the terms "income," "principal" and "power of appointment" and the provisions thereto would be interpreted under the laws of the state of Illinois. AT3 named a trust protector who was an Illinois resident, but he was replaced by December, 2002 with a Connecticut resident. In February, 2004, the trustee of AT3 filed a complaint in a Texas court to reform provision 15 of the trust to strike the language referring to Illinois law, leaving the trusts to be construed and regulated only by Texas law. In November, 2005, the Texas court entered an order granting the relief requested, but providing that the judgment would only become effective as of the date that the Internal Revenue Service would issue a favorable ruling holding that the modification and declarations of the judgment did not cause the trust to lose its GST grandfathered status. No such ruling was ever obtained. In 2006, none of Linda, her children, nor any other contingent beneficiaries of the AT3 were Illinois residents.

In April, 2007, AT3 filed a 2006 non-resident Illinois income tax and replacement tax return, reporting no income from Illinois sources and no tax owed. The Illinois Department of Revenue reclassified AT3 as an Illinois resident trust and assessed a deficiency liability. AT3 paid the tax under protest and filed a complaint for declaratory and injunctive relief, asserting that Illinois' imposition of income tax on AT3 violated the commerce, due process and equal protection clauses of the United States Constitution, and the uniformity clause of the Illinois Constitution of 1970. Each side filed a motion for summary judgment. The trial court held for the Department of Revenue, and the plaintiff appealed, relying on its constitutional arguments under the due process and commerce clauses.

The Appellate Court reversed, finding the imposition of the tax to be a violation of the due process clause of the U.S. Constitution. It did not rule on the commerce clause argument.

Quill Corp. v. North Dakota, 504 U.S. 298 (1992), held that for a tax to comply with the due process clause (1) a minimum connection must exist between the state and the person, property, or transaction it seeks to tax, and (2) the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state. Linn focused on the "minimum contacts" portion of the two-prong test. For the tax year in question the only contact that still existed with Illinois was that AT3 owed its existence to the original Illinois trust, and various terms in provision 15 of AT3 continued to be interpreted under Illinois law, since a GST ruling had never been obtained.

Both parties cited the Connecticut Supreme Court case <u>Chase Manhattan Bank v. Gavin</u>, 733 A.2d 782 (Conn., 1999), which considered four testamentary trusts and one inter-vivos trust. Connecticut's tax statute was slightly different from that of Illinois law. In Connecticut a resident inter-vivos trust was a trust, or a portion of a trust, consisting of property of a person who was a resident of Connecticut at the time the property was transferred to the trust if the trust was then irrevocable. However, the income of a resident trust was modifiable under a formula that took into account whether the trust had any resident, noncontingent beneficiaries. In short, the taxability of an inter-vivos trust in Connecticut was based on the facts of the grantor being a resident when the trust became irrevocable and the residency of a noncontingent beneficiary. Connecticut law protected the rights of the noncontingent beneficiary so long as the beneficiary remained a resident of the state. This connection was sufficient to satisfy due process for the inter-vivos trust.

In <u>Linn</u> there was no beneficiary who was an Illinois resident, and therefore the holding in <u>Gavin</u> was distinguishable. In holding for the trust, the Fourth District stated:

> Defendants begin their argument the Autonomy Trust 3 owes its existence to Illinois by noting the trust's grantor was an Illinois resident. In support of that argument, they cite portions of the <u>Gavin</u> opinion that found the grantor's in-state residency was sufficient to establish a minimum contact as to the four testamentary trusts as well as other case law addressing testamentary trusts. However, we are dealing with an inter vivos trust. Since an inter vivos trust is not created by the probate of the decedent's will in a state court, its connection with the state has been described as more attenuated than a testamentary trust. <u>Gavin</u>, 733 A.2d at 802; <u>District of Columbia v. Chase Manhattan Bank</u>, 689 A.2d 539, 547 n.11 (D.C. 1997). Moreover, an irrevocable inter vivos trust does not owe its existence to the laws and courts of the state of the grantor in the same way a testamentary trust does and thus does not have the same permanent tie. District of Columbia, 689 A.2d at 547 n.11. With the inter vivos trust, the Connecticut Supreme Court found the critical link between the state and the inter vivos trust was the trust's noncontingent beneficiary was a Connecticut resident during the tax year in question. <u>Gavin</u>, 733 A.2d at 802. Autonomy Trust 3 does not have a noncontingent beneficiary in Illinois. Defendants cite no cases finding a

grantor's in-state residency is a sufficient connection for due process with an inter vivos trust.

On the other hand, we note decisions from other states have found the grantor's in-state residence insufficient to establish a minimum connection. In Blue v. Department of Treasury, 462 N.W.2d 762, 764 (Mich. Ct. App. 1990), the Michigan appellate court found insufficient connections between an inter vivos trust whose grantor was a Michigan resident and the State of Michigan's imposition of an income tax. There, the only thing in Michigan was one non-income-producing parcel of real estate, and thus the court concluded Michigan provided no ongoing protection or benefit to the trust. Blue, 462 N.W.2d at 764. In Mercantile-Safe Deposit & Trust Co. v. Murphy, 242 N.Y.S.2d 26, 28 (N.Y. App. Div. 1963), a New York appellate court found a due process violation where New York imposed an income tax on income accumulated in a trust created by a New York resident where the trustee resided in Maryland, the trust was administered in Maryland, and trust assets were in the trustee's exclusive possession and control in Maryland. Accordingly, we find the fact the Autonomy Trust 3's grantor was an Illinois resident is not a sufficient connection to satisfy due process.

Defendants further argue the Autonomy Trust 3 exists only because of Illinois law. However, Autonomy Trust 3 resulted from a January 2002 exercise of the limited power of appointment by the trustee of the P.G. Linda Trust, which was provided for in the March 1961 trust agreement. Assuming arguendo, an Illinois court ruling validated a provision of the March 1961 agreement that allowed for the limited power of appointment that was later invoked to create the Autonomy Trust 3, the Autonomy Trust 3 was created by the provisions of the March 1961 agreement allowing for powers of appointment and not Illinois law. Further, with income taxation, the focus of the due process analysis is on the tax year in question, which would be 2006 in this case. See Gavin, 733 A.2d at 802 (noting the connection for the inter vivos trust was the fact a noncontingent beneficiary was an in-state resident during the tax year in question); see also In re Swift, 727 S.W.2d 880, 882 (Mo. 1987) (addressing income taxation on a testamentary trust and stating, "An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period"). Thus, what happened historically with the trust in Illinois courts and under Illinois law has no bearing on the 2006 tax year.

Additionally, defendants argue the State of Illinois provides the trustee and beneficiary of the Autonomy Trust 3 with a panoply of legal benefits and opportunities. In support of its assertion, it again cites case law addressing testamentary trusts. See Gavin, 733 A.2d at 799; District of Columbia, 689 A.2d at 544. As we have stated, this case involves an inter vivos trust, not a testamentary trust. The Autonomy Trust 3 was not in existence when A.N. Pritzker died and thus was not part of his probate case. Accordingly, no Illinois probate court has jurisdiction over the Autonomy Trust 3, unlike in the testamentary trust cases.

Defendants also cite several Illinois statutory provisions and claim the Autonomy Trust 3, plaintiff, Linda, or a contingent beneficiary can seek

> those statutory provisions at any time. However, the parties agree that, after the November 2005 Texas reformation order, the Autonomy Trust 3 choice of law provision provided for only the application of Texas law. Further, as stated earlier, the 1977 Cook County case has no application at all to the Autonomy Trust 3 because it dealt with beneficiary powers of appointment, not trustee powers of appointment in the March 1961 trust agreement. Accordingly, we find the Autonomy Trust 3 receives the benefits and protections of Texas law, not Illinois law.
>
> Last, we note the company in Quill Corp. mailed catalogs into North Dakota, seeking business there. Quill Corp., 504 U.S. at 302. Here, in 2006, the Autonomy Trust 3 had nothing in and sought noting from Illinois. As plaintiff notes, all of the trust's business was conducted in Texas; the trustee, protector, and the noncontingent beneficiary resided outside Illinois; and none of the trust's property was in Illinois. Moreover, the Autonomy Trust 3 meets none of the following factors that would give Illinois personal jurisdiction over the trust in a litigation: "the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted." Sullivan v. Kodsi, 359 Ill. App. 3d 1005, 1011, 836 N.E.2d 125, 131 (2005) (citing People v. First National Bank of Chicago, 364 Ill. 262, 268, 4 N.E.2d 378, 380 (1936)). Accordingly, we find insufficient contacts exist between Illinois and the Autonomy Trust 3 to satisfy the due process clause, and thus the income tax imposed on the Autonomy Trust 3 for the tax year 2006 was unconstitutional. Thus, summary judgment should have been granted in plaintiff's favor. Since we have found the income taxation of the Autonomy Trust 3 in 2006.violates the due process clause, we do not address plaintiff's commerce clause argument.

See also **McNeil v. Commonwealth, 67 A.3d 185 (Commonwealth Court, PA, 2013)** in which an intermediate court of appeals in Pennsylvania ruled the imposition of the Pennsylvania income tax ("PIT") on two trusts to be unconstitutional as a violation of the commerce clause of the U.S. Constitution. The two trusts had been created inter vivos is 1959 by a Pennsylvania resident; however, the trusts were established under Delaware law with a Delaware trustee; they were administered in Delaware, and during the tax year in question (2007), the trusts had no Pennsylvania-source income. The beneficiaries of the trusts, who were discretionary beneficiaries, were Pennsylvania residents. Pennsylvania's income tax law, similar to that of Illinois, taxes "resident" trusts and defines those trusts to include inter-vivos trusts created by a settlor who was a resident of the state.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) established a four prong test to determine whether a state tax withstands constitutional scrutiny. Those four prongs, all of which must be satisfied for the tax to be constitutional, are: (1) the taxpayer must have a substantial nexus to the taxing jurisdiction; (2) the tax must be fairly apportioned; (3) the tax being imposed upon the taxpayer must be fairly related to the benefits being conferred by the taxing jurisdiction; and (4) the tax may not discriminate against interstate commerce. In McNeil the Pennsylvania Commonwealth Court ruled that the tax failed to satisfy prongs (1), (2), and (3). Specifically, the Court found that residency of the beneficiaries to be irrelevant to the nexus between Pennsylvania and the trust, and the bare fact of the settlor's residency to be insubstantial. The tax was not "fairly apportioned" because there was no Pennsylvania income, and the tax was not fairly related to any benefits conferred by the state. On this last point the Court stated:

> . . . the Trusts do not benefit from Pennsylvania's roadways, bridges, police, fire protection, economic markets, access to its trained workforce, courts, and laws. We recognize that the Trusts' discretionary beneficiaries almost certainly benefit from Pennsylvania's societal and legal framework because they reside in Pennsylvania; however, they are not the taxpayer in this matter and, importantly, as discretionary beneficiaries, they have no present or future right to distributions from the Trusts. Moreover, pursuant to Sections 302 and 305 the Tax Code, 72 P.S. §§ 7302 and 7305, the beneficiaries will pay PIT on any distributions they do receive from the Trusts, which are fairly related to the benefits they receive from residing in Pennsylvania. Similarly, Settlor, who was deceased in TY 2007, is not the taxpayer in this matter.