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President’s Message

by Judith W. McCue
Chicago, Illinois

The 2005 ACTEC Summer Meeting was a rousing success. A record number of Fellows and guests (527 Fellows and 250 spouses and other guests) attended. Despite what was sometimes swelteringly hot weather, my adopted hometown, the city of Chicago, proved to be a welcoming venue in which to hold a meeting. The professional program was both informative and entertaining, the committee meetings were up to their usual high level of excellence, the tours showed Chicago for the sophisticated art-filled city that it is, and the parties were lots of fun.

At the committee meetings, I was reminded of the exceptional work that our committees do for our Fellows and for the College generally. Included among the highlights of the committee meetings were the following:

1. Estate and Gift Tax Committee: The Committee had lively and informative discussions of a number of topics, including recent developments in valuation, special valuation and Section 2036 cases, led by Mil Hatcher.


3. Practice Committee: Nate Chace led a roundtable discussion regarding file and document retention policies.

4. Elder Law Committee: Dr. John Lantos of the University of Chicago discussed medical issues of which lawyers should be aware in preparing health care powers of attorney and other health care proxy documents.

5. Business Planning Committee: The committee considered the final report of the Sample LLC Operating Agreement Subcommittee.

6. Technology Committee: Mark Gillett demonstrated his new software product, Gillett Estate Management Suite.

7. State Laws Committee: Jack Terrill gave a presentation on asset protection trusts.

8. Employee Benefits Committee: The committee enjoyed a presentation of case studies entitled: “Can This IRA Be Saved?: Consideration of Planning Stage or Clean Up Stage Problems Involving Employee Benefits.”

9. Professional Responsibility Committee: Hugh Kendall made a presentation on the ethical and practical implications of a lawyer or law firm providing ancillary business services.

10. Legal Education Committee: Gerry LeVan addressed the committee on the application of collaborative law to the trusts and estates practice.

Every committee affected by Circular 230 devoted a significant amount of time to consideration of the implications of the new rules that had just become effective in the week preceding the start of the meeting. These discussions helped provide the Fellows with the framework they need in order to negotiate the maze of new regulations.

The committee meetings proved the point that I often have made, which is that ACTEC committees provide the best possible CLE opportunities on a regular basis. In addition, I am constantly impressed by the collegial nature with which our Fellows, who might vigorously disagree with one another on a significant matter, express their disagreements at committee meetings. Intellectual muscle flexing is kept to a minimum; the spirit of sharing information with respected colleagues prevails. I am particularly proud of this.

In addition to keeping us up to date on pending developments, our committees produce extraordinary written work product. The document published in the summer 2005 edition of this journal, “What It Means to Be a Trustee: A Guide For Clients” (the “Guide”), was prepared by the Fiduciary Matters Subcommittee of the Practice Committee. The Guide, which complements an earlier publication of the Practice Committee (“A Guide for ACTEC Fellows Serving as Trustees”) is an exceptional resource for us and for our clients and I commend it to you for reading and for use in your practices.

The Guide can be easily accessed through the private side of the ACTEC website (www.actec.org/private). Once at the site, click on “Committees, Boards, etc.”, then on “Substantive Committees”; then click on the Practice Committee link, and locate “Committee Projects”; you will find both Word and PDF versions there. Because the Guide contains tax advice, some Fellows are concerned that any distribution of the Guide to clients should be accompanied by a Circular 230 marketed opinion banner in order to avoid possible violation of Circular 230. Others believe, based on recent announcements made by representative of Treasury and the Service, that Circular 230 was not intended to reach educational materials such as the Guide and that they intend to issue fur-
ther guidance to this effect. Although these announce-
ments are heartening, they do not rise to the level of of-
official policy. While we are waiting for such guidance, Fel-

ows should consider attaching an appropriate Circular 230 banner to any copy of the Guide that they distribute. Further developments in this regard, in the form of 
hoped-for guidance, will, no doubt, be reported on the 
ACTEC-PRAC listserv, as soon as they happen.

Another ground-breaking product of the ACTEC com-
mittee structure is the volume entitled ACTEC Com-
mentaries on the Model Rules of Professional Conduct. 

Authored by ACTEC’s Professional Responsibility Com-
mittee, the Commentaries (the publication of which is 
supported by the ACTEC Foundation) and accompanying 
annotations have provided an invaluable tool for ACTEC 
Fellows grappling with issues regarding the professional 
responsibility of the trusts and estates lawyer. The Com-
mentaries also have been a leading resource for courts 
and ethics committees as well as a teaching tool for those 
studying ethics issues affecting our practice. The Profes-
sional Responsibility Committee recently completed, and 
the Regents approved at their meeting in Pittsburgh last 
fall, the fourth edition of the Commentaries. This 
document will be published shortly; a copy will be sent free of 
charge to each ACTEC Fellow and will be made available 
to its national audience. Special thanks are due to Cynda 
Ottaway, Chair of the Professional Responsibility Com-
mittee, and to Charles Bennett, who acted as co-reporters 
for the fourth edition of the Commentaries, and to Bruce 
Ross, who has overseen each edition since the Comment-
aries first were published in 1993.

For those readers who have not yet decided whether 
to register for the fall meeting at Amelia Island Plantation 
(October 20-24, 2005), I hope that I can persuade you to 
attend. The Plantation is a special place for me and my 
family, as we have spent many happy holidays there. 
However, my planning visits to the Plantation increased 
my appreciation for what a wonderful place it is. The 
resort is family friendly, with a myriad of activities for 
Fellows and guests of all ages. I believe you will discover 
, in addition, that the accommodations are fine values. 
In particular, I encourage those of you traveling with fam-
ilies to inquire about the larger accommodations that the 
Plantation has made available. While not immediately 
adjacent to the Inn and the Conference Center, these spa-
cious villas can make travel with children and grandchil-
dren both comfortable and inexpensive; transportation to 
the Inn and Conference Center is provided by the Plant-
tion’s continuously running trams.

The professional program, which will be held on Fri-
day and Saturday mornings, looks dazzling, and includes 
the following topics:

Friday Morning, October 21
1. “Everything I Wish I Had Known about Financial 
   Instruments When I Was in Private Practice,” with 
   James B. Ellis and George F. Albright.
2. “The Use of Intra-Family Derivatives,” with S. Stacy 
   Eastland and Carlyn S. McCaffrey.
3. “Investment of Retirement Funds for Professionals,”
   with Michael Rose and Allan Rudnick presenting and 
   James M. (“Mack”) Trapp moderating.

Saturday Morning, October 22
   with Henry Christensen, III, and Juan Manuel Pri-
eto.
2. “File Retention and Disposition Policies,” with Jef-
   frey W. Jones and Dominic J. Campisi.
3. “Asset Protection Planning without Asset Protection 
   Trusts,” with Duncan Elliott Osborne and John A. 
   (“Jack”) Terrill, II.

We are likely to have additional developments on the 
Circular 230 front, and it appears increasingly likely that 
we will have significant transfer tax changes to discuss. 
Danny Markstein and the other members of the Program 
Committee are poised and ready with headline speakers 
to address additional matters should particularly “hot” 
topics emerge before the meeting.

When you review the list of topics and speakers for 
the professional program, you will note that two of the 
topics (document retention policies and asset protection) 
originated at the summer committee meetings. If I have 
not already convinced you of the benefits of attending 
committee meetings, I hope that this fact will prove per-
suasive.

Included in this issue of ACTEC Journal is a form 
that will permit you to request appointment to a commit-
tee for the next ACTEC year, or to be reappointed to a 
committee upon which you already serve. I encourage 
you promptly to complete the form and to return it to the 
ACTEC office, so that your wishes in this regard can be 
made known to President-Elect Bruce Ross, who will 
make appointments to committees later this year.

Finally, as I write, just six days after Hurricane Katri-
na devastated parts of Louisiana, Alabama and Mississip-
pi, I consider how the problems of most Fellows who do 
not live in the areas affected seem quite small. We send 
condolences to those who have lost loved ones and who 
have, as a result, been most deeply touched by this 
tragedy. We worry about our colleagues who have no 
access to critical client records and basic communica-
tions, whose court houses are under water, whose possess-
sions are inaccessible and quite possibly destroyed, and 
whose lives have been turned upside down for the fore-
seeable future. Our thoughts are with our Fellows who 
are suffering in Katrina’s wake, their families and other 
loved ones, and their neighbors, and we wish them 
 speedy relief.
Editor’s Page

by Charles D. Fox, IV
Charlottesville, Virginia

Susan Bart’s and my goal is to provide articles that will assist Fellows in their practice. The articles in this issue should do that. First, Wendy Goffe provides a comprehensive overview of the issues involved in keeping a family home in the family. As she points out, a summer house or other family home might contribute either to family solidarity or to family disharmony. This is an issue that we all face from time to time and finding a solution is never easy.

Ed Moses, Clay Singleton and Stewart Marshall complete their excellent series of four articles on modern portfolio theory. In their concluding article, Ed, Clay and Stewart discuss determining the appropriate withdrawal rate when comparing a total return trust to a principal and income trust. David Pratt shares his analysis of completing the new gift tax return and how to opt out or in of the rules on mandatory allocation of GST exemption to lifetime transfers.

Mary Ann Mancini provides a very good discussion of the recent Chawla case in which the United States District Court for the Eastern District of Virginia, applying Maryland law, granted a motion for summary judgment which may call into question the ability of trusts to procure insurance on an individual’s life. Her article also addresses dealing with the long-held concern of many estate planning attorneys about how the laws of some states do not include a trust as a type of entity that has an insurable interest in an insured’s life.

Layne T. Smith, of the J. Reuben Clark Law School, Brigham Young University, Provo, Utah, was the winner of the Second Annual Mary Moers Wenig Student Writing Competition. In his article, Layne discusses the bona fide sale exception under Section 2036(a) for family limited partnerships and limited liability companies. Conrad Teitell gives a timely synopsis of the steps that should be taken in doing year-end planning for charitable giving. Mil Hatcher has also graciously provided his report on the Fifth Circuit’s July 15, 2005 decision in Strangi.

We hope that you enjoy and benefit from these articles.

Last month, the Editorial Board announced that each Fellow for whom the college had an e-mail address (which is about 90% of the Fellows) would receive his or her copy of the Journal electronically as soon as it was ready for publication. The electronic delivery of the summer edition was a great success and provided two advantages to users. These were the delivery of the Journal several weeks earlier than the printed version and the ability to download particular articles and features. Fellows can opt out of receiving the printed edition by sending an e-mail to webmaster@actec.org. Fellows can also opt out of receiving the e-mail edition by sending an e-mail to webmaster@actec.org. In addition, the entire Journal will be made available on the ACTEC website a few weeks in advance of the mailing of the printed version. Prior to that, selected articles and columns will continue to be placed on the website as they are ready. Many Fellows find the articles on the website a useful and valuable resource since the website version contains html links to the sources cited in each article.

We would appreciate any comments that Fellows have on the electronic delivery of the Journal and ways in which it could be improved. These comments can be sent to webmaster@actec.org.

In addition, we would welcome articles and ideas for articles from Fellows. The Journal is your journal and we want to make it as useful and productive a resource for you as possible.
I. INTRODUCTION

With all the current attention being given to family dissolution, institutions, which promote family solidarity over the generations, are usually ignored by the media and researchers. A summer house may contribute to either outcome: if the heirs disagree over their inheritance and its use, the fighting may lead them to sell it and never speak to each other again. Thereby they earn the fate to which Dante consigned traitors to kindred in The Inferno: two brothers who killed one another over their inheritance ended up entwined together in an icy eternity of hatred in the lowest, most frozen level of Hell. However, if the founders and their heirs use the summerhouse wisely, it serves as the sacred hearth for all, to which they return for personal and familial renewal....

Why do some family homes serve as a magnet that pulls the family together, and others become the family battleground, literally and figuratively? The answers to these questions are both sociological and legal. While the sociological component is fascinating and important to understand, it is beyond the scope of this paper. This paper will focus mainly on the equally important legal component of how families succeed in passing on ownership of a cabin from one generation to the next. Note the term “cabin” is used herein collectively to refer to second homes of all shapes, sizes, styles, and fair market values.

One reason that the transfer of the cabin is more emotionally loaded than other property transfers between family members is that it typically involves a property with multiple uses, often located in environmentally pristine areas, and tends to embody the family’s values and sense of identity. Cabins are frequently located in desirable areas where the property values have increased at a rate far beyond the family’s other assets. Cabins also represent a large percentage of a
family’s financial holdings, posing unique estate tax and liquidity issues for the senior generation. For the junior generation, keeping a cabin in the family poses financial issues, and brings with it the challenge of reaching a consensus among family members as to how to deal with this property—whether wanted, or in some cases, not wanted.

The legal mechanism for transferring the property is only the first of many challenges. Following the transfer, the next generation must determine how it will be maintained, how taxes, insurance, and maintenance will be paid for, and how its use will be divided among the family members, to name only a few of the issues that may arise.

This article will outline some of the estate planning tools for transferring these properties, followed by a brief discussion of some unusual transfer issues: cabins in British Columbia and cabins on public land. However, transferring the property is relatively easy, compared to maintaining harmony among its owners following the transfer. Methods of management and organization to accomplish this more daunting task are also discussed below.

II. CREATING A MASTER PLAN

Before a plan to transfer the family cabin to the next generation can be implemented, the family needs to reach a consensus as to what will be done with it. A plan imposed by a senior generation upon the junior generation is almost doomed to fail. The most successful plans involve detailed and thoughtful advanced planning involving both generations.1

Once the family members are informed of the various options (which may include identifying portions to be set aside for conservation purposes, identifying portions that could be sold to raise capital to support the remaining property, and determining which portions are to be transferred to succeeding generations), the first step in creating a master plan is to have each family member interviewed. Ideally, a neutral facilitator or mediator trained in this style of communication would do this. The use of a mediator or other trained neutral party can be invaluable in developing a master plan.2

The interview process is an opportunity for each family member to freely express his or her wishes and apprehensions with respect to the property. Not all family members need to participate in the interview process, but all should be given the opportunity.

The neutral party could then prepare a report summarizing his or her findings, identifying areas of consensus, if any, and pointing out areas where feelings and opinions diverge. This report can be shared by the family, and used by the members of the senior generation and their legal counsel to begin to develop a master plan.

In some cases, the family members are able to make decisions with respect to the property jointly. Ideally, a series of family meetings would be held by a facilitator to resolve areas of dispute, further define areas of agreement, and continue building a consensus. This process is especially useful where the senior generation has already ceded control of the property to the next generation, and questions and issues concerning actual management have arisen.

Of course, the use of a facilitator in estate planning is not going to be accepted by all clients. It is understandably difficult to impress upon clients the value that could be added by employing a facilitator to guide this process. At a minimum, the lawyer could offer to distribute a survey to family members that they could respond to anonymously, in order to give the senior generation insight into the wishes and apprehensions of the next generation. As a result of the facilitator’s work or the lawyer’s survey, the senior generation may discover that some or all of the members of the younger generation honestly have no interest in retaining the cabin. They also may be able to determine the apprehensions of those who do want to retain the cabin, and resolve those issues before the cabin becomes a battleground.

Often, the next step in developing a master plan is the creation of a mission statement to address the family’s goals and values with respect to the cabin. Issues to address in the mission statement could include: (1) What is most important to the family about the cabin; (2) What does the family value most about how it uses the cabin; and (3) How would the family like to see the ownership of the cabin affect the ways the various members interact.

It may be the case that rather than transferring all of the property to the next generation as part of the master plan, the property may need to be divided into separate portions, each to be dealt with differently. The different uses may include: (1) development, (2) conservation, and (3) residential use. There are estate planning techniques to accomplish each of these objectives, which are discussed below.

1 See James S. Sligar, “Estate Planning for Major Family Real Estate Holdings,” 133 Trusts & Estates 148 (Dec. 1994) for a comprehensive discussion of master plans.
III. DEVELOPMENT OF PROPERTY

As part of the master plan, the family may decide to sell some of the property to raise funds to maintain what is remaining, and/or to reduce the ongoing costs of maintaining the property. The proceeds can be set aside in a trust, or transferred with the cabin into any of the entities discussed in Section V below, for ongoing management of the cabin.

IV. CONSERVATION AND PRESERVING OPEN SPACE

Frequently, families determine that certain portions of their land should be preserved as open space, and may choose to restrict development or other uses. There are several ways this can be accomplished, described below.


One common way to restrict development is with a conservation easement. A conservation easement is a permanent restriction on the use of privately owned land that promotes land conservation by preventing most types of land development.5 The Internal Revenue Code permits income and gift or estate tax deductions for a grant of a conservation easement over certain real property.6 The Treasury Regulations set forth detailed requirements for deductibility.7 Typically, a conservation easement reduces the value of the underlying property, thus reducing transfer tax costs.

There is a three-prong test to determine whether a gift is a qualified conservation contribution (i.e., qualifies as a conservation easement):

i. The property contributed must be a “qualified real property interest.” In other words, it must be a perpetual interest in land.8

ii. The property must be donated to a “qualified organization” that will enforce the easement and has a commitment to protecting the conservation purposes of the donation.9

iii. The gift must be exclusively for “conservation purposes,”10 which means that it must satisfy one or more of the following three purposes:

1. Preservation of land areas for recreation or education of the general public;

2. Preservation of a natural habitat of fish, wildlife or plants; and/or

3. Preservation of open space, including farmland and forestland, for the scenic enjoyment of the public, or pursuant to a clearly delineated federal, state or local conservation policy that will yield a “significant public benefit.”

Few families want to open up their land for use by non-family members. So, preservation of a natural habitat and preservation of open space are more likely to be useful conservation purposes than preservation of land for use by the general public.

A family may want to convey a conservation easement, yet retain certain development rights over the property. There are two ways of accomplishing this: The “reservation method” and the “carve-out method.” The reservation method permits the grantor to convey an easement over an entire parcel, and reserve a right to develop a discrete number of lots (e.g., one single-family dwelling for every 40 acre parcel) on the property. The carve-out method permits the grantor to carve out specific portions for development. The carve-out method allows the parcels not subject to the easement to be developed, and often enhances the market value of these parcels because of their proximity to the parcels subject to the conservation easement. Both methods may be useful in the development of the family’s master plan.11

As a general rule, the value of an easement or other perpetual conservation restriction is equal to the difference between the fair market value of the property the restriction encumbers “before and after” the contribution.12 If there is a substantial record of sales of comparable easements, however, the fair market value of the donated easement must be based on the sales prices of the comparable easements.13 Because sales of conservation easements are not common, perpetual conservation restrictions are usually valued pursuant to the “before and after” method.

The Treasury Regulations provide special rules for valuing a qualified conservation contribution that take into account any economic benefit that may accrue to the donor or related parties as a consequence of the gift of the easement. For a gift of a perpetual conservation restriction covering a portion of contiguous property owned by the “donor” or a “member of his family,”14 the value of the contribu-

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6 I.R.C. §§170(h), 2055(f) and 2522.
8 Treas. Reg. §1.170A-14(b)(2).
9 I.R.C. §170(h)(3) and Treas. Reg. §1.170A-14(c)(1).
10 See I.R.C. §170(h)(1)(C) and §170(h)(4).
13 Id.
14 As defined in I.R.C. §267(c)(4).
tion is the difference between the fair market value of the entire contiguous parcel before and after granting the restriction.\footnote{15\textsuperscript{1}}

If the gift of an easement has the effect of increasing the value of any other property owned by the donor or a related person,\footnote{16\textsuperscript{1}} the value of the contribution is reduced by the amount of the increase in value of the other property, whether or not the property is contiguous.\footnote{17\textsuperscript{1}}

Conservation easements may also be taken into account by local jurisdictions when assessing the land value for real property tax purposes.

Even if a decedent did not specifically provide for a gift of a conservation easement, an executor or inheriting “family member” can grant a conservation easement on estate property.\footnote{18\textsuperscript{1}} The family member may be any of the following: the decedent’s ancestor, spouse, or lineal descendant; the spouse of a lineal descendant; or a lineal descendant of the descendant’s spouse or parent.\footnote{19\textsuperscript{1}}

b. Direct Gifts to Charity.

In some cases, it may make sense for the family to directly contribute land that is environmentally sensitive to a charity that will hold and protect it. A direct gift eliminates the cost and complication of establishing a conservation easement. It will also entitle the donor or donors to either an income and gift tax deduction for an inter vivos gift or an estate tax deduction at death.

Many parts of the country have local land trusts or land banks, which are nonprofit organizations established to protect and preserve valuable open space and environmentally sensitive land. A land trust or land bank can either take title in fee simple or hold a conservation easement over property.

Where property is contiguous with public land, it may also be possible to donate the property to a government agency. However, there are limitations. For example, Congress determines the boundaries of national parks, and donations of real property are only permissible within those boundaries. Thus, even where land is contiguous with public land for National Park purposes, a land bank may be a more feasible donee.

c. Gifts to a Charitable Entity.

Another method of making a charitable gift is through the use of a private foundation or a supporting organization. A charitable contribution gift and income tax deduction is permitted for the value of an inter vivos charitable gift.\footnote{20\textsuperscript{1}} If the contribution is made at death, an estate tax deduction is allowed for the value of the contribution.\footnote{21\textsuperscript{1}}

i. Private Foundations.

A private foundation is a charitable entity that may be controlled by the family members, and is exempt from income tax under I.R.C. §501(c)(3). The foundation would need to be established and operated to use the property exclusively for charitable or educational purposes that will confer a benefit upon the public and not the donors or their family members. Public uses include hiking and riding trails, and open spaces that can be viewed by the public.

Private foundations are subject to strict regulation and scrutiny by the IRS, and are generally limited to passive grant making to public charities, which are to receive distributions of income from the foundation. Among the many compliance limitations that apply to private foundations and their donors, the donor family will not be able to use or have access to the donated property in any manner that is more advantageous than the public’s access to the property.

The tax benefits of a private foundation are somewhat restricted. However, in spite of the many technical compliance requirements, in the appropriate situation the private foundation can provide a family with considerable flexibility in its charitable giving. The family of a private foundation donor may control the management of the foundation. Specifically, the foundation could use the funds to perpetuate the preservation of environmentally sensitive or pristine land.

ii. Supporting Organizations.

A “supporting organization” is another form of family foundation, which is described under Section 509 of the Internal Revenue Code. Generally, the tax benefits of a supporting organization are more generous than those of a private foundation, but the donor does not retain as much management or control over the use of the funds.

The tax benefits come at the expense of the donor’s management or control over the use of the donated property. In return for the greater tax benefits of a supporting organization, the family of a supporting organization donor may participate in but not control the supporting organization.

A supporting organization must identify the charitable organizations or purposes it will support and must affiliate with an established public charity or

\footnotesize{Planning 273 (2003) for an in depth discussion of postmortem granting of conservation easements.}
charities.\textsuperscript{23} While more costly to establish, a supporting organization offers significantly greater freedom from technical compliance requirements and is often the preferred charitable vehicle.

A supporting organization, which is affiliated with or controlled by a governmental unit or a publicly supported charitable organization, could also be the recipient of a contribution of real property.\textsuperscript{23} A supporting organization could be funded, in part, with a portion of the family’s real property intended to be set aside for conservation purposes. The supporting organization could then support another charity, such as a state or local public park agency, land trust, historical society or conservation organization, by donating the land to a supported charity and/or providing funds for the supported charity to conduct conservation programs on the land.

V. TRANSFERRING THE CABIN FROM THE SENIOR GENERATION TO THE JUNIOR GENERATION

Once the portions to be set aside for preservation and development (if any) have been identified, the linchpin of the master plan is transferring the cabin to succeeding generations. As indicated above, there are a number of techniques for transferring the cabin to the next generation, some of which are discussed below.

a. Outright Gifts.

An outright gift to the younger generation (or to a trust for their benefit) will transfer the value of the property and all future appreciation, thereby reducing the taxable estate value of the senior generation.\textsuperscript{24} If the gift is given as undivided interests in real property, it may also be possible to apply minority and other discounts to further reduce the value of the gift for gift tax purposes.

b. Charitable Gifts

A charitable gift to the younger generation (or to a trust for their benefit) will reduce the taxable estate value of the senior generation,\textsuperscript{25} and the donor may be entitled to a charitable deduction for the value of the gift.

c. Testamentary Gifts

A testamentary gift can be made through a will or trust. The gift will reduce the taxable estate value of the senior generation,\textsuperscript{26} and the donor may be entitled to a charitable deduction for the value of the gift.

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\textsuperscript{22} I.R.C. §509(a)(3)(A) and Treas. Reg. §1.509(a)-4(c)(1).

\textsuperscript{23} I.R.C. §509(a)(2) and §509(a)(3).


\textsuperscript{25} I.R.C. §2503(b).

\textsuperscript{26} I.R.C. §2513.

\textsuperscript{27} The exclusion is scheduled to increase in phases (for estate tax, but not gift tax purposes) to $3.5 million by year 2009, and expire in 2010. I.R.C. §2010 and I.R.C. §2505. Gifts qualifying for the annual exclusion do not use up any portion of the donor’s remaining applicable credit. Once a taxpayer has used up his or her applicable credit, gifts are subject to federal tax pursuant to a graduated and cumulative rate of gift tax. I.R.C. §2501. Assets transferred at death, in the excess of the taxpayer’s remaining applicable credit, are subject to estate tax at the same graduated rates applicable to gifts. I.R.C. §2502 and I.R.C. §2001(c). In some states, there may also be a state estate tax over and above the amount owed at the federal level. EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001 Pub.L. No. 107-16)
tion that gifts at death are entitled to a full stepped-up tax basis to date-of-death fair market value.\footnote{I.R.C. §1014(a).} Inter vivos gifts, on the other hand, only retain a carry-over basis equal to the basis in the hands of the donor, plus the amount of gift tax paid.\footnote{I.R.C. §1015.} Thus, in a nontaxable estate, it may be best to hold onto property until death, in order to take advantage of the stepped-up basis.

b. Qualified Personal Residence Trusts.

i. Background.

One estate planning technique that can be effective for transferring real estate between family members is the qualified personal residence trust or “QPRT.”\footnote{See Edwards, supra at 15-21 and Kevin M. Flatley, “Estate Planning Strategies for Real Estate,” 27 Estate Planning 222, 223 (2000).} A QPRT permits a homeowner to make a gift of his or her personal residence (i.e., a primary residence and/or a vacation home, along with a reasonable amount of surrounding property) to a trust for the benefit of children or other beneficiaries at a reduced gift tax cost.\footnote{Treas. Reg. §25.2702-5.} The “grantor” (i.e., the homeowner who transfers the residence to the QPRT) is permitted to reserve the right to live in the house for a number of years (referred to as a “reserved term of years”). The number of years is selected by the grantor. During the trust term, the grantor may use the residence, rent-free. Upon expiration of the trust term, the residence is distributed to the remainder beneficiary or beneficiaries (usually the grantor’s children), or held in further trust for their benefit.

The value of the gift is the fair market value of the residence at the time of transfer to the QPRT, decreased by the value of the reserved term of years (determined according to IRS tables).\footnote{I.R.C. §1014(a).} Generally, a longer reserved term produces a correspondingly lower value of the gift for gift tax purposes. The grantor consumes a portion of his or her applicable credit when the transfer is made to the QPRT (or, if the applicable credit has been exhausted, the transfer is subject to gift taxes that year). At the end of the trust term, the residence passes to or for the benefit of the children with no further gift or estate tax consequences. As a result, all appreciation that occurs during the trust term is “shifted” to the remainder beneficiaries free of gift or estate tax.

For example, assume that a husband, 55, and wife, 50, wish to create a QPRT for 15 years using their cabin valued at $500,000, which is community property and is not subject to any debt. Because of the QPRT, their combined gifts to their children for tax purposes would be valued at approximately $262,085. And, upon expiration of the trust term, the cabin (plus any appreciation occurring during the trust term) would be transferred to or for the benefit of the children without further estate or gift tax consequences. (Note: The amounts estimated in this example are based upon interest tables, which change monthly.)

When creating a QPRT, the gift to the trust is irrevocable, and assuming the grantor survives for the reserved term of years, the residence will not be included in the grantor’s estate for federal estate tax purposes. The QPRT enables the grantor to remove the value of the residence, plus any appreciation, from the (taxable) estate for a lower transfer tax cost than would be imposed if the residence were a part of the estate.

ii. Disadvantages of the QPRT.

There are three main drawbacks to the QPRT:

1. The residence passes to the children (or other beneficiaries) outright or in further trust, upon the expiration of the reserved term of years. If the grantor wishes to continue to occupy the residence at the end of the reserved term, the grantor must pay rent to the beneficiaries. If a home has appreciated considerably over the term of the QPRT, fair market rent may pose a financial burden. The rental payments would represent taxable income to the children. However, the amount of rent paid by the grantor would be removed from the (taxable) estate; because the estate tax rate generally exceeds the income tax rate, for those parents interested in reducing potential estate tax liability, this represents further overall tax savings.

2. The tax advantages of a QPRT also depend on the grantor surviving the trust term. If the grantor fails to survive the term of years, the entire value of the trust’s interest in the residence at the grantor’s death will be included in the grantor’s estate for estate tax purposes. Therefore, the estate and gift tax advantages will be lost, but the effect will generally be the same as if the QPRT had not been established.

3. If a residence were transferred using a QPRT, it would not be entitled to the step-up in basis that would otherwise be available at the time of the transferor’s death, because the stepped-up basis is available only if the property is included in a decedent’s estate.\footnote{Treas. Reg. §25.2702-5.} Therefore, in some circumstances, it may be advantageous to transfer the residence at death (e.g., where the parent’s estate is not expected to be taxable even if the residence is included or when the
property is expected to be sold by the younger generation upon the death of the senior generation).

iii. Additional Considerations.

When determining if a QPRT is appropriate for any client, one must balance the likely estate tax savings (i.e., the highest marginal estate tax rate applicable to the dollars in question, multiplied by the value of the residence that is being removed from the taxable estate) against the capital gains tax rate (generally, 15% under current law) that will be applied if the property is sold. Note that when determining if a QPRT is appropriate for any client, capital gains tax applies to the difference between fair market value and basis (i.e., acquisition cost) of the property, and is paid at the time of sale of the property (when cash is available). In contrast, estate taxes are imposed on the entire fair market value of the property and are due nine months after death, regardless of whether the property has been sold by that time. These factors, plus the fact that the capital gains tax rate usually is lower than the estate tax rate, can make the QPRT an attractive estate planning technique.

In some cases it may be necessary to subdivide the property to carve out the cabin, associated outbuildings and an appropriate amount of surrounding real property to be transferred via the QPRT. There are a number of private letter rulings that give guidance as to what the IRS considers a reasonable amount of property to be transferred. Other sources of guidance would be the minimum lot size under local zoning regulations, and the parcel sizes of comparable residences in the area.

c. Other Types of Trusts.

i. Irrevocable Trusts.

An irrevocable trust (other than a QPRT) owning real estate, which removes the house from the grantor’s estate, can serve as a vehicle for gift giving to younger generations during the senior generation’s lifetime. The trust can name beneficiaries and grant others the power to expand the number of beneficiaries. The parents can give their children and grandchildren (or others) annual exclusion gifts of $22,000 interests in the trust owning the real estate. Similarly, parents can also give their children larger lifetime gifts that consume a portion of their applicable exclusion amount.

Where a house is placed in an irrevocable trust by a parent, if the parent then chooses to remain in the home, he or she must pay fair market rent for that right, or the value of the house will be included in his or her estate at death.35

The advantage of a trust is that for some families it is a familiar arrangement already, because of other aspects of their estate planning.

For most families, however, a trust is not the preferred arrangement. Duration may be limited by the applicable rule against perpetuities. Where a house is intended to be held in trust for future generations, the trust is often established with an endowment to cover future expenses. This arrangement is frequently found to be inadequate for future generations. As the value of the property increases (which it often does in desirable vacation spots), the endowment may prove to be insufficient to cover expenses. Furthermore, trust terms are more difficult to amend—to adjust to unanticipated changes of circumstance or desires, as situations may warrant—than a tenancy in common or LLC agreement. Similarly, ownership interests cannot be adjusted over time to account for unequal contributions of money or labor. Also, it is difficult to add new owners who are not lineal descendants of the trust founder.

Trusts also raise fiduciary duty issues. Typically, one generation would be the lifetime beneficiaries of the trust. Members of that generation may also serve as trustees and make certain decisions that would benefit them individually over the interests of the remainder beneficiaries, violating the fiduciary duty of loyalty. These issues may be avoided by using other types of entities, discussed below.

ii. Revocable Trusts.

The senior generation may consider using a revocable trust to transfer ownership of the cabin at a later date. A revocable trust offers the senior generation an opportunity to plan for the management of the cabin, without making those plans final, because the grantor or grantors retain the right to revoke the trust.

Along with the power to revoke the trust, the grantors may retain the power to amend the terms of the trust. Typically, the parents would serve as the initial trustees and they would name their successors, should they become unable to serve, or simply choose to resign. Upon the death of the grantor (or of both grantors in the case of a married couple), the trust would become irrevocable and either could continue as an irrevocable trust for the next generation, or it could distribute its assets to named beneficiaries pursuant to its terms, and terminate.

For a senior generation starting to plan on transferring the cabin but not be willing to make those plans irrevocable, the revocable trust is an excellent first step.

35 I.R.C. §2036.
d. Family Limited Liability Companies.

Formation of a family LLC may provide a useful vehicle for transferring a cabin to younger generations. (Similarly, a family limited partnership may also be used.) The business purpose of the LLC would be the ownership and management of valuable real estate.

i. Management of the LLC.

Management of an LLC may be by all of the members, voting by percentage interests. Alternatively, one or more managers may govern an LLC. Usually, a manager also is a member/owner. In a manager form of LLC, non-manager/members have no voice in management, and they vote only on specified matters. The managers have complete control over normal operations.

If a manager form of LLC is used, decision making can be concentrated in fewer than all owners. This permits the transfer of ownership interests to other family members while maintaining control in one or only a few. Thus, Mom and Dad could name themselves as managers but transfer significant ownership interests to their children. By being managers, Mom and Dad retain the right to decide the use of the home, make repairs and improvements, and, in general, run the home as they always have done. At the same time, they may give significant portions of the value of the home to the next generation.

ii. Transfer of LLC Interests.

After formation of the LLC, the lifetime transfer of a membership interest to a child must occur within the framework of the federal gift tax law. The gifts can be structured, however, to give very favorable tax results. If the gifts are to come within the annual gift tax exclusion, it is likely that in each year only a small percentage interest can be given to each recipient. The small annual gifts become significant ownership percentages, however, if repeated over a number of years. As an alternative, the senior generation may gift an amount in excess of the gift tax annual exclusion. The excess can apply against and use part of the lifetime gift tax exemption amount.

iii. Valuation of LLC Interests.

Because of the discounts normally available for minority interests and lack of marketability associated with an LLC, such an entity can permit the transfer of assets at a lower gift tax cost than is generally available with respect to direct transfers. In other words, the LLC permits gift and estate tax savings because the LLC interests are valued at less than a pro rata portion of the underlying assets. Gift taxes are generally lower because of the discounted value of the gifted LLC interests, and the LLC interests held at the death of the older generation often are discounted as well, assuming the older generation has retained less than a majority interest.

The value of a percentage interest gift is established in a two-step process. The first step is to value the company property, i.e., the vacation home (and a bank account or other assets owned in the LLC). This is done by obtaining an appraisal from a competent real estate appraiser. The second step is to value the fractional membership interest that constitutes the gift. This requires a second appraisal by a person qualified to value fractional interests in business entities. The second appraisal takes into account the facts that the asset is a minority interest, it lacks control, and little, if any, market exists for such an interest. The result of the second appraisal is likely to be a discounted value of 20% or more from the proportionate share of the total value. Thus, the membership interests typically can be transferred on a very favorable gift tax basis.

iv. Advantages of LLCs.

Use of the LLC can protect the underlying assets of the LLC from the claims of creditors in the event of a lawsuit, the bankruptcy of a member, court judgment, tax lien, or from claims of a non-family member spouse in the event of divorce. The LLC agreement may contain transfer restrictions to prevent the sale to an outside party without unanimous consent of the members.

The LLC offers the added advantage (over a partnership, although not a limited liability partnership) of limited liability for its members, as in the case of a corporation, even if all of the members are involved in management.

In addition to the gift or estate tax benefits afforded by use of the LLC, by making gifts of LLC interests gradually over time, the gradual and orderly transfer of responsibility and management can take place. At the same time, it is possible for the senior family members to retain significant control over management if they so choose, by naming themselves as managers of the LLC.

Unlike trusts, in most states LLCs can have perpetual existence. The controlling documents are much easier to amend than a trust agreement. The ability to alter LLC ownership is also possible, whereas it is not usually an option with trusts.

v. Disadvantages of LLCs.

The main disadvantage of the LLC is that if the senior generation had held on to the cabin and not transferred it to the LLC, and it was later sold, it might have been possible to treat it as a principal residence and exclude the capital gain on sale under

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36 Sligar at 55.
Section 121 of the Internal Revenue Code. This exclusion is not available if the cabin is sold as an asset of an entity such as an LLC.

In addition, in order to establish an LLC, there are legal fees that some families may not want to incur, and there will be ongoing legal and accounting fees to maintain the entity.

vi. LLCs Versus Trusts.

As circumstances change, the LLC operating agreement is easier to amend than an irrevocable trust. If all of the members agree, the LLC operating agreement may be amended or even terminated. At the same time, this may provide less long-term certainly than the senior generation would prefer.

vii. Using LLCs to Accomplish an Estate Freeze.

Finally, LLCs can be used to “freeze” the value of the property interests retained by the senior generation. Chapter 14 of the Internal Revenue Code and the regulations thereunder impose detailed restrictions on how LLC interests may be structured so as to insure that the appropriate value is attributed to the senior family members when they have transferred LLC interests to younger family members. This type of transaction transfers property that is not likely to appreciate to the senior generation, while transferring an interest in the same property that is likely to appreciate to descendants, either simultaneously or shortly after the first transfer. A discussion of estate freezes is beyond the scope of this paper, but it is a useful planning tool to consider in connection with structuring an LLC.

e. Sales to Family Members.

In addition to the transfer techniques discussed above, property can be sold by the senior generation to members of the next generation. Such a sale should eliminate from the estate of the senior family member any appreciation in value of the property. However, the selling/senior generation will receive the sales proceeds, which will be subject to capital gains tax. Eventually, the proceeds and its further appreciation will also be subject to estate tax, if not spent or given away prior to death.

Sales can be structured in any of the following ways:

i. An outright sale for cash.

ii. An installment sale.

I.R.C. §7872 imputes interest for loans with an interest rate less than the applicable federal rate (“AFR”). There is a risk that the IRS may assert that the difference between the AFR and the stated rate on the promissory note generates both income and gift tax consequences for the seller. The IRS will impute taxable income to the seller and impute a taxable gift received from the seller by the purchaser in the amount of this difference.

iii. An installment sale with a self-canceling installment note that will cancel on the death of the senior family member.

The self-canceling installment sale employs the use of a promissory note that, by its express terms, expires upon the death of the payee. As a result, the unpaid balance of the note is reduced to zero at death of the payee prior to payment in full. Given the uncertainty of collecting all of the payments, the purchase price should reflect “full and adequate consideration,” which includes a built in premium to pay for the risk of not collecting the entire sum. While the IRS has accepted the use of self-canceling installment notes, there is minimal guidance on setting the amount of risk premium. Because the seller’s life expectancy should exceed the payment period, the premium need not be excessively large. However, if the seller’s actual life expectancy is reduced for known reasons, the risk premium should be increased accordingly. Failure to do so may result in the IRS asserting that the sale is a disguised gift.

iv. An exchange for a private annuity.

A private annuity is a contract that provides for specified payments to the named annuitant during the annuitant’s lifetime. Typically, one party agrees to transfer property to an individual in return for the right to an annuity payment for life. A private annuity is similar to the self-canceling installment note, but under a private annuity, the payments never cease so long as the annuitant is alive, even if the annuitant outlives his or her life expectancy. The primary advantage of the private annuity is that the annuity amount can be determined from IRS valuation tables, eliminating the speculation as to the amount of the periodic payments to be made. Because a private

37 The Taxpayer Relief Act of 1997, Pub.L. No. 105-34, amended I.R.C. §121 (formerly providing a one-time exclusion of gain from sale of a principal residence by an individual who has attained age 55) and permits exclusion of up to $250,000 of gain by an individual or $500,000 by a married couple on the sale or exchange of a principal residence, if the property was a principal residence for 2 of the last 5 years.
38 Sligar, supra at 54.
annuity is essentially a sale in return for a promise to pay—like promissory notes used with installment sales—private annuities cannot be secured, putting the annuitant at risk that the buyer may default.

VI. VACATION HOMES ON PUBLIC LAND

Cabin on national forest land have existed since the late 1800s, when national forests were reserved and were administered by the General Land Office in the U.S. Department of the Interior. The first lots for private cabins were authorized by the Forest Management Act of June 4, 1897, also known as the “Organic Act,” to encourage public recreation. In the early years, thousands of permits were issued on national forests near large cities, such as Angeles, the Oregon (Mount Hood), and the Pike-San Isabel National Forests. The program continued to grow until permits numbered around 20,000 at mid-19th century.

Often National Forest leases have been referred to as “99-year leases.” However, there has never actually been a 99-year Forest Service lease. In the early 1900s, some portions of private land were leased for summer homes and subdivisions for 99 years, and some of those leases still exist. Because they were located adjacent to National Forest land in the foothills and mountains, National Forest Recreation residence tracts became associated with this type of lease. The Forest Service issues recreation residence permits for a maximum of 20 years.

Most of the recreation residence permits involved high-value recreation land. In 1968, in recognition of other recreation needs, the Forest Service decided against establishing any additional new tracts. In 1976, this moratorium was expanded to include no development of new lots within existing tracts. Transfer of permits takes place now only by sale, gift, or inheritance.

A permit holder and prospective buyer or transferee must meet with the local Forest Service Special Use Administrator to discuss the transfer process. If a term permit is issued, the cabin owner will be permitted the remaining number of years on the current term. This allows for a common expiration date for all recreation residences located in the National Forest.

There is no guarantee that a new Term Special-Use Permit will be reissued at the end of the stated term. If a permit is not going to be renewed, the Forest Service will give 10-years notice, and the permit holder will be required to remove all improvements from the lot and restore it to the original conditions at his or her expense.

Recreation residences are for recreation use only and may not be used as a primary residence. In addition, a cabin must be used at least 15 days per year by the permit holder to ensure that the privilege granted by the permit is exercised and the continued use of public land is justified. Owners may only rent their cabin for a maximum of 14 days per year, with written authorization from the special use administrator.

The special use permit does not provide exclusive use of National Forest lands to homeowners, but allows for use of the lot. The public is allowed free access for all lawful and proper purposes to the National Forest lands. Within tracts, the general public may access National Forest lands by walking across lots or parking in areas not under permit. The public does not have the right to use the lands within the permitted “lot boundary” for activities such as picnicking, camping, vehicle travel, or parking.44

In addition, some states regulate cottage leases on state forestland.45 Washington does not have such a program. However, under certain circumstances, Washington does provide for the lease of state lands for residential use.46

VII. VACATION HOMES IN BRITISH COLUMBIA

British Columbia levies a tax on real estate transactions recorded in the Land Title Office. This tax is known as the Property Transfer Tax (“PTT”).47 The rate is 1% on the first $200,000 in value and 2% on any value over $200,000.48 “Real estate” is defined in the legislation to capture and tax transactions involving interests in land, including leases, life estates, and fee simple interests.49

There are many exemptions to the PTT, including a transfer to a surviving joint tenant; transfers between related individuals of principal residences, family farms, or recreational residences (sometimes the exemption only applies to land having a value not exceeding $275,000, which can limit their use); transfers incident to divorce; and some transfers involving estates. Registration of a transfer document in the Land Title Office triggers application of the tax. However,

44 Further information on Forest Service leases can be found at http://www.fs.fed.us/r5/eldorado/recreation/recre.html (last visited January 26, 2004). See also 16 U.S.C. ch. 81, User Fees Under Forest System Recreation Residence Program.
45 See, e.g., Idaho Code §58-304, Leases, and IDAPA 20.03.13, Rules for Administration of Cottage Site Leases on State Lands.
46 RCW ch. 79.13.
47 RSBC 1996 ch. 378 (the “Act”).
48 Sec. 3 of the Act.
49 Sec. 1 of the Act.
some transfers do not require filing with the Land Title Office. Methods of transfer that do not require filing with the Land Title Office are discussed below.

Land may be held in a corporation as nominee for the actual owner. Because the corporation will not carry on a business, it will not be required to file income tax returns. PTT will apply at the time the property is acquired. However, subsequent transfers of shares of the corporation, rather than transfers of the underlying real property, will not be registered in the Land Title Office, and thus not subject to PTT.

It is also possible to hold real property in British Columbia in trust. Again, the property will be subject to PTT at the time the property is transferred into the trust, but once in the trust the beneficial ownership of the land can be changed without limit and without triggering PTT.

More information on the PTT and links to the applicable legislation may be found on the web site of the Income Taxation Branch of the Ministry of Provincial Revenue for British Columbia at http://www.rev.gov.bc.ca/itb/ (last visited Jan. 26, 2004).

VIII. ONGOING MANAGEMENT OF THE CABIN

a. Written Agreements.

Once the property has been transferred to the next generation using any of the methods described above, the family will need to put into place a mechanism to manage the property, resolve conflicts, and facilitate maintenance of the property.50 This agreement may be in the form of, for example, a joint venture agreement, LLC operating agreement, trust agreement, contract, tenancy in common agreement, or bylaws. For most families, an agreement where all members have consented to the terms tends to be more successful than an agreement imposed upon them by the senior generation, whether under a trust or other form of binding contract.

Many of the issues are similar to those dealt with in a family-owned business. By using a format they are already familiar with, families that already have partnership or shareholder agreements in place often achieve great success in the context of planning for the family cabin.

b. Issues to Be Addressed.

In order to assure the smooth operation of the vacation home for the extended family, the agreement needs to facilitate ongoing use and resolve issues that may arise. The following is an outline of only some of the issues that need to be addressed in the agreement.51

i. A schedule for use of the cabin.

ii. Establish rules applicable during the time that the cabin is in use.

iii. Determine how to handle the periodic replacement of improvements such as a dock or a deck.

iv. Determine how maintenance and repairs are to be handled.

v. Establish annual membership dues or rent (normally equal in amount per member).

vi. Establish usage fees (to reflect actual use of the property by members). The use of membership dues and usage fees allows the managers to spread the financial burden among members in a manner that reflects differing amounts of use and differing percentage ownership interests. This promotes fairness between those who frequently use the property and those who are unable to enjoy it regularly.

vii. Levy special assessments (generally proportionate to percentage ownership interests) if annual membership dues are insufficient.

viii. If there are to be a manager or managers, who should serve in that role? Should a successor manager be identified? If multiple families own the property, should there always be a manager from each family?

ix. Determine whether outsiders should be allowed to use the cabin, on what basis (e.g., will outsiders only be allowed to use the cabin when accompanied by a family member/owner), and whether they will be charged rent.

x. Determine whether outsiders can become owners.

xi. Determine whether family members should be allowed to withdraw. If they are allowed to withdraw, what value will they receive? (A withdrawal may place a definite financial burden on the remaining members.)

xii. Determine how ownership rights may be transferred and how to deal with the financial crisis of an owner (bankruptcy, judgment, tax lien, marital dissolution) resulting in a lien against the property.

xiii. Establish a procedure to resolve future disputes.

c. Suggested Terms.

The following is a collection of terms that have worked for other families in the ongoing management of their cabins.

i. A family manager shall be appointed to do the following:

   (1) Maintain the property in its current...

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51 See Ken Huggins & Judith Huggins Balf, How to Pass It On: The Ownership and Use of Summer Houses (1999) at ch. 5.
condition (capital improvements to be made only with authorization unless urgent or to protect the property);
(2) Maintain insurance with specified coverage and limits;
(3) Pay taxes and other specified charges;
(4) Lease the property, with specific authorization, to tenants;
(5) Keep records and render accountings at specified times; and
(6) Take reasonable compensation and reimbursement of reasonable expenses.

ii. The beneficiaries have a duty to reimburse promptly all proper expenses assessed by the manager, with appropriate conditions relating to various classes and amounts of capital expenditures.

iii. The beneficiaries have rights of contribution among themselves.

iv. The right of use and occupancy is allocated by a procedure, which could include any of the following:

(1) Drawing of straws;
(2) Rotation;
(3) Authority of the manager;
(4) Bid; or
(5) Some other mechanism (e.g., length of travel, age, lottery).

v. Transfer of beneficial interests to anyone who is not a descendant (or, in some cases, a spouse of a descendant) is prohibited, except:

(1) Under a right of first refusal;
(2) By gift or bequest to a descendant of a certain common ancestor; or
(3) By transfer to anyone else, but subject to a condition subsequent by which the family can buy the interest from the transferee.

vi. Withdrawals may be permitted, but to discourage a withdrawal that is motivated primarily by the desire to cash in on appreciated real estate values, the payout might be at a discount (e.g., 80% of market value) and be extended over several years (e.g., over 10 years at a below market interest rate).

vii. The members may be given the right to purchase an interest that goes outside the family as the result of a divorce or bankruptcy.

viii. Owners may be given the right to vote on unusual events such as obtaining a mortgage for the property, leasing the property to a nonmember, selling the property, and amending the rules or operating agreement.

ix. To provide a check against arbitrary management, the owners should be given the right to call a meeting to review the decisions of the manager.

d. Family Homeowners Associations.

If several residences have been built on the family property, or there is a possibility that several could be built, the family ought to consider the formation of a homeowners association to facilitate the ongoing management of the family property. A homeowners association is a formal legal entity created to maintain common areas and facilities, and enforce common covenants and restrictions. A homeowners association is especially useful where the family intends to create or retain common facilities such as a dock or swimming pool. Generally, the procedure to create a homeowners association is to subdivide the property, and cause each lot to be subject to a set of common restrictions and covenants.

The purposes of the covenants could:

i. Identify common open space and common use facilities;

ii. Restrict or limit development of the affected parcels;

iii. Provide guidelines for, or a mechanism to review, construction and development;

iv. Establish aesthetic and design standards;

v. Establish use restrictions;

vi. Establish penalties to encourage compliance;

vii. Restrict transfers or create rights of first refusal if an owner wishes to sell, or if their interest is subject to a bankruptcy or other type of lien; and

viii. Provide a mechanism to resolve disputes.

A homeowners association can be formed as a partnership, LLC, or a not-for-profit association. Typically, each lot owner is required to be a member.52

A homeowners association is funded by dues or assessments from the owners. If organized as a not-for-profit entity, it can qualify for an income tax exemption for revenue received from its members under I.R.C. §528.

The rules and regulations of the homeowners association could be established by the senior generation before transferring the property to the junior generation. Or, the junior generation could jointly develop its own association rules.

IX. LIFE INSURANCE AND IRREVOCABLE LIFE INSURANCE TRUSTS

In situations where it is available, life insurance can provide an effective means of creating a fund to support maintenance and other expenses associated with the formation and governance of homeowners associations (last visited January 26, 2004).
with cabin ownership.\textsuperscript{53}

The taxation of life insurance proceeds can be avoided under present law if a trust, instead of the insured, owns the policy.\textsuperscript{54} A trust holding life insurance is commonly referred to as an Irrevocable Life Insurance Trust or “ILIT.” Generally, the mechanics of an ILIT are as follows: The potential insured/grantor will transfer cash into the irrevocable trust. The ILIT agreement allows the beneficiaries of the trust (usually the children) a “Crummey” right of withdrawal so the gift into trust qualifies for the annual exclusion from gift tax.\textsuperscript{55}

The trustee uses the cash to purchase life insurance on the life of the grantor. Each year, the insured transfers to the trust an amount slightly greater than the amount sufficient to cover the annual premium on the policy.

A potential insured can allocate a portion of his or generation-skipping transfer tax exemption (or “GST” exemption) (currently $1,500,000) to the trust each year when the gifts are made, and by these allocations, the entire trust corpus (including the insurance proceeds payable upon the insured’s death) can be sheltered from the GST tax.\textsuperscript{56} Generally, the allocations of the GST exemption are made with respect to a trust that is structured to remain in existence for the benefit of multiple generations of the donor’s descendants. Because the GST exemption is allocated only to the cash transferred to the trust to pay the premiums—and the insurance proceeds usually exceed the total premi-

ums by a substantial amount—the life insurance trust offers an opportunity to “leverage” all or a portion of the GST exemption.

The ILIT, if established as part of a master plan to transfer ownership of a cabin, can provide that the policy proceeds will continue to be held in the trust and used to maintain the cabin and to cover related expenses.

\textbf{X. PLANNING AHEAD}

Finally, for the client who is still in the planning stages of purchasing a second home, there is an excellent article outlining important considerations in connection with this purchase.\textsuperscript{57}

\textbf{XI. CONCLUSION}

The family cabin is an asset that often serves as a symbol of a family’s history, emotions and values, a focus of all that is good in the family. It is important to recognize that the cabin also embodies negative emotions for some family members. While some cabins will be retained by succeeding generations, others are likely to be sold because the younger generation has no emotional attachments to it, can’t agree on how to retain it, or simply can’t afford it. Understanding the attitudes toward the cabin held by various family members and building consensus is critical in order to assist the family in developing a master plan to transfer and to continue to happily own the cabin, if that is the goal.


\textsuperscript{54} I.R.C. §101(a).

\textsuperscript{55} \textit{Crummey v. Commissioner}, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321 (1973); Treas. Reg. §25.2503-3(b).

\textsuperscript{56} Beginning in 2004, the GST exemption amount is equal to the estate tax applicable exclusion amount under I.R.C. §2010(c) for the year in which the generation-skipping transfer is made ($1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009), and for year 2010, the GST tax will be repealed in its entirety (and thus there will be no GST exemption amount). I.R.C. §2641. In 2011, the GST exemption is scheduled to revert back to $1,100,000 (plus post-2002 inflation adjustments). I.R.C. §2664.

\textsuperscript{57} Liz Pulliam Weston, “10 Tips for happy second-home ownership: Many families dream of a cabin in the woods or a house at the beach. But the costs and aggravation can be more than you expect,” http://moneycentral.msn.com/content/Banking/Home buyingguide/P61924.asp (last visited Jan. 26, 2004).

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I. INTRODUCTION.
In 2004, the Internal Revenue Service (the “IRS”) substantially revised Form 709, United States (and Generation-Skipping Transfer Tax Return) (the “709”), which is applicable to gifts made in 2003. In 2005, the IRS released another revised Form 709, which is substantially the same as the 2003 709. The most significant change to Form 709 (from the 2002 and prior year’s forms) was to Schedule A. Specifically, a new Part 3 and three additional columns were added. Such revisions were implemented to (1) modify the method in which spouses who elect to gift-split report such gifts under Section 2513 of the Internal Revenue Code of 1986, as amended (the “Code”); (2) add a section to Schedule A to report “indirect skips”; (3) add a mechanism to elect out of the automatic allocation of generation-skipping transfer (“GST”) tax exemption for direct and indirect skips; and (4) add a line to Part 2 of Schedule C (GST tax schedule) to illustrate the automatic allocation of GST tax when an indirect skip is reported. While the 709 has changed significantly from its prior version, practitioners who file returns to report gifts made prior to 2003 will presumably still need to use the prior form for the applicable year.

II. INITIAL CONSIDERATIONS.
A. Reportable gifts. Any individual citizen or resident of the United States who makes a transfer by gift must file a 709, unless such transfer is not includible in such individual’s total amount of gifts for the year by the application of Sections 2503(b) or 2503(e) of the Code, or when such individual makes a transfer of an interest with respect to which a marital deduction is allowed for the value of the entire interest under Section 2523 of the Code. I.R.C. §6019(a). It is necessary to file a 709 in order to elect to gift-split under Section 2513 of the Code, regardless of the amount of the gift. Section VII. of this article provides a detailed analysis of the gift-splitting rules under Section 2513 of the Code.

1. Section 2503(b). Section 2503(b) provides that in the case of present interest gifts made by a donor during the year, the first $10,000 of each gift (indexed for inflation and currently $11,000) shall not be included in the total amount of gifts made during the year by the donor. Section 2523(i) of the Code substitutes $100,000 (indexed for inflation and currently $117,000) for the $10,000 figure provided in Section 2503(b) of the Code when the donee spouse is a non-U.S. Citizen.

2. Section 2503(e). Section 2503(e) provides that a “qualified transfer” shall not be treated as a transfer of property for gift tax purposes. A qualified transfer is a payment of tuition for the benefit of the donee paid directly to the educational institution, or the payment of medical care for the benefit of the donee paid directly to the medical care provider.

3. Section 2523. a. General. Section 2523 provides that when a donor transfers an interest in property to an individual, who at the time of the gift is the donor’s spouse, a deduction shall be allowed in computing the donor’s taxable gifts for the year in an amount equal to the value of the property transferred.

b. Inter Vivos Qualified Terminable Interest Property (“QTIP”) Trusts. If the donor transfers property to a QTIP trust for the benefit of his or her spouse, and wants to make a QTIP election with respect to such transfer, a 709 must be filed in order to make the election. Such an election can only be made on a timely filed 709 (including extensions). Treas. Reg. §25.2523(f)-1(b)(4)(i). If the donor dies during the same year of the transfer, the election must be made on a 709 filed no later than the due date of the Federal estate tax return (including extensions). Treas. Reg. §25.2523(f)-1(b)(4)(ii). Because this election is prescribed by statute, as opposed to being a regulatory election, Section 9100 relief is unavailable to make a late QTIP election under Section 2523 of the Code. PLR 9641023 (July 10, 1996).

B. Form 709-A. Form 709-A, which could previously could be used by taxpayers solely to report split gifts in limited circumstances, is now obsolete. All

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reportable gifts must now be reported on Form 709.

C. Party responsible for filing the 709.


2. Donor is unable to sign. If a donor is legally incompetent, his guardian may file a 709 on his behalf. Treas. Reg. §25.6019-1(g). Additionally, an agent of the donor may file the 709 on behalf of the donor. In order for an agent to file on behalf of a donor, the donor must be unable to file for himself by reason of illness, absence, or nonresidence, and such return must be ratified by the donor when he becomes able to do so. An agent may not sign on behalf of the donor as a matter of mere convenience. Treas. Reg. § 25.6019-1(h); Revenue Ruling 78-27, 1978-1 C.B. 387.

3. Donor is deceased. If the donor is deceased, the executor of the deceased donor’s estate may file the 709 on behalf of the donor for gifts made prior to the donor’s death. Treas. Reg. §25.6019-1(g).

D. Due date.

1. General. The 709 may not be filed prior to January 1st of the year following the year in which the gift was made, and cannot be filed later than April 15th of such year, unless the appropriate extension of time to file is requested. I.R.C. §6075(b).

2. Extensions.

a. Taxpayer extends time to file individual tax return. If the taxpayer files Form 4868 to automatically extend the due date of his or her individual income tax return by four months to August 15th, such extension will also automatically extend the time to file his or her 709. I.R.C. §6075(b)(2). It is no longer necessary for the taxpayer to check a box on such form in order to extend the deadline for filing his or her 709. If the taxpayer expects to owe gift or GST tax, he or she must pay the estimated gift tax at the time of filing Form 4868. In addition, if the taxpayer files Form 2688 to request an additional extension of time to file his or her individual income tax return to October 15th, such extension will also automatically extend the time to file his or her 709.

b. Taxpayer does not extend time to file individual income tax return. If the taxpayer is not requesting an extension of time to file his or her individual income tax return, the taxpayer must request an extension of time to file his or her 709 by filing Form 8892. The filing of Form 8892 automatically extends the due date of the taxpayer’s 709 to October 15th.

E. Where to file.

1. Within the U.S. Individuals located within the United States or the District of Columbia should file their 709s in Cincinnati, Ohio at the following address:

   INTERNAL REVENUE SERVICE
   CINCINNATI, OHIO 45999

2. Outside of the U.S. Individuals located elsewhere or have an APO or FPO address should file their 709s in Philadelphia, Pennsylvania at the following address:

   INTERNAL REVENUE SERVICE
   PHILADELPHIA, PENNSYLVANIA 19255

F. Method of Payment. Payment of any gift (or GST) tax due can be made by personal check or money order payable to the United States Department of the Treasury. The instrument should also bear the donor’s social security number.

III. THE ANATOMY OF THE RETURN.

This section of the outline will describe the method of reporting gifts and the allocation of GST tax exemption on a 2002 (and prior years) 709, followed by a detailed description of how the reporting should be done on the new 709.

A. Page 1.

1. Part 1 (709 prior to 2003). Part 1 is the General Information section in which the taxpayer provides the IRS with basic information, such as his or her name, social security number and address. In addition, the taxpayer answers various questions. For example, the taxpayer will address whether the 709 was put on extension and whether he or she has previously filed a 709. Part 1 also provides an area in which the taxpayer can elect to have the gifts made by him or her to third parties considered as gifted one-half (½) by the taxpayer and one-half (½) by the taxpayer’s spouse. If the taxpayer elects to gift-split, his or her spouse is required to provide his or her social security number, where indicated, on Part 1 of the 709 and sign, where indicated, on line 18. The consenting spouse must also file his or her own 709 in order to report one-half (½) of the gifts made by his or her spouse, unless only one spouse made a gift during the year and the value of such gift was less than two times the annual exclusion amount.

2. Part 2 (709 prior to 2003). Part 2 of the 709 is the Tax Computation section, wherein the amount of taxable gifts is be carried over from Schedule A and the tax due, taking into account the taxpayer’s available gift tax exemption, is calculated.

3. New 709. Page 1 of the 709 was not substantially altered. The only change made was to line 1 of Part 2 so that the value carried over from Schedule A is taken from line 11 of Part 4, rather than from line 15 of Part 3, as it was on the 2002 709. The reason for such change is described in Section III. B. of this article, wherein the changes to Schedule A are discussed.

   It should also be noted that the spousal consent for gift-splitting under Section 2513 of the Code contained in Part 1 of the 709 has remained
unchanged, although the method to report split gifts has changed significantly, as described in Section III. B. of this article, wherein the changes on how split gifts are reported on Schedule A are discussed.

B. Schedule A.

On the 2002 709 and prior year’s forms, Schedule A consists of Part 1—Gifts Subject Only to Gift Tax, Part 2—Gifts that are Direct Skips and Subject to Both Gift Tax and Generation-Skipping Transfer Tax and Part 3—Taxable Gift Reconciliation. The new 709 adds a new Part 3 and moves the tax reconciliation section to Part 4. In addition, a new column C was added, which is used in Part 2 and Part 3 to elect out of the automatic allocation of GST tax exemption, as discussed in greater detail below. The method of reporting split gifts was also significantly changed by the addition of columns G and H.

1. Questions A and B (709 prior to 2003).
   a. Valuation discounts. The taxpayer must indicate in question A, located at the top of Schedule A, whether the value of any gift reported on Schedule A reflects a discount of any kind, including, but not limited to, lack of marketability, fractional interest or minority interest discounts. If so, the taxpayer must attach an explanation giving the basis for taking such discounts. For example, if a taxpayer gifted limited partnership units and the value of such units reflects discounts for lack of marketability and minority interest, question A must be answered yes and an appraisal of the limited partnership units must be attached to the 709.

   i. Section 6501 of the Code. It should be noted that the proper disclosures should be made when reporting a gift, the value of which was discounted, in order to commence the gift tax statute of limitations. Section VI. of this article discusses the adequate disclosure requirements of Section 6501 of the Code in detail.

   b. Qualified state tuition programs. If a taxpayer gifted cash to a qualified state tuition plan under Section 529 of the Code in excess of the annual exclusion amount ($11,000 in 2005) on behalf of any individual beneficiary, he or she may elect to treat up to five times such amount ($55,000 in 2005) of such contribution as made ratable over a 5-year period, beginning in the year of the contribution. If the taxpayer elects to do so, he or she must check the box in question B, located at the top of Schedule A. A contribution to a qualified state tuition program on behalf of a designated beneficiary is considered to be a present interest gift and, thus, qualifies as an annual exclusion gift (currently $11,000) under Section 2503(b) of the Code.

   c. New 709. Questions A and B both remain unchanged.

2. Part I.
   a. 709 prior to 2003. All gifts subject to gift tax only, whether or not such gifts could be subject to GST tax at a later date, are reported on Part 1 of Schedule A in chronological order. For example, a transfer to a trust with GST potential in the future (i.e., an indirect skip) is reported on Part 1 of Schedule A.

   i. Indirect Skip. An indirect skip is a transfer of property (that is not a direct skip) subject to the gift tax that is made to a “GST Trust.” I.R.C. §2632(c)(3). A GST Trust is any trust that could have a GST with respect to the transferor unless:

      • Age 46 Trust. The trust provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (1) before the date the individual attains the age of 46; (2) on or before one or more dates specified in the trust that will occur before the date that such individual attains the age of 46; or (3) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains the age of 46.

      • Ten Year Age Difference Trust. The trust provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the trust who is more than 10 years older than such individuals.

      • Partial Estate Tax Inclusion Trust. The trust provides that, if one or more individuals who are non-skip persons die on or before a date or event described in the first two exceptions, more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals.

   b. Column B. The taxpayer must identify the donee’s name and address, the relationship of the donee to the donor and a description of the gift.
In addition, if the gift was made to a trust, the trustee’s name and address, and such trust’s EIN must be provided, and the taxpayer must attach a copy of the trust to the 709. If a security was gifted, such as a stock or bond, the taxpayer must provide the CUSIP number for such security.

iii. Column C. The taxpayer must state his or her basis in the gifted property.

iv. Column D. The taxpayer must disclose the date the gift was made to the donee. As noted above, all gifts are listed in chronological order.

v. Column E. The taxpayer must disclose the fair market value of the gifted property as of the date of the gift. If a valuation discount was taken, such discount is reflected in column E and the taxpayer must indicate that a valuation discount was taken, as discussed above, by answering yes to question A, located at the top of Schedule A, and disclosing the requisite information and attaching the appropriate documentation, as provided for in Section 6501 of the Code.

b. New 709. In 2003, the 709 was changed so that only gifts subject to gift tax, and having no chance of being subject to GST tax at a later date, are reported in Part 1 of Schedule A. Note that gifts are still reported in chronological order.

i. Column B. The information reported in column B remained unchanged.

ii. Column C. Column C was changed on the new 709; however, such column is not applicable in Part 1 of Schedule A of the new 709.

iii. Column D. In column D, the taxpayer now includes his or her basis in the gifted property, as was done in column C in previous years.

iv. Column E. In column E, the taxpayer now discloses the date the gift was made to the donee, as was done in column D in previous years.

v. Column F. In column F, the taxpayer now discloses the value of the gift as of the date of the gift, as was done in column E in previous years.

vi. Column G. In column G, the taxpayer now discloses one-half of the value reported in column F in cases in which the taxpayer has elected to split gifts with his or her spouse under Section 2513 of the Code. If the taxpayer is filing a 709 to report gifts of his or her spouse, which he or she elected to gift-split, and such taxpayer did not make any gifts during that year, Column F would contain no values in the top part; Column F in the bottom part would include the taxpayer’s spouse’s gifts. In addition, one-half of the value of his or her spouse’s gifts would be reported in Column G.

vii. Column H. In column H, the taxpayer indicates the net transfer. If the taxpayer elects to split his or her gifts with his or her spouse under Section 2513 of the Code, the gift is reduced by one-half of his or her gifts (this one-half is reported in Column G, as described above).


a. 709 prior to 2003. In 2002 and prior year’s returns, all gifts that were subject to both GST tax and gift tax (direct skips) are reported on Part 2 of Schedule A. The information disclosed in columns C through E is the same as the information disclosed in columns C through E in Part 1 of Schedule A of the 2002 709.

i. Direct Skip. A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person, which may be an individual or certain trusts. I.R.C. §2612(c). An individual is a skip person if he or she is two or more generations removed from the transferor’s generation. I.R.C. §2613(a)(1). A trust is a skip person if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution be made to a person who is not a skip person. I.R.C. §2613(a)(2).

ii. Election out of automatic allocation of GST tax exemption. Section 2632(b) of the Code provides that an individual’s GST tax exemption shall be automatically allocated to direct skips so that the inclusion ratio of such property is zero. In 2002 and prior year’s returns, there is no place to indicate that the taxpayer wants to opt-out of such allocation. Instead, the taxpayer is required to attach a statement to the 709 describing the election and clearly identifying the transfer to which the election applied.

b. New 709. Direct skips are still reported on Part 2 of Schedule A of the 709. As noted above, additional columns were added for the purposes of electing out of the GST tax exemption automatic allocation rules and reporting split gifts. The information disclosed in columns B through H is the same information disclosed in columns B through H in Part 1 of Schedule A of the new 709.

i. Election out of automatic allocation of GST tax exemption. As described above, Section 2632(b) of the Code provides that an individual’s GST tax exemption shall be automatically allocated to direct skips so that the inclusion ratio of such property is zero. The new 709 was changed so that an election to opt-out of the automatic allocation of GST tax exemption to direct skips can be made on the Form 709 by indicating such opt-out in column C of Part 2 of Schedule A. It should be noted that it is still necessary to attach an explanation to the 709 clearly describing the transaction and the extent to which the automatic allocation of GST tax exemption should not apply.

4. Part 3.

a. 709 prior to 2003.
i. Calculation of taxable gifts. On line 1 of Part 3, the taxpayer must provide the total amount of gifts as provided for in column E of Parts 1 and 2 of Schedule A. If the taxpayer elects to split the gifts pursuant to Section 2513 of the Code (presuming that the taxpayer’s spouse consented to such split) so that one-half of the gifts made to third parties by the taxpayer is treated as made by his or her spouse, then one-half of the total amounts gifted is indicated on line 2 and subtracted from the amount on line 1. As a result, line 3 contains the total amount of gifts subject to gift tax made by the taxpayer. On line 4, the taxpayer inserts the amount of any gifts made by the taxpayer’s spouse that are included on the taxpayer’s 709 by reason of the taxpayer electing to gift-split under Section 2513 of the Code (presuming that the taxpayer consented to such split); such amount is then added to the balance of gifts subject to gift tax provided for in line 3. Accordingly, line 5 contains the total amount of gifts subject to gift tax, taking into account any gift splitting elected by the taxpayer and the taxpayer’s spouse. On line 6, the total amount of gifts which qualifies for the annual exclusion is subtracted from the total amount of gifts subject to gift tax. Line 7 contains the total amount of includible gifts.

ii. Deductions. The taxpayer accounts for any deductions applicable to the includible gifts on lines 8 through 15 of Part 3. For example, gifts which qualify for the gift tax marital deduction would be subtracted on line 8. An example of such a gift would be a transfer to an inter vivos trust for which QTIP treatment is elected. The taxpayer cannot take the marital deduction for gifts of terminable interests, where someone other than the donee will have an interest in the property following the termination of the donee spouse’s interest, unless the interest meets the following requirements:

• Donee spouse is entitled to all income for life;
• Income is paid at least annually;
• Donee spouse has a general power of appointment; and
• No part of the interest is subject to another person’s power of appointment.

If the donee spouse does not have a general power of appointment over the interest, the taxpayer may elect QTIP treatment so that the transfer qualifies for the marital deduction. The QTIP election is made by listing such property on line 8 of Part 3 of Schedule A (checking a box to make such election is not necessary).

iii. Joint and survivor annuities. Section 2523(f)(6) of the Code provides that in the case of a joint and survivor annuity in which only the donor spouse and donee spouse have the right to receive payments before the death of the last spouse to die, the donor spouse is treated as electing QTIP treatment, unless he or she elects otherwise. Accordingly, if a taxpayer purchased a joint and survivor annuity for a spouse (and only the donor spouse and donee spouse have the right to receive payments before the death of the last spouse to die) and such gift was reported on Schedule A by the donor spouse, the donor spouse could indicate on Line 17 that he or she wishes to opt out of having such annuity automatically treated as QTIP property.

b. New 709. Part 3 of Schedule A was substantially changed so that “indirect skips” are reported therein. An indirect skip is any transfer of property, other than a direct skip, subject to gift tax and made to a GST trust. I.R.C §2632(c)(3)(A). A GST trust is any trust that could have a generation-skipping transfer with respect to the transferor, subject to certain exceptions. I.R.C. §2632(c)(3)(B). The Taxable Gift Reconciliation, which was contained in Part 3 of Schedule A on the Form 709 for 2002 and prior years, was moved to Part 4 of Schedule A. The information disclosed in columns B through H is the same information disclosed in columns B through H in Parts 1 and 2 of Schedule A of the new 709.

i. Election out of automatic allocation of GST tax exemption. Section 2632(c) of the Code provides that an individual’s GST tax exemption shall be automatically allocated to transfers to trusts from which a taxable distribution or taxable termination may occur. In 2002 and 2001 (the first year in which an “indirect skip” and the automatic allocation rules thereto applied), there was no place to indicate that the taxpayer wanted to opt-out of such allocation. Instead, the taxpayer was required to attach a statement to the 709 describing the election and clearly identifying the transfer to which the election applied. The new 709 was changed so that an election to opt-out of the automatic allocation of GST tax exemption to trusts with GST tax potential can be made on the Form 709 by indicating such opt-out in column C of Part 3 of Schedule A. A taxpayer may wish to opt-out of such allocation, for example, if he or she was the grantor of an irrevocable life insurance trust and such trust owned a term life insurance policy. If the policy expired while in the trust and GST tax exemption was allocated to such trust, the exemption could be wasted. Furthermore a taxpayer may elect to have a trust treated as a GST trust so that the automatic allocation rules apply to such trust. This election can also be made by checking the box in Column C of Part 3 of Schedule A.

c. Final Regulations on Election out of Automatic Allocation. On June 29, 2005, the IRS issued final regulations (“Final Regulations”) with respect to
elected out of the automatic allocation rules of Section 2632(c) of the Code for transfers made to GST trusts (indirect skips) and for making an election to treat a trust as a GST trust. Treas. Reg. §26.2632-1, 70 Fed. Reg. 37258. Column C of Part 3 of Schedule A of the new 709, as discussed above, provides a mechanism for a taxpayer to make these elections. However, according to the Final Regulations, it is also necessary to attach a statement to the 709 stating the taxpayer’s intention to elect out of the automatic allocation rules; such statement is referred to as an “election out statement” in the Final Regulations. The Final Regulations contain numerous examples which illustrate the provisions contained therein.

i. Taxpayers may elect out of the automatic allocation rules for the following transfers:
   • One or more prior-year transfers subject to Section 2642(f) of the Code [regarding estate tax inclusion periods (“ETIPS”)] made by the transferor to a specified trust or trusts;
   • One or more (or all) current-year transfers made by the transferor to a specified trust or trusts;
   • One or more (or all) future transfers made by the transferor to a specified trust or trusts;
   • All future transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); or
   • Any combination of the above.


ii. Manner of election out. The taxpayer must attach an “election out statement” to a timely filed 709 (whether or not a 709 is otherwise required). The election out statement must identify the trust (unless such trust is not in existence at the time of the election out), identify the transfers to which the election out shall apply, and state that the taxpayer is electing out of the automatic allocation rules with respect to the transfer(s) described therein. Furthermore, any prior year transfer subject to Section 2642(f) of the Code must be identified (see subparagraph iv. below). Treas. Reg. §26.2632-1(b)(2)(iii)(B). In addition, unless the election out is made for all transfers made to the trust in the current year and/or in all future years, the current-year transfers and/or future transfers to which the election out is to apply must be specifically described or otherwise identified in the election out statement. The Final Regulations contain examples of election out statements for various scenarios.

iii. Termination of election out. If a taxpayer wants to terminate an election to not have the automatic allocation rules apply to any transfers made to a specific trust, the termination may be done on a timely filed 709 for the year in which the taxpayer wants the election to terminate (whether or not a 709 is otherwise required to be filed for such year). Treas. Reg. §26.2632-1(b)(2)(iii)(E). A statement, referred to in the Final Regulations as a “termination statement,” must be attached to the 709 identifying the trust, describing the prior election that is being terminated and specifically providing that such election out is being terminated, and either describe the extent to which the prior election out is being terminated or describe any current-year transfers to which the prior election is not to apply. Id. It should be noted that a termination of an election out does not affect any transfer, or any election out, that is not described on the termination statement. Id.

iv. Election out of automatic allocation to an indirect skip subject to an ETIP. A transferor may elect out of the automatic allocation rules with respect to a transfer subject to an ETIP by filing a 709 for any year within the ETIP; such return cannot be filed any later than the due date for the year in which the ETIP closes. The election out statement referred to above must identify any prior year transfers that are subject to 2642(f) and to which the election out is to apply. It should be noted that a return filed during an ETIP which purports to elect out of the automatic allocation rules for all future transfers will not apply to an allocation that is to occur at the close of an ETIP, unless such election out is specifically identified as described herein.

v. Election to treat a trust as a GST Trust. A taxpayer may elect to treat a trust, which is not a GST trust, as a GST trust (regardless of whether such trust is subject to an ETIP), so that the automatic allocation rules of Section 2632(c) will apply to any current transfer(s), selected future transfer(s), all future transfers made to such trust, or any combination thereof. Treas. Reg. §26.2632-1(b)(3)(i)(A-D). The taxpayer must attach a statement, referred to in the Final Regulations as a “GST trust election statement,” to a timely filed 709 for the year of the transfer (whether or not a 709 is otherwise required to be filed for such year) identifying the trust, describing the transfer, and specifically providing that the taxpayer is electing to have the trust treated as a GST trust. Id. This election may be terminated by filing a timely filed 709 for the year in which the taxpayer wants the election to terminate. §26.2632-1(b)(3)(iv). The taxpayer must attach a statement to the 709 identifying the trust, describing the transfer and providing that the prior election to treat the trust as a GST trust as provided is terminated. Id.

vi. Effective Date. The Final Regulations with respect to the election out of the automatic allocation rules took effect on the date the Final Regulations were published in the Federal Register.
allocation rules for indirect skips and the election to treat a trust as a GST trust, are effective for elections made on or after July 13, 2004 (the date of publication of the proposed regulations). The Final Regulations as they relate to transfers subject to ETIPS are effective for elections made after June 29, 2005.

5. **Part 4.** The 709 for 2002 and prior years did not contain Part 4 of Schedule A. Because Part 3 was added to Schedule A in 2003, the Taxable Gift Reconciliation section of the former Part 3 was moved to Part 4. Changes were made to the section to account for the fact that gifts made by the taxpayer, which such taxpayer’s spouse consented to split under Section 2513 of the Code, and gifts of the taxpayer’s spouse which the taxpayer consented to split, are now listed on Schedule A and accounted for in the total of value of gifts of donor, as reported on line 1 of Part 4 of Schedule A. In prior years, such gifts were accounted for in the Taxable Gift Reconciliation section, formerly Part 3 of Schedule A.

**C. Schedule B.** The taxpayer reports gifts from prior periods on Schedule B. In column A, the taxpayer lists the year of the prior gift. In column B, the taxpayer lists the IRS office where the 709 was filed. In column C, the taxpayer lists the amount of unified credit used for such gift for gifts made after December 31, 1976. In column D, the taxpayer lists the amount of exemption used for gifts made before January 1, 1977. In column E, the taxpayer lists the amount of the taxable gifts for the corresponding year. The total amount of taxable gifts from prior periods is then carried over to line 2 of Part 2 on Page 1 of the 709. No changes were made to Schedule B of the new 709.

**D. Schedule C.**

1. **709 prior to 2003.**
   a. **Part 1.** All direct skips, whether or not such gifts qualify for the GST tax annual exclusion under Section 2642(c) of the Code, are reported on Part 1 of Schedule C. In column A, the taxpayer lists the corresponding item number from column A of Part 2 of Schedule A. In column B, the taxpayer lists the value of the gift, as provided in column E of Part 2 of Schedule A. In column C, the taxpayer lists an amount equal to one-half of the amount listed in column B, if the taxpayer’s spouse consents to split the gifts of the taxpayer under Section 2513 of the Code. The taxpayer then subtracts the amount in column C from the amount in column B and inserts such difference in column D. In column E, the taxpayer lists the applicable annual exclusion amount and subtracts such amount from the value in column D. Finally, the taxpayer lists the amount in excess of the annual exclusion amount in column F and such amount equals the net transfer subject to GST tax.

   **Note that a direct skip made to a trust will not qualify for the GST tax annual exclusion under Section 2642(c) of the Code unless the trust meets the following requirement as provided for in such Section:**
   - During the life of the trust beneficiary, no portion of the trust corpus or income may be distributed to or for the benefit of any person other than the beneficiary; and
   - If the trust does not terminate before the individual dies, the assets of the trust will be includible in the gross estate of the beneficiary.

   Gifts made by the taxpayer’s spouse, which the taxpayer elects to split pursuant to Section 2513 of the Code, are reported on Part 1 of Schedule C. Columns C through F, as described above, have a space in which such gifts can be reflected so that the total net transfer subject to GST tax reflected in Column F can include the gifts of the taxpayer’s spouse which are attributable to the taxpayer.

   b. **Part 2.** On line 1, the total applicable GST tax exemption amount is indicated. On line 2, the total amount of such exemption used in prior periods is listed. Line 2 is subtracted from line 1 and the resulting number (the exemption amount available for the current year’s 709) is listed on line 3. On line 4, the taxpayer indicates the amount of GST tax exemption allocated in Part 3 of Schedule C, as described more fully below. On line 5, the taxpayer allocates any GST tax exemption such taxpayer wants to allocate to transfers not reported in Part 1 of Schedule C, such as indirect skips. Line 6 provides the total amount of GST tax exemption allocated, including the exemption allocated on the current year’s 709, and line 7 provides the total amount of available exemption accounting for the exemption allocated on the current year’s 709.

   c. **Part 3.** Every gift listed in Part 1 of Schedule C is also required to be listed in Part 3 of Schedule C. The net transfer of each gift, as calculated in Part 1 of Schedule C, is listed in column B. The amount of GST tax exemption allocated to each gift is listed in column C. The taxpayer cannot allocate exemption in excess of the exemption available to such taxpayer at the time the 709 is filed. Columns D through H guide the taxpayer in calculating the amount of GST tax due with the 709, if any.

   d. **Notice of Allocation.** If a taxpayer wants to allocate GST tax exemption to a transfer other than a direct skip, and the transfer does not qualify under the automatic allocation rules, the taxpayer is required to allocate the exemption on line 5 of Schedule C and attach a Notice of Allocation to the 709. Such notice must clearly identify the trust, provide the taxpayer identification number of the trust, indicate which item number(s) from Part 1 of Schedule A report the transfers to the trust, the value(s) of the gift(s) shown in column E of Part 1 of Schedule A (it is important to note if the taxpayer and his spouse elect to gift-split under Section 2513 of the Code, the amount of GST tax
exemption allocated should take such election into account), the amount of GST tax exemption allocated to each transfer (formula allocations are permitted), and the inclusion ratio of the trust after the allocation.

It may be advisable to attach a Notice of Allocation to the 709 even when the automatic allocation rules may apply. This practice ensures that the proper GST tax exemption is allocated in the case in which it was not necessarily clear that the gift to the trust was within the parameters of the automatic allocation rules and the taxpayer wants to allocate GST tax exemption to such trust.

e. Late Allocation of GST tax exemption.

If the taxpayer wants to allocate GST tax exemption to a trust so that the trust’s inclusion ratio is zero, and wants to make such allocation on a 709 that is not timely filed, the taxpayer must allocate an amount of GST tax exemption equal to the value of the property either on the date the return is filed or on the first day of the month in which that return is filed. I.R.C. §2642(b)(3). The IRS issued Notice 2001-50, 2001-2 C.B. 189, which provided that taxpayers may seek an extension of time in which to affirmatively allocate GST tax exemption pursuant to Treas. Reg. Section 301.9100-3. If relief is granted, the amount of GST tax exemption necessary to reduce the trust’s inclusion ratio to zero is based on the value of the property as of the date of the gift. In order to obtain such relief, it was necessary for the taxpayer to request a private letter ruling.

i. Rev. Proc. 2004-46. On August 2, 2004, the IRS issued Rev. Proc. 2004-46, 2004-31 I.R.B. 142, in order to provide taxpayers a simplified alternative method for the late allocation of GST tax exemption. In order to be eligible for such relief, the taxpayer must satisfy the following requirements:

- On or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a generation-skipping transfer could be made;
- At the time the taxpayer files the request for relief under this revenue procedure, no taxable distributions have been made and no taxable terminations have occurred;
- The transfer qualified for the annual exclusion under Section 2503(b) of the Code, and the amount of the transfer, when added to the value of all other gifts by the transferor to that donee in the same year, was equal to or less than the amount of the applicable annual exclusion for the year of the transfer;
- No GST tax exemption was allocated to the transfer, whether or not a 709 was filed;
- At the time the taxpayer files a request for relief under the revenue procedure, the taxpayer has unused GST tax exemption available to allocate to the transfer; and
- All the procedural requirements, as set forth in Rev. Proc. 2004-46, have been met.

The procedural requirements set forth in Rev. Proc. 2004-46 are as follows:

- File a 709 for the year of the transfer to the trust, regardless of whether a 709 was filed for such year. State at the top of the 709 that the return is “FILED PURSUANT TO REV. PROC. 2004-46”;
- Report the value of the transferred property on the date of the gift on the 709; and
- Allocate GST tax exemption to the trust by attaching a Notice of Allocation containing a clear identification of the trust, as defined in Section 6109 of the Code, including the trust’s taxpayer identification number, the value of the property transferred as of the date of the transfer (adjusted to account for split-gifts, if any), the amount of the taxpayer’s unused GST tax exemption at the time the Notice of Allocation is filed, the amount of GST tax exemption allocated to the trust, the inclusion ratio of the trust after the allocation and a statement that all of the requirements of section 3.01 of Rev. Proc. 2004-46 have been met.

If relief is granted under Rev. Proc. 2004-46, the taxpayer will be able to allocate GST tax exemption based on the value of the assets transferred to the trust, as of the date of the transfer. It is not necessary to apply for a private letter ruling pursuant to the Revenue Procedure.

2. New 709. Schedule C was changed significantly on the new 709.

a. Part 1. The values listed in column B of Part 1 of Schedule C include the adjustments for gift-splitting due to the fact that if the taxpayer elects to split gifts made by such taxpayer’s spouse or if the taxpayer’s spouse elects to split gifts made by the taxpayer, the values of the taxpayer’s gifts, as reported on Schedule A, have already been adjusted to reflect the gift-splitting. In 2002 and in prior years, the taxpayer was required to make such adjustments for purposes of allocation GST tax exemption directly on Schedule C.

b. Part 2. A line was added to the new 709 to allow taxpayers to allocate GST tax exemption to transfers reported on Part 3 of Schedule A (i.e., indirect skips). Transfers reported in such section are transfers to trusts which qualify for the automatic allocation rules. The donor is not required to attach a Notice of Allocation with respect to such transfers. Instead, the automatic allocation rules will apply to effectively allocate GST tax exemption, and such exemption allocation should be noted on line 5 of Schedule C. If it is unclear whether the automatic allocation rules apply, the taxpayer should attach a Notice of Allocation to the 709 to ensure that the proper GST
tax exemption is allocated. Moreover, some practitioners, as a matter of practice, always opt-out of the automatic allocation of GST tax exemption and allocate using a Notice of Allocation. If the taxpayer wants to allocate GST tax exemption to a transfer which is not a direct skip or to which the automatic allocation rules do not apply, such as a late allocation of GST tax exemption, the allocation is made on line 6 of Part 2 of Schedule C. Note that it is necessary for the taxpayer to attach a Notice of Allocation in such a case.

c. Part 3. The only change made to Part 3 on the new 709 was that the maximum estate tax rate, as indicated in column F of Part 3 of Schedule C, was amended to show the lower 2003 estate tax rate of 49%

IV. SECTION 7520 OF THE CODE.

This section is not meant to be a comprehensive review of the laws related to Section 7520. Rather, this section will highlight two issues regarding Section 7520 pertaining to 709s.

A. Applicable rate for valuing transfers to charitable remainder and lead trusts. The remainder interest of a charitable remainder trust and lead interest of a charitable lead trust is valued for gift tax purposes under the actuarial tables of Section 7520 of the Code. The practitioner has a choice of using the rate in effect for the month of the transfer or the rate in effect for either of the two months preceding the transfer. Treas. Reg. §25.7520-2(a)(2).

1. Statement attached to 709. In order to use the rate in effect for either of the two months preceding the transfer, the taxpayer must elect to do so as provided for in the Gift Tax Regulations. Accordingly, the taxpayer should attach a statement to the 709 stating that the election is being made. In addition, such statement should describe the interest being valued, provide the valuation date, identify the beneficiaries and identify the parties whose lives were used to calculate the value of the discount.

Note that if any of the measuring lives are terminally ill, the taxpayer must disclose such fact on the statement and provide an explanation as to how the illness impacted the valuation of the remainder interest. Lastly, a computation of the deduction should be included.

2. Time period in which to make the election. The election should be made on the first return on which the taxpayer takes the deduction. In addition, the taxpayer may file an amended 709 to make the election, provided that the return is filed within 24 months after the later of the date the original return for the year was filed or the due date for filing the return. Treas. Reg. §25.7520-2(b)(1).

3. Revocability of election. The taxpayer may revoke such election by filing an amended return within 24 months after the later of the date the original return was filed or the due date for filing the return. Treas. Reg. §25.7520-2(b)(3).

B. Terminally Ill Donors.

1. Regulations. Section 25.7520-3(b)(3) of the Gift Tax Regulations provides that the mortality component described in Section 7520 of the Code may not be used to determine the present value of an annuity, income, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the gift. Such regulation is effective for gifts made after December 13, 1995.

2. Definition of terminally ill. The regulation further provides that the individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year. Treas. Reg. §25.7520-3(b)(3). If the individual survives for eighteen months or longer after the transfer, that individual shall be presumed to have been terminally ill at the date of the transfer unless the contrary is established by clear and convincing evidence. Id.

3. Applicable rate. When a donor is terminally ill, the rates provided for in the tables under Section 7520 may not be used. Id. Instead, a special rate accounting for the donor’s actual life expectancy must be calculated.

4. Revenue Ruling 96-3. 1996-1 C.B. 348. Revenue Ruling 96-3, 1996-1 C.B. 348, provides that the valuation tables are not to be used if the individual, who is the measuring life, is known to be terminally ill at the time of the transfer. Such ruling renders Revenue Ruling 80-80 and Revenue Ruling 66-307 obsolete.

V. REPORTING FORMULA GIFTS.

When a taxpayer gifts or sells an asset that is difficult to value, an adjustment clause is often utilized. The purpose of such a clause is to prevent the imposition of additional gift tax if the IRS later revalues the asset transferred and determines that such value exceeds the value reported on the 709. In McCord v. Comm’r, the Tax Court declined to validate a formula clause used in a transfer of limited partnership interests, but did not necessarily discourage practitioners from using such clauses. 120 T.C. No. 13 (May 14, 2003). This case is in on appeal to the Fifth Circuit.

VI. ACHIEVING FINALITY ON THE VALUE OF A REPORTED GIFT.

A. Sections 6501(a) and 6501(c)(9) of the Code. Section 6501(a) of the Code provides that the statute of limitations for assessment of tax is generally three years from the time the tax return is filed. Section
6501(c) provides exceptions to such rule, such as filing a false return, fraud and, in the case of 709s, where a gift is not adequately disclosed in a manner adequate to apprise the Secretary of the nature of such item. Under Section 6501(e)(2) of the Code, if the taxpayer omits from the total amount of gifts for the year an amount in excess of 25% of the gifts reported in the return, the statute of limitations as provided in Section 6501(a) of the Code is increased to six years.

1. Transfers valued under Sections 2701 and 2702 of the Code made after January 28, 1992. Such transfers include transfers to Qualified Personal Residence Trusts and Grantor Retained Annuity Trusts. According to Treas. Reg. §301.6501(c)-1(e)(3), with respect to all transfers valued under the aforementioned sections of the Code and made within the time frame indicated, the following information must be disclosed to commence the statute of limitations:
   a. A description of the transaction, including a description of transferred and retained interests and the method (or methods) used to value each. Treas. Reg. §301.6501(c)-1(e)(2);
   b. The identity of, and relationship between, the transferor, transferee, all other persons participating in the transaction and all parties related to the transferor holding an equity interest in any entity involved in the transaction. Id.; and
   c. A detailed description (including all actuarial factors and discount rate used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date. Id.

2. All other transfers and the Adequate Disclosure Rules. The Taxpayer Relief Act of 1997 amended the regulations under Section 6501 of the Code to apply to all transfers, not just to those valued under Sections 2701 and 2702 of the Code. Section 301.6501(c)-1(f) of the Gift Tax Regulations (effective for transfers made after December 31, 1996) was added to apply to such transfers and provides that the following information must be disclosed in order to commence the statute of limitations:
   a. A description of the transferred property and any consideration received by the transferor;
   b. The identity of, and relationship between, the transferor and each transferee;
   c. If the property is transferred in trust, the trust’s tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;
   d. A detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that was utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property;

   In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the adequate disclosure requirements. In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100% of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the 709. If 100% of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required herein must be provided for each entity if the information is relevant and material in determining the value of the interest; and
   e. A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

   In lieu of the requirement described in paragraph d. above, the donor may submit an appraisal that meets certain requirements.
   • The appraiser must meet the following requirements:
The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

Because of the appraiser’s qualifications, as described in the appraisal that details the appraiser’s background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued; and

The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in Section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either.

- The appraisal must contain the following information:
  
  i. The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;
  
  ii. A description of the property;
  
  iii. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;
  
  iv. The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;
  
  v. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;
  
  vi. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and
  
  vii. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

It is suggested that the appraisal contain a summary of the adequate disclosure requirements and indicates that such appraisal satisfies the foregoing requirements.

B. CCA 200221010. In 1997, the taxpayer gifted 19% of his membership units in ABC, LLC (the “LLC”) to a trust exempt from GST tax and 1% of his membership units in the LLC to a family trust. Taxpayer’s spouse consented to gift-split under Section 2513 of the Code and both spouses filed 709s. The value of the gift as reported on the taxpayer’s 709 was $200,000. The following description of the gift was attached to the 709: “Class B units in ABC, LLC. Units acquired on 4/6/1997 for $200,000 cash.”

The IRS challenged the return on the basis that the value of the trusts as of the date of the transfer was $14,000,000. The IRS was prepared to issue a notice of deficiency with respect to the return, but raised the question of whether it could rely on Sections 6501(c)(9) or 6501(c)(2) of the Code as a basis for arguing that the statute of limitations remained opened with respect to such return.

In order to rely on Section 6501(c)(2), the IRS must show that the omitted item was property includible in the total gifts shown on the 709, the omitted items comprised more than 25% of the total gifts shown on the return and the information on the return or any statement attached to the return was not sufficient to apprise the IRS of the nature and amount of the omitted item. The IRS referred to income tax cases for guidance in determining what information must be shown to apprise the IRS of the nature and amount of the omitted item, as there were no gift tax cases on such subject. The income tax cases require the production of a “clue” respect to the omission of income, meaning that it is not necessary to provide a detailed revelation of each and every underlying fact. The disclosure must be sufficiently detailed that a decision whether to select the return for audit may be a reasonably informed one. The six year statute will apply when there is a complete omission of an item or a misstatement of the item. The IRS concluded that the taxpayer did not provide sufficient information to apprise them of the nature and amount of the omitted item and, thus, the six year statute was applicable.

Although the regulations under Section 6501(c)(9) of the Code were not applicable to the facts due to the dates which such regulations became effective, the IRS stated that the principles implicit in the regulations are the same principles implicit in the Code section itself. Accordingly, the IRS found that the taxpayer did not adequately disclose the gift so that the statute of limitations did not commence upon filing the 709.

C. Rev. Proc. 2000-34, 2000-34 I.R.B. 186. The IRS published such Revenue Procedure to advise taxpayers that amended 709s could be filed in order to comply with the adequate disclosure requirements of Section 6501 and commence the statute of limitations for previously filed 709s. Any amended 709 filed for such purpose after August 21, 2000 must be done in accordance with Rev. Proc. 2000-34 and the top of the first page of the amended 709 must have the words “Amended Form 709 for gift(s) made in [insert the calendar year that the gift was made] pursuant to Rev. Proc. 2000-33, 2000-34 I.R.B. 186.”

D. Section 2504(c) of the Code. For gifts made after August 1997, 2504(c) prevents the IRS from revaluing gifts that are adequately disclosed on the taxpayer’s 709 when the statute of limitations has expired under Section 6501(c) of the Code.
E. Section 2001(f)(2) of the Code. Such Section provides that the value of a gift shall be deemed finally determined if such value is shown on a 709 (as provided under Section 6501 of the Code) and is not contested by the IRS within the applicable statute of limitations.

VII. SECTION 2513 OF THE CODE—GIFT-SPLITTING.

Many practitioners assume that they have a complete understanding of Section 2513 of the Code and the Gift Tax Regulations thereunder. In fact, the laws surrounding gift-splitting are complex and an election to gift-split, or the failure to properly gift-split, could cause unintended adverse tax consequences. When practicing in the field of estate and gift taxation, a practitioner should have a complete understanding of the requirements that must be met in order for a married couple to elect to gift-split, as well as the effects of such an election. For example, once an election under Section 2513 of the Code has been made, the taxpayers may not choose which gifts they will split. Instead, the election is applicable to all gifts made during the calendar year. Moreover, once made, the election is irrevocable.

A. Requirements under Section 2513 of the Code for all gifts to third parties (gifts to spouses may not be split) made by the donor spouse to be considered as made one-half by donor spouse and one-half by non-donor spouse.

1. U.S. citizenship or residency. At the time of the gift, each spouse must be a U.S. citizen or a U.S. resident.

2. Married at time of gift. At the time of the gift, the spouses must be married. If during the same year the gift was made, the spouses divorce, they may still elect to split gifts made while they were married, provided neither of them remarry during the same calendar year.

3. Consent by both spouses. Both the donor spouse and the non-donor spouse must signify their consent to the election to gift-split.

B. Limitations as to which gifts a couple may elect to gift-split.

1. Gifts to spouse. A couple may not elect to split gifts to each other.

2. Spouse with power of appointment. A gift by the donor spouse cannot be split where the donor spouse created in the non-donor spouse a general power of appointment as defined in Section 2514(c) of the Code. I.R.C. §2513(a)(1).

3. Elections made by executor or agent. An election to gift-split may be made on behalf of a deceased donor by such donor’s executor. However, the gift must have been made while the donor spouse was still living. An election to gift-split may also be made by an agent of the spouse pursuant to Section 25.6019-1(d) of the Gift Tax Regulations. Such regulation provides that a return shall not be made by an agent unless by reason of illness, absence or nonresidence, the person liable for the return is unable to make it within the time prescribed. The regulation further provides that if by reason of illness, absence or nonresidence, a return is made by an agent, the return must be ratified by the donor or other person liable for its filing within a reasonable time after such person becomes able to do so.

a. Revenue Ruling 73-207, 1973-1 C.B. 409. The donor spouse owned various life insurance policies on the life of her husband, the non-donor spouse. The couple’s children were designated as the beneficiaries of the policies’ death benefits. Following the death of the non-donor spouse, the donor spouse filed a 709 on which she reported the transfer of the death benefit proceeds to her children. The executor of the estate of the non-donor spouse signed the 709 to signify the consent of the non-donor spouse to gift-split and, thus, the gift was treated as being made one-half by the donor spouse and one-half by the non-donor spouse. The IRS noted that Section 25.2513-1(b)(1) of the Gift Tax Regulations provides that consent to gift-split is not effective with respect to any gift made by the surviving spouse during the part of the year that the non-donor spouse is deceased. The IRS held that the designation of the children as the beneficiaries of the policies was not a completed gift, as the beneficiaries could be changed at any time prior to the death of the non-donor spouse. The IRS held that the gift was made at the time of the non-donor spouse’s death, which was also the exact time the marital relationship ceased to exist. Accordingly, the IRS held that the gift was not eligible for gift-splitting.

b. Revenue Ruling 78-27, 1978-1 C.B. 387. The donor spouse gifted real property to the child of the donor spouse and the non-donor spouse. The donor spouse went to the preparer’s office to sign the 709 and, as a matter of convenience, forged the non-donor spouse’s signature on the line where the non-donor spouse was required to consent to gift-split. One year later, the donor spouse filed an amended 709. On such return, the non-donor spouse signed her own name to signify her consent to gift-split. The IRS held that the signature by the donor spouse of the non-donor spouse’s name was not sufficient to signify consent to gift-split and that the filing of the amended 709 did not perfect such consent.

4. Interest gifted to third party must be ascertainable. If a donor spouse transfers property so that a portion of the property interest is gifted to a third party and a portion of the interest is gifted to his or her spouse, in order for the portion gifted to a third party to...
be eligible for gift-splitting, such interest must be ascertainable at the time of the gift and hence severable from the interest transferred to the non-donor spouse.


**FACTS:** Donor spouse made a gift in trust of corporate stock. The value of the stock as of the date of transfer was $54,000. The donor spouse and non-donor spouse each filed a 709 electing to split the gift of corporate stock to the trust. The trust provided that the net income of the trust should be paid to the non-donor spouse for life. The trustees of the trust, in their absolute discretion, could pay from the principal of the trust any sum they deemed necessary or advisable for the “general welfare” of any income beneficiary to such beneficiary.

**ISSUE:** Whether the portion of the transfer of the stock to the trust attributable to third parties was ascertainable so that such transfer would be eligible for gift-splitting.

**HOLDING:** The Tax Court held that the interest transferred to the third parties was not ascertainable, as it could not be shown that the wife’s other funds would make the invasion of the trust’s principal for her benefit unlikely.


**FACTS:** Donor spouse was the grantor of a trust agreement. The trust agreement provided that during the joint lives of the donor spouse and the non-donor spouse, the trustee(s) should distribute the trust income to the non-donor spouse. Upon the death of the donor spouse, if the non-donor spouse was living, the trustee(s) were to set apart a separate portion of the trust assets, to be referred to as “Fund A” to be administered for the non-donor spouse’s benefit. “Fund A” was to consist of an amount equal to the difference between one-half of the value of the donor spouse’s adjusted gross estate and the value of all the property passing to the non-donor spouse pursuant to the donor spouse’s will or by operation of law. Only assets that would qualify for the marital deduction were to be used to fund “Fund A.” The balance of the trust was to be used to fund “Fund B.” The non-donor spouse was to receive the income from “Fund A” during her lifetime and she had a noncumulative right to withdraw $10,000 per year from the principal of “Fund A” for any purpose whatsoever and in her sole discretion. The non-donor spouse also had a general power of appointment over “Fund A.” The trustees were also allowed to distribute as much of the trust’s principal to the non-donor spouse as they deemed necessary or advisable for her proper care, support, and health or in the event of an emergency affecting the non-donor spouse. Upon the death of the non-donor spouse, the balance of the trust was to be divided equally into three trusts. Each then living child of the donor-spouse would be the beneficiary of one trust and if a child had predeceased the non-donor spouse, such child’s share would be administered for the benefit of such deceased child’s issue.

The donor spouse filed a 709 for 1963; such return reported that property valued at $71,141.73 was transferred to the trust. The donor spouse reported $50,829.34 as attributable to the remainder interest transferred in trust for the benefit of third parties. Accordingly, the donor spouse and the non-donor spouse elected to split such gift under Section 2513 of the Code and, thus, each reported a gift of $25,414.67.

The IRS issued a notice of deficiency to the donor spouse claiming that the portion of the gift attributable to third parties was not ascertainable and, thus, not eligible for gift-splitting.

**ISSUE:** Whether the gift of the remainder interest of property in trust by donor spouse should be considered as made one-half by such spouse and one-half by the donor spouse under Section 2513 of the Code.

**HOLDING:** Gift Tax Regulations Section 25.2513-1(b)(4) provides that consent to split gifts is effective with respect to an interest transferred to third parties only insofar as such interest is ascertainable at the time the gift is made, and hence severable from the interest transferred to the spouse.

The Tax Court referred to the principles established in cases where it was necessary to determine whether a power given to a trustee to invade the principal of a trust for the benefit of a life tenant renders the bequest to a charity by way of a charitable remainder trust so indefinite as to render it impossible to ascertain the value of such bequest for the purposes of a charitable deduction. The court noted that such cases held that the answer depends on whether the trustee’s power was limited by an ascertainable standard. The court noted that an ascertainable standard only exists when the language of the document provides that the trustee is only permitted to invade the principal for health, education, support and maintenance.

The court held that the standard in the trust at issue was not an ascertainable standard, as the term “emergency” was not limited to preserving the spouse’s present standard of living. Thus, the gifts of remainder interests were not subject to gift-splitting under Section 2513 of the Code.

c. **PLR 200345038.** Donor spouse established three irrevocable trusts. The beneficiaries of Trust 1 are the non-donor spouse and her daughter, the beneficiaries of Trust 2 are the non-donor spouse and her son, and the beneficiaries of Trust 3 are the non-donor spouse and her other son. The trusts have identi-
cal terms. The trustee was to pay to the beneficiaries as much of the trust’s income and principal as they deemed necessary or appropriate for the beneficiaries’ health, maintenance, education and support of the beneficiaries. Each child had a general power of appointment over the trust of which he or she was a beneficiary. The donor spouse transferred assets to such trusts and the donor spouse and the non-donor spouse filed 709s to report such gifts, and elected to gift-split, but failed to allocate the proper amount of GST tax exemption. The taxpayers requested a private letter ruling requesting an extension of time to allocate their GST tax exemptions to such transfers. In the private letter ruling, the IRS discussed the issue of whether the transfer to the third parties was ascertainable and, thus, eligible for gift-splitting. The Service concluded that because the trust provided that income and principal could be paid to the non-donor spouse for such spouse’s health, maintenance, education and support, the interest transferred to the children was ascertainable and, thus, eligible for gift-splitting.

C. Manner and time of signifying consent to gift-split.

1. When only one spouse files a 709. If gift-splitting is elected and only one spouse makes gifts during the calendar year, the other spouse is not required to file a 709, provided that the total value of the gifts made to each third party donee is not in excess of two times the annual exclusion amount (currently $22,000) and no portion of the property transferred constitutes a gift of a future interest. In such a case, the consent of both spouses should be signified on the donor spouse’s 709. Treas. Reg. §25.2513-2(a)(1).

2. When both spouses file 709s. Consent may be signified in one of three ways: (1) the consent of the husband may be signified on the wife’s 709 and the consent of the wife may be signified on the husband’s 709, (2) consent of each spouse may be signified on his or her own 709, or (3) the consent of both spouses may be signified on one of the returns. Treas. Reg. § 25.2513-2(a)(1).

3. Time for consent. Consent may not be signified after April 15th of the year following the year in which the gift was made (due date of the 709). However, if no 709 was filed by either spouse on or before April 15th, consent may be signified on a late 709. If one of the spouses filed on or before April 15th and consent was not signified, consent may not be signified on the second spouse’s 709 when it is filed. If either spouse receives a notice of deficiency with respect to gift tax for the year in which the gift was made, consent to split may not be signified for such period. Treas. Reg. § 25.2513-2(b)(1).

4. Time for consent for gifts made after December 31, 1970 and before January 1, 1982. Consent must have been signified by the 15th day of the second month following the calendar quarter in which the gift was made if a 709 was filed by such time. If no 709 was filed, consent must have been signified on the 709 at the time of filing such return. Once a 709 was filed, consent could no longer be signified. Treas. Reg. §25.2513-2(b)(2). See Revenue Ruling 80-224, 1980-2 C.B. 281.

5. Revocation of consent. If consent was made on or before April 15th of the year following the year in which the gift was made, the consent may be revoked on or before April 15th of such year. The revocation may be made by either spouse filing in duplicate a signed statement of revocation. Such statement must be filed on or before April 15th of the year following the year in which the gift was made. If consent is signified after April 15th of the year following the year in which the gift was made, it may not be revoked. Treas. Reg. §25.2513-3.

D. Joint and Several Liability. Pursuant to Section 2513(d) of the Code and Section 25.2513-4 of the Gift Tax Regulations, when spouses elect to gift-split, the entire gift tax liability of each spouse for that tax year is joint and several. In CCA 2000205027, the IRS held that although the gift tax liability was joint and several, fraud on the part of the donor spouse could not cause the statute of limitations to remain open with respect to the 709 filed by the non-donor spouse.

E. No deemed gift for payment of entire gift tax liability by one spouse. Pursuant to Section 25.2511-1(d) of the Gift Tax Regulations, if a husband and wife elect to gift-split under Section 2513 of the Code and the gift tax liability with respect to such transfers is paid by one spouse, the payment of the tax is not deemed a transfer subject to gift tax.

F. Allocation of GST tax exemption.

1. 2652(a)(2) of the Code. If an election to gift-split is made under Section 2513 of the Code to treat the gift as made one-half by the donor spouse and one-half by the non-donor spouse, then such gift shall also be treated as if made one-half by each spouse for purposes of the GST tax. For example, if A transfers real property to a trust for the benefit of his grandchild
and A and his spouse, B, each file a 709 which signi-

fies their consent to split all gifts made during the cal-
egendar year; each spouse should also allocate GST tax

exemption to the transfer in an amount equal to one-
half of the value of the gift.

2. PLR 200422051 and Section 26.2652-

1(a)(4) of the Generation-Skipping Transfer Tax Regu-
lations. It should be noted that if A transferred prop-

ty to a trust for the benefit of his wife, B, during her

life and for the benefit of a third party following her
death, and A and B want to elect to split the gift of the

remainder interest (assuming it was ascertainable and

severable from the wife’s interest in the trust), the

spouse’s would each allocate GST tax exemption in

amount equal to one-half of the value of the property

transferred to the trust. Although the spouses may not

split the gift attributable to the interest transferred to

the non-donor spouse, Section 26.2652-1(a)(4) of the

Generation-Skipping Transfer Tax Regulations pro-

vides that the non-donor spouse is treated as the trans-

feror of one-half of the entire value of the property

transferred by the donor, regardless of the interest the

non-donor spouse is actually deemed to have trans-

ferred under Section 2513 of the Code.

3. TAM 200147021. Husband and wife each

made gifts to their grandchildren during the calendar

year. At the time of the gift, husband had utilized all of

his gift tax exemption and GST tax exemption. Thus, the

direct skips were subject to GST tax. Husband and wife

elected to gift-split and under Section 2513 of the Code.

The additional gift imposed by Section 2515 of the Code,

which states that the gift tax attributable to a direct skip

will be considered an additional deemed gift to the

donee, was also split by the spouses on their respective

709s. The IRS held that such treatment was required.

4. GST tax exemption allocation when split-
gift subject to an ETIP. If a gift is made subject to an

ETIP and such gift is split by the donor spouse and non-
donor spouse pursuant to Section 2513 of the Code, no
allocation of GST tax exemption is made at the time the

gift is reported. As discussed above, the GST tax

exemption will be allocated at the close of the ETIP. If

the non-donor spouse dies prior to the close of the

ETIP, such spouse’s executor may allocate GST tax

exemption to such transfer up to the amount of which

the non-donor spouse is treated as the transferor. The

allocation will not be effective until the close of the


G. Uniform Transfers to Minors Act.

1. Section 2038 of the Code. Such section

provides that the gross estate of a decedent shall

include the value of all property transferred by the
decedent, in trust or otherwise, over which he holds at
the date of his death, either alone or in conjunction with
any other person, the power to alter, amend, revoke or

terminate the enjoyment of the beneficial interest.


Such revenue ruling holds that the value of any transfer
of property to a minor under the Uniform Gifts to

Minors Act is includible in the gross estate of the donor

for Federal estate tax purposes if the donor appoints

himself custodian and dies while serving as such.

The donor spouse transferred securities owned by him,

individually, to himself as custodian for his minor
daughter under the Uniform Gifts to Minors Act. The

donor spouse and the non-donor spouse elected to gift-
split under Section 2513 of the Code. After filing the

709, the donor spouse became incapacitated and the

non-donor spouse was appointed as successor custodi-
an. The non-donor spouse died while serving in such

capacity. The issue was whether one-half of the value

of the securities should be included in the estate of the

non-donor spouse on the basis that he transferred such

securities by signing her consent to gift-split and

she held the securities as custodian upon her death.

In order for an asset to be included in the estate of a de-
cedent under Sections 2035 and 2038 of the Code, the
decedent must “transfer” such asset prior to his or her
death. Because a spouse who elects to gift-split under

Section 2513 of the Code does not “transfer” the gifts

of the donor spouse, which he or she consents to gift-
split, the IRS held that no part of the value of the assets

transferred by the donor spouse would be included in

the estate of the non-donor spouse upon her death.

H. Section 2001(e) of the Code—Coor-
dination of Sections 2513 and 2035 of the Code.

1. Section 2035 of the Code. Such Section

provides that if a decedent made a transfer (by trust or

otherwise) of an interest in any property, or reli-

quished a power with respect to any property, during the

3-year period ending on the date of the decedent’s

death, and the value of such property (or any interest

therein) would have been included in the decedent’s

gross estate under Sections 2036, 2037, 2038 or 2042

of the Code if such transferred interest or relinquished

power had been retained by the decedent on the date of

his death, the value of the gross estate shall include the

value of any property (or interest therein) which would

have been so included. Section 2035(b) provides that

the amount of any gift tax paid by the decedent or his

estate on any gift made by the decedent or his spouse,
during the 3-year period ending on the date of deced-

tent’s death, shall also be included in the decedent’s

gross estate.


Donor spouse made a gift to his child and the non-
donor spouse elected to gift-split under Section 2513

of the Code. The gift tax attributable to the transfer

was paid entirely from the donor spouse’s assets.
Soon thereafter, the non-donor spouse died. No part of the gift was included in her gross estate, but one-half of the gift was included in her estate as an adjusted taxable gift. Such amount was reduced by the gift tax attributable to one-half of the gift. Upon the death of the donor spouse, which was within three years of the date of the gift, the total amount of the gift, including the one-half treated as having been made by the donor spouse, and the total gift taxes thereon, were includible in the donor spouse’s estate under Section 2035 of the Code. The estate of the non-donor spouse filed a claim for refund claiming that the estate tax should be recomputed due to the fact that such tax was absorbed by the estate of the donor spouse. The IRS held that when a donor spouse dies after the death of the non-donor spouse and a gift that the non-donor spouse consented to split was includible in the donor spouse’s estate under Section 2035 of the Code, the estate of the non-donor spouse is entitled to recompute its tax as a result of the application of Section 2001(e) of the Code. Accordingly, one-half of the gift should not be included in the adjustable taxable gifts of the non-donor spouse and the tentative tax should not reduced by any amount of gift tax payable on the split gift.

3. Revenue Ruling 82-198, 1982-2 C.B. 206. Donor spouse transferred property to an irrevocable trust under which the income was payable to the donor spouse for life and, upon the death of the donor spouse, the remainder would pass to a third party. The donor spouse and the non-donor spouse each filed a 709 and elected to gift-split under Section 2513 of the Code. Upon the death of the donor spouse, which was within three years of the date of the gift, the value of the assets gifted to the irrevocable trust were included in the donor spouse’s estate under Section 2035 of the Code. The IRS held that upon the death of the non-donor spouse, which was also within three years of the date of the gift, no portion of the gift would constitute an adjustable taxable gift in the estate of the non-donor spouse, where the full amount of the gift is included in the gross estate of the donor spouse under Section 2035 of the Code. The IRS further held that the estate of the non-donor spouse would receive no credit under Section 2001(b)(2) of the Code for the gift tax paid by such spouse and any gift tax paid by the non-donor spouse is included in that spouse’s gross estate under Section 2035(c) of the Code.

4. Transfers to QPRTs/GRATs/GRITs. In general, gift-splitting should not be elected when one spouse gifts assets to a QPRT, GRAT or GRIT. If the donor spouse dies during the term of the trust, the entire value of the assets gifted will be included in the gross estate of the donor spouse and the non-donor spouse will receive no credit for such inclusion upon his or her death. The result is that the gift tax exemption of the non-donor spouse could be wasted. In the case of a gift to a “zeroed out” GRAT, it shouldn’t make a difference whether gift-splitting is elected.
The Appropriate Withdrawal Rate: Comparing a Total Return Trust to a Principal and Income Trust

by Edward A. Moses, Winter Park, Florida*
J. Clay Singleton, Winter Park, Florida and
Stewart Andrew Marshall, III, Orlando, Florida

Editor’s Note: Modern Portfolio Theory has become a customary tool used by investment professionals and, as such, constitutes an industry standard prudent fiduciaries cannot ignore. Further, the Prudent Investor Rule and Modern Portfolio Theory are inextricably intertwined. We have elected to publish four articles in consecutive editions of ACTEC Journal, this current article being the last, in order to provide our readership with an understanding of Modern Portfolio Theory, demonstrate the necessity of applying this theoretical construct in accordance with the Prudent Investor Rule and apply this theory to other pertinent issues surrounding the administration and litigation of portfolios managed by fiduciaries. Sequential publication eliminates the need to redevelop Modern Portfolio Theory and other concepts in each article. ACTEC Journal readers will have the option of reviewing earlier articles to clarify any points of interest in subsequent articles.

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I. Introduction
Tom Harold swiveled his desk chair so he could look out the window from his office on the 33rd floor. Tom did this often when he was troubled. The city skyline view allowed him to put into perspective any of his concerns.

Earlier in the week, Tom had a telephone conversation with Doris Winthrop, the widow of his best friend, Jared Winthrop. Jared had died unexpectedly at a relatively young age. Prior to his death, Jared had appointed Tom, with his concurrence, as successor trustee for his then revocable trust. The trust named his current wife, Doris, as income beneficiary and two sons from his first marriage as remainder beneficiaries. The trust language was rather standard and Tom, given his background in the investment industry, was comfortable with his ability to manage the trust in a professional manner. He was quite conversant with the requirements of Restatement (Third) of Trusts, the Prudent Investor Rule (Rule), the Uniform Prudent Investor Act (Act), and the Uniform Principle and Income Accounting Act (2001) (UPIAA).

During their conversation in early April 2005, Doris had complained bitterly about her most recent quarterly income distribution and the income she received during 2004 from the $15 million in trust assets. Under the trust’s terms, her income disbursements were limited to traditional fiduciary accounting income. Given the interest rate downturn and relatively low dividend yield generated by equities, the trust’s income had been declining since Jared’s death three years ago. Currently the income from interest and dividends was approximately three percent of the trust’s asset value. In their conversation, Doris indicated a strong desire for the trust’s portfolio to be reallocated heavily toward debt, allowing for a larger dollar income distribution.

Adding to Tom’s concern was the attitude of Jared’s two sons toward their stepmother. Their relationship with Doris could be described as dysfunctional at best. He knew they would oppose vigorously any portfolio reallocation that increased Doris’ income at the expense of their remainder interest upon her death—which, according to actuarial tables, was approximately twenty years hence.

Tom believed the trust’s current asset allocation served the interests of both income and remainder beneficiaries reasonably well as required by his fiduciary duty of impartiality. He realized the portfolio’s allocation was weighted somewhat toward income producing assets (debt and real estate investment trusts or REITs) to provide income for Doris and he thought any further weighting in that direction would be unfair to the remainder beneficiaries.

As Tom pondered the situation, he contemplated “total return investing” as a possible solution. Under the total return concept, he could invest the portfolio without concern as to whether the return came from income or appreciation. Upon advice of counsel, Tom understood in his jurisdiction he had available two alternative approaches: the power to adjust income and principal; and, conversion to a unitrust.

Based on §103 and §104 of UPIAA, Tom was confident that he had the power to make equitable adjustments and he decided to investigate this total return approach. However, he had always been a little unsure about the “Coordination with the Uniform Prudent Investor Act” section of UPIAA’s Prefatory Note. Because he kept a copy of UPIAA on his desk, he picked it up and began to read a portion of that section:

The law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of Trusts, 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settler, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives the trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee’s ability to fully implement modern portfolio theory.¹

Tom understood the intent of the section and had a reasonably sound understanding of Modern Portfolio Theory (MPT). However, he did not have a good grasp on how to determine the appropriate withdrawal rate for the current beneficiary and comport with his impartiality duty.

Tom decided to consult with John Dowd, a financial expert. During their conversation, John requested Tom send to him a copy of the current portfolio’s holdings, the year-end statements for the past three years, a

¹ Uniform Principal and Income Act, Prefatory Note (amended last 2001).
copy of the trust document, and the trust’s investment policy statement (IPS). John promised to provide Tom an analysis within the next three weeks. That analysis is the subject of the remainder of this article.

Section II presents the feasible set of assets from which the Efficient Frontier was constructed as of the end of March 2005. The development of a proposed portfolio is discussed and the proposed and current trust portfolios are examined relative to the Efficient Frontier. Section III describes the simulation results of the current and proposed portfolios under the assumption of different withdrawal rates. Section IV identifies the crossover rate as the withdrawal rate that matches the ending expected values of the current and proposed portfolios. Section V discusses the need for periodic review of the trust portfolio and the withdrawal rate. Section VI summarizes an approach for determining the appropriate withdrawal rate for a total return trust.

II. The Efficient Frontier and the Financial Expert’s Proposed Portfolio

A. The Feasible Set. Upon receiving and reviewing the information from Tom, John created an Efficient Frontier as of the end of March 2005. He determined the asset classes and their corresponding benchmark indexes, shown in Chart II.1, which John determined to be appropriate under the circumstances, as the feasible set for constructing the Efficient Frontier.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Large Cap Growth</td>
<td>S&amp;P/BARRA 500 Growth</td>
</tr>
<tr>
<td>U.S. Large Cap Value</td>
<td>S&amp;P/BARRA 500 Value</td>
</tr>
<tr>
<td>U.S. Mid Cap Equities</td>
<td>S&amp;P MidCap 400</td>
</tr>
<tr>
<td>U.S. Small Cap Equity</td>
<td>Russell 2000</td>
</tr>
<tr>
<td>International Equities</td>
<td>MSCI EAFE</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>S&amp;P/IFC Composite</td>
</tr>
<tr>
<td>Real Estate</td>
<td>NAREIT – Equity</td>
</tr>
<tr>
<td>U.S. Short Term Gvt Bonds</td>
<td>Ibbotson Associates US 1 yr Treasury</td>
</tr>
<tr>
<td>U.S. High Yield Bonds</td>
<td>Lehman Bros. High Yield Index</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>Lehman Bros. 20 yr Municipal Bonds</td>
</tr>
<tr>
<td>International Bonds</td>
<td>Solomon Bros. Non-US 1 yr Gvt Bonds</td>
</tr>
<tr>
<td>U.S. Cash Equivalent</td>
<td>Solomon Bros. 90 Day T-Bills</td>
</tr>
</tbody>
</table>

B. The Efficient Frontier. The Efficient Frontier that results from the feasible set is shown in Chart II.2.

C. Actual and Proposed Portfolios. John examined the current trust portfolio as of March 2005 and assigned each of the assets in the portfolio to a specific asset class. The composition of the current trust portfolio, in terms of dollars and percentage of the total portfolio, is shown in Chart II.3. He noted the portfolio asset allocation had not changed significantly over the past three years and he was comfortable using the current allocation.

After reviewing the IPS and assessing the required return contained in the policy statement, John located a portfolio on the Efficient Frontier containing an expected return, and thus expected risk, higher than the level indicated in the current IPS. John deemed increasing portfolio expected return and risk as consistent with the concept of total return investing. If the trust was allowed to distribute income and principal to the income beneficiary, the portfolio would no longer be constrained to invest a large percentage of its assets in low-return, income-producing securities. After examining the composition of the proposed portfolio, its location relative to the Efficient Frontier, and its associated expected risk, John was comfortable in selecting the proposed portfolio shown in Chart II.3.

---

Footnotes:

1. A discussion of the underpinnings of Modern Portfolio Theory and its connection to the Prudent Investor Act appears in the first article in this series.

2. Other than the two end point asset classes, Cash and Emerging Markets, the asset classes in the feasible set are not labeled in Chart II.2. This was done to avoid clutter in the chart. The unlabeled boxes in the chart represent the remaining 12 asset classes considered as part of the feasible set.

3. The use of the trust’s investment policy statement to assist in determining the appropriate risk level for a trust is presented in the second article in this series.
D. Preparing for the Simulation.

John’s next step was to compare the current and proposed portfolios by simulating returns over a twenty year investment horizon—Doris’ life expectancy. In preparing the simulation, John noted the trust had passed all income to Doris. Tom had also managed the trust such that historically all capital gains had been offset by capital losses and the portfolio did not incur capital gains taxes. Though perhaps slightly unrealistic, for illustrative purposes John assumed the trust would continue not to be liable for capital gains taxes. Neither would it be liable for income taxes as it was expected all net income would be distributed within the anticipated withdrawal amount. He also gathered statistics (expected returns, standard deviations, and correlations) on the performance of the asset classes in Chart II.3 for the period 1991 through March 2005.\(^5\)

III. Simulation of Investment Returns

A. Purpose of the Simulation. John used a simulation to help him compare the current and proposed trust portfolios and to determine a new withdrawal rate that balanced Doris’ need for current distributions with her stepsons’ desire for capital growth. Towards this end, John’s simulation was designed to identify the maximum withdrawal rate, or crossover rate, such that the remainder beneficiaries’ expected ending value of the proposed portfolio is not less than the expected ending value of the current portfolio at its current 3% withdrawal rate. John realized that to generate a crossover rate, the proposed portfolio must offer a higher expected return and, thus, more risk than the current portfolio. John’s proposed portfolio, shown in Chart II.3, met this criterion.

B. Inputs to the Simulation. Because an investment return simulation requires values for each constituent asset class to describe a portfolio’s future path, John used the historical asset class statistics to build forecasts. He knew asset class returns should not be forecast independently, however, because MPT recognizes the importance of the relationships between them.\(^6\) John simulated short-term interest rates and stock returns in any one period, they should not be systematically higher over time. Similarly bonds are assumed to have a lower average expected risk and return than stocks. The simulation also assumes that all assets have correlations that are stable on average.

---

\(^5\) The historical record of the indexes varies from 80 to 13 years. In this case the shortest index began in 1991.

\(^6\) For example, the simulation assumes small cap stocks will have a higher expected risk and return than large cap stocks. Though large cap stock returns might be higher than small cap

---

The current and proposed portfolios relative to the Efficient Frontier John created are displayed in Chart II.4.

---

![Chart II.3 Current and Proposed Portfolio Allocations as of March 2005](image)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Current Portfolio</th>
<th>Proposed Portfolio</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>%</td>
<td>$</td>
</tr>
<tr>
<td>U.S. Large Cap Growth</td>
<td>1,500,000</td>
<td>10</td>
<td>-100</td>
</tr>
<tr>
<td>U.S. Large Cap Value</td>
<td>4,500,000</td>
<td>30</td>
<td>2,410,500</td>
</tr>
<tr>
<td>U.S. Mid Cap Equities</td>
<td>1,500,000</td>
<td>10</td>
<td>2,874,000</td>
</tr>
<tr>
<td>International Equities</td>
<td>1,500,000</td>
<td>10</td>
<td>1,092,000</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>2,554,500</td>
<td>17</td>
<td>1092,000</td>
</tr>
<tr>
<td>Real Estate Investment Trust</td>
<td>3,000,000</td>
<td>20</td>
<td>3,711,000</td>
</tr>
<tr>
<td>U.S. Long Term Gvt Bonds</td>
<td>3,000,000</td>
<td>20</td>
<td>2,358,000</td>
</tr>
<tr>
<td>International Bonds</td>
<td>1,500,000</td>
<td>10</td>
<td>15,000,000</td>
</tr>
</tbody>
</table>

*Note: Percentages are rounded.*

---

![Chart II.4 Actual and Proposed Portfolios Relative to the Efficient Frontier as of March 2005](image)
used the relationship between those short-term rates and the asset classes in the feasible set to build scenarios of returns for the actual and proposed portfolios over twenty years.7

C. Simulation Results. John’s simulation produced 500 return scenarios.8 Chart III.1 summarizes these scenarios by listing the 95th through the 5th percentile of the returns to the two portfolios over the 500 scenarios. As John expected, the proposed portfolio outperformed the current portfolio at every level.

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>95th</td>
<td>14.07%</td>
<td>17.68%</td>
</tr>
<tr>
<td>75th</td>
<td>11.38%</td>
<td>14.10%</td>
</tr>
<tr>
<td>67th</td>
<td>10.74%</td>
<td>13.13%</td>
</tr>
<tr>
<td>50th</td>
<td>9.59%</td>
<td>11.67%</td>
</tr>
<tr>
<td>33rd</td>
<td>8.45%</td>
<td>10.29%</td>
</tr>
<tr>
<td>25th</td>
<td>7.82%</td>
<td>9.33%</td>
</tr>
<tr>
<td>5th</td>
<td>5.17%</td>
<td>6.16%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>95th</td>
<td>141,004,522</td>
<td>211,678,496</td>
</tr>
<tr>
<td>75th</td>
<td>70,393,831</td>
<td>114,043,398</td>
</tr>
<tr>
<td>67th</td>
<td>62,761,548</td>
<td>96,165,775</td>
</tr>
<tr>
<td>Expected</td>
<td>74,766,314</td>
<td>60,369,193</td>
</tr>
<tr>
<td>50th</td>
<td>60,242,975</td>
<td>48,860,044</td>
</tr>
<tr>
<td>33rd</td>
<td>46,985,647</td>
<td>38,107,693</td>
</tr>
<tr>
<td>25th</td>
<td>39,502,111</td>
<td>32,038,173</td>
</tr>
<tr>
<td>5th</td>
<td>22,346,198</td>
<td>17,777,118</td>
</tr>
</tbody>
</table>

D. Withdrawal Rates. Chart III.2 compares the distribution of the ending values for the two portfolios at the current 3% withdrawal rate.

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>95th</td>
<td>$113,422,505</td>
<td>$211,678,496</td>
</tr>
<tr>
<td>75th</td>
<td>70,393,831</td>
<td>114,043,398</td>
</tr>
<tr>
<td>67th</td>
<td>62,761,548</td>
<td>96,165,775</td>
</tr>
<tr>
<td>Expected</td>
<td>57,937,192</td>
<td>91,984,784</td>
</tr>
<tr>
<td>50th</td>
<td>50,933,540</td>
<td>74,116,761</td>
</tr>
<tr>
<td>33rd</td>
<td>41,300,823</td>
<td>57,806,309</td>
</tr>
<tr>
<td>25th</td>
<td>36,759,138</td>
<td>48,599,335</td>
</tr>
<tr>
<td>5th</td>
<td>22,346,198</td>
<td>26,966,459</td>
</tr>
</tbody>
</table>

John noted across the entire distribution the proposed portfolio had higher simulated ending values after twenty years than the current portfolio.9 As expected, these results were consistent with his construction of the proposed portfolio with a higher expected return than the current portfolio. The chart indicated also the proposed portfolio had a wider range of possible outcomes, reflecting its higher risk.

E. Target Expected Ending Values. John’s targets for the simulation were a series of expected ending values for the proposed portfolio at different withdrawal rates that bracketed the expected ending value of the current portfolio ($57,937,192) at the 3% withdrawal rate. He knew that as the withdrawal rate increased the expected ending value naturally falls. Chart III.3 shows John’s simulation results with different withdrawal rates.

<table>
<thead>
<tr>
<th>Withdrawal Rates</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>95th</td>
<td>$172,054,770</td>
<td>$139,544,962</td>
<td>$112,927,348</td>
</tr>
<tr>
<td>75th</td>
<td>92,695,815</td>
<td>75,180,909</td>
<td>60,840,467</td>
</tr>
<tr>
<td>67th</td>
<td>78,164,672</td>
<td>63,395,431</td>
<td>51,303,019</td>
</tr>
<tr>
<td>Expected</td>
<td>74,766,314</td>
<td>60,369,193</td>
<td>49,072,522</td>
</tr>
<tr>
<td>50th</td>
<td>60,242,975</td>
<td>48,860,044</td>
<td>39,540,196</td>
</tr>
<tr>
<td>33rd</td>
<td>46,985,647</td>
<td>38,107,693</td>
<td>30,838,811</td>
</tr>
<tr>
<td>25th</td>
<td>39,502,111</td>
<td>32,038,173</td>
<td>25,927,027</td>
</tr>
<tr>
<td>5th</td>
<td>21,918,655</td>
<td>17,777,118</td>
<td>14,386,207</td>
</tr>
</tbody>
</table>

In reviewing Chart III.3, John observed that with a 5% withdrawal rate, the simulation produced an expected ending value of $60.6 million. With a 6% withdrawal rate it produced an expected ending value of $49.1 million. The current portfolio’s ending expected value is $57.9 million with a 3% withdrawal rate. Therefore, a withdrawal rate between 5% and 6% from the proposed portfolio would provide Doris with additional income while leaving the stepsons no worse off in terms of the expected ending portfolio value twenty years hence. Thus the crossover rate is between 5% and 6%.

---

7 Many possible simulation techniques exist to take account of all these relationships. Most of the investment-oriented simulations use a variation of the Monte Carlo approach, so named because it uses a random number generator (like a Roulette wheel) to create investment scenarios. Our goal is not to explain the detailed calculations of the simulation – different experts may very well come to different results because they use different inputs – but to show how the results could be used.

8 In general the more scenarios the more accurate is the simulation in terms of reducing the variability of results. The number of scenarios used here is reasonable for expository purposes and should be determined on a case-by-case basis.

9 The expected value, the probabilistic expectation of all the possible ending values, is not equal to the median because the empirical distribution is not symmetric.
IV. The Crossover Rate

A. Identifying the Crossover Rate. John next created Chart IV.1, summarizing the simulations. It shows the expected ending values of the current and proposed portfolios under different withdrawal rate assumptions.

<table>
<thead>
<tr>
<th>Withdrawal Rate</th>
<th>Expected Value Current Portfolio</th>
<th>Expected Value Proposed Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>3%</td>
<td>$57,937,192</td>
<td>$91,984,784</td>
</tr>
<tr>
<td>4%</td>
<td>47,092,031</td>
<td>74,766,314</td>
</tr>
<tr>
<td>4.5%</td>
<td>42,421,907</td>
<td>67,351,728</td>
</tr>
<tr>
<td>5%</td>
<td>38,193,976</td>
<td>60,639,193</td>
</tr>
<tr>
<td>5.215%</td>
<td>36,540,394</td>
<td>57,937,192</td>
</tr>
<tr>
<td>6%</td>
<td>30,908,635</td>
<td>49,072,522</td>
</tr>
</tbody>
</table>

At a withdrawal rate of 5.215% the expected ending value of the proposed portfolio was equal to $57.9 million, the targeted ending value. He elected to recommend to Tom that he propose a 5% withdrawal rate to the beneficiaries. John had a number of reasons for recommending a withdrawal rate slightly less than the crossover rate. First, the increase in the withdrawal rate from 3% to 5% represented a significant, immediate increase in annual income for Doris of $300,000 or 67% from her current level. Second, Doris’ stepsons would realize that the expected value of the proposed portfolio in twenty years would be almost $2.7 million ($60.6 - $57.9) larger at a 5% withdrawal rate than the expected value of the current portfolio with a 3% withdrawal rate. Although John recognized the proposed portfolio carried more risk, he thought the stepsons would agree to the change in withdrawal rate because their interest in terms of expected value would be increased. Finally, the 5% withdrawal rate was within the 3% - 5% range often considered reasonable by some fiduciaries and, perhaps, a safe harbor in some jurisdictions.

B. Another Advantage of the Proposed Portfolio. John noted that Chart IV.1 also underscores one of the advantages of moving to the proposed portfolio. If the current portfolio is maintained and the withdrawal rate increased to 5%, the expected value twenty years hence falls to $38.2 million from $57.9 million, almost a $20 million decline. Changing the portfolio composition avoids the problem of increasing the withdrawal rate to satisfy the income beneficiary without regard to the ultimate impact on remainder beneficiaries.

V. Periodic Review

A. Annual Reviews. John realized implementation of the proposed portfolio and new withdrawal rate should not be put into practice and forgotten. Over time capital markets change. What appears to be appropriate policy given currently available information may not hold into the future. Therefore, he planned to recommend a formal review of the portfolio’s asset allocation and the withdrawal rate be undertaken, preferably each year.10

B. Potential Adjustments to the Withdrawal Rate. John also intended to stress to Tom the importance of explaining to the trust’s beneficiaries what might happen in the future. For example, if capital markets declined for an extended period, then to maintain impartiality among the beneficiaries either a) Doris would have to accept a lower withdrawal rate, b) the remainder beneficiaries would have to accept a lower ending expected value, c) the trust portfolio’s composition would have to be reconstructed resulting in a higher level of expected return and risk, or d) a combination of the above.

VI. Conclusions

A. Impartiality. Tom finished reading John’s report and was somewhat relieved it provided support for his total return investing solution. The problem of balancing Doris’ current distribution requests and the stepsons’ interest in maximizing their remainder value would always remain. Though he was confident about implementing John’s recommendation for the portfolio’s allocation, his concern was getting the beneficiaries to agree so as to avoid potential acrimony and possible litigation. Because the proposed portfolio carried more risk than the current portfolio, Tom was concerned that a 5% withdrawal rate might be perceived as favoring unfairly the current beneficiary at the remainder beneficiaries’ expense.

B. Return and Risk. Tom began to formulate how to present the new investing and withdrawal approach to the beneficiaries. He was particularly pleased that the charts in John’s report were, for the most part, formulated in terms of dollars. Tom had always found that in explaining outcomes to financially unsophisticated people, dollar figures had much more meaning than percentages. He wanted to present his recommendation as a potential “win-win” situation for all parties, but he was not certain the stepsons would believe they benefited from the proposed portfolio allocation and a 5% withdrawal rate. Tom was concerned the stepsons would not perceive much gain to themselves, particularly in light of higher risk in the proposed portfolio.

10 This recommendation is consistent with the need for a periodic review of the IPS suggested in the second article of this series.
C. Withdrawal Rates, Fairness and Compromise. The withdrawal crossover rate determination of 5.125% was extremely helpful to Tom in setting an upper limit to the new withdrawal rate. But, to pursue his win-win strategy, the proposed withdrawal rate would have to be, as John suggested, less than the crossover rate. In examining Chart IV.1, Tom was pleased that John had presented a 4.5% withdrawal comparison of expected portfolio values. At a 4.5% withdrawal rate, Doris would receive a substantial increase in annual income, at least initially, from $450,000 to $675,000. The expected value of the portfolio in twenty years would be $67.4 million as compared to the expected value under the current portfolio allocation and 3% withdrawal rate of $57.9 million. Tom planned to explain to the beneficiaries that this arrangement was subject to change depending upon an annual review. Nevertheless, he was hopeful both sides would agree to compromise and accept his proposed changes.
The *Chawla* Case, Insurance Trusts and the Insurable Interest Rule:
“Houston, We Have a Problem”

*by Mary Ann Mancini*

Washington, D.C.

Introduction

On February 3, 2005 the United States District Court for the Eastern District of Virginia, applying Maryland law, granted a motion for summary judgment against the plaintiff in a case which may call into question the ability of any trust subject to the laws of a state with an insurable interest statute similar to Maryland’s statute, to procure insurance on an individual’s life. Although many commentators have been quick to draw factual distinctions between the case of *Vera Chawla, Trustee for Harald Geisinger Special Trust v. Transamerica Occidental Life Insurance Company,* (“Chawla”) and the more usual insurance trust situation; those same factual distinctions may be what prevents practitioners from relying on a successful appeal of the case to resolve the question of whether trusts have an insurable interest in an individual’s life. Furthermore, in light of the current pressures placed on the insurance industry by Congress and the life settlement market, the insurance industry may find itself in the position of being unable to support the position that a trust has an insurable interest in an individual. Finally, if the issue raised in *Chawla* is not resolved, insurance proceeds received by irrevocable insurance trusts may be subject to estate tax if the trust’s situs is located in a state whose insurable interest statute or case law mandates the payment of such proceeds to the estate of the insured if the person receiving the proceeds lacks an insurable interest in the insured.

The decision in *Chawla* highlights a long-held concern of many estate planning attorneys about how many state laws, whether in statutory form or developed in case law, do not include a trust as a type of entity that has an insurable interest in the insured’s life. The requirement for the existence of an insurable interest is a public policy issue and therefore, without an insurable interest a policy may be void as a matter of law or the proceeds payable to someone other than the insurance trust. A shareholder of an insurance company would be well within its rights to object to an insurance company paying out company assets on a void policy, and the various state insurance commissioners may have similar questions. From a trustee’s perspective, the trust’s beneficiaries could well question the wisdom of a trustee who continues to pay premiums on a void policy or on a policy the proceeds of which will not be payable to the trust.

Accordingly, the *Chawla* case did not cause a problem for insurance trusts; it brought a long-ignored problem to light. A similar situation in the area of insurable interests arose in the early nineties when the question was asked (and could not be adequately answered) of whether a charity had an insurable interest in an individual. In that instance, the insurance industry rallied to lobby state legislatures to pass legislation establishing that charities do have insurable interests in donors. In the present situation, the question that must be asked is whether the same legislative effort is necessary for insurance trusts.

Facts of Chawla

A substantial reason for the decision in *Chawla* was due to the medical misrepresentations the insured, Harald Geisinger, made on the application for the insurance policy. These misrepresentations alone may have been enough to decide the case, but there is some evidence in the record that Transamerica Occidental Life Insurance Company (“Transamerica”) knew, or should have known, about Mr. Geisinger’s medical condition, and as such, should be estopped from arguing that, based on these misrepresentations, it should not have to pay out the death benefit. As a result of this uncertainty, a second argument for denying coverage was made by Transamerica’s counsel. Transamerica argued that the owner of the policy did not have an insurable interest in the insured and therefore the policy was void as a matter of law. This article will address the facts and arguments that address the insurable interest issue and will not address the medical issues.

1. Issuance and maintenance of the policy.

On or about May 4, 2000 Harald Geisinger, a divorced man with no children, applied to Transamerica for a ten-year term life insurance policy with a death

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2 The facts are taken from the pleadings that were filed by the parties in the case.
benefit of one million dollars. Vera Chawla, a resident of Potomac, Maryland who was not related to Mr. Geisinger, was named in the original application as the owner and beneficiary of the policy. Mr. Geisinger lived with Ms. Chawla and her husband occasionally and was apparently living with them at the time of the application; however, his legal residence was in the District of Columbia. The office of the independent insurance agent Mr. Geisinger used was located in Fredericksburg, Virginia. On the same day as he signed the application, presumably in Virginia, he underwent a physical examination in Fredericksburg and the results of that exam were submitted to Transamerica.

At the time the application was received by Transamerica, it was pointed out that Ms. Chawla did not have an insurable interest in Mr. Geisinger. It is unclear from the record who suggested a trust as the owner and beneficiary of the policy, but Mr. Geisinger and Ms. Chawla resubmitted the application listing a trust previously created by Mr. Geisinger as the owner and applicant. They provided to Transamerica a “Verification of Irrevocable Trust Agreement” which indicated that Mr. Geisinger was the grantor and co-trustee of the trust and Ms. Chawla was the other co-trustee. The parties are in dispute as to whether Transamerica saw the actual trust agreement before Mr. Geisinger’s death. Ms. Chawla signed the application as a co-trustee at her home in Maryland.

On July 20, 2000 Transamerica issued a policy to the Harald Geisinger Special Trust under agreement dated June 9, 1995 (the “Trust”) in the amount of one million dollars. The policy was delivered to Ms. Chawla at her home in Maryland. At the same time, Ms. Chawla provided a check for the premium drawn on a joint bank account she owned with her husband.

In September, 2000 Mr. Geisinger applied to increase the death benefit of the policy to two million four hundred fifty thousand dollars and on or about September 28, 2000, the new policy was issued and it was delivered to Ms. Chawla at her home in Maryland. Again, Ms. Chawla delivered a check for the premium due.

Mr. Geisinger died on September 23, 2001 as a result of a heart attack.

2. Terms of the Trust.

The terms of the irrevocable trust that purchased the policy provided that it shall initially consist of the grantor’s principal residence which was located in Washington, D.C. During the grantor’s lifetime the grantor had the right to all of the income from the Trust, and the right to occupy the residence. Upon the death of the grantor, the Trust assets were to be distributed to Ms. Chawla; or, if she was not living, as provided pursuant to a testamentary general power of appointment granted to Ms. Chawla; or if not executed, to her then-living issue, per stirpes.

If Mr. Geisinger could no longer serve as co-trustee, Ms. Chawla would serve as sole trustee.

The Trust agreement stated that the Trust was subject to the laws of the District of Columbia and beyond the general and broad powers provided in the agreement, the Trust did not specifically provide for the ownership of a life insurance policy on any beneficiary. This lack of authority was noted by the Chawla Court but did not enter into the reasoning behind the Court’s decision.

3. Developments after the death of Mr. Geisinger.

After Mr. Geisinger’s death in 2001, Ms. Chawla applied, on behalf of the Trust, for the payment of the death benefit under the policy. Since the policy had not been in force for two years, Transamerica investigated Mr. Geisinger’s health and facts provided in the application and on June 9, 2002, Transamerica informed Ms. Chawla that it was rescinding the policy. Transamerica repaid the premiums that had been paid.

On September 24, 2003, Ms. Chawla brought a complaint against Transamerica in the United States District Court for the Eastern District of Virginia for a breach of contract action. The jurisdiction and venue for a Federal action was found as a result of diversity (Transamerica was a citizen of Iowa, the trustee was a citizen of Maryland) and the amount in controversy exceeded $75,000. The District Court in Virginia had personal jurisdiction over Transamerica because Transamerica transacts business in Virginia and has offices in Virginia. The Court’s venue was found because a substantial part of the events giving rise to the breach of contract claim occurred in Virginia.

On October 20th, 2003 Transamerica answered the complaint and filed a counterclaim. Transamerica did not argue over the jurisdiction or venue of the case.

Later on in the proceedings, the parties argued about whether the substantive law of Virginia or Maryland should be applied. This was not discussed in the pleadings, but the Virginia insurable interest statute (which has since been changed) provided that “…no person shall knowingly procure or cause to be procured any insurance contract upon another individual unless the benefits are payable to (i) the insured or his personal representative, or (ii) a beneficiary designated by the insured, [italics supplied] or (iii) a person having an insurable interest in the insured at the time the contract was made.” The Maryland insurable interest statute is not that broad and states “…a person may not procure or cause to be procured an insurance contract on the life or body of another individual unless
the benefits under the insurance contract are payable to 
(i) the individual insured; (ii) the individual’s insured’s 
personal representative; or (iii) a person with an insur-
able interest in the individual insured at the time the 
insurance contract was made.” The Virginia statute 
provided a much easier basis for Ms. Chawla to claim 
that the death benefit should have been paid to the 
trust, since Mr. Geisinger signed the application as Co-
Trustee of the Trust designating the Trust as the benefi-
ciary of the policy. For estate tax reasons, the insured 
is rarely a trustee of an insurance trust holding the pol-
icy on his or her life, so the Virginia statute would not 
have helped the more usual insurance trust, but it does 
explain why Ms. Chawla’s counsel argued so hard for 
the application of the substantive law of Virginia.

If an appeals court finds that Virginia law subst-
stantive law should have applied, and upon applying 
such law, finds that the death benefit is properly 
payable to the trust under Virginia’s old insurable 
interest statute, this is one of the instances where a suc-
cessful appeal of the Chawla case, if solely on this 
basis, does not resolve the question of whether the 
more usual type of insurance trust has an insurable 
interest in the insured.

4. Decision of Chawla Court.

The Court in Chawla held that the substantive 
law of Maryland applied to the case. This decision 
was arrived at by the reasoning that the federal court 
must apply the law of the forum state including its 
choice of law principles. The forum state in this case 
was Virginia but under Virginia choice of law principles, the substantive law that applies is the law of the 
state where the contract is made. Virginia law provides 
that “a contract is made when the last act to complete 
it is performed and in the context of an insurance policy, 
the last act is delivery to the insured.” In this case, 
both the original policy and the documents increasing 
the death benefit were delivered to Ms. Chawla in 
Maryland, who also paid the premium in Maryland. 
Where the payment of the first premium is made is 
important because the terms of the policy also required 
payment of the first premium in order to render the 
policy effective.

Once it was determined that Maryland sub-
stantive law applied, the Court found that as a matter of 
law Ms. Chawla’s claim fails because the Trust “main-
tained no insurable interest in the life of the decedent 
thus rendering the policy void.” The Court’s analysis 
of Maryland’s insurable interest statute and how it 
applies to trusts was taken almost verbatim from 
Transamerica’s arguments made in the pleadings.

The Court set out the provisions of the statute 
as stated above and concentrated on the third permissi-
ble recipient of death benefit, namely, “a person with an 
insurable interest in the individual-insured at the time 
the insurance contract was made”. The Court stated 
that Maryland statutes define a “person” as “an individ-
ual, receiver, trustee, guardian, personal representative, 
fiduciary, representative of any kind, partnership, firm, 
association, corporation or entity.” The trustee of a 
trust, as a defined person, is required to have an insur-
able interest in the insurer under the statute.

The Court went on to enumerate those persons 
under the Maryland statute that have insurable inter-
ests in a decedent-insured and pointed out that none of 
the classes of persons referred to a trust. The classes 
of such persons with insurable interests under the 
Maryland statute discussed by the Court included 
those persons who are related by blood or law (which 
is not the case with a trust); those with a lawful and 
substantial economic interest in the continuation of the 
life, health, bodily safety of the insured and those in 
certain business relationships with the insured. The 
Court looked at this second class and the economic 
arrangements between the Trust and Mr. Geisinger and 
could not find any economic interest the Trust would 
have in the continued life of Mr. Geisinger. The Court 
also looked at the limited business settings where an 
insurable interest could be found and did not find that 
the Trust met any of these requirements.

What the Court did not consider was whether 
the insurable interest statute should be applied by look-
ning through the Trust to its beneficiary (namely, Mr. 
Geisinger) and apply the statute to the Trust’s benefi-
ciary.

Finally, the Court addressed Ms. Chawla’s 
assertion that the doctrine of estoppel precludes 
Transamerica from asserting the insurable interest 
defense. Here the Court, citing a Maryland case,3 sta-
eted that “public interest, as protected by the insurable 
interest doctrine, is ‘of paramount important and over-
rides the equitable doctrines of waiver and estoppel.”

The Court granted summary judgment to 
Transamerica on all counts. The case is being appealed.

The Law of Insurable Interests

1. Public Policy behind the Requirement for an 
Insurable Interest

The common law of the United States, which 
has been codified in many states, holds that to allow 
someone to speculate on a person’s life by buying a life 
insurance policy on such person is against public poli-
cy. The possible ramification of allowing such policies 
would be that any person who is so insured could not 
feel safe in light of any investor’s natural desire to see 
his or her investment “pay off.” In fact, to so endanger 
someone’s life can expose the insurance company to

3 Beard v. American Agency Life Insurance Company, 314 
tort liability, as illustrated in Liberty National Life Ins. Co. v. Weldon, a case that appears in a footnote in an article written by Franklin L. Best for the Fall 1986 Tort and Insurance Law Journal. In that case the insurance company, who had issued three policies on the life of a 2 1/2 year old child, was found liable for damages when the child was given arsenic in a soft-drink, presumably by the beneficiary of the policy who was the widow of the child’s uncle. In light of public policy and to protect itself from such tort actions, an insurance company is required to ascertain that an insurable interest exists in the policy at the time set forth in the statute and such a requirement cannot be contracted away in an agreement between the insurance company and the owner of the policy, even if the insured consented to the application for such insurance.

Wisconsin included in its Comments to its insurable interest statute a very compelling argument against the need for an insurable interest statute at all. The reason for this Comment is because under the Wisconsin statute, the lack of an insurable interest does not render the contract void, as discussed later in this article. The Comment states:

Insurable interest [does not make sense] as a prerequisite to the validity of an insurance policy. If viewed as a disincentive to deliberate loss-causing, it is largely ineffective; most known cases of homicide . . . were committed by persons with a clear insurable interest. If viewed as a disincentive to gambling, it need only be pointed out that the house’s cut is smaller in Las Vegas or at the local race track.

More of these Comments are cited later in this article.

Insurable interest statutes are generally directed at who originally acquired the policy and whether the original owner had an insurable interest in the insured. There are some insurable interest statutes and case law in states without a statute that also require that the beneficiary of the policy (and not just the owner) have an insurable interest in the insured. The requirement for an insurable interest to be held by the beneficiary is usually imposed on certain classes of insureds, such as minors.

The existence of an insurable interest is tested, under most state statutes and case law, at the time the policy is acquired and is not tested again. However, there is case law in states where the beneficiary of the policy is required to have an insurable interest in the insured that requires that the beneficiary’s insurable interest must continue after the purchase of the policy for the remainder of the insured’s life, so long as the policy is in existence.

2. Insured May Always Purchase Insurance on His or Her Own Life

The insured is always permitted to purchase insurance on his or her own life and designate anyone as the beneficiary of the policy, either under the applicable insurable interest statute or in case law. Therefore, if Dr. Geisinger had purchased the policy on his life himself and named Vera Chawla as a beneficiary or named himself as the beneficiary and subsequently gifted or sold the policy to Vera Chawla or to the trust, Transamerica’s argument that the trust did not have an insurable interest and therefore the company should not pay the proceeds to the trust, would not have been successful. The only successful argument against this type of arrangement would be if the means of acquiring the insurance policy was part of a plan to circumvent the public policy against a person (the beneficiary or new owner) “wagering” on the life of the insured.

Since the insured may always purchase an insurance policy on his or her own life, the issue of whether a trust has an insurable interest in the insured only arises as a result of the “three-year rule” of section 2035 of the Code. Section 2035 states, in part:

(a) Inclusion of certain property in gross estate. If—

(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, . . . during the 3-year period ending on the date of the decedent’s death, and

(2) the value of such property (or an interest therein) would have been included in the decedent’s gross estate under section . . . 2042, if such transferred interest . . . had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of

(Continued on page 129)

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1 267 Ala. 171, 100 So. 2d 696, 61 A.L.R. 2d 1346 (1957).
2 Defining Insurable Interests in Lives 22 Tort & Ins. LJ 104.
4 Id.
6 Id. §41:19.
7 All references to a “section” shall refer to a section of the Code, which shall mean the Internal Revenue Code of 1986, as amended.
# Calendar of Events
## 2005 Regional and State Meetings

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Place</th>
<th>Guest</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Thursday</strong>&lt;br&gt;September 15</td>
<td>Ohio Fellows Dinner</td>
<td>Columbus, Ohio</td>
<td>Judith W. McCue</td>
<td>ACTEC President</td>
</tr>
<tr>
<td><strong>Friday</strong>&lt;br&gt;September 16</td>
<td>Rocky Mountain Dinner</td>
<td>Four Points Sheraton at Cherry Creek Denver, Colorado</td>
<td>W. Bjarne Johnson</td>
<td>ACTEC Treasurer</td>
</tr>
<tr>
<td><strong>Friday-Sunday</strong>&lt;br&gt;September 23-25</td>
<td>Mid-Atlantic Regional Meeting</td>
<td>The Westin Hotel on 17th and Chestnut St. Philadelphia, Pennsylvania</td>
<td>Judith W. McCue</td>
<td>ACTEC President</td>
</tr>
<tr>
<td><strong>Friday-Sunday</strong>&lt;br&gt;September 23-25</td>
<td>Southeast Regional Meeting</td>
<td>Inn on Biltmore Estates Asheville, North Carolina</td>
<td>Bruce S. Ross</td>
<td>ACTEC President-Elect</td>
</tr>
<tr>
<td><strong>Wednesday</strong>&lt;br&gt;December 7</td>
<td>Iowa Fellows Luncheon</td>
<td>Des Moines, Iowa</td>
<td>W. Bjarne Johnson</td>
<td>ACTEC Treasurer</td>
</tr>
<tr>
<td><strong>Friday</strong>&lt;br&gt;December 9</td>
<td>Louisiana Fellows Dinner</td>
<td>New Orleans, Louisiana</td>
<td>Judith W. McCue</td>
<td>ACTEC President</td>
</tr>
</tbody>
</table>

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## In Memoriam

Charles Earl Brown<br>Toledo, Ohio

Gary J. Dietsch<br>Cleveland, Ohio

Lawrence Dunmire<br>Hastings, Nebraska

Jerry G. Dygert<br>St. Paul, Minnesota

Alexander J. Holland<br>Greenwich, Connecticut

Robert L. Kamholz<br>Milwaukee, Wisconsin

Raymond A. Reister<br>Minneapolis, Minnesota

Frank W. Rogers<br>Roanoke, Virginia

Albert Creswell Todd<br>Columbia, South Carolina

Richard V. Wellman<br>Athens, Georgia

Thomas G. Woolsey<br>Versailles, Missouri

*Any gift to the ACTEC Foundation made in the memory of a deceased Fellow will be acknowledged to the family.*
**2006 Annual Meeting**  
*March 7–13, 2006*  
Maui, Hawaii

Come to Maui, the magic island, created by volcanoes millions of years ago. The volcanic eruptions left Maui with rich, red soil, ideal for growing sugar cane and pineapple, and a varied landscape of palm-fringed, golden sand beaches, the mammoth reaches of Haleakala’s vertical forests, waterfalls framed by hillsides carpeted in exotic blooms, and lush rainforests.

The Grand Wailea Resort Hotel & Spa, site of the 1999 Annual Meeting, is situated on 40 meticulously landscaped acres, opening onto beautiful Wailea Beach, one of the world’s top beaches. In addition to its beautiful setting, the resort offers luxurious accommodations and opportunities for relaxation and a variety of adventurous activities. Learn to scuba dive, spend a day at the beach snorkeling or swim in the resort’s 2,000 foot-long river pool with its water slides, waterfalls, caves, white water rapids, grottoes, and the world’s only water elevator. Play golf at three courses featuring spectacular ocean views, play an invigorating game of tennis, or indulge in Grand Wailea’s fabulous Spa Grande.

The professional program will address topics ranging from how to deal with the latest tax developments to how to better practice our profession. As always, the Trachtman Lecture will be a high point of the ACTEC year.

You will want to venture beyond the Grand Wailea to enjoy Maui’s unique natural environment, so we have arranged some wonderful tours. You can enjoy natural wonders while kayaking and snorkeling among reef fish and coral, canter up green pastures to the edge of a tropical valley on a Maui horseback ride, explore ancient trails in the rainforest, catch a wave learning to surf, visit Upcountry lavender and goat cheese farms, and explore the hidden wonders of Maui from the air in a state-of-the-art helicopter flight.

So come and enjoy the camaraderie, the professional program and the experiences we have planned for you. Maui is just the place to unwind, to learn and to enjoy oneself.

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**Dates:**  
March 7 through March 13, 2006

**Place:**  
The Grand Wailea Resort Hotel & Spa  
Maui, Hawaii

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**Tuesday**  
**March 7**

Committee meetings—as scheduled

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**Morning Tours**

Upcountry Lavender and Goat Cheese Farms  
Kayak Snorkel

---

**Afternoon**

Lei Making Class

---

**Evening**

Dinner for 2005-2006 Committee Members and their spouses/guests
*Sponsored by The Northern Trust Company.*

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**Wednesday**  
**March 8**

Committee meetings—as scheduled

---

**Morning Tours**

*Island Star* Sail/Whale Watching  
Kayak Snorkel

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**Afternoon Tours**

Upcountry Lavender and Goat Cheese Farms  
Surfing Lessons  
Rainforest and Waterfall Hike  
Adventure

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**Evening**

Young Fellows Reception  
*Sponsored by Management Planning, Inc.*

---

**Thursday**  
**March 9**

Opening Breakfast and Annual Business Meeting  
*Sponsored by Bessemer Trust Company.*

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Seminars, Symposium I  
*Seminar materials sponsored by Willamette Management Associates.*

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Spouses/Guests Keynote Speaker

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**Afternoon**

Committee meetings—as scheduled

---

**Evening**

Molokini Garden Pacific Rim Party  
*Sponsored by Empire Valuation Consultants, Inc.*
<table>
<thead>
<tr>
<th>Day</th>
<th>March 10</th>
<th>March 11</th>
<th>March 12</th>
<th>March 13</th>
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</thead>
<tbody>
<tr>
<td><strong>Friday</strong></td>
<td>Breakfast Buffet</td>
<td>Seminars, Symposium II, Computer Workshops</td>
<td><strong>Sunday</strong></td>
<td>Breakfast Buffet</td>
</tr>
<tr>
<td><strong>March 10</strong></td>
<td>Kayak Snorkel</td>
<td><strong>Morning</strong></td>
<td><strong>March 12</strong></td>
<td>Sponsored by Fiduciary Trust.</td>
</tr>
<tr>
<td><strong>Morning Tour</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>Afternoon</strong></td>
<td><strong>Morning Tours</strong></td>
<td>Hot Topics, Seminars</td>
</tr>
<tr>
<td><strong>Afternoon</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>Afternoon</strong></td>
<td><strong>Afternoon Tours</strong></td>
<td>Iao Valley—self tour</td>
</tr>
<tr>
<td><strong>Afternoon Tour</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>Afternoon</strong></td>
<td><strong>Afternoon Tours</strong></td>
<td>Lei Making Class</td>
</tr>
<tr>
<td><strong>Saturday</strong></td>
<td>Breakfast Buffet</td>
<td><strong>Afternoon</strong></td>
<td><strong>Afternoon Tours</strong></td>
<td>Island Star Sail/Whale Watch</td>
</tr>
<tr>
<td><strong>March 11</strong></td>
<td>John L. Sullivan 5K Walk/10K Fun Run</td>
<td><strong>Saturday</strong></td>
<td><strong>State Chairs Meeting</strong></td>
<td>State Chairs Meeting</td>
</tr>
<tr>
<td><strong>Morning</strong></td>
<td>Breakfast Buffet</td>
<td><strong>Afternoon</strong></td>
<td><strong>Morning Tours</strong></td>
<td>Dinner for 2005-2006 Regents, Regents-elect, State Chairs, State Chairs-elect and Past Presidents and their spouses/guests Sponsored by Sotheby’s.</td>
</tr>
<tr>
<td><strong>Afternoon</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>Saturday</strong></td>
<td><strong>Afternoon Tours</strong></td>
<td>Board of Regents Breakfast</td>
</tr>
<tr>
<td><strong>Tour</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>State Chairs Meeting</strong></td>
<td><strong>Monday</strong></td>
<td>Board of Regents Meeting</td>
</tr>
<tr>
<td><strong>Saturday</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>Saturday</strong></td>
<td><strong>State Chairs Meeting</strong></td>
<td>Board of Regents Meeting</td>
</tr>
<tr>
<td><strong>Tour</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>State Chairs Meeting</strong></td>
<td><strong>Monday</strong></td>
<td>Board of Regents Meeting</td>
</tr>
<tr>
<td><strong>Tour</strong></td>
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<td><strong>Tour</strong></td>
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</tr>
<tr>
<td><strong>Tour</strong></td>
<td>Committee meetings—as scheduled</td>
<td><strong>State Chairs Meeting</strong></td>
<td><strong>Monday</strong></td>
<td>Board of Regents Meeting</td>
</tr>
</tbody>
</table>
## ACTEC National Meeting Schedule

<table>
<thead>
<tr>
<th>Year</th>
<th>ANNUAL</th>
<th>SUMMER</th>
<th>FALL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2006</strong></td>
<td>Wednesday–Monday&lt;br&gt;March 7–13&lt;br&gt;Grand Wailea Resort&lt;br&gt;Maui, Hawaii&lt;br&gt;(March 6*)</td>
<td>Thursday–Sunday&lt;br&gt;July 6–9&lt;br&gt;Millennium Biltmore Hotel&lt;br&gt;Los Angeles, California</td>
<td>Thursday–Monday&lt;br&gt;October 12-16&lt;br&gt;The Westin Providence/ Providence Biltmore&lt;br&gt;Providence, Rhode Island</td>
</tr>
<tr>
<td><strong>2007</strong></td>
<td>Wednesday–Monday&lt;br&gt;March 7–12&lt;br&gt;The Westin Kierland&lt;br&gt;Resort &amp; Spa&lt;br&gt;Scottsdale, Arizona&lt;br&gt;(March 5*)</td>
<td>Thursday–Sunday&lt;br&gt;June 28–July 1&lt;br&gt;The Grand America Hotel&lt;br&gt;Salt Lake City, Utah</td>
<td>Thursday–Monday&lt;br&gt;November 1-5&lt;br&gt;The Greenbrier&lt;br&gt;White Sulphur Springs,&lt;br&gt;West Virginia</td>
</tr>
<tr>
<td><strong>2008</strong></td>
<td>Wednesday–Monday&lt;br&gt;March 5–10&lt;br&gt;Boca Raton Resort and Club&lt;br&gt;Boca Raton, Florida&lt;br&gt;(March 3*)</td>
<td>Thursday–Sunday&lt;br&gt;June 26–29&lt;br&gt;The Coeur d’Alene Resort&lt;br&gt;Coeur d’Alene, Idaho</td>
<td>Thursday–Monday&lt;br&gt;October 23-27&lt;br&gt;The Westin Savannah Harbor Golf Resort &amp; Spa&lt;br&gt;Savannah, Georgia</td>
</tr>
<tr>
<td><strong>2009</strong></td>
<td>Wednesday–Monday&lt;br&gt;March 4–9&lt;br&gt;The Westin Mission Hills&lt;br&gt;Resort&lt;br&gt;Rancho Mirage, California&lt;br&gt;(March 2*)</td>
<td>To be determined</td>
<td>To be determined</td>
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</tbody>
</table>

* Committee members early arrival
any property (or interest therein) which
would have been so included.

Section 2035(d) provides an exception to section
2035(a) if the transfer was a bona fide sale for ade-
quate and full consideration.

Section 2042 provides, in part:

The value of the gross estate shall
include the value of all property—
(1) Receivable by Executor. To
the extent of the amount receivable by
the executor as insurance under poli-
cies on the life of the decedent.
(2) Receivable by other beneficia-
ries. To the extent of the amount
receivable by all other beneficiaries, as
insurance under policies on the life of
the decedent with respect to which the
decedent possessed at his death any of
the incidents of ownership, exercisable
either alone or in conjunction with any
other person.

The Regulations to section 2042 define “inci-
dents of ownership” as those rights to the economic
benefits of the policy, including the power to change
beneficiaries, to surrender or cancel the policy, to
assign a policy, to revoke an assignment, to pledge a
policy for a loan, or to borrow against the cash surren-
der value of the policy.\footnote{Treas. Reg. § 20.2042-1(c)(2).} These are all rights that a
trustee of a trust as the purchaser and owner of an
insurance policy would hold.

Therefore, the common means of avoiding an
insurable interest rule, at least a rule that is tested at the
time the policy is acquired, which is to have the
insured purchase the policy and then transfer the poli-
cy to a trust, will trigger the application of section
2035. However, if the transfer of the policy and the
incidents of ownership to the trust is made for full and
adequate consideration, section 2035 does not apply
and this transaction will not cause inclusion of the
death benefit in the insured’s estate if the insured dies
within three years of the transfer.

3. Insured’s Consent to a Person Purchasing
Insurance on Insured’s Life

For a long time some practitioners have been
advocating that insurable interest statutes should be
changed to provide that anyone can have an insurable
interest in the insured, as long as the insured affirm-
atively grants an insurable interest to the applicant/
owner. This suggestion has drawn criticism because it
is considered to favor the market in insurance policies
commonly referred to as “investor-owned live insur-
ance” that many feel is an unsavory practice.

4. Persons with Insurable Interests
   a. Close Relationships

People in certain relationships to the
insured are recognized in most states as having an
insurable interest in the insured because they are
considered to be so closely related to the insured that
they receive a benefit by the continued life of the
insured (and therefore would not wager on the life of
the insured). There are differing opinions of whether
this is really the case. The words commonly used to
describe these relationships are “closely related by
blood or law.” The list of relationships that are con-
sidered closely related by blood or law is not as
broad as they probably should be, in light of the
modern world of extended families that include step-
brothers and step-sisters, step-children, in-law rela-
tions and unrelated people who are living together in
a marital relationship, whether of the same sex or
not. The statutes usually only contain the phrase
“closely related by blood or law”; in order to deter-
mine what relationships that phrase includes, the
case law in the applicable state must then be
reviewed to determine if a relationship is close
enough for the statute to apply. The case law rarely
goes beyond defining these relationships as those
individuals who are parents and children of the
insured. Sometimes the relationships will include
sisters and brothers and grandchildren, but rarely
grandparents, nieces and nephews. There is no close
relationship by blood or law between unmarried cou-
ples, in-law relations and step-relations.

Courts that have addressed who is closely
related enough to the insured to have an insurable
interest look for “persons so closely related by blood
or affinity that they want the [insured] to continue to
live, irrespective of monetary considerations.”\footnote{Couch on Insurance 3rd Ed. §41:17.}

   b. Pecuniary Advantage

The general rule of when a person holds
an insurable interest in the insured is that a person with
an insurable interest is one who will receive a benefit if
the insured continues to live. In addition to the emo-
tional benefit received by those closely related to the
insured, the benefit can also be pecuniary and, if so,
the person receiving such pecuniary benefit does not
have to be related to the insured by blood or law. It
usually does not matter if the person will also receive a
benefit when the insured dies. When describing the
pecuniary benefit, many state statutes, such as the
Georgia statute states “an insurable interest...is an
interest based on a reasonable expectation of pecuniary
advantage through the continued life, health or bodily safety of any other person and consequent loss by reason of such person’s death or disability...”

Delaware’s statute finds an insurable interest when such person has a “lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured.”

Most courts have generally held that the required pecuniary interest does not have to be capable of precise valuation, but (and courts differ on this) in order to rise to the level of an insurable interest it should be an enforceable financial claim on the insured. For example, creditors have an insurable interest in their debtors, but someone receiving support from another person on a purely voluntary basis, may not have the requisite insurable interest in the provider (unless a contractual or reliance claim, in law or equity, arose from the support payments or a court recognizes a moral claim).

**c. Companies**

Many statutes specifically address companies or employers and provide that they have an insurable interest in their key employees or even in their non-key employees, if the non-key employee meets certain criteria such as being employed for a certain period of time and even then, the insurance amounts that will be permitted will be limited. Some statutes provide that companies have an insurable interest in shareholders, if there exists a contract or option for the purchase or sale of the shareholder’s stock in the company, and other parties to such contract oftentimes are listed in such statutes as also having insurable interests in the other parties to the contract. Having this type of statute ensures that companies with a redemption obligation upon the death of a shareholder will have an insurable interest in the shareholder and can therefore fund its obligation with insurance.

If the state statute does not mention this type of interest, then a company must establish the pecuniary benefit it receives from the continued life of the insured.

**d. Charities**

Most state statutes provide that organizations described in section 170(b)(1)(A) or more commonly section 501(c) or section 501(c)(3) of the Code have an insurable interest in an insured, although the statute may impose additional requirements on the charity.

e. **Certain Trusts**

Most insurable interest statutes will mention certain types of employee trusts, but no other type of trust, as having an insurable interest in the insured under certain circumstances. This leads to the question of whether the omission in the statute of any other type of trust, such as an insurance trust, as a trust with an insurable interest in the insured was a deliberate decision by the state legislature.

f. **Statutes That Specifically Address Trusts.**

The Delaware statute includes, as the fifth type of person with an insurable interest, the trustee of a trust established by an individual has an insurable interest in that individual and the same insurable interest in the life of any other individual as does any person who is treated as the owner of such trust for federal income tax purposes. The trustee of a trust has the same insurable interest in the life of any individual as does any person with respect to proceeds of insurance on the life of such individual (or any portion of such proceeds) that are allocable to such person’s interest in such trust. If multiple beneficiaries of a trust have an insurable interest in the life of the same individual, the trustee of such trust has the same aggregate insurable interest in such life as such beneficiaries with respect to proceeds of insurance on the life of such individual (or any portion of such proceeds) that are allocable in the aggregate to such beneficiaries’ interest in the trust.

What Delaware has done is recognize that the trust itself, if created by the insured, has an insurable interest in the insured. In this part of the statute Delaware treats the trust as a separate entity with its own insurable interest in the insured, so long as the insured created the trust. Furthermore, under the Delaware statute, a trust that is not created by the insured but whose beneficiaries have insurable interests in the insured also has an insurable interest in the insured. Delaware treats a trust not created by the insured as an aggregation of its beneficiaries (rather

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15 Couch on Insurance 3rd Ed. §41:17 citing to various cases in different states.
16 The author has not been able to find any legislative history behind any statute that discusses this issue, although her search was admittedly less than exhaustive.
than as a separate entity) and if those beneficiaries have an insurable interest in the insured, then the trust has an insurable interest in the insured, at least to the extent the proceeds are allocable to those beneficiaries with insurable interests. Had Chawla been decided solely on an insurable interest argument based on Delaware law, Mrs. Chawla would have collected those proceeds because Mr. Geisinger had created the Trust and was the beneficiary of the Trust at the time the policy was acquired. If this offends anyone, keep in mind that under the present Maryland statute, had Mr. Geisinger purchased the policy himself and named Mrs. Chawla as the beneficiary or subsequently gifted or sold the policy to Mrs. Chawla or to the Trust, Mrs. Chawla or the Trust would have been able to collect the proceeds, because at the inception of the policy an insurable interest existed. The only issue is whether a trust can be used to hold an insurance policy on the insured from the inception of the policy, not whether it is appropriate to allow an individual such as Mrs. Chawla, who does not have an insurable interest in the insured, to receive the death benefit.

At the time of publication of this article, Virginia will have enacted a new insurable interest law which will include a specific reference to trusts such as an insurance trust or other types of trusts created for estate planning purposes. This legislation will be effective as of July 1, 2005. In the new legislation, Virginia addressed the issue in a manner similar to Delaware by providing that

In the case of a trustee, other than the trustee of a domestic business trust or foreign business trust ... the [insurable interest ...] shall be deemed to exist in (i) the individual insured who established the trust, (ii) each individual in whose life the owner of the trust for federal income tax purposes has an insurable interest, and (iii) each individual in whose life a beneficiary of the trust has an insurable interest ...18

There is no language in the Virginia statute addressing the situation of when some beneficiaries have an insurable interest but not all beneficiaries, as Delaware’s statute does.

Washington State also enacted an insurable interest statute that expressly addressed trusts. In the list of the persons who have an insurable interest in the insured is the provision that “[A] guardian, trustee or other fiduciary has an insurable interest in the life of any person for whose benefit the fiduciary holds property, and in the life of any other individual in whose life such person has an insurable interest.”19 This wording is a little difficult to follow, but under the Washington State statute, a trustee has an insurable interest in any of its beneficiaries and an insurable interest in any person in which a trust beneficiary would have an insurable interest. If a beneficiary is closely related to the insured, then the beneficiary has an insurable interest in the insured, which would result in the trust having an insurable interest in the insured.

In all of these state statutes, the insurable interest only has to exist at the time the contract is made.

5. Insurable Interest in the Common Law

Many states do not have an insurable interest statute as detailed as the ones discussed above, if they have one at all. Many insurable interest statutes state that only persons with an insurable interest in the insured may procure insurance on the insured’s life and leave it to the case law to determine if a person has an insurable interest. The only description of a person with an insurable interest in the insured that appears consistently in these types of statutes is a charity. The persons who are considered to have an insurable interest under the common law are oftentimes the same as those listed in state statutes. However, in states where the insurable interest rule is found in case law, rather than in a statute, the definition of these persons is capable of more subjective interpretation. Without a statute, the determination may be made that in the absence of any case law to the contrary, a person should have an insurable interest in the insured so long as it doesn’t violate the public policy behind the rule itself because there was no wagering on a person’s life. This analysis is not possible in a state with a statute that clearly sets out who has an insurable interest. In a state with an insurable interest statute, if a person is not listed in the statute, it is presumed the omission was deliberate and such person does not have an insurable interest in the insured.

Practitioners trying to establish the existence of an insurable interest in an insurance trust may oftentimes be better off in a state with only a common law insurable interest rule than in a state with an insurable interest statute that does not specifically address trusts, since the public policy behind the insurable interest rules can be argued in a common law insurable interest state. A good argument can be made under the common law that insurance trusts do not wager on

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18 Virginia Acts of Assembly, “An Act to amend and reenact §38.2-301 of the Code of Virginia, relating to life insurance contracts procured by an individual other than the insured,” H 2766 and S 1227.

insured’s life and therefore there is no public policy preventing a trust from being considered to have an insurable interest in the insured.

What if there is no insurable interest?

The existence of an insurable interest (or lack thereof) is something the insurance company’s underwriters should determine at the same time as they are pricing the policy. It must exist or the insurance cannot be issued and as a result, a statement by the insured/applicant that an insurable interest exists is not enough to satisfy the requirement. Despite this, the insurance industry’s practice is to accept the insured/applicant’s statement of the existence of an insurable interest and to make no independent investigation of its own. This practice may change now that this issue has been raised by Chawla.

If no insurable interest exists, there are several possible results. The first possibility is that insurance contract is void and all of the agreements between the parties, set forth in the provisions of the contract, disappear. This will include the two-year non-contestability provision, any provision that states which state law will apply in the event there are any disputes between the parties, and any obligation on the part of the insurance company to pay out the death benefit. Since the contract is void, all premiums paid are returned.

Although the insurance contract is void due to a lack of an insurable interest, is the payment of the death benefit enforceable against the insurance company under an estoppel theory? The answer is “it depends.” It depends on what state law applies to the transaction. The estoppel theory holds that the insurance company should be estopped from arguing that it should not have to pay the death benefit proceeds due to the lack of an insurable interest because promises were exchanged and consideration in the form of premiums was paid. Therefore, notwithstanding the lack of insurable interest, there is a contract between the individual or entity who has paid the premiums and the insurance company and as a result of that contract the insurance company must pay out an amount equal to the death benefit under the policy, since that is what the parties agreed to under the contract.

If the insurance company is prevented from making the argument that as a result of a lack of insurable interest no death benefit must be paid, and a contract exists in equity, there still may be no life insurance policy for tax purposes. The insurance company may be considered making a payment it is contractually obligated to make, and not paying out a death benefit under the policy (because there is no policy due to the lack of an insurable interest). Accordingly, as a payment under a contract, it is questionable if such payment would be excludable from the taxable income of the recipient under section 101(a)(1). If section 101(a)(1) does not apply, the only tax-free amount the recipient would receive is an amount equal to the recipient’s basis in the policy which would equal the premiums paid on the policy.

Can the insurance company be estopped from making the argument it shouldn’t have to pay out the proceeds? The Chawla court citing a Maryland case, held that “public interest, as protected by the insurable interest doctrine, is ‘of paramount importance and overrides the equitable doctrines of waiver and estoppel’….“20 Accordingly, notwithstanding the exchange of promises and consideration, Transamerica was permitted to make the argument and could not be forced to pay out the death benefit in Chawla under Maryland law.

The law in many other states is not the same as Maryland’s. Although the lack of an insurable interest renders the policy void, the insurance company can be estopped from making the argument that it should not have to pay any death benefit. The insurance company must pay out an amount equal to the death benefit based on the exchange of promises the parties made. The question remains as to whether this payment would be excluded from the recipient’s taxable income under section 101(a)(1) as insurance proceeds.

Another possible result is that the lack of an insurable interest does not render the policy void and the insurance company must pay the death benefit, but it is paid to the estate of the insured. This is provided for in some state statutes and in some case law in a state with no statute. The Wisconsin statute, which provides that if there is no insurable interest then a court may order the proceeds to be paid to someone other than the beneficiary who is equitably entitled to the death benefit, explains its position in its Comments:

The best way to discourage insurers from issuing insurance policies to persons without insurable interest is to make them pay if they do, not to permit them freely to issue such policies knowing that they have a good public policy defense that lets them off the hook whenever a loss occurs.21

If the estate of the insured raises the lack of an insurable interest with an insurance company prior to

the distribution of the death benefit the estate would demand that instead of paying the proceeds to the designated beneficiary, the insurance company should make an equitable distribution to the estate. If an insurance company pays out the death benefit to the beneficiary designated in the policy, the estate of the insured can recover the insurance proceeds from the recipient under this type of statute or case law.

This alternative, however, is the most troubling from an estate tax perspective (although from a cash flow perspective it is a better alternative than receiving nothing but a return of premiums paid from the insurance company). In a state where the case law or statute provides that the insurance company must pay the proceeds to the insured’s estate (either as the entity most equitably entitled to the proceeds or as other state statutes provide, because the estate is designated under the statute as the recipient of such proceeds if no insurable interest exists), isn’t the executor of the estate under a duty to make a claim for the proceeds if the executor reasonably believes the trust does not have an insurable interest in the insured? If the beneficiaries of the estate are different from the beneficiaries of the trust, the executor would have to make the argument for the benefit of the estate beneficiaries. If the beneficiaries of the trust and the estate are the same, the executor may not feel that it is necessary to make the claim but the estate’s creditors may feel differently. Most troubling of all, even if the executor does not make a claim for the proceeds, the Internal Revenue Service may take the position that in light of the estate’s right to make a claim to the policy death benefit, the insurance in includable in the estate of the insured for estate tax purposes under section 2042(1).

If the lack of insurance interest becomes an estate tax issue, then an insurance company may refuse to pay the death benefit to the insurance trust until the issue is resolved, in light of the possible transferee liability to the Internal Revenue Service that the company could face if it pays the insurance proceeds to the insurance trust.

What state law applies to determine the existence of an insurable interest?

The state law that would apply in determining when an insurable interest exists is not certain. In Chawla, the plaintiff brought the case in Virginia, due to the fact that the agent was based in Virginia, the application was made and the medical exam took place in Virginia. Transamerica didn’t argue about the venue of the case, so we don’t know if, had there been an argument about venue, the case could have been moved to a federal court in a Maryland District or the District of Columbia, since there were ties to each of these venues in the transaction. If that were the case, then the substantive law of Maryland or the District of Columbia with its choice of laws principles would have applied, with perhaps a different result.

The issue of the lack of insurable interest will rise when an insurance company either refuses to provide life insurance at the outset, due to the lack of insurable interest in the owner, refuses to pay the death benefit or pays the death benefit and a party claims it was paid to the wrong entity (a trust received the death benefit rather than the insured’s estate). In the first case, the prospective owner will probably seek other insurance companies who are willing to overlook the lack of any insurable interest. However, if a potential applicant is unable to obtain insurance due to the perceived lack of insurable interest, then the applicant and the insurance company may end up in court litigating the issue.

In the second instance, a court action is necessary to force the insurance company to pay out the death benefit and in the third instance a court action is necessary to force the trust to disgorge the proceeds.

Determining which forum to litigate (and as a result, what state law will be applied to the transaction) is in all these situations, to a great extent, under the control the party seeking the payment of the insurance proceeds and not the insurance company. However, there is no certainty when trying to ascertain whether an insurable interest exists in a particular situation, which state law should apply because the forum could change based on venue arguments made by either party. Therefore, no practitioner can provide a legal opinion with a certainty when the forum is not specific and as they pertain to insurable interests and the opinion would be different based on which state law was being applied. Virginia, as discussed above, has a statute that was more favorable for the plaintiff than Maryland’s statute; the District of Columbia has no statute listing who has an insurable interest in the insured and therefore common law would apply.

Does an insurance trust have an insurable interest in states where the common law or statute does not specifically address a trust?

There is no case law, other than the Chawla case, on point. Many commentators have cited a Massachusetts case as the case law that establishes that a trust has an insurable interest in the insured; however, in that case, the insured purchased and owned the policy, the trust was only the beneficiary of the policy. Accordingly, the issue raised in Chawla, where the

trust purchased and owned the policy from the outset, when the existence of an insurable interest is required, was not addressed in that case. In another case that addressed trusts and the insurable interest rule, the trust was a business trust that was, in reality, a partnership, and although the trust was listed as the proposed owner of the insurance on the application, the insured was the actual owner of the policy when it was issued (and the owner’s wife was named the beneficiary).\textsuperscript{23} There was a discussion in that case of whether the trust had a claim against the beneficiary for the proceeds since the intention was that the trust was to be the owner of the policy in order to fund certain buy-sell obligations. In reaching its decision, the court found that the trust did not have an insurable interest in the insured on any basis other than the insurable interest a creditor has against a debtor-insured based on the buy-sell obligation. As a result, the court held that the trust had an insurable interest in the insured as a creditor and the insurable interest that was found was limited to the amount of the buy-sell obligation. The trust in this case is easily distinguishable from the usual insurance trust, since it was a business trust and was managed as a partnership by four doctors. However, what is troubling in this case is that the court discussed the insurable interest rules in general with respect to trusts and found that a trust does not have an insurable interest in the insured. The court’s discussion in the case, albeit a case that is easily distinguishable from a case involving the more traditional types of trusts, when read with the Chawla case, could cause a problem for those taking the position that a trust has an insurable interest in the insured.

A trust under state law (and ignoring federal tax law) is a separate entity from the settlor and the insurable interest statutes must be applied to the trust in the same manner as it is applied to any third party who is applying for insurance on the insured’s life. An insurance trust, as a separate entity, will usually be unable to show that it receives any pecuniary benefit from the insured’s continued life; in fact, it only benefits if the insured dies. The trust has no financial claim against the insured while the insured is living; indeed, in order to address any potential adverse gift and estate tax consequences, practitioners are careful to eliminate any hint of such a claim against the insured in the trust agreement and in the circumstances surrounding the purchase of the policy on the life of the insured. The trust is not closely related to the insured, by blood or by law, as that standard is interpreted. It is not a company in which the insured is an owner or employee and it is not a charity. Accordingly, an insurance trust, as a separate entity, does not meet any of the requirements set forth in most statute statutes for having an insurable interest in the insured.

There are two ways of looking at the trust, however, with respect to an insurable interest statute. Either the trust is a separate entity and the insurable interest statute is applied to that entity, or the trust is a collection of trust beneficiaries and the insurable interest statute is applied to the beneficiaries. Howard M. Zaritsky points out in his article for Steven Leimberg’s estate planning newsletter,\textsuperscript{24} that he has reviewed what little case law there is in this area and found that when courts have analyzed how a particular statute, such as the Bankruptcy Code, has applied to a trust, courts have found trusts to be a collection of its beneficiaries and applied the statutes to the beneficiaries and not the trust itself.

Many practitioners take comfort in this and believe that this second line of reasoning, that a trust is a collection of trust beneficiaries, and the insurable interest rules are applied to those beneficiaries, will protect their insurance trusts from attack because most insurance trust beneficiaries are closely related to the insured. But is this really the case? Such a position doesn’t address the present uncertainty under the state statutes of just who is “closely related by blood or by law.”

Furthermore, what if some but not all the beneficiaries of the trust are closely related to the insured? Does the existence of one beneficiary without an insurable interest invalidate the entire trust? Does the insurance company only pay a percentage of the insurance proceeds to the trust based on the percentage of the beneficiaries who have insurable interests, or do only those beneficiaries who have an insurable interest in the insured become entitled to receive the insurance proceeds? Do you then have to create separate share trusts to segregate the one beneficiary without an insurable interest from the others? What if the trust is a pot trust with a spray provision and one permissible member of the class is not a person with an insurable interest (such as the insured’s spouse’s child from the spouse’s first marriage or the spouse’s nephew)? What if the beneficiaries are not ascertainable due to powers of appointment held by non-beneficiaries? What if a court states that the beneficiaries are not ascertainable because no beneficiary has a vested interest in the trust, or finds a lack of insurable interest because the remaindermen are not closely related to the insured? As these are all questions that estate planning practitioners have faced in different areas of tax law, why

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would they not be raised in context of an insurable interest statute as well?

Interpreting a trust as a collection of beneficiaries may mean that beneficiaries who are not related to the insured will not be able to be permissible beneficiaries of an insurance trust. Consider step-children who are beneficiaries of the insurance trust as part of the overall estate plan when there has perhaps been a pooling of assets within the marriage and children of both parents are treated the same under each parent’s estate plan. Consider too, unmarried partners who wish to insure each other’s lives to protect each other in the event of the death of one of them, and want to use an insurance trust because they do not have the advantage of the marital deduction to shield the proceeds from estate tax at the death of one of them. Unless these persons are found to have another type of insurable interest in the insured, such as receiving a pecuniary benefit from the continued life of the insured, if the insurable interest rules are applied based on a trust being considered a collection of beneficiaries, a trust with such beneficiaries will be unable to obtain insurance on the insured.

Responses to Chawla

1. Why Many Practitioner s Do Not Believe Chawla Is a Problem.

Many practitioners do not believe Chawla is a problem but some of the reasons given for ignoring the case are unfortunately the product of wishful thinking. Although as oftentimes stated, the facts of the case are bad and the medical misrepresentations provide a substantial basis for the decision in the case, it is clear from the pleadings in the case that the lack of an insurable interest was an important part of Transamerica’s case and the Court’s decision. The holding that the Trust lacked an insurable interest in Mr. Geisinger was not dicta in the opinion. It was raised early in the pleadings and the argument does not rely upon the case’s medical “bad facts.” The case has been dismissed by practitioners as a misinterpretation of Maryland law by a Virginia court, but that is not the case, for a very obvious reason. Maryland has no law in the area of trusts and the insurable interest statute. Since there are no cases in this area, there was no misinterpretation of Maryland law. Any court could reach the same decision as the Chawla Court in any state with a statute similar to Maryland’s insurable interest statute when there is no case law to the contrary.

Another argument some practitioners make for ignoring the case is that an insurance company would be “crazy” to claim that an insurance trust does not have an insurable interest in the insured/grantor because insurance trusts are the core of the insurance industry’s business. However, Transamerica did make the argument and another insurance company may feel it has to make the same argument in a situation similar to the one in Chawla where there is a possibility that the argument about medical misrepresentation may not prevail. An insurance company may have to make the argument if a shareholder in a class action suit asks for damages for loss of share value because the company is paying out money on void policies. Alternatively, the state insurance commission may raise the issue and question why the existence of an insurable interest is not being investigated at the outset of the policy. Finally, the executor of an estate or the Internal Revenue Service may put the insurance company in the position of having to make the argument in order to protect themselves.

The attorney’s role in the usual life insurance transaction is usually one of advising the client of the legal issues that arise when insurance is purchased by a trust. In this area, one issue that attorneys need to be mindful of is that they are allowing their clients to enter into what is essentially a one-sided contract. The owner pays the premium on the insurance but there is no certainty that the insurance company must perform and pay the death benefit. The insurance company can withdraw from the contract at any time by returning the premiums and claiming that the owner does not have an insurable interest in the insured. Although the insurance industry has protested to the contrary, that they would never raise this issue on their own, it brings to mind other situations where a client is assured in a negotiation that a particular issue would never raised by the other party, such as when negotiating a pre-nuptial agreement or a shareholders agreement. No attorney would feel comfortable relying on such a statement in these situations, why are so many attorneys comfortable with the insurance industry’s assertions in this instance?

2. The Insurance Industry May Not Be an Ally of the Trusts and Estates Bar.

The insurance industry may find itself in the position of encouraging insurance companies to deny coverage based the insurable interest rule as a means of shutting down investor-owned life insurance. An insurance company may want to deny coverage based on a lack of insurable interest by a trust, if at the insured’s death, the company finds that an investor and not someone related to the insured owns the policy or is the beneficiary of the trust that owns the policy. Furthermore, as the existence of an insurable interest is raised with respect to different entities used by such investors to hold the policies, it will raise questions about why trusts can hold these policies and have an insurable interest but a partnership, corporation or limited liability company cannot.

The end result may be that investors structure their deals using trusts rather than other entities and then trusts will be at the center of the investor owned life insurance controversy.

3. Legislative Solutions
The best solution to Chawla is for the insurance industry, the Insurance Bar and the Estates and Trust Bar to work together to enact a statute in each state that clearly states that a trust has an insurable interest in the insured. Model language will have to be developed that satisfies the insurance industry’s concerns about investor-owned life insurance as well as clearly stating that all insurance trusts, even those trusts with beneficiaries some or all of which are not closely related to the insured, have an insurable interest in the insured. Virginia’s, Delaware’s or Washington State’s statutes should all be reviewed when considering possible model language.

Earlier in 2005, the Trusts and Estates Bar in Maryland attempted to enact an insurable interest statute to rectify the situation raised in the Chawla case. The Bar presented three versions of such a statute and the insurance industry either actively opposed the version or took a neutral position and would not assist with enacting it. According to representatives of the insurance industry one version was considered too broad by the insurance industry (it stated that limited liability companies and partnerships have insurable interest in the insured), one version was considered by the insurance industry to have constitutional issues (it was intended to be declarative of existing Maryland law that trusts have an insurable interest in the insured) and the last version was one where the legislature would have expressed its intent that Chawla should not be used as precedent, which the insurance industry would neither support nor oppose.

Representatives of the insurance industry have stated that they believe the best result is a successful appeal of Chawla. However, that position does not take into account the immediate issues facing trustees of insurance trusts and their legal counsel and the fact that, as illustrated here, a successful appeal may not resolve the issue. It has become apparent that representatives of the insurance industry and members of the Trusts and Estates Bar are not talking to one another in order to determine the best means of addressing the issues raised by Chawla.

4. If the Chawla Appeal Is Successful, Are We out of the Woods?

If the decision in the appeal is not restricted to the facts of Chawla and affirmatively states that a trust, as an entity, does have an insurable interest in the insured who created the trust, trusts subject to the jurisdiction of the Fourth Circuit will be deemed to hold an insurable interest in the insured. Trustees of trusts in other Circuits may not be so sanguine. Although the one case in the United States that deals with trusts and the insurable interest rule would be a favorable one if the Chawla appeal contains this language, another Circuit court addressing the question may ignore Chawla and agree with Transamerica’s argument. So long as that possibility exists, a practitioner must always consider the lower court’s ruling in Chawla.

If the Circuit Court reverses the lower Court’s decision with respect to the insurable interest of the trust based on the facts of the case and does not take a broader position in its opinion that can be applied to all trusts, then practitioners will be left with a case that can easily be distinguished on its facts from the more usual insurance trust. However, again, the one case in the United States that deals with trusts and the insurable interest law would be a favorable case.

A successful appeal on any basis is desirable, to eliminate an unfavorable decision in the one existing case on point. But Chawla raised an issue that a successful appeal may not be able to resolve completely for all trusts.

5. Immediate Non-legislative Solutions

a. When Insurance Is Already in the Trust and New Insurance Is Possible

In this situation, the trustees should consider a section 1035 exchange and exchange the old policy procured by the insurance trust for a new policy procured by the trust in which an insurable interest exists. This may require moving the trust to a state with an insurable interest statute that specifically addresses trusts prior to making the exchange.

Alternatively, the insured could acquire new insurance in his or her name and then transfer the new policy to the trust and surrender the old policy. The trust would use the proceeds from the cash surrender value of the old policy, if any, to pay premiums on new policy. If the transfer is a gift, section 2035 will be an issue. The insured could purchase a policy that is large enough to cover the resultant estate tax if the insured dies within three years of the gift (and reduce the death benefit after the three year period has ended). If the new policy is sold to the trust, the three year rule of section 2035 would not be an issue. Under recent IRS rulings, if the trust is a grantor trust for income tax purposes with respect to the insured, the sale of the policy to the insurance trust will not give rise to taxable income and will not be considered a transfer for value under section 101(a)(2).25 The sale should not trigger the modified endowment rules of section 7702A as a disposition of the policy, although there is no authority on this issue. If the trust will be giving the grantor a note in exchange for the policy, the trust should have other assets or value to support the sale transaction.

If the risk of a gift upon transfer and the application section 2035 is unacceptable, then consider having those persons who are closely related to the insured acquire a new policy and then transfer the policy

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to a trust or entity. If those persons are the intended beneficiaries of the trust, inclusion in their estate of the policy or proceeds must be considered. If the transfer is by sale, the transfer for value rules and the exceptions there-
to should be considered. Another potential purchaser of
a new policy are those persons who have a pecuniary
interest in the continued life of the insured or a company
in which the insured is an employee or shareholder (or
any person or entity who is defined as having an insur-
able interest in the insured under the applicable state
insurable interest law). A purchaser with an insur-
able interest in the insured could purchase the policy and
thereafter sell the policy to a trust in which the purchaser
is not a beneficiary or owner. So long as the transaction
falls within the transfer for value exceptions the trust will
receive the death benefit income tax free.

b. When New Insurance Is Not Possible Due
to Cost or Health

The trustees could approach the insurance
company and suggest entering into a separate contract
with the insurance company in which the insurance
company agrees that if the policy is found to be void
due to a lack of insurable interest, the company will
pay to the trust not only the premiums paid but an
amount equal to a market rate of return. This separate
contract will have to be supported by separate consid-
eration so it is not considered part of the insurance pol-
cy provisions. This may protect the trustees from a
claim that the trustees breached their duties to the trust
beneficiaries by knowingly investing in an asset (pre-
mium payments) that produced no return.

Trustees in this situation should consider
requesting that their state legislature enact a state statute
in the trust’s situs that specifically states that trusts have
an insurable interest in the insured and make sure the
new statute is retroactive. Without a state statute,
trustees must wait and hope for a successful appeal of
Chawla. If there is a successful appeal (and see above
for the discussion of whether an appeal can be success-
ful from a trustee’s standpoint), a trustee may want to
take the position that there is no case law that states that
a trust does not have an insurable interest in the insured.
While the trustee is waiting for that appeal, and possibly
after the appellate decision is handed down, the trustee
will want to inform the client that there is a problem
with the trust and obtain indemnifications from the trust
beneficiaries, if premiums will continue to be paid.

The trustee could also request that the
insurance company relieve the trust temporarily from its
premium obligation while the Chawla case is on appeal.

c. When considering whether to purchase
insurance to hold in a trust

The practitioner will want the insured and
the trustees to create as many contacts as possible to a
state with a statute that specifically addresses trusts.

The agent’s location, where the exam is done, where
the contract is delivered, where the premiums are paid
and the residence of the trustees and the trust are all
important contacts.

Structuring the transaction as described
above when considering new insurance, such as having
the insured acquire the insurance and thereafter transfer
it to the trust, or having those persons who are closely
related to the insured or otherwise qualify as having an
insurable interest in the insured under the applicable state statute acquire the policy, should be considered.

Please note that nowhere is it suggested
that the trustee request a letter from the insurance com-
pany assuring the trustee that they will not raise the
issue of the lack of insurable interest. It is not only
the insurance company that can raise the issue and the
insurance company may be forced to withhold pay-
ment of the death benefit, notwithstanding the letter. If
a contractual relationship is found to exist between the
parties the letter isn’t necessary and if it is determined
that no insurance interest existed but the doctrine of
estoppel cannot be raised due to the applicable state
law, the insurance company will not pay the proceeds,
regardless of the letter. If the policy is void but other-
wise payable in equity to the estate, the insurance com-
pany will pay the proceeds to the estate and not the
trust. Therefore, such a letter is useless.

Conclusion

As stated at the outset of this article, the Chawla
case did not cause a problem in the area of insurable
interests, it merely brought a problem that already
existed, albeit largely ignored, to light. As more practi-
tioners look at holding insurance in entities, whether it
is an insurance trust or other type of entity, and as
investor owned insurance policies become more popu-
lar, this issue will be raised more often. Eventually the
determination of whether an insurance trust or other
type of entity has an insurable interest in the insured
will have to be developed by the individual state courts,
if it is not addressed proactively with a legislative solu-
tion. If the courts address the issue, it will be addressed
one case at a time, in one state at a time, which will
quickly turn the area of insurance trusts and other enti-
ties holding life insurance policies into a legal quag-
mire. The better solution is the enactment of a uniform
insurable interest law that specifically addresses trusts
and is retroactive in effect. This may not be the most
desirable solution, but so long as there is uncertainty
with respect to which state law would apply to each
transaction, a uniform law seems to be the only viable
solution and it has more likelihood of passage than the
likelihood that Congress will change section 2035 so
that it no longer applies to transfers of incidents of
ownership in life insurance policies.
FLPs and the 2036(a) Bona Fide Sale Exception: The Vital Role of the Presumption of Adequate and Full Consideration

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I. Introduction

Over the past several years, the Internal Revenue Service (the “Service”) has enjoyed success in a string of cases involving the use of the family limited partnership and the family limited liability company as estate planning vehicles. The Service’s victories may be motivating many taxpayers to take more conservative positions in claiming valuation discounts on family limited partnership interests. But practitioners and commentators have responded with a barrage of literature criticizing decisions that favor the Service, and the family limited partnership continues to be an oft-used instrument in the estate planner’s toolbox.

When a taxpayer transfers property to a family limited partnership or a family limited liability company (for simplicity, both entities are referred to herein as an “FLP”), the partnership interests received in return typically qualify for valuation discounts from net asset value of as much as forty percent. This allows a taxpayer to then transfer the partnership interests to family members at significant transfer tax savings, and all the while, the transferor may, if desired, retain certain control over the partnership assets. The abuse invited by this unique combination of benefits necessitates the continued tightening of the estate tax law governing FLPs.4

The Service’s most effective tool of late for attacking abusive FLPs is Section 2036 of the Internal Revenue Code. This section pulls transferred property back into a taxpayer’s estate if the taxpayer retains enjoyment of the property, the right to income from the property, or the power to control who enjoys the property or income from the property.5 However, Section 2036 contains an exception for bona fide transfers made for adequate and full consideration in money or
money’s worth (the “bona fide sale exception”).

Seeking refuge from the grasp of Section 2036(a), taxpayers have argued for a liberal application of the bona fide sale exception. The Fifth Circuit in *Kimbell v. United States* ⁶ has adopted such an interpretation by failing to apply the heightened scrutiny required for transfers among family members. Meanwhile, the Tax Court has applied a stricter, more appropriate standard when evaluating whether transfers to an FLP qualify for the bona fide sale exception. Nevertheless, even the Tax Court is confused concerning the proper standard that should be applied to determine when a transfer qualifies for the bona fide sale exception, as evidenced by the Tax Court’s recent attempt in *Estate of Bongard v. Comm’r* ⁷ to formulate a new rule governing when the exception should be applied to FLPs.

This confusion is a result of the failure to recognize the proper justification for holding that a discounted partnership interest constitutes adequate and full consideration. Normally, consideration is adequate and full when its value equals that of the transferred property, but the value of a discounted partnership interest will never equal the value of the property transferred to an FLP. Rather, the only time a discounted partnership interest should qualify for the bona fide sale exception is when it is obtained through a transfer in the ordinary course of business. Courts may presume that transfers in the ordinary course of business are for adequate and full consideration in money or money’s worth. This is the only proper justification for finding that a discounted partnership interest qualifies for the bona fide sale exception.

Part II of this Comment provides a background discussion of how FLPs are used as tax planning vehicles. Part III introduces Section 2036(a) and discusses how the Third Circuit, the Fifth Circuit, and the Tax Court have applied the bona fide sale exception. Part IV explains why a discounted partnership should never qualify for the bona fide sale exception on the grounds that it replenishes the estate. It also demonstrates that the only way such an interest should be able to qualify for the exception is through a presumption of adequate and full consideration, and this presumption is only appropriate where the transfer is bona fide, made at arm’s length, and involves no donative intent.

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### II. The Use of Family Limited Partnerships as Estate Planning Vehicles

The FLP can be a valuable tool for managing a large estate. It potentially allows wealthy individuals to retain control over their assets and simultaneously decrease the value of their gross estate by as much as forty percent. ⁸

In a prototypical estate plan employing an FLP, the taxpayer will transfer a substantial portion of her assets to the FLP, retaining sufficient assets to provide for her personal support. In exchange, the transferor taxpayer will take a general partnership (“GP”) interest in the FLP’s equity, typically one percent of the partnership interest, and a limited partnership (“LP”) interest representing the remaining ninety-nine percent. The taxpayer may then engage in a gifting program and transfer the LP interest to her heirs, taking advantage of the $11,000 annual gift tax exclusion and the applicable exclusion amount. Whether the taxpayer makes inter vivos or testamentary transfers of her interests in the FLP, those interests will qualify for significant valuation discounts, thus reducing, or potentially eliminating, the transfer tax that would otherwise be incurred on the disposition of the property.

#### A. Valuing FLP Interests at a Discount from Net Asset Value

The standard under which partnership interests are valued for transfer tax purposes opens the door for significant valuation discounts. For gift and estate tax purposes, the standard for valuing property, including interests in businesses such as FLPs, is the “fair market value” standard. ⁹ The fair market value of property is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” ¹⁰ The willing buyer and willing seller are hypothetical persons, not “the actual transferor nor the actual transferee.” ¹¹

In general, contributing property to a legal entity in exchange for an ownership interest alters the nature of the transferor’s property rights, often dramatically. This frequently causes a disparity between the value of the contributed property and the value of the interest received. ¹² In the case of an FLP, the disparity can be substantial and takes the form of a lack-of-con-
trol discount and/or a lack-of-marketable-bility discount.

Under the fair market value standard, the value of a minority LP interest in an FLP is discount-
ed from net asset value for the lack-of-control associated with such an interest. The lack of control dis-
count is based on the theory that an outsider who pur-
chases a minority interest in a closely-held family business has no means of ensuring that the business
will make distributions or that she will receive an
income-paying position in the company.\footnote{Jensen, supra note 3, at 167–68.} Plus, under
partnership law, an owner of an LP interest does not
have the power to force liquidation of the partnership.
Due to this uncertainty as to when, if ever, the
acquired interest will produce economic benefits for
the investor, the amount that an outsider would pay for
an LP interest is discounted for the lack of control
associated with that interest.

In addition, both LP and GP interests in an
FLP qualify for a lack-of-marketable-bility discount from
net asset value. Unlike publicly-traded securities,
there is rarely a ready market for FLP interests. The
resultant difficulty associated with liquidating these
interests justifies a discount for lack of marketability.\footnote{In the 1980s and early 1990s, the Service unsuccessfully
attacked the proposition that minority interests in family-controlled businesses should not qualify for discounts for lack of marketability
and lack of control. Brier & Darby, supra note 12, at 131–132
(discussing Estate of Watts v. Comm’r, 51 T.C.M. 60 (CCH) (1985),
aff’d. 823 F.2d 483 (11th Cir. 1987), and Estate of Harrison v.
Comm’r, 52 T.C.M. 1306, 1307 (CCH) (1987)).}

A taxpayer who transfers property to an FLP
in exchange for a discounted partnership interest may receive one of several intangible benefits that compen-
sate for the “immediate destruction of value” that
occurs upon making the transfer.\footnote{Jensen, supra note 3, at 170 (describing potential nontax reasons a taxpayer would transfer property to an FLP knowing that the interests received will be valued at a discount).} Some of these ben-
efits are personal to the taxpayer. Examples include
involving the children in management of the property,
attaining financial leverage over the LP interest hold-
ers (often the children), creating a testamentary plan,
or facilitating a gifting program. Other intangibles are
benefits that would be valuable to any interest holder
in the FLP. Examples might include asset protection
against creditors or management expertise.\footnote{See Kimbell v. United States, 371 F.3d 257, 266 (5th Cir.
2004); S. Stacy Eastland, “Family Limited Partnerships: Non-
transfer Tax Benefits,” 7 Prob. & Prop. 10 March–April 1993.}

In the eyes of the transferor of property to an
FLP, the fair market value standard often “understates
actual value.”\footnote{Jensen, supra note 3, at 158–59.} A lack of control and marketability
would be a substantial concern to the hypothetical
buyer and seller; however, it is often not an important
factor for a family member interest holder, especially
where family members work together in harmony.
Also, the fair market value standard fails to take into
account for valuation purposes those benefits of the
FLP form that are personal to the transferor. In effect,
under the fair market value standard, the transfer of
property to an FLP may create a valuation discount on
paper that is much greater than in the mind of the
transferor.

\textit{1. An illustration of the power of discounts}

The following example illustrates the
transfer tax advantages an FLP can offer.\footnote{Jensen, supra note 3, at 172–73.} Assume Father (F) and Mother (M) own a business worth
$4,000,000 in equal shares, and they transfer their
interests therein to an FLP. In return, each takes a 0.5
percent GP interest and a 49.5 percent LP interest in
the FLP. Assume further that the LP interest qualifies
for a combined 30 percent lack-of-control and lack-
of-marketability discount and that the GP interest
qualifies for a 10 percent lack-of-marketability dis-
count. If F and M have two children and four grand-
children, utilizing the annual exclusion and the applic-
able credit they can gift their entire LP interests to
their six heirs over a six-year period without incurring
any gift tax.\footnote{Jensen, supra note 3, at 158–59.} The valuation discount created by using
an FLP allows the taxpayers to transfer $1,188,000 in
assets tax-free.\footnote{Jensen, supra note 3, at 159–60.}

\begin{itemize}
\item [\footnote{See Kimbell v. United States, 371 F.3d 257, 266 (5th Cir.
2004); S. Stacy Eastland, “Family Limited Partnerships: Non-
transfer Tax Benefits,” 7 Prob. & Prop. 10 March–April 1993.}]
\item [\footnote{Jensen, supra note 3, at 158–59.}]
\item [\footnote{Jensen explains,}]
\item [\footnote{In year one] F and M each make gifts of $177,666 to each
child and grandchild, resulting in total gifts by each donor of
$1,065,996. These gifts are not taxable because of the gift tax uni-
ified credit that shelters $1,000,000 from tax in the case of each
donor and each donor’s annual gift tax exclusion of $11,000
per donee. [$1,000,000 + ($11,000 x 6 donees) = $1,066,000]. The
combined gifts of F and M during Year 1 amount to $2,131,992.
\item [\footnote{In years two through five] F and M each make gifts of
$11,000 to each child and grandchild during each year in this per-
iod, resulting in total gifts by each donor of $264,000 [$11,000 per
year x 6 donees x 4 years]. These gifts are sheltered from tax by
reason of the annual exclusion. The combined gifts of F and M during
Years 2–5 amount to $528,000.
\item [\footnote{In year six] F and M each make gifts of $9,334 to each
child and grandchild, resulting in total gifts during Year 6 of $112,008
[2 donors x $9,334 per donee x 6 donees]. Assuming that the values
have remained constant over the six year period, F and M will have
completely divested themselves of LP interests. The gifts in Year 6
are completely sheltered from gift tax by the annual exclusion.
\item [\footnote{Jensen, supra note 3, at 159–60.}]
\end{itemize}
Adding to the attractiveness of the FLP, through their continued ownership of the GP interest, F and M retain complete control over management of the FLP, including whether the business makes distributions to the interest holders and whether their children and grandchildren receive highly compensated employment with the family business. Moreover, upon the death of F and M, their GP interest still qualifies for the 10 percent lack of marketability discount for estate tax purposes.

B. Ensuring Transferred Assets Are Not Pulled Back Into the Estate
To benefit from these valuation discounts, the taxpayer must comply with certain partnership formalities and the FLP must have a certain level of substance. Otherwise, the taxpayer may be forced to include in her gross estate the assets transferred to the partnership at their fair market value instead of the value of the discounted partnership interests.

1. Heightened scrutiny required in the family context
Whenever a taxpayer makes a transfer of property to a family member or a family-owned entity, the transaction is subject to heightened scrutiny for tax purposes. Courts presume that “the intra-family transfer is not at arm’s length.”22 Rebutting this presumption entails inquiring “beyond the form of a transaction between family members to determine whether the substance justified the claimed tax treatment.”22 Such special scrutiny is necessary because, as the Supreme Court has recognized, “the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used.”23

2. Structuring an FLP to withstand heightened scrutiny
The single most important characteristic an FLP should have to withstand heightened Service scrutiny is a legitimate, nontax business purpose.24 Perhaps the most persuasive business purpose for using an FLP is facilitating the active management of the FLP assets.25 Other potential business purposes for using an FLP include: (1) pooling assets for investment purposes; (2) preventing disputes between family members; (3) enabling children to participate in or take over management of assets; (4) consolidating fractional interests in family assets; (5) restricting the rights of third parties from acquiring interests in family assets; and (6) protecting assets against future claimants.26 Merely stating that an FLP is formed for these or other business purposes is insufficient. Courts will scrutinize the substance of the FLP to see if the claimed purposes are indeed the true motivation for its creation.27

Aside from having a business purpose, to ensure the assets in an FLP are not drawn back into the transferor’s estate, taxpayers should “carefully follow all formalities in forming and operating the FLP and respect the form of the partnership.”28 This includes carefully maintaining “contemporaneous books and records reflecting all partnership transactions” and ensuring the partnership has its own checking account.29

Also, the individual interest holders must respect the form of the partnership and avoid any indicia of continued ownership of the transferred assets.30 The partnership should “operate at arm’s-length” with all interest holders and family members.31 Partnership assets should not be commingled with personal assets, and if the FLP makes loans to family members, they should be carefully documented, market-rate interest should be charged, and timely payments should be enforced.32 The FLP should make distributions pro rata and should not time them to meet the family members’ personal needs.33 Also, distributions should be made to the distributee partner, and not to the partner’s creditors.34 Finally, it is best not to fund an FLP with “personal use property, such as the principal residence or the family’s art

21 Black, supra note 8, at 315.
22 Kimbell, 371 F.3d at 263.
25 Id. at 51 (finding that an FLP did not have a legitimate business purpose where it “never diversified its assets during decedent’s life, never had an investment plan, and never functioned as a business enterprise or otherwise engaged in any meaningful economic activity”); see also Susan Kalinka, “Individuals and Pass through Entities,” 83 Taxes: The Tax Magazine 19, 28 (Jan. 2005).
27 See e.g., Bongard, 124 T.C. No. 8, at 54–55 (scrutinizing and ultimately rejecting the FLP’s claimed purposes of facilitating a gifting program and creditor protection).
28 Kalinka, supra note 25, at 28.
29 Id.
30 See Jensen, supra note 3, at 184–85.
31 Kalinka, supra note 25, at 28.
34 Kalinka, supra note 25, at 28.
 collection.”  Taking such precautions ensures that the taxpayer’s relationship to her property changes when it is transferred to an FLP.

### III. Section 2036(a) and the Bona Fide Sale Exception

#### A. Section 2036(a)

Recently, the Service’s most potent weapon for attacking the abusive use of the FLP is Section 2036(a). Section 2036(a) provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

1. the possession or enjoyment of, or the right to the income from, the property,
2. the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Congress enacted Section 2036 to prevent avoidance of the federal estate tax “by the use of inter vivos transactions which do not remove the lifetime enjoyment of property purportedly transferred by a decedent.” As the Supreme Court explained, such transfers are “essentially testamentary” in that they “leave the transferor a significant interest in or control over the property transferred during his lifetime.” Under 2036(a), “[a]n interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.”

The Third Circuit opinion, Thompson v. Commissioner, illustrates the application of Section 2036(a) to an abusive FLP. The decedent, Mr. Thompson, transferred $1,286,000 in property consisting of securities, notes, and a ranch to the Turner FLP in exchange for a 95.4 percent LP interest. The decedent’s son-in-law contributed $50,000 in assets to the partnership in exchange for a 3.54 percent limited partnership interest. A corporation owned by Mr. Thompson (49 percent) and by members of his family and a charity (51 percent) held the remaining 1.06 percent GP interest. The Turner FLP never “engaged in business or loan transactions with anyone outside of the family.” Also, the FLP distributed cash to Mr. Thompson on several occasions when he desired money for personal purposes. On these facts, the Third Circuit concluded that “an implied agreement [existed] at the time of the transfer that decedent would retain enjoyment and economic benefit of the property transferred to the family limited partnership[.]” Thus, instead of including Mr. Thompson’s partnership interests in his gross estate, which were valued “by applying a 40% discount rate to the net asset value of the partnerships and corporations for lack of control and marketability,” the court included in his estate the FLP assets themselves under Section 2036(a)(1).

Another case illustrating the power of Section 2036(a) is Strangi v. Commissioner, in which the Tax Court held that under certain circumstances 2036(a)(2) may be invoked to include the assets of an FLP in a decedent’s gross estate. Section 2036(a)(2) “mandates inclusion in the gross estate of transferred property with respect to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income.” The Strangi court held that this section applies if the transferor owns a GP interest in an FLP and thus holds the right to determine distributions or to dissolve the partnership, whether alone or in conjunction with others. The Strangi holding has been the topic of much controversy. On appeal, the Fifth Circuit affirmed the Tax Court’s decision on other grounds and did not reach the Section 2036(a)(2) issue.

#### B. The Bona Fide Sale Exception

The effects of Section 2036(a) may be avoided altogether if property is transferred to an FLP in a...
“bona fide sale for an adequate and full consideration in money or money’s worth.” The rationale behind this bona fide sale exception to 2036(a) is that such transfers do “not deplete the gross estate.” If the value of the consideration is “roughly equivalent” to the value of the transferred property, then the estate is replenished and the need to include the transferred property in the gross estate is altogether obviated, even if the transferor retains control over the transferred property. An estate hoping to qualify for this exception must establish two elements: (1) the transfer must be bona fide, and (2) the transfer must be for adequate and full consideration in money or money’s worth.

1. The bona fide sale prong
Courts have applied two separate standards in determining whether a transfer to an FLP constitutes a bona fide sale.

The good faith standard. The Third and Fifth Circuits have applied a “good faith” transfer standard in evaluating this prong. The Regulations define a bona fide sale as a transfer “made in good faith.” A good faith transfer is one in which “the transferor actually part[s] with the... interest and the transferee actually part[s] with the requisite adequate and full consideration.” A transfer to an FLP is not made in good faith if the transferor’s relationship to her assets does not change, or in other words, if the transfer results in “a mere recycling of value.” The good faith requirement thus serves to prevent sham transactions and disguised gifts from qualifying for the bona fide sale exception.

The Third and Fifth Circuits have weighed several factors in scrutinizing whether a transfer to an FLP in exchange for a partnership interest is a transfer made in good faith. The most important factor is whether the transfer “provide[s] the transferor some potential for benefit other than the potential estate tax advantages that might result from holding the assets in partnership form.” If a transfer to an FLP is “motivated solely by tax planning,” then the sale is not bona fide, even if all the “i’s are dotted and the t’s are crossed.” When an FLP is created for a genuine non-tax purpose, the transferor’s relationship to her assets is altered, which consummates the transferor’s good faith parting with her interest in the transferred property.

Other factors evaluated under the first prong include: (1) whether partnership formalities are satisfied, including the assignment of assets to the FLP; (2) whether the partnership assets are used for personal expenses; (3) whether the transferor retained sufficient assets for her support so that she need not rely on FLP assets to maintain her standard of living; and (4) whether partnership funds are commingled with personal funds.

The arm’s length standard. Unlike the Third and Fifth Circuits, which have defined a bona fide sale as “a transfer made in good faith,” the Tax Court has equated a bona fide sale with an “arm’s length transaction.” An arm’s length transaction is a transaction involving “meaningful negotiation or bargaining [between] anticipated interest holders.” The test of whether a transaction is arm’s length involves questioning whether “the transaction [was] carried out in the way that the ordinary parties to a business transaction would deal with each other.”

The courts have held that family members can enter into an arm’s length transaction. When applying heightened scrutiny to family transactions, the most important factor weighed by the Tax Court is the presence of genuine business purpose motivating

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43 26 U.S.C. § 2036(a) (2000). The bona fide sale exception also exempts taxpayers from the provisions of several other estate and gift tax provisions, e.g., I.R.C. §§ 2037, 2038, 2512.
44 Estate of Bongard v. Comm’r, 124 T.C. No. 8, at 66–67 (Laro, J. concurring) (citing cases that emphasize the importance of replenishing the estate in applying the bona fide sale exception).
50 Kimbell v. United States, 371 F.3d 257, 262 (5th Cir. 2004).
51 Id. at 261.
52 Id. at 263; Estate of Thompson v. Comm’r, 382 F.3d 367, 382 (3d Cir. 2004).
53 Treasury Regulation §§ 20.2036-1(a), 20.2043-1(a); see also Kimbell, 371 F.3d at 263; Thompson, 382 F.3d at 382.
54 Wheeler v. United States, 116 F.3d 749, 764 (5th Cir. 1997); Kimbell, 371 F.3d at 265; Thompson, 382 F.3d at 382.
55 Kimbell, F.3d at 263; see also Strangi v. Comm’r, 85 T.C.M. (CCH) 1331, 1344 (2003) (finding there was no bona fide sale where “all decedent did was to change the form in which he held his beneficial interest in the contributed property”).
56 Thompson, 382 F.3d at 383; see also Kimbell, 371 F.3d at 264.
57 Thompson, 382 F.3d at 383.
58 See Kimbell, 371 F.3d at 264; Kalinka, supra note 25, at 28.
59 See Kimbell, 371 F.3d at 267.
60 Strangi, 85 T.C.M. (CCH) at 1343 (defining the first prong as requiring “a bona fide sale, meaning an arm’s-length transaction”); Harper v. Comm’r, 83 T.C.M. (CCH) 1641, 1653 (2002) (citing Estate of Goetchius v. Comm’r, 17 T.C. 495, 503 (1951) (“[T]he exemption from tax is limited to those transfers of property where the transferor or donor has received benefit in full consideration in a genuine arm’s length transaction”).
61 Strangi, 85 T.C.M. (CCH) at 1334.
63 E.g., Rosenthal v. Comm’r, 205 F.2d 505, 509 (2d Cir. 1953) (“E]ven a family transaction may for gift tax purposes be treated as one ‘in the ordinary course of business.’”); Bongard, 128 T.C. No. 8, at 47 (noting that “heightened scrutiny is not tantamount to an absolute bar”).
in a mere “recycling” of value, and whether the transferee’s relationship to her assets changes. 71 In essence, employed by the Fifth and the Third Circuits. 72

whether the FLP is formed for a genuine business purpose, whether the transfer of property to an FLP results in a mere “recycling” of value, and whether the transferee’s relationship to her assets changes. 73 In essence, the arm’s length transaction standard, as applied by the Tax Court, incorporates the good faith standard employed by the Fifth and the Third Circuits. 72 Because it incorporates both of these elements into the first prong of the bona fide sale exemption, the arm’s length standard is a much higher hurdle for taxpayers to overcome than the good faith standard.

2. The adequate and full consideration prong

The second prong of the bona fide sale exception requires that the transfer of property to the FLP be for “adequate and full consideration in money or money’s worth.” 74 The consideration received in exchange for a transfer of property to an FLP is either a GP interest or an LP interest, or some combination of both. “In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate.” 75

The Stone rule. The source of the current, predominant rule for determining whether a transfer of property to an FLP is for adequate and full consideration is the Tax Court’s opinion in Estate of Stone v. Commissioner. In Stone, an elderly couple, Mr. and Mrs. Stone, created five FLPs for the purpose of allowing their children to manage their assets, which included a manufacturing business. The Stones also formed the FLPs to prevent future litigation among the children, who already had an extensive history of litigating issues involving their parents’ assets. After holding that the formation of these partnerships was completed via an arm’s length transaction, the Tax Court explained that the transfer was also for adequate and full consideration based on two considerations. First, all the partners received partnership interests proportionate to the respective value of property they contributed, and capital accounts were credited accordingly, with liquidating distributions to be made in accordance with capital accounts. 76 And second, the partnerships were formed for a genuine business purpose. 76 Under these circumstances, the court concluded that the Stones “received in exchange for their respective transfers of assets to each such partnership respective partnership interests in the basis of the arm’s length dealings involved and their bona fide business objectives”).

71 See, e.g., Bongard, 124 T.C. No. 8, at 52; Harper, 83 T.C.M. (CCH) at 1652.

72 While these two concepts are distinct, “[a]s a practical matter, an ‘arm’s length’ transaction provides good evidence of a ‘bona fide sale,’ especially within intra-family transactions.” Estate of Thompson v. Comm’r, 382 F.3d 367, 381 (3d Cir. 2004).


74 Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004).


76 Id. at 581 (weighing “the fact that each of the Five Partnerships was created, funded, and operated as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services”).
each such partnership that were adequate and full equivalents reducible to a money value.\textsuperscript{77}

The Fifth Circuit in \textit{Kimbell} adopted part of the \textit{Stone} rule in its analysis of the adequate and full consideration prong. The Fifth Circuit, like the Tax Court, held that in determining if a transfer to an FLP is for adequate and full consideration, the proper focus is whether the transferor received a partnership interest proportionate to the value of the transferred property, whether the fair market value of the transferred assets is credited to the transferor’s capital account, and whether liquidating distributions were to be in proportion to capital accounts.\textsuperscript{78} However, the Fifth Circuit did not adopt the \textit{Stone} requirement that the transfer be motivated by a genuine business purpose as part of the adequate and full consideration analysis. Thus, regarding the second prong, like the first, the Fifth Circuit rule is more taxpayer friendly than the Tax Court rule.\textsuperscript{79}

3. \textit{The Estate of Bongard decision}

In March of 2005, the Tax Court, in \textit{Estate of Bongard v. Commissioner}.\textsuperscript{80} formulated a “new” rule specifically for applying the bona fide sale exception to FLPs. The Tax Court conducted a lengthy summary of recent case law dealing with the application bona fide sale exception to FLPs and concluded:

In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred.\textsuperscript{81}

After stating this rule, the court proceeded to analyze the transfers in question under the traditional two-prong test. The Tax Court’s “new” rule focused additional attention on the issue of a genuine business purpose, but beyond that, it did little to substantively alter the court’s bona fide sale analysis. If anything, it demonstrated the court’s confusion over the proper framework for analyzing the bona fide sale exception.

At issue in \textit{Bongard} were two separate transactions involving the decedent and his family members. In the first transaction, the decedent formed a holding company and the members of his family transferred all of their stock in a family-owned corporation to the holding company. The Tax Court held that this transfer satisfied both the bona fide sale prong and the adequate and full consideration prong, and thus qualified for the bona fide sale exception. The evidence established that the genuine business purpose of the transaction was to better position the family company for a corporate liquidity event. Because the transfer was undertaken for a legitimate and significant nontax reason and because the terms of the transaction did not differ “from those of two unrelated parties negotiating at arm’s length,” the court held that it was an arm’s length transaction.\textsuperscript{82} The Tax Court also found that the transfer was a bona fide sale because it “resulted in a true pooling of assets.”\textsuperscript{83} These two findings fulfilled the requirements of the Tax Court’s arm’s length standard for the first prong of the bona fide sale exception. The court then held that the second prong of the exception was satisfied, applying the \textit{Stone} rule.\textsuperscript{84} Having found that the transfer of stock to the holding company was bona fide and for adequate and full consideration, the court concluded that it qualified for the bona fide sale exception.

However, the Tax Court was not so friendly toward the second transaction, in which the decedent transferred some of the holding company membership units to an FLP. The court found no business purpose motivating this transfer. The FLP did not diversify its holdings, perform any management function, or enter into any businesslike transaction. On these facts, the Tax Court held that the transfer of membership units to the FLP was merely a recycling of value that lacked any legitimate and significant nontax business purpose and as a result did not qualify for the bona fide sale exception.\textsuperscript{85}

\begin{thebibliography}{99}
\bibitem{77} \textit{Kimbell}, 371 F.3d at 266; \textit{Strangi v. Comm’r}, 2005 WL 1660817 (5th Cir.).
\bibitem{78} The Third Circuit, in \textit{Thompson v. Comm’r}, 382 F.3d 367, 381–83 (2004), held that the transfer in question failed the first prong and did not discuss the second prong of the exception.
\bibitem{79} 124 T.C. No. 8 (2005).
\bibitem{80} \textit{Id.} at 39.
\bibitem{81} \textit{Id.} at 47–48.
\bibitem{82} \textit{Id.}
\bibitem{83} \textit{Id.}
\bibitem{84} The court held that the transfer was for adequate and full consideration because (1) each partner received interests in the holding company in proportion to the number of shares of stock contributed and the capital accounts were structured so as to reflect partnership contributions and distributions, and (2) the transaction was effectuated for a legitimate and significant nontax, business reason. \textit{Id.} at 49–50.
\bibitem{85} \textit{Id.} at 51–56. The estate argued that the decedent formed the FLP for creditor protection purposes and to facilitate a gifting program. The court found these purposes to be unpersuasive, concluding instead that estate tax savings motivated the transfer to the FLP. \textit{Id.} at 53.
\end{thebibliography}
In substance, the legitimate and significant nontax reason rule, as applied by the Tax Court in Bon- 
gard, adds little to the Tax Court’s traditional analysis of the bona 
fi de sale exception set forth in Stone. In Bon-gard, even after stating its “new” rule, the Tax 
Court still applied the same two-prong test that it used in Stone, and both of those prongs already incorporat-
ed a legitimate business purpose element. Moreover, 
to support a finding of a legitimate and significant 
business purpose, the Tax Court weighed the same fac-
tors that it weighed under the arm’s length transaction 
standard. The court stated:

A list of factors that support such a finding includes the taxpayer standing on both sides of the transaction; the taxpayer’s financial dependence on distributions from the partnership; the partners’ commingling of partnership funds with their own; and the taxpayer’s actual failure to transfer the property to the partnership.

The first of these factors is part of the arm’s length inquiry. The last three factors are part of the bona fide inquiry. Thus, the legitimate and significant nontax reason standard applied by the Bongard court is nothing more than a rearrangement of the Tax Court’s arm’s length standard, with extra emphasis placed on the genuine business purpose factor.

The Bongard court’s creation of a “new” rule demonstrates the confusion that exists over the proper standard for determining when the bona fide sale exception applies to FLPs. The fact that the Tax Court went to the effort of attempting to define a new rule shows that it was not content with the arm’s length standard it had applied previously. Moreover, the fact that the new rule, for the most part, simply emphasizes the key element of the old standard illustrates that the court is struggling to identify the principal, underlying issues in applying the bona fide sale exception.

4. The Estate of Biegolow decision

Two weeks after releasing the Bongard opinion, the Tax Court issued another opinion, Estate of Biegolow v. Comm’r, that serves as a useful illustration of how the court plans to apply the Bongard rule.

In Biegolow, an elderly woman transferred a personal residence that operated as a rental property from her revocable trust to an FLP, but she left the debt that accompanied the transferred property in the trust. Soon thereafter, having relinquished the income generated by the residence, the woman found herself with insufficient funds to repay the retained loans and meet her other financial obligations. The FLP stepped in and began to make payments on the loans for her, which led the court to conclude that there was an implied agreement that she would retain the economic benefit of the transferred property.

In its statement of the rule governing the bona fide sale exception, the Tax Court cited Thompson and noted, “[t]o constitute a bona fide sale for adequate and full consideration, the transfer of the property must be made in good faith.” The court then explained, “such a sale requires that the transfer be made for a legitimate nontax purpose.” The court proceeded to hold that the transfer in question was not a good faith transfer because the transferor failed to retain sufficient assets to meet her financial obligations, because the FLP did not maintain capital accounts in accordance with the terms of the partnership agreement, and because the transfer to the FLP offered the transferor no potential for benefit other than tax savings.

The Biegolow opinion merits three observations. First, Biegolow illustrates that the legitimate and significant nontax requirement is merely an element (albeit an essential element) of a good faith transfer rather than a new, independent requirement for the bona fide sale exception. Second, Biegolow demonstrates that the legitimate and significant nontax requirement is not the only element of a good faith transfer, but one of several factors that courts should consider. Third, the Biegolow opinion is peculiar in the standard that the court chose to apply. The Tax Court diverged from its history of applying the arm’s length standard, choosing instead to apply the good faith standard. It could be argued that the Tax Court waivered in its application of the arm’s length standard in the face of two circuit court opinions holding that an arm’s length transfer is not an essential element of a bona fide sale for adequate and full consideration. However, it is more likely that the court applied the good faith standard because a transfer that

86 See supra note 64 and note 76 and accompanying text.
87 124 T.C. No. 8, at 39–40 (internal citations omitted).
89 Id. at 22.
90 Id. at 25.
91 Id.
92 The revocable trust took both a GP and an LP interest in the FLP in exchange for transferring the residence to the FLP. Because
93 Estate of Thompson v. Comm’r, 382 F.3d 367, 382 (3d Cir. 2004); Kimbell v. United States, 371 F.3d 257, 267 (5th Cir. 2004).
does not meet the good faith standard cannot qualify under the more stringent arm’s length standard. Under this view, after Bigelow the arm’s length standard is still good law outside the Third and Fifth Circuits.

The confusion among the courts over the proper standard is understandable considering the conceptual difficulty associated with finding that a partnership interest valued at a discount from net asset value constitutes adequate and full consideration for the transfer of assets to an FLP. The cause of this confusion, as discussed below, is the Tax Court’s failure to recognize the proper justification for applying the bona fide sale exception to transfers in exchange for discounted partnership interests.

IV. Analysis: The Proper Rationale for a Finding of Adequate and Full Consideration

In March of 2005, in separate concurring opinions in Estate of Bongard, Judge Larø and Judge Halpren explained that there are two possible justifications for applying the bona fide sale exception. The traditional rationale is that the bona fide sale exception may be applied when the value of the consideration equals the value of the transferred property, thus replenishing the estate. The second rationale is that when a transaction occurs in the ordinary course of business, courts may presume that there is adequate and full consideration in money or money’s worth.94

Courts have struggled to conceptually fit a transfer to an FLP in exchange for a discounted partnership interest into the framework of the first of these justifications. This is because the value of a discounted partnership interest will never, due to the valuation discount, equal the value of the property transferred to an FLP, and thus will never replenish the estate. Thus, in the context of transfers of property to an FLP, only transfers made in the ordinary course of business should qualify for the bona fide sale exception. When a transfer is made in the ordinary course of business, courts should simply presume that the transfer is for adequate and full consideration. Recognizing the proper justification for applying the bona fide sale exception to FLPs is imperative in order to eliminate confusion over the proper standard for determining when the exception should apply to FLPs.

A. Dollar for Dollar Replenishment

In several recent FLP cases, the Service has argued that it is inconsistent for an estate to argue, on one hand, that a decedent’s interest in an FLP qualifies for a substantial discount and, on the other hand, that the partnership interest qualifies as adequate and full consideration for the transfer of assets to the FLP.95 This inconsistency argument has definite appeal—if a taxpayer transfers $1,000 to an FLP in exchange for a partnership interest discounted by 35 percent and thus valued at $650, it would seem that the FLP interest could never constitute adequate and full consideration. Despite the logical simplicity of this argument, no court has found this argument persuasive, but neither has any court presented a compelling reason why this argument must fail.

The Tax Court in Stone, for example, explained that the argument that a discounted partnership interest can never constitute adequate and full consideration improperly reads the bona fide sale exception out of Section 2036(a).96 However, the Stone court did not explain how this argument improperly reads the exception of Section 2036(a), nor did it provide any other support for its rejection of the Service’s inconsistency argument.97 Rather, the Stone court held that receipt of a partnership interest proportional to the value of the transferred property could constitute adequate and full consideration. Proportionality, however, does not ensure that the estate is replenished and thus is an insufficient test as to whether consideration is adequate and full.98

The Fifth Circuit in Kimbell attempted to respond to the Service’s inconsistency argument by holding that intangible considerations make up for the difference in value between the transferred property and the partnership interests. The court reasoned that there are “financial considerations other than the ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar” that motivate a transferor to use an FLP.99 As examples of such financial considerations, the court listed, “management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability.”100 The court continued:

Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor’s dollars have acquired a limited partnership interest at arm’s length for adequate and full consideration and, on the other hand, that the

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94 Bongard, 124 T.C. No. 8, at 64–65 (Larø, J., concurring); Id. at 86 (Halpren, J., concurring).
95 See, e.g., Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004); Estate of Stone, 86 T.C.M. (CCH) 551, 581 (2003).
96 Stone, 86 T.C.M. (CCH) at 581.
97 See Estate of Thompson v. Comm’r, 382 F.3d 367, 386 (2004) (Greenberg, J., concurring) (criticizing Snow for not explaining why the Service’s argument reads the exception out of Section 2036(a)).
98 Bongard, 124 T.C. No. 8, at 82–83 (Halpren, J., concurring).
99 Kimbell, 371 F.3d at 266.
100 Id.
asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid—a classic informed trade-off.\textsuperscript{101}

The Fifth Circuit thus implicitly argued that a transfer to an FLP is for adequate and full consideration when the sum of the value of the discounted partnership interests and the value of the intangible economic benefits received from utilizing the partnership form equals the value of the property transferred to the partnership. The Tax Court also implicitly advanced this argument in Estate of Harper, when it stated, “there is at least the potential that intangibles stemming from a pooling for joint enterprise might support a ruling of adequate and full consideration.”\textsuperscript{102}

The argument that intangibles help give rise to a finding of adequate and full consideration fails to take into account two limitations on a court’s freedom to consider such intangible economic benefits when valuing consideration received in exchange for a transfer of property. The first limitation is the fair market value standard, which allows only intangibles that would be of value to the hypothetical buyer to be considered. The second is the statutory requirement that the consideration be in money or money’s worth.

1. Limitations imposed by the fair market value standard

The correct standard for valuing property for purposes of the bona fide sale exception is the fair market value standard. The Treasury Regulations clearly explain that the fair market value standard is the proper standard for valuing “property includible in a decedent’s gross estate” and for valuing taxable gifts.\textsuperscript{103} However, Section 2036(a) consideration does not fit into either of these two categories, and as a result, the Regulations do not indicate the correct standard for valuing such consideration. The Tax Court and the Ninth Circuit, however, have filled the gap, holding that the fair market value standard is still applicable when determining the value of consideration received in the context of Section 2036.\textsuperscript{104}

Under the fair market value standard, only those intangibles that have value to the hypothetical, unrelated buyer or seller may be considered when valuing the 2036(a) consideration. The intangible benefits listed by the Fifth Circuit—“management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability”\textsuperscript{105}—would all potentially have value in the eyes of an unrelated buyer and thus could be considered. However, the Fifth Circuit’s list was noninclusive, and many of the other intangibles that might motivate a transferor to contribute property to an FLP would not have any value to the unrelated buyer.\textsuperscript{106} Due to this limitation, in order for the adequate and full consideration requirement to be met, the value of those intangibles which are subject to fair market valuation by itself must be equal to the discount claimed by the taxpayer on the partnership interest. This makes it more difficult for a discounted partnership interest and the accompanying intangibles to fully replenish the estate.

Perhaps recognizing the effect of this limitation, the Fifth Circuit, in Kimbell, errantly held that the fair market value standard is not the proper means of valuing consideration received for purposes of the bona fide sale exception.\textsuperscript{107} The Kimbell court did not attempt to justify its rejection of the fair market value standard, and it also failed to suggest an alternative standard. The Fifth Circuit’s unsupported holding on this issue flies in the face of the purpose of the bona fide sale exception as well as contradictory (albeit non-binding) Tax Court and Ninth Circuit authority.

The Tax Court’s and the Ninth Circuit’s holdings that the fair market value standard is the appropriate standard is the superior position. The purpose of the bona fide sale exception is to disengage Section 2036(a) when consideration for a transfer of property replenishes the estate.\textsuperscript{108} In light of this purpose, the fair market value standard is the only appropriate standard for valuing consideration to determine whether it is adequate and full. Because transferred property pulled back into the gross estate by Section 2036(a) will be valued under the fair market value standard upon the transferor’s death, reliable assurance that the estate has been replenished can only be obtained by applying the same standard to the consideration received.\textsuperscript{109} To use any other standard would be to compare apples and oranges.\textsuperscript{110}

\textsuperscript{101} Id.
\textsuperscript{102} Harper v. Comm’r, 83 T.C.M. (CCH) 1637, 1564 (2002).
\textsuperscript{103} Treas. Reg. §§ 20.2031-1(b), 25.2512-1.
\textsuperscript{104} Magnin v. Comm’r, 81 T.C.M. (CCH) 1126, 1130–31 (2001) (“[T]he proper standard to apply in valuing the property interests transferred and received by [the decedent] was the hypothetical willing buyer and willing seller standard.”), aff’d Estate of Magnin v. Comm’r, 184 F.3d 1074, 1081 (9th Cir. 1999).
\textsuperscript{105} Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).
\textsuperscript{106} See supra note 16 and accompanying text.
\textsuperscript{107} Kimbell, 371 F.3d at 266.
\textsuperscript{108} See supra notes 48–49 and accompanying text.
\textsuperscript{109} Estate of Bongard v. Comm’r, 124 T.C. No. 8, at 67 (Laro, J., concurring) (“I believe it only natural to conclude that the same approach should apply to determine the value of the consideration that would have replaced the transferred property in the transferor’s gross estate.”).
\textsuperscript{110} Cf. Kimbell, 371 F.3d 257.
2. Limitations imposed by the money or money’s worth requirement

In addition to the limitation on valuing intangibles imposed by the fair market value standard, the requirement that consideration be in money or money’s worth further limits the valuation of intangibles. The bona fide sale exception applies “in case of a bona fide sale for an adequate and full consideration in money or money’s worth.”111 The Treasury Regulations explain that consideration “in money or money’s worth” is consideration that is “reducible to a money value.”112 As examples of consideration that is not reducible to a money value, the Regulations list “love and affection, promise of marriage, etc.”113 Such consideration is to be “wholly disregarded.”114 However, consideration in money or money’s worth does include “tangible or intangible property, services, and other consideration reducible to a money value.”115

The money or money’s worth requirement imposes an additional limitation on the valuation of intangible benefits. Some intangible benefits that might motivate a taxpayer to use the FLP structure—such as involving the children in the management of property—may not be reducible to a money value.

In valuing a partnership interest, an appraiser must consider “[a]ll relevant facts and data,”116 which includes intangible benefits associated with the partnership interest.117 Thus, inasmuch as intangible benefits such as “management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability”118 are reducible to a money’s value, their value should already be reflected in the appraised value of the partnership interest. The fact that an appraisal of an interest in an FLP still comes in at a significant discount from net asset value evidences that the value of the intangibles is insufficient to help replenish the estate. Either because they are not relevant to the hypothetical buyer and seller, or because they are not reducible to a money’s value, the value of intangible benefits fails to support a finding of adequate and full consideration.119

The money or money’s worth requirement must be enforced to fulfill the requirement that a statute be interpreted so as to “give effect to all of its parts.”120 Also, the money or money’s worth requirement is essential to fulfilling the purpose of the bona fide sale exception. Absent this requirement, there is no assurance that the transfer of property to an FLP does not deplete the estate.

Therefore, when the restraints imposed by the fair market value standard and the money or money’s worth requirement are considered, it is extremely difficult, even impossible, to support the argument implicitly advanced by the Fifth Circuit and the Tax Court that the value of intangible benefits can give rise to a finding that a discounted partnership interest constitutes adequate and full consideration. Indeed, a transfer to an FLP for a discounted partnership interest cannot qualify for the bona fide sale exception on the grounds that the consideration sufficiently replenishes the estate. However, this does not lead to the extreme conclusion asserted by the concurrence in Thompson that whenever a partnership interest qualifies for a valuation discount, “the decedent could not have received and adequate and full consideration for his transfers in terms of ‘money’s worth.’”121

B. A Presumption of Adequate and Full Consideration.

The second rationale for justifying a finding of adequate and full consideration does not suffer the same fate as the first in the context of discounted partnership interests. When a transfer of property is made to an FLP in the ordinary course of business, courts should presume that it was made for adequate and full consideration in money or money’s worth. In the case of discounted partnership interests, whose dollar value will never rise to the value of the transferred property, this presumption is the only means of holding that such interests constitute adequate and full consideration in money or money’s worth.

The gift tax Treasury Regulations provide that “a transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money’s worth.”122 There is thus a presumption under the gift tax regime that consideration received in a transaction entered into in the ordinary

112 Treasury Reg. § 20.2043-1(a).
114 Id.
115 Treasury Reg. § 301.6323(h)-1(a)(3) (defining “money or money’s worth” in the context of a security interest).
117 Treas. Reg. § 20.2031-3 provides that the fair market value of a business interest should be “determined on the basis of all relevant factors including...[a] fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will.”
118 Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).
119 See Estate of Thompson v. Comm’r, 382 F.3d 367, 384 (5th Cir. 2004) (Greenberg, J., concurring).
120 Estate of Magnin v. Comm’r, 184 F.3d 1074, 1078 (9th Cir. 1999).
121 Thompson, 382 F.3d at 384 (Greenberg, J., concurring).
course of business constitutes adequate and full consideration in money or money’s worth under the fair market value standard.\(^{123}\) This presumption also applies to Section 2036 because the phrase “adequate and full consideration” is construed the same for both the estate and gift tax purposes.\(^{124}\)

This presumption serves to qualify certain discounted partnership interests for the bona fide sale exception because when a transfer to an FLP is shown to be in the ordinary course of business, “the inquiry as to full consideration is avoided (and the actual fair market value of the consideration given for the transferred property is irrelevant).”\(^{125}\) Thus, for a transfer in the ordinary course of business, it does not matter that the discounted partnership is worth less than the transferred property, nor does it matter that the estate has not been fully replenished. With transactions in the ordinary course of business, the purpose of ensuring that the estate is replenished is superceded by the desire not to “impede the socially important goal of encouraging accumulation of capital for commercial enterprises.”\(^{126}\)

However, the presumption of adequate and full consideration is justifiable only where the transaction in question is truly in the ordinary course of business—meaning “bona fide, at arm’s length, and free from any donative intent.”\(^{127}\) Transfers of property between family members require heightened scrutiny to ensure that substance is congruent with form. This requires rebutting the presumption that intra-family transactions are not arm’s length transactions.\(^{128}\) Thus, the presumption of adequate and full consideration should only be applied where the evidence establishes that the transferees acted in their own self-interest, in a manner similar to unrelated parties operating in the ordinary course of business.

No court has relied upon the presumption of adequate and full consideration rationale in support of a finding that the bona fide sale exception has been met,\(^{129}\) but the Tax Court rule incorporates nearly all of the elements necessary to apply the presumption. Unfortunately, the failure to recognize the role of the presumption of adequate and full consideration has led to substantial confusion in the Tax Court and in the circuit courts concerning the proper standard for the bona fide sale exception.

C. The Correct Statement of the Rule

When the proper justification for holding that a discounted partnership qualifies for the bona fide sale exception is recognized, it is simple to state the exact standard that should be applied. Courts should presume a transfer of property to an FLP is for adequate and full consideration when the transfer is made in the ordinary course of business. Thus, the proper test is whether the transfer in question is made in the ordinary course of business, which requires proving that the transaction is (1) bona fide, (2) at arm’s length, and (3) free from any donative intent.\(^{130}\) Once these three elements are shown, courts need not inquire any further as “the actual fair market value of the consideration given for the transferred property is irrelevant.”\(^{131}\)

1. The Tax Court standard closely approximates the ordinary course of business standard.

The ordinary course of business standard is quite similar to the Tax Court’s arm’s length standard. The arm’s length standard applied by the Tax Court in evaluating the first prong of the bona fide sale exception already involves an inquiry into whether the transfer in question is bona fide and at arm’s length.\(^{132}\) Thus, the only additional requirement imposed by the ordinary course of business test is that there be no

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\(^{123}\) See, e.g., Rosenthal v. Comm’r, 205 F.2d 505, 509 (2d Cir. 1953) (“[E]ven a family transaction may for gift tax purposes be treated as one ‘in the ordinary course of business’ as defined in this Regulation if each of the parenthetical criteria is fully met.”).

\(^{124}\) Merrill v. Fahn, 324 U.S. 308, 311 (1045); Wheeler v. United States, 116 F.3d 749, 761 (5th Cir. 1997).

\(^{125}\) Estate of Bongard, 124 T.C. No. 8, at 79 (Halprin, J., concurring).

\(^{126}\) Thompson, 382 F.3d at 386 (Greenberg, J., concurring).


\(^{128}\) See supra Part II.B.1.

\(^{129}\) The Tax Court did recognize the presumption in one sentence in Harper v. Comm’r: “We also note that section 25.2512-8, Gift Tax Regs., specifies that transfers “made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent),” will be considered as made for an adequate and full consideration in money or money’s worth.”

\(^{129}\) Bongard, 124 T.C. No. 8, at 79 (Halprin, J., concurring).

\(^{123}\) See supra note 70 and accompanying text.
donative intent motivating the transfer. This element is closely related to the arm’s length requirement—in fact, it could be argued that finding a transaction is arm’s length necessarily includes a finding that it was not motivated by donative intent. Nevertheless, to explicitly comply with the requirements of the Regulations, courts should include a separate finding regarding donative intent in their bona fide sale exception analysis.

Also, under the ordinary course of business standard, there is no need to delve into an analysis of the second prong of the bona fide sale exception. The adequacy of consideration is simply presumed.

Finally, the ordinary course of business standard encompasses the Tax Court’s legitimate and significant nontax purpose rule enunciated in Bongard. Both the bona fide element and the arm’s length element require an inquiry into whether the transfer in question was motivated by a legitimate business purpose. The importance of this factor in both the bona fide and the arm’s length elements essentially guarantees that no transaction will ever qualify as a transaction in the ordinary course of business unless it is motivated by a genuine business purpose.  

2. The Fifth and Third Circuit standards are too lenient

Under the good faith standard applied by the Third and Fifth Circuits, to qualify for the bona fide sale exception, a contribution to an FLP must be a good faith transfer and the partnership interests received in exchange must be proportionate to the fair market value of the transferred property. In these circuits, there is no requirement that the transfer be arm’s length or free from any donative intent. The Third and Fifth Circuits developed the good faith standard operating under the framework of trying to show how a discounted partnership interest can somehow constitute adequate and full consideration. As demonstrated above, this rationale does not hold water. The only proper way to justify applying the bona fide sale exception to a transfer in exchange for a discounted partnership interest is by presuming that adequate and full consideration exists, and this presumption is only appropriate where the transfer is in the ordinary course of business. For this reason, the standard applied by the Fifth and Third Circuits fails to require the necessary level of scrutiny to transfers of property to an FLP.

V. Conclusion

The FLP potentially offers taxpayers substantial transfer tax savings in the form of valuation discounts for lack of control and lack of marketability. Under the fair market value standard, these discounts are entirely appropriate and justifiable. However, when taxpayers use FLPs as testamentary vehicles with little accompanying business purpose, the availability of tax savings resulting from these discounts should be curtailed. Recognizing this, courts have been quite willing over the past few years, when appropriate, to bring property transferred to an FLP back into the decedent’s gross estate using Section 2036(a). But courts should be wary of an overly liberal application of the bona fide sale exception that could negate the effectiveness of Section 2036(a).

The general failure to recognize the proper justification for applying the bona fide sale prong has led to confusion among courts concerning the correct standard for evaluating transfers of property to an FLP. The bona fide sale exception cannot be applied to a transfer to an FLP on the grounds that the discounted partnership interest received in return replenishes the estate dollar for dollar. Instead, the exception should only be applied to discounted interests received in exchange for a transfer to an FLP in the ordinary course of business. When a transaction is entered into in the ordinary course of business—that is when the transfer is both bona fide, at arm’s length, and free from donative intent—courts may presume that the transferor received adequate and full consideration in money or money’s worth. Because this presumption is the only proper justification for holding that the bona fide sale exception applies to transfers to an FLP, only transactions entered into in the ordinary course of business should be excepted from the reach of Section 2036(a) as bona fide transfers for adequate and full consideration.

133 See supra note 69 and accompanying text.
134 Nevertheless, the inquiry in the second prong into whether the transferor received a partnership interest proportional to the value of the property contributed to the FLP is still relevant to the ordinary course of business standard. Specifically, the proportionality of assignment of partnership interests is the type of term that unrelated potential interest-holders would negotiate in an arm’s length transaction. Bongard, 124 T.C. No. 8, at 82 (Halprin, J., concurring) (“[A]n inquiry as to proportionality may have some bearing on whether the transfer was in the ordinary course of business, within the meaning of section 25.2512-8, Gift Tax Regs. (e.g., was at arm’s length).”). This factor is thus evidence of an ordinary course of business transaction.
135 See supra Part III.B.
136 See supra Part V.A.
TIME AND TIMING OF THE ESSENCE:

Once you’ve determined that a donor wants to deduct a charitable gift on this year’s tax return, it’s crucial to know the date-of-delivery rules and the adjusted gross income ceilings on deductibility. The 3%-reduction-of-deduction and a number of other rules must also be considered.

Here is a primer and checklist.

DATE-OF-DELIVERY RULES:

A charitable gift is considered made on the “date of delivery.” Determining that date is important for three reasons:

1. It determines the tax year in which the gift is deductible;
2. It determines the value of the gift for assets that fluctuate in value (e.g., stock); and
3. In close cases, it determines whether a gift is of long-term or short-term property.

The date of delivery depends on the type of property contributed and how and when it is transmitted to the charity.

SECURITIES:

The delivery date depends on how and to whom delivery is made. Delivery must be unconditional and the stock certificate must be properly endorsed. If the stock certificate is not endorsed, the donor should give the charity a properly endorsed stock power with the stock certificate. (Electronic transfers are discussed soon.)

Hand Delivered: For securities that are hand-delivered to the charity by the donor (or delivered to the donor’s broker or agent who then hand-delivers them to the charity), the delivery date is the day the charity receives the securities.

Mailed: For securities that are mailed by the donor to the charity or to its broker or other agent (or delivered to the donor’s broker or agent who then mails them to the charity), the delivery date is the day the securities are mailed to the charity or to its agent, provided the securities are then received by the charity or its agent in the “ordinary course of the mails.”

CAVEAT: The delivered-when-mailed rule only applies to U.S. Postal Service, not to private couriers.

Reissu ed in Charity’s Name: For securities that are delivered by the donor to her bank or broker (as her agent) or to the issuing corporation (or its agent) with instructions that the securities be reissued in the charity’s name, the delivery date is the day the stock is transferred to the charity’s name on the corporation’s books.

CAVEAT: Doing it that way, a donor loses control over the delivery date and the amount of the deduction if the securities fluctuate in value.

DEPOSITORY TRUST CORPORATION (D.C.)—ELECTRONIC TRANSFERS:

The Code and the regulations on date of delivery were written back in the pony express days and haven’t been updated. But relying on general principles, the gift is made when the transfer to the charity’s account is completed.

MUTUAL FUND GIFTS:

The donor should direct the fund’s management to transfer her shares to the charity’s name; the delivery date is the date the transfer takes place. Depending on the fund, it can take several weeks to complete the transfer, so mutual fund gifts should be planned well in advance.

GIFTS BY CHECK:

Under the “mailbox rule,” the date of mailing to the charity is deemed to be the date of delivery if there are no restrictions on the time or manner of payment and the check is honored when presented. Thus a donor will get a deduction on a 2005 income tax return for a check mailed on December 31, even though it isn’t received by the charity until January 2006.

CAVEAT: A donor shouldn’t rely on a postage meter to establish the date of delivery for a gift that is mailed. In three cases (not in the charitable area), the Tax Court dismissed petitions that were not timely filed, even though the petitions had been stamped on the proper date by a private postage meter. (Shipley, 572 F.2d 212 (9th Cir. 1978); Lindenmood, 566 F.2d 646 (9th Cir. 1978); and Estate of Labovitz, 50 TCM 1325 (1985)).

Not only must the date be correct, but: “the document…must be received…not later than the time when a document…contained in an envelope that is properly addressed, mailed, and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U. S. Postal Service.” Reg. §301.7502-1(c)(1)(iii)(B).

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Thus a donor who depends on a private postage meter places herself at the mercy of the post office (not a good place to be). When it is important to establish the delivery date, the gift should be mailed through the post office, certified or registered mail, return receipt requested. See Correia, 58 F.3d 468 (9th Cir. 1995).

USE CERTIFIED MAIL:

Unlike registered or certified mail, a certificate doesn’t identify the item sent; it merely vouches that some piece of mail was received by the post office. Haaland, 48 TCM 348 (1984). So use “return receipt requested” mail.

CAUTION: As noted earlier, the delivered-when-mailed rule only applies to U.S. postal mail, not to private couriers. Leith, 47 TCM 255 (1983). In 1996, Congress authorized IRS to expand the “timely mailing as timely filing” rule for tax returns and other documents filed with IRS, and documents filed with the Tax Court to include designated private delivery services. IRC §7502(f). That law doesn’t extend that rule to charitable gifts of cash and securities sent by private delivery services.

INSUFFICIENT FUNDS:

Generally, if a check is dishonored for insufficient funds, the gift won’t be deemed made when it was mailed or delivered. But in Reedy, 42 TCM 1401 (1981), a check was deductible for the year of mailing even though it was dishonored for insufficient funds the following year. When the check was written, the donors had enough money in their account to cover the check. Unbeknownst to them, IRS served a notice of levy against their account before the check could clear. The check bounced; however, on receiving the returned-check notice, the donors placed funds in their account to cover the check, and it was honored the next day. The Tax Court held that the contribution was deductible in the year of mailing even though it was later dishonored.

DON’T POST-DATE THE CHECK!

The date of mailing won’t make any difference if the check is postdated. In Griffin, 49 TC 253 (1967), the Tax Court disallowed a deduction for the year of mailing, stating: “A postdated check is not a check immediately payable but is a promise to pay on the date shown. It is not a promise to pay presently and it does not mature until the day of its date, after which it is payable on demand the same as if it had not been issued until that date although it is, as in the case of a promissory note, a negotiable instrument from the time issued.”

GIFTS OF TANGIBLE PERSONAL PROPERTY:
The date the property is received by the charity is the delivery date. Title must also be transferred.

Some donations can present logistical problems when, for example, the donee doesn’t have the facilities to store or display the gift. Donors may try to surmount those difficulties by transferring title to the property while keeping possession until the charity is ready. But that should be a last resort; IRS may deny that a gift was actually made. See, e.g., Bennett, TCM 1991-604 (grand piano), and Estate of Miller, TCM 1991-515 (hunting trophies).

Usually, state law determines what sort of legal formalities are necessary to effect “constructive delivery.” Nevertheless, the surrounding facts and circumstances will generally reveal the parties’ true intentions.

Courts will sometimes give credence to constructive delivery, but only with substantial evidence that the donor hasn’t kept title, dominion and control over the gift. In Murphy, TCM 1991-276, the Tax Court believed that the charity had no place to put a 7 1⁄2-foot sandstone statue of John Wayne’s face. Besides, the donee had paid for storage and insurance in the interim.

REAL ESTATE:
The date the charity receives a properly executed deed is the delivery date. But if the deed must be recorded to pass title under local law, the delivery date is the date of recording. See Ankeny, 53 TCM 827 (1987), and Letter Ruling 8901004.

PLEDGES:

For income tax purposes, pledges are deductible in the year they’re fulfilled, not in the year they’re made. Rev. Rul. 75-348, 1975-2 CB 75. Pointer. Satisfying a pledge with property doesn’t give rise to taxable gain or deductible loss. Rev. Rul. 55-410, 1955-1 CB 297.

Suppose a legally binding pledge isn’t satisfied by a donor during his or her lifetime. It is treated as a debt of the donor’s estate and is deductible by the estate as a debt, not as a charitable contribution.

From a federal estate tax standpoint, it is important that pledges be enforceable. If a donor dies before the pledge is fulfilled, an estate tax debt deduction is allowed, but only if

A. the amount of the unfulfilled pledge is paid to the charity;
B. the donor’s promise was enforceable against his estate; and
C. an estate tax charitable deduction would have been allowed if the gift had been made by the donor’s will. Reg. §20.2053-5(b).

If an unfulfilled pledge isn’t enforceable against the donor or the estate, no estate tax deduction is allowable. But if a donor makes a non-binding pledge during lifetime and provides in her will that any unfulfilled pledge be satisfied by the estate, she is deemed to
have made a charitable gift that qualifies for the estate tax charitable deduction.

Either way, the pledge is deductible (as a debt or as a charitable contribution), but the type of deduction may be important to the donor’s estate—e.g., meeting the 35% of adjusted gross estate test for paying estate tax on a closely held business over a number of years.

If it’s a debt, the pledge is deducted from the gross estate in arriving at the adjusted gross estate. If it is treated as a charitable contribution, the pledge is deductible from the adjusted gross estate. See Letter Ruling 9718031.

State law determines whether a pledge is enforceable. And unless a pledge agreement specifies which state’s law governs, a conflict-of-laws issue may arise if the donor and the charity are in different states.

Pledges have been held to be binding on one or more of these grounds:

- The pledge is an offer to contract that becomes binding when work obligated by the pledge has begun, or the charity has otherwise incurred a liability in reliance on the pledge.
- The consideration for the donor’s pledge is that it is supported by pledges of others.
- Other pledges have been induced by the donor’s pledge.
- The charity’s acceptance of the pledge imparts a promise to apply the funds according to the donor’s wishes, and the donor’s pledge is supported by that promise.
- Public policy requires the donor’s liability on a pledge.

NO DEDUCTION FOR PROMISED GIFTS:

The donor died before fulfilling his promise to create 20 charitable remainder trusts, but the executor made the charitable payments and deducted them as claims against the estate. IRS said no deduction was allowable because the charities’ claims weren’t enforceable under local law as required by IRC §2053(a).

A promise to make a charitable gift is only enforceable under local law if the donor reasonably expects the charity to act on the promise. There was nothing indicating the donor expected that, so the payments weren’t deductible. Payments to individuals promising an income interest in trusts aren’t deductible, because the donor didn’t receive anything in exchange for the payments, as required by IRC §2053(c)(1)(A). Estate of Levin, TCM 1995-81.

OPTIONS:

An option is a promise to sell specified property at a certain price in the future. The gift of an option is treated like a transfer of a donor’s own promissory note or pledge.

If the option allows the holder to buy property for less than fair market value, it’s considered a promise to make a bargain sale at a future date. Even though the promise may be enforceable, it isn’t deemed a “payment” for purposes of the income tax charitable deduction.

Due to the deductibility rules for options, a donor doesn’t know the amount of his deduction until the charity exercises its option. The amount of the contribution is the fair market value of the property on the date the option is exercised, minus the exercise price.

CAVEAT: The IRS concluded in Letter Ruling 9501004 that a donor who transferred an option to a charitable remainder trust wasn’t entitled to a charitable deduction. So donors should read carefully when making gifts of options.

In Letter Ruling 200141018 (similarly, Letter Ruling 200202034), a Corporation pledged to Private Foundation an option to purchase shares of Corporation’s common stock at an option price. Private Foundation can only transfer and assign the option to other unrelated charitable organizations (“permitted transferee”), but the permitted transferee can only transfer or assign the option with Corporation’s written consent. The option is exercisable by a cash payment of the exercise price, or a “cashless” (“net exercise”) procedure.

Under a “cashless” procedure, Corporation wouldn’t receive any consideration for its stock. Instead, Private Foundation would elect to receive shares of Corporation’s stock equal to the option’s value. Upon Private Foundation’s notice of its election, Corporation would issue certain shares (computed using a specified formula in the pledge agreement), and those shares would satisfy Corporation’s pledge obligation.

Private Foundation plans to exercise a portion of the option by using the “net exercise” procedure. As to the remainder, Private Foundation intends to sell the option to a permitted transferee for an amount equal to the difference between the stock’s fair market value on the exercise date and the option’s exercise price.

IRS ruled: Corporation would be entitled to a charitable deduction when the option is exercised (i.e., stock is transferred to a charity) either by Private Foundation or a permitted transferee. More specifically, if the option is exercised by a permitted transferee, Corporation’s charitable contribution would be equal to the excess of the stock’s fair market value over the option price.

On the other hand, if the option is exercised by either Private Foundation or a permitted transferee under the “net exercise” procedure, Corporation’s deduction would be the fair market value of the contributed stock since Corporation would not receive any cash payment. In addition, IRS said that Corporation’s deduction would be subject to the percentage limitations under IRC §170(b)(2). But the reduction rules
under IRC §170(e)(1), and the bargain sale provisions of IRC §1011(b) wouldn’t apply since a corporation does not recognize gain or loss on the sale of its own stock. IRC §1032(a).

PROMISSORY NOTES:

The deductibility rules for a promissory note gift depend on whether the donor gives a note that he or she holds as a creditor, or whether the donor gives his or her own note.

A gift of a donor’s own promissory note may not be deducted until the year the note is paid, even if the charity discounts the note at a bank and gets the money immediately. Petty, 40 TC 521 (1964).

But if a donor gives a promissory note that he or she holds as a creditor (i.e., a third-party note), he or she may claim a charitable deduction for the note’s fair market value in the year of the gift. Woodward, 37 TCM 715 (1978).

CREDIT CARD GIFTS:

Charitable contributions made using a credit card are deductible when the bank pays the charity; it isn’t necessary to wait until the donor pays the bank. Because use of a credit card creates the cardholder’s own debt to a third party, it is similar, says IRS, to the use of borrowed funds to make a contribution. Rev. Rul. 78-38, 1978-1 CB 67.

A process similar to the use of a credit card, but having the opposite result, is the use of a “pay-by-phone” account with a bank. If a donor directs his or her bank to make a charitable contribution, the gift is deemed made as of the date the bank mails, transfers, or delivers the funds to the charity. That date is shown on the bank’s monthly statement, but it might not be the date (or, more significantly, the year) that the donor directed the transfer. Rev. Rul. 80-335, 1980-2 CB 170.

BEWARE OF GIFTS OF INSTALLMENT OBLIGATIONS:

A gift of an installment obligation (gain is reportable in installments under IRC §453) accelerates any remaining deferred gain in the year of the gift. Rev. Rul. 55-157, 1955-2 CB 293.

GIFTS TO PUBLIC CHARITIES—CEILINGS AND OTHER DEDUCTIBILITY RULES:

The itemizable income tax charitable deduction is subject to a dizzying array of rules depending on the type of property contributed, holding period, who the donee is, sometimes what the donee does with the gift, and a number of other variables.

By contrast, the gift and estate tax charitable deductions are simple. The deduction is unlimited.

CASH:

(Do donors still give cash? I know of one religious organization that welcomes all denominations.) Gifts of money are deductible up to 50% of a donor’s adjusted gross income. IRC §170(b)(1)(A); Reg. §1.170A-8. A five-year carryover is allowed for any “excess.” IRC §170(d)(1); Reg. §1.170A-10(a).

CAPITAL GAIN PROPERTY:

Gifts of appreciated securities and real estate held long-term (i.e., more than one year) are deductible at the full fair market value, with no tax on the appreciation. IRC §170(e).

Gifts of long-term capital gain property are deductible up to 30% of adjusted gross income, with a five-year carryover for any “excess.” IRC §170(b) (1)(C)(i); Reg. §1.170A-8(d)(1); IRC §170(b)(1)(C)(ii).

RAISING THE CEILING WITH THE 50% ELECTION:

A donor may elect to increase the ceiling to 50% of adjusted gross income by making the same gift, but: (1) reducing the amount of the deduction for all long-term property gifts during the year by 100% of the appreciation; and (2) similarly reducing the deduction for long-term property gifts being carried over from earlier years. IRC §170(b)(1)(C)(iii) and (e)(1)(B); Reg. §1.170A-8(d)(2).

The donor makes the election on her original return, or on an amended return filed by the due date for filing the original return. A donor whose contributions of capital gain property were deducted on a timely return subject to the 30% ceiling may not elect to increase the ceiling to 50% on an amended return filed after the due date for filing the original return. Rev. Rul. 77-217, 1977-1 CB 64.

The election can’t be revoked after the tax return’s due date. Woodbury, 55 TCM 1131 (1988), aff’d, 90-1 USTC ¶50,199 (10th Cir. 1990). See also Grynberg, 83 TC 255 (1984). (“Once the taxpayer makes an elective choice, he is stuck with it.”)

Should the ceiling be increased? Generally, no—if the donor will be able to deduct the “excess” as a “30% gift” in carryover years. Generally, yes—if the appreciation on the donated property is small, or if the gift (alone or combined with other gifts) is so large that the donor won’t be able to deduct them as “30% gifts” by using the carryover. Sometimes—if the donor is in a much higher tax bracket this year than she will be in carryover years. Do the math in each case.

Often overlooked. A donor’s executor or administrator should make the 50% election on the decedent’s final income tax return (for the decedent’s last taxable year) because any remaining carryover will be lost. It’s a carryover, not a carryunder.
HOW TO MAKE THE 50% ELECTION:

The donor attaches a statement to his or her income tax return for the election year, stating that the election under IRC §170(b)(1)(C)(iii) and Reg. §1.170A-8(d)(2) is being made. If there is a carryover from a prior taxable year or years, the statement should show a recomputation of the carryover (reduced by 100% of the appreciation), with sufficient information from the previous taxable year, or any intervening year, to show the basis of the recomputation.

The statement should indicate the District Director or the Director of the IRS Center with whom the prior return was filed, the name (or names) in which the returns were filed and whether the returns were joint or separate.

Yet another way. If a generous donor won’t be able to deduct an entire contemplated gift—even with the 50% election and the five-year carryover—he or she might consider this option. First, the donor makes a life income gift (charitable remainder trust, pooled fund transfer, gift annuity) and deducts the value of the charity’s remainder interest. Then, some years later, he or she donates his or her life income interest, taking a charitable deduction for that interest.

This method requires some caution.

If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), the deduction will not be allowed. Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him.

If the taxpayer transfers the remainder interest in such property to his son and immediately thereafter contributes the income interest to a charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer’s entire interest consisting of the retained income interest.

In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him. If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer’s entire interest consisting of the reversionary interest. Reg. §1.170A-7(a)(2)(i).

Still, in Rev. Rul. 72-419, 1972-2 CB 104, a donor had received a remainder interest in property from a trust created under his father’s will. The donor gave an undivided 1/5 of his remainder interest to a qualified charity several years later. That ruling held that the 1/5 interest was an undivided portion of the donor’s entire interest in the property and, thus, was deductible.

And in Rev. Rul. 76-523, 1976-2 CB 54, donors contributed reversionary interests in trusts that were established in 1960 for the benefit of relatives. There, IRS concluded that the donors had not set up the trusts to avoid IRC §170(f)(3)(A), because that section was not enacted until 1969.

GIFTS OF APPRECIATED SECURITIES AND REAL ESTATE HELD SHORT-TERM:

Gifts of appreciated securities and real estate held short term (one year or less) are deductible at cost basis. IRC §170(e)(1)(A). The ceiling is 50% of adjusted gross income, with a five-year carryover for any “excess.” IRC §170(b)(1)(A); IRC §170(d)(1); Reg. §1.170A-10.

ORDINARY INCOME PROPERTY:

Assets that would generate ordinary income on a sale by the donor (e.g., gifts of inventory, crops, artworks created by the donor, real estate if the donor is deemed to be a “dealer”).

A deduction is allowed for the property’s cost basis or its fair market value, whichever is lower. IRC §170(e)(1)(A). The ceiling is 50% of adjusted gross income, with a five-year carryover for any “excess.” IRC §170(b)(1)(A); IRC §170(d)(1); Reg. §1.170A-4(b)(1).

TANGIBLE PERSONAL PROPERTY—RELATED USE GIFTS:

The rules for gifts of appreciated artworks, antiques, books, etc., held long-term depend on how the charity uses the gifts. Reg. §1.170A-4. When the charity’s use of the property is related to its exempt function (e.g., a painting given to an art museum or to a school for its art gallery), the donor can deduct the full present fair market value. IRC §170(e)(1)(B)(i).

These gifts are deductible up to 30% of adjusted gross income, with a five-year carryover for any “excess.” IRC §170(b)(1)(D)(i); IRC §170(d)(1).

The ceiling can be raised to 50% of adjusted gross income, with a five-year carryover for any “excess” if the donor makes the election described earlier for gifts of long-term securities or real estate.

Reminder: Making the election results in a deduction for cost basis only.

Proof of use. A donor may treat a gift as put to a related use by the donee if: (1) the donor establishes that the property is not in fact put to an unrelated use by the donee; or (2) at the time of the contribution, it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. Reg. §1.170A-4(b)(3)(ii). A letter from the donee stating its intended use can help a donor show that he or she reasonably anticipates that the charity’s use will be related.

Special rule for gifts to museums: In the case of a contribution of tangible personal property to or for the
use of a museum, if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee. Reg. §1.170A-4(b)(3)(ii)(b).

UNRELATED USE GIFTS:
If the gift is unrelated to the donee’s exempt function (e.g., the charity sells the property), the deduction is for cost basis or fair market value, whichever is lower. IRC §170(e)(1)(B). In that case, the gift is deductible up to 50% of adjusted gross income, with a five-year carryover for any “excess.” IRC §170(b)(1)(A); IRC §170(d)(1).

TANGIBLE PERSONAL PROPERTY HELD SHORT TERM:
Tangible personal property held one year or less is deductible at cost basis or fair market value, whichever is lower. IRC §170(e)(1)(A). The ceiling is 50% of adjusted gross income, with a five-year carryover for any “excess.” IRC §170(b)(1)(A); IRC §170(d)(1); Reg. §1.170A-10.

INTERPLAY AMONG CEILINGS:
Doping out the deductibility ceilings for various types of charitable gifts can be complicated enough. But the interplay among ceilings when a donor contributes different types of property in the same year makes it even stickier.

Stickier still: interplay among carried-over deductions. See Reg. §1.170A-10 or hope that your tax-preparation software can figure this out.

STANDARD DEDUCTION CLAIMED IN A CARRYOVER YEAR:
First, the donor determines how much carryover from previous years he’d be able to deduct if he were to itemize this year. Then he kisses that deduction good-bye forever. Reg. §1.170A-10(a).

Reason: The carryover amount is treated as being “paid” in the current year. Because he’s taking the standard deduction, the donor has no deductible contribution for the year.

PITFALL—SALE BY BROKER:
It is elementary (indeed, eleemosynary) tax law that a donor who has long-term appreciated securities should contribute the securities, rather than sell them and donate the proceeds. By contributing the stock to a publicly supported charity, a donor gets a charitable deduction for the full fair market value and completely avoids capital gains tax on the appreciation.

Poor Sheffield, he gave his broker the wrong instructions. He had appreciated stock that he wanted to contribute to three local charities. He directed his broker to sell his stock and send the sales proceeds to the charities. The Tax Court agreed with IRS that Sheffield was taxable on the capital gain from the sale. Sheffield, 76-2 USTC ¶9561 (D.C. Ga. 1976).

Unless a donor completely and irrevocably transfers the stock to a charity, so that he retains no control over it, he is taxed on the capital gain. The facts of this case left little room for doubt: The donor had directed his agent to distribute the proceeds of the sale to the donees. Had Sheffield contributed the stock instead of the proceeds, the charities could have sold the stock and kept the proceeds without paying tax on the appreciation, said the court.

SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY (SSBIC) ROLLOVER TO THE RESCUE?
You can elect to roll over—without payment of tax—capital gain that would otherwise be payable on the sale of publicly traded securities. How? Use the sales proceeds to buy common stock or a partnership interest in a SSBIC within 60 days of selling your securities. An SSBIC is a corporation or partnership licensed by the Small Business Administration that finances small businesses owned by the disadvantaged.

The gain that can be rolled over for any year is limited to $50,000, with a $500,000 lifetime cap.

Day of reckoning. The basis in the SSBIC is reduced by the amount of any gain not recognized on the sale of the publicly traded securities. Thus, any gain protected from tax on the rollover will be taxed on a later sale of the SSBIC stock.

What does the SSBIC provision have to do with charitable giving? Lots. The SSBIC rollover can serve as a capital gains escape hatch for an individual who sold appreciated publicly traded securities and then learned that he or she could have made an outright charitable gift of the securities or transferred them to a charitable remainder trust (for sale and reinvestment) without having to pay capital gains tax.

If the discovery is made within 60 days of the sale of the publicly traded securities, a donor can use the sales proceeds (within the $50,000 annual-gain limitation) to buy stock in an SSBIC. Then the donor either makes an outright gift of the SSBIC stock to charity, or contributes the SSBIC stock to a charitable remainder trust.

The charity can keep the SSBIC stock or sell it without capital gains tax to the charity or the donor. And a charitable remainder trust can keep the SSBIC stock as an investment, or can sell the SSBIC stock and reinvest the sales proceeds without capital gains tax to the donor or the trust.
Caution. Make sure that the SSBIC stock is not one that generates unrelated business income.

Valuation implications. If the value of the SSBIC stock contributed outright, or the remainder interest in a charitable remainder trust exceeds $10,000, a qualified appraisal and Form 8283 will be required.

A directory of SSBICs is available from: Associate Administrator for Investment, U.S. Small Business Administration, 409 Third Street S.W., Washington, D.C., 20416. Phone (202) 205-6510.

PITFALL—CONTRIBUTING SECURITIES THAT HAVE GONE DOWN IN VALUE:

When securities have gone down in value, a donor should sell them and contribute the proceeds. The donor’s deduction is the same whether he or she gives the proceeds or the securities, but by selling the securities and then giving the proceeds, the donor can establish a capital loss deduction. Bear in mind that the capital loss deduction isn’t available for personal use assets (e.g., personal residences, automobiles).

Poor Withers, he donated depreciated stock and claimed a charitable deduction for the stock’s cost basis; he also claimed a capital loss deduction. The Tax Court limited his charitable deduction to the donated stock’s fair market value rather than his higher cost basis. Further, Withers couldn’t deduct the difference between the property’s fair market value and his cost basis as a loss. Withers, 69 TC 900 (1978).

THE 3% REDUCTION OF ITEMIZED DEDUCTIONS:

Taxpayers must reduce their itemized deductions (except medical expenses, casualty and theft losses, and investment interest) by an amount that equals 3% of adjusted gross income over $145,950 (over $72,975 if married filing separately) in 2005. (This amount is adjusted annually for inflation.)

The charitable deduction generally isn’t affected by this rule because most itemizers pay home mortgage interest and state and local taxes. So, in effect, those non-discretionary payments bear the burden of any reduction. Donors with very high adjusted gross incomes, however, may well be affected.

As an example, a single taxpayer with an AGI of $150,000 in 2004 will lose $219 of itemized deductions that would otherwise be allowable:

<table>
<thead>
<tr>
<th>AGI</th>
<th>$150,000</th>
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</thead>
<tbody>
<tr>
<td>Threshold</td>
<td>$145,950</td>
</tr>
<tr>
<td>Reduction Base</td>
<td>$4,050</td>
</tr>
</tbody>
</table>

x 3%

Reduction
$121.50

A small break. No matter what a taxpayer’s income level, the disallowance rule is designed so it won’t take away more than 80% of his or her itemized deductions.

Take a taxpayer with a $225,000 AGI in 2005. Generally, he or she stands to lose the first $2,371.50 of itemized deductions ($225,000 – $145,950 x 3%).

However, if he or she had only $3,000 of itemized deductions—unlikely though that might be for a taxpayer at that income level—he or she would still be able to deduct $600 ($3,000 x 20%).

PRIVATE FOUNDATIONS—CEILINGS AND OTHER DEDUCTIBILITY RULES

GENERAL RULE:

For appreciated securities, real estate and tangible personal property (even if for a “related use”) held long-term, the deduction is for the cost-basis (fair market value minus 100% of appreciation). IRC §170(e) (1)(B)(ii).

SPECIAL RULE—LONG-TERM APPRECIATED QUALIFYING PUBLICLY TRADED STOCK:

A deduction for full fair market value is allowable for certain contributions of stock in a corporation for which (as of the contribution date) market quotations are readily available on an established securities market.

Full fair market valuation is only allowed for an aggregate 10% (per donor) of any one corporation’s outstanding stock donated to private foundations. For purposes of this rule, both donors and donees are aggregated: a donor’s spouse, siblings, ancestors and lineal descendants are all treated as one donor; similarly, all private foundations are treated as one foundation.

What is publicly traded stock? Listed securities, of course. IRS’s definition also includes mutual fund shares if quotations are published daily in readily available newspapers. Reg. §1.170A-13(c)(7)(xi)(A)(3). It also includes securities traded on a national or regional over-the-counter market. Reg. §1.170A-13(c)(7)(xi)(A)(2). Letter Ruling 9623018. Gifts of stock subject to SEC rule 144 restrictions, including volume and resale limitations, may not qualify for FMV deductibility. Letter Ruling 9746050 See also Letter Ruling 9812030.
ORDINARY INCOME AND SHORT-TERM PROPERTY GIFTS:

Deduction is for cost basis. IRC §170(e)(1)(A).

CEILINGS ON DEDUCTIBILITY:

- Gifts of cash and ordinary income property: 30% of adjusted gross income.
- Gifts of all capital gain property (including stock deductible at fair market value under qualifying publicly traded stock rule): 20% of adjusted gross income. IRC §170(b)(1)(D).

Carryover. Five-year carryover for “excess” gifts. IRC §170(b)(1)(B).

A passthrough private foundation to the rescue? During the year, a donor contributed highly appreciated long-term real estate and nonmarketable securities to her own private foundation. She now learns—much to her surprise—that she can only deduct the cost basis and has a 20% adjusted gross income ceiling on her charitable deduction.

She can make her foundation qualify as a passthrough foundation for the year—thus increasing the amount deemed contributed and increasing the deductibility ceiling.

Qualifying as a passthrough foundation—the basics. The foundation can qualify if it distributes an amount equal in value to 100% of all contributions received in the tax year by the 15th day of the 3rd month after the close of its tax year; has no remaining undistributed income for the year; and distributes only qualifying distributions that are treated as distributions out of corpus.

Distributions aren’t qualifying distributions if made to an organization controlled directly or indirectly by the foundation or by one or more disqualified persons, or a private foundation that is not an operating foundation.

To qualify for the 50%/30% public charity contribution limits and fair market value deductibility, the foundation must distribute all contributions received in any year, whether of cash or property. Distributions will be treated as made first out of contributions of property and second out of cash contributions received by the foundation during the year to qualify for the deduction of the full value of appreciated property.

A private foundation is not required to trace specific contributions of property, or amounts into which those contributions are converted, to specific distributions. A private foundation may choose to treat part or all of one or more distributions, made by the 15th day of the 3rd month after the close of the year, as made out of corpus.

The fair market value of contributed property, determined on the date of the contribution, generally must be used to determine whether an amount equal to 100% of the contributions received has been distributed. If the property is sold, the foundation may reduce the property’s fair market value by any reasonable selling expenses incurred. The foundation must distribute the balance of the fair market value of the property that was sold to meet the 100% distribution requirement.

However, if within 30 days after receiving the contributed property, the foundation sells the property or distributes the property to a public charity, the foundation may choose to treat either the gross amount received on the sale, minus reasonable selling expenses incurred, or the fair market value of the contributed property at the date of its distribution to the public charity as the fair market value for purposes of the 100% distribution requirement.

A donor claiming a deduction for a charitable contribution to a passthrough foundation must get adequate records or other sufficient evidence from the foundation showing that the foundation made the required qualifying distributions in the time prescribed. Records or other evidence must be attached to the taxpayer’s return for the tax year the charitable contribution deduction is claimed.

Being a passthrough foundation isn’t forever. The decision can be made from year to year.

BOTTOM LINE:

After taking all the foregoing rules into account, make sure to comply with the $250-and-over substantiation and qualified appraisal rules.

P.S. The appraisal requirements now also apply to C Corps.
Round 4 of the never-ending Strangi saga goes to the Government. The Fifth Circuit has held that Section 2036(a)(1) applies and that the assets contributed to a FLP by the decedent in a deathbed context are includible in the decedent’s estate on an undiscounted basis. The decision is not a clear victory for the government, however, for in certain important respects, the Fifth Circuit’s bona fide sale exception standards appear to have been relaxed.

Facts:

1. Albert Strangi (the “decedent”), through his son-in-law acting as attorney-in-fact under a general power of attorney, contributed just under $10,000,000 of assets, representing 98% of the decedent’s total assets, to a newly-formed limited partnership for a 99% limited partner interest and slightly less than $50,000 for a 47% interest in the stock of the 1% corporate general partner. The decedent’s four children contributed just over $50,000 for an aggregate 53% stock interest in the 1% corporate general partner. A .25% stock interest in the 1% corporate general partner was shortly thereafter given to a charity, apparently as a charitable contribution from the corporate general partner.

2. The assets contributed by the decedent to the FLP consisted of over $7,500,000 of marketable securities or liquid assets. The balance consisted of $400,000 of limited partnership interests and real estate, including the decedent’s personal residence.

3. The decedent was terminally ill at the time of the FLP formation and died approximately two months thereafter.

4. Prior to his death, the decedent received two distributions, one for $8,000 and one for $6,000, “to meet his needs and expenses.”

5. After the decedent’s death, his estate received FLP distributions of over $100,000 to pay funeral expenses, administration expenses, and a specific bequest under the decedent’s will (although $65,000 was treated as an advance and was subsequently repaid by the estate) and $3,187,800 to pay estate and inheritance taxes.

6. The corporate general partner received FLP distributions proportionate to its 1% FLP interest.

7. The decedent continued to reside in his personal residence after its contribution to the FLP. Although rentals at apparently a fair rate were accrued for decedent’s occupancy of this residence, the rent was not paid by the estate until 2 years and 3 months after the decedent’s death.

Legal Analysis:

1. Clearly Erroneous Standard. The Fifth Circuit’s decision in Strangi 4 is very fact specific and defers to the factual findings of the Tax Court as not being clearly erroneous while following in part and subtly modifying in part the standards set forth in Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004), at least in regard to the bona fide sale exception.

2. Section 2036(a)(1). Footnote 4 seems to set forth the standard used to define whether an implied agreement of enjoyment or possession under Section 2036(a)(1) exists: “The controlling question is not whether Strangi actually kept any asset in his possession, but whether he received a general assurance that his assets [apparently meaning those transferred to the partnership] would be available to meet his personal needs.” The court held that “part of the ‘possession or enjoyment’ of one’s assets is the assurance that they will be available to pay various debts and expenses upon one’s death.” Thus, the court seems to be saying that not only should the decedent have retained sufficient liquid assets to provide support for the balance of his lifetime, but he also should have retained sufficient additional assets to cover the post-mortem payment of reasonably foreseeable personal debts and estate expenses, including funeral expenses, administrative expenses, and possibly estate taxes (although the court did not stress estate taxes as much as debts and other estate expenses). This is a very material expansion of the concept of what assets need to be retained outside of the partnership solution. Next, the court’s finding of an implied agreement seems to have been heavily influenced by the fact that partnership distributions, even though pro rata, were made to meet the cash needs of the decedent and his estate, and were not driven by partnership-related considerations. Third, over a 2 1/4 year deferral in the payment of what apparently would have otherwise been fair rental for the decedent’s house in itself provided a substantial economic benefit for the decedent and his estate, and thus supported the Tax Court’s finding of an implied agreement.

3. Section 2036(a)(2). In footnote 7, the Fifth Circuit passed on reaching any decision on Section 2036(a)(2) grounds because it had already found an

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implied agreement of retained enjoyment under Section 2036(a)(1). The Fifth Circuit, in Strangi 4, thus avoided addressing the Kimbell decision’s confusing control analysis relating to a Section 2036(a)(2) retained right, alone or in conjunction with any person, to designate the persons who would possess or enjoy the transferred property or the income therefrom. In U.S. v. Byrum, 408 U.S. 125 (1972), the Supreme Court expressly rejected a control standard as the basis for applying Section 2036(a) generally, including Section 2036(a)(2). Nonetheless, the Fifth Circuit, in Kimbell, discussed control in a Section 2036(a)(2) context, and even though the Fifth Circuit, in Strangi 4, did not decide the Section 2036(a)(2) issue, the court made several disturbing references to control being a basis for inclusion under Section 2036(a).

4. Bona Fide Sale Exception. The court found that the bona fide sale exception did not apply.

a. The adequate and full consideration prong of the bona fide sale exception was satisfied, for each partner received FLP interests proportionate to his or its capital contributions, each partner’s capital account was properly credited for such capital contributions, and distributions upon dissolution were to be based on capital account balances. In so holding, the Fifth Circuit followed the standards which it had set out in Kimbell.

b. The court then made a subtle shift in analyzing the bona sale prong of the bona fide sale exception. Kimbell has generally been construed as holding that “substantial business and other non-tax reasons” are at least factors in determining whether contributions to a FLP qualify as a bona fide sale. The Fifth Circuit, in Strangi 4, holds that a sale is “bona fide” if, as an objective matter, it serves “a ‘substantial business [or] other non-tax’ purpose,” paraphrasing but significantly altering the Kimbell language. Ostensibly, both business and other non-tax reasons are no longer required. Instead, only “a substantial non-tax purpose” is required, although such a purpose apparently is no longer merely a factor but instead is a requirement. Interestingly, the court then clouds the issue by stating that “the finder of fact is charged with making an objective determination as to what, if any, non-tax business purposes the transfer was reasonably likely to serve at its inception.” (Emphasis added) Although the issue is not free from doubt after this one reference to “non-tax business purposes” immediately following references in the same paragraph to “a ‘substantial business [or] other non-tax’ purpose” and to “a substantial non-tax purpose,” the Fifth Circuit apparently does not require a business purpose per se, but an active business would obviously be highly probative. Also, as in Bongard, a single non-tax purpose, if “legitimate and significant” as per Bongard or “substantial” as per Strangi 4, should suffice. The Fifth Circuit does not attempt to define “substantial,” but the Bongard and Strangi 4 standards appear to be operationally similar. On its face, neither requires a primary non-tax purpose, but both require enough of a reason that it objectively must have been sufficiently important to have been an actual motivation for setting up the FLP.

c. The Fifth Circuit then found that the Tax Court’s rejection of 5 rationales offered by the decedent’s estate as substantial non-tax reasons was not clearly erroneous—but stressed that it was applying a clearly erroneous standard of review and may have concluded differently if the rationales were matters of first impression. Among the rationales was that the FLP served as a joint investment vehicle. The language used by the Fifth Circuit seems to imply that “meaningful economic activity”, to borrow the phrase used in Bongard, must take place if only de minimis contributions are made by partners other than the decedent. The decision also may be construed to imply that an active business may be necessary to support active management as a substantial non-tax purpose. Again, this may reflect the Tax Court’s framing of the purported non-tax reason and the context of the Tax Court’s factual findings more than the Fifth Circuit’s requirements. Otherwise why would the court have backed away from the Kimbell language, “substantial business and other non-tax reasons,” and substituted “a ‘substantial business [or] other non-tax’ purpose?” Unfortunately, the business references could be regarded as narrowing the scope of what is required for asset management to qualify as a substantial non-tax reason.

d. In all likelihood, the Fifth Circuit was probably heavily influenced by the Tax Court’s express skepticism about the purported non-tax reasons for forming the FLP in question, especially in light of the deathbed context. This express skepticism goes all the way back to Strangi 1, the reviewed decision, and is not necessarily based on Strangi 2, Judge Cohen’s 2003 Memorandum decision. The review of these non-tax reasons in Strangi 1 was in the context of an analysis by the Tax Court of the business purpose and economic substance doctrines, not Section 2036(a). Ironically, the taxpayer prevailed on the economic substance issue both in the Tax Court’s Strangi 1 decision and the initial Fifth Circuit appeal. Upon remand on the Section 2036(a) issue, the Tax Court did not conduct a new trial but instead relied upon evidence introduced at the initial Strangi 1 trial. The factual findings concerning business purpose in Strangi 1 should be viewed in the context of not being part of a Section 2036(a) analysis, although such findings served as the basis for the Fifth Circuit’s Section 2036(a) review. This may explain some of the confusing “business” references by the Fifth Circuit in Strangi 4.
Washington Report

by Ronald D. Aucutt and John M. Bixler
Washington, D.C.

After a month when the estate tax received perhaps the most attention from the press ever, the Senate recessed at the end of July without a vote on repeal or modification of the estate tax. Nevertheless, when the Senate adjourned on July 29, the stage was set for a potentially decisive vote, perhaps as early as September 6 (as we explain below under “Current Status”).

Linger ing Repeal Efforts

Two legislative streams almost converged in July, but in the end they did not. The first stream, of course, is the congressional sentiment for full and permanent repeal of the estate and GST taxes. Sometimes this sentiment manifests itself in a desire to also accelerate the repeal to a date earlier than 2010, but usually it adopts the simpler form of merely removing the 2011 “sunset” from the Economic Growth and Tax Relief Act of 2001 (“EGTRRA”), allowing the 2010 repeal to remain in effect beyond 2010. Such permanent repeal has been the official policy of the White House and the Republican congressional leadership since before the ink was dry on EGTRRA, and it appears to be favored by a majority of the members of both Houses of Congress, especially the House of Representatives.

The House has passed a permanent repeal measure almost every year since 2001, most recently the 109th Congress’s version of H.R. 8, the “Death Tax Repeal Permanency Act of 2005,” which the House passed by a vote of 272-162 on April 13, 2005, with 42 Democrats voting for it and only one Republican (Rep. Jim Leach of Iowa) voting against it. Even though a slim majority of Senators appear to favor repeal of the estate tax, bringing H.R. 8 to a vote will require the parliamentary action of “cloture,” basically the Senate form of “calling the question,” which requires approval of 60 Senators (the same 60-vote requirement that has been so prominent in the debate over judicial nominations). After widespread speculation that Senate Majority Leader Bill Frist of Tennessee would press for such a cloture vote before the August recess, he announced on July 27 that he would file the cloture motion before the recess and expected the vote to occur in early September. The cloture motion was filed on July 29, the last day before the recess.

Parallel Compromise Efforts

The second stream is a somewhat bipartisan effort in the Senate to reach a compromise that could attract at least 60 votes for a permanent stabilization of estate tax rates and the unified credit. In October 2003 (as we reported in the Winter 2003 issue1), the Washington Post reported that Republican Senator Jon Kyl of Arizona, an acknowledged foe of the estate tax, was working to put together bipartisan support for a compromise that would set the unified credit at a level equivalent to an exemption of $15 million and would reduce the rate to 15%, the rate of the individual income tax on capital gains. Senator Kyl immediately repudiated the Post article with a vehemence that in Washington is usually reserved for rumors that are true. More recently, it has become acceptable to admit the existence of the compromise effort, and this year Senator Kyl and others have been quite open about it in public.

In her Joseph Trachtman Lecture to the College in San Antonio in March 2004, Dr. Margo Thorning, Senior Vice President and Chief Economist of the American Council for Capital Formation, described the negative economic impact many economists have attributed to the estate tax. Unable to predict full repeal of the tax, she concluded by pointing out the enthusiastic reception for the American Council for Capital Formation’s “CAPTAX” proposal that would align the estate tax rate with the top individual income tax rate on capital gains—that is, the same rate of 15% that had been associated with the rumored Senate compromise efforts.2

The idea of a 15% rate, quite a departure from the top 55% rate of just a few years ago and even the 45% top rate projected to arrive in 2007 under present law, has proved remarkably durable, and it remained the target rate openly discussed by Senator Kyl and others as the compromise discussions reached their public crescendo in July 2005.3 In contrast, the $15 million

1 29 ACTEC Journal 220 (Winter 2003).
3 We continue to note, as we have before, that a dramatically lower estate tax rate can be an occasion to consider “base-broadening” in the form of changes to the substantive estate, gift, and GST tax rules. See 31 ACTEC Journal 76, 77-78. That means that the availability of some estate planning techniques could be significantly and perhaps abruptly altered, perhaps even some time this fall.
exemption level reported in October 2003 has been elusive. As we entered 2005 following the 2004 elections, the most often mentioned aspiration was an exemption of $10 million. In mid-July, we saw $8 million mentioned in the tax press;\(^4\) and by the end of July it was $3.5 million.\(^5\) Since questioning the stability of a tax system with an exemption as high as $10 million in the last issue of the ACTEC Journal,\(^6\) we have watched as public predictions of the exemption level have steadily come down—certainly not because of our observation, but perhaps with some regard to what it might take to make a rate as low as 15% fiscally feasible.

On the other hand, there is no way at all to be sure that the negotiation of an estate tax compromise is particularly sensitive to fiscal constraints. With 55 Republican Senators, all Senators Frist and Kyl and the rest of the Republican leadership need to do is to secure the votes of five Democrats (plus, of course, one more Democrat for each Republican vote that is lost). The cost of either repeal or substantial reduction of the tax can be large (in light of the inclusion of fiscal years 2012, 2013, 2014, and 2015, as we discussed in the last issue), and some measure of fiscal responsibility in the current environment of budget deficits will no doubt be important to some swing-vote Senators. Nevertheless, we suspect that if any compromise can be fashioned at all, it will depend mainly on the “gut” reactions of the Senators most actively involved to the fairness of the levels of rates and exemptions. If comfortable levels can be agreed to, the leadership will somehow find a way to pay for them or otherwise make them fit within acceptable fiscal estimates.\(^7\)

There was much talk in the months leading up to July about Senator Kyl’s negotiations with Senator Max Baucus of Montana, the ranking Democrat on the Senate Finance Committee. Senator Charles Schumer of New York was also involved, as was Senate Minority Leader Harry Reid and others. In the last week of July, other Democrats that got actively involved were Senators Blanche Lincoln and Mark Pryor of Arkansas and Senator Ron Wyden of Oregon. Although Finance Committee Chairman Charles Grassley of Iowa has affirmed the efforts of Senator Baucus and the other Democratic leaders to forge a consensus, the Democrats did not seem to be in as much of a hurry as Senator Kyl, who had really hoped to complete a deal before the end of July.

It is hard to tell what is either the motivation or the likely result of Senator Frist’s cloture motion. A cynical explanation is that forcing a roll-call vote on permanent repeal will embarrass the Senators who vote against it, especially Democrats who face reelection in 2006. The estate tax is unpopular with the American people, and this unpopularity could translate into retaliation at the polls. Some Republican leaders think the opposition of then Minority Leader Tom Daschle to repeal of the estate tax contributed to his defeat last year. Senator Frist is known to have presidential ambitions, and it is a fact of life in partisan Washington that a record of annoying and embarrassing opponents facing tight election races is a credential in seeking the nomination. By this theory, the insistence on a roll-call vote might only create resentment and set back the compromise negotiations.

On the other hand, it is possible that a cloture motion will simply introduce some discipline into the compromise efforts, encouraging Democrats to give the matter the same priority as some Republicans have. An argument can be made that it is in everyone’s best political interest to resolve the estate tax issue in 2005 and not let it carry over into the election year of 2006. Presumably, the Republicans who control Congress will benefit from not having to explain in an election year why they have not “done something” to make significant estate tax relief (if not repeal) permanent, and Democrats will benefit from not being forced to go on record against the repeal of an unpopular tax. But it rarely is that straightforward.

Reprise on Full Repeal

There is another scenario, of course—that Senator Frist’s cloture motion will attract 60 votes and the Senate will pass H.R. 8 as it is, sending to President Bush the permanent estate tax repeal he has called for. It is becoming increasing apparent that this scenario is unlikely, however, and hardly anyone talks convincingly about it anymore. As we discussed in the Spring 2005 issue, the success of this scenario required, at a minimum, a high-priority expenditure of President Bush’s personal and political capital, and he simply has had other things on his desk.\(^8\) Some of these competing priorities, such as energy policy, may have been addressed for the time being. But many others are still at least as much of a distraction as we would have predicted six months ago, obviously including Iraq, Social Security reform, and judicial nominations.

While the Administration has not relaxed its official

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\(^6\) 31 ACTEC Journal 76, 77 (Summer 2005).

\(^7\) The debate is complicated by what seems to us to be an extraordinary lack of consensus on how the net revenue impact of estate tax repeal should be calculated, with ten-year estimates ranging from a revenue loss of hundreds of billions to an actual net gain supported by more “dynamic” modeling that takes account of anticipated increases in realized capital gains and anticipated increased efficiency in the economy.

\(^8\) 30 ACTEC Journal 320-21 (Spring 2005).
commitment to full repeal of the estate tax, it has not been particularly vocal or proactive, and the President has clearly not thrown himself into the fight. In mid-July, White House Council of Economic Advisers Chairman Ben Bernanke reportedly restated the Administration’s commitment to “full repeal,” despite discussions in Congress about what the press described as “partial repeal.” References to “partial repeal,” if indeed that was the context of Dr. Bernanke’s remarks to reporters, suggest to us the terms in which, at the end of the day, advocates of “repeal” can claim victory short of full repeal, particularly if the focus on substantially lower rates is maintained and the measure of victory is therefore meaningful.10

Current Status

As of this writing at the end of July, Senator Frist’s cloture motion on H.R. 8 will be pending when the Senate reconvenes on September 6, the day after Labor Day. There is one matter ahead of it, a cloture motion on S. 147, the “Native Hawaiian Government Reorganization Act of 2005.” If that is approved, the Senate will have 30 hours to debate the question of proceeding on S. 147. It is entirely possible, however, that the substantive issues or at least the procedural issues with the Native Hawaiian legislation will be resolved before September 6, in which case S. 147 could be immediately debated, scheduled for debate at a later time, or even disposed of by unanimous consent or in short order. In any of those scenarios, cloture on H.R. 8 would probably become the next order of business for the Senate—maybe on September 6, maybe later.

If, without more, the Senate votes on cloture on H.R. 8, we expect the vote to fail, as we have said, because there are not 60 Senators at this time who will support full repeal. On the other hand, if an acceptable compromise is worked out before September 6, there could be 60 votes for cloture under an agreement that H.R. 8 would then be amended in accordance with the compromise. As amended, H.R. 8 would then be passed by the Senate and sent to a conference with the House. Such a compromise could include any combination of exemptions, rates, and substantive changes, with any combination of effective dates.11

Administrative Developments

On the administrative front, the Treasury-IRS “Priority Guidance Plan” (popularly referred to as the “Business Plan”), which is typically released in July and analyzed in our Fall column, was late this year. By the time this column is read, the Plan will probably have been published, and Fellows will have a better idea what to expect in regulations and other published guidance in the near future. Items we are looking for include guidance under the expanded S corporation rules in the American Jobs Creation Act of 2004, continued clarification of issues regarding charitable remainder trusts (including the brouhaha about potential spousal claims raised by Rev. Proc. 2005-24), and maybe more attention to Circular 230.

Meanwhile, the recent completion of items on the 2004-05 Plan has again been an occasion to note the general disposition of policymakers to be responsive to the concerns of practitioners and professional organizations. For example, proposed regulations to govern the elections in and out of the deemed allocation of GST exemption provided in EGTRRA were published in July 2004 and, while generally welcomed, were critiqued for possible shortcomings. In last year’s Fall column, we commented on the rigid and sometimes impractical requirements of the proposed regulations to “identify” the trust or trusts to which the contemplated elections would apply.12 The definition of a “GST trust” in section 2632(c)(3)(B) is not simple, and it is sometimes hard to tell when a trust is a “GST trust,” especially when a trust has multiple beneficiaries in multiple generations and maybe in multiple branches of the family. Similarly, it is sometimes not clear when a transfer is made to a trust or who the transferor is, or the deemed transferee might not even realize that a transfer has been made. This problem most commonly arises in trusts with complex arrays of Crummey withdrawal powers or in trusts holding, for example, interests in group life insurance policies, as to which the premium payments are made by a third party such as an employer.

Thus, we were gratified to see the final regulations permit elections to be made in a much more generic and flexible manner. The final regulations permit an election out of automatic allocation in very broad terms with respect to “(1) one or more prior-year transfers subject to section 2642(f) (regarding ETIPs) made on April 13 to permanently repeal the estate tax.

10 Another signal of the softening resolve on full repeal was the May 4 informal comment of House Ways and Means Committee Chairman Bill Thomas that if Congress is unable to permanently repeal the estate tax, the next best thing would be to provide stability and certainty. 86 Daily Tax Report G-3 (May 5, 2005). This remark came less than a month after the House had voted 272-162 in light of Ways and Means Committee Chairman Thomas’s interest in stability and certainty (described in the preceding footnote).

11 In a House-Senate conference, the Senate is likely to largely prevail, as in 2001, at least as to rates and exemptions, because of the small margin of support in the Senate. This is especially true in light of Ways and Means Committee Chairman Thomas’s interest in stability and certainty (described in the preceding footnote).

12 30 ACTEC Journal 154, 156 (Fall 2004).
by the transferor to a specified trust or trusts; (2) one or more (or all) current-year transfers made by the transferor to a specified trust or trusts; (3) one or more (or all) future transfers made by the transferor to a specified trust or trusts; (4) all future transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); or (5) any combination of [the foregoing].”

Another example of the common-sense approach of the final regulations is the treatment of an affirmative partial allocation of GST exemption as an effective election out of any automatic allocation. Thus, if a person transfers $100,000 to a GST trust and affirmatively allocates $40,000 of GST exemption to that trust, the transferor will be treated, without more, as having elected out of automatic allocation rules for the remaining $60,000. Although such an allocation seems to be an unusual and inefficient use of the GST exemption, it always reduces the chances for errors and ambiguities when taxpayers and return preparers are relieved of the obligation to say the same thing more than once in different ways on the same return.

**Supreme Court Changes**

Finally, while we have frequently made passing references to judicial nominations as one of the priorities competing with the estate tax for presidential and congressional attention, we note that the first of these nominations in the high-profile context of the Supreme Court was occasioned by the retirement of Justice Sandra Day O’Connor. We enjoyed and still treasure the opportunity to have gotten to know Justice O’Connor when her husband John was our partner in the 1980s after their move to Washington from Phoenix. She made friends with everyone (of course), and she and John set incredibly high standards on the dance floor at Miller & Chevalier gatherings. Her friendship with Immediate Past President Bob Rosepink and his wife Susan is legendary. In the past year, she has been elected by the Board of Regents as an Honorary Fellow of the College, has delivered the Joseph Trachtman Lecture at our annual meeting, and, having achieved those milestones, has announced her retirement from the Supreme Court. We join all thoughtful and grateful Americans in wishing her and John the very best.

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Committee Appointments 2006-2007

by Bruce S. Ross
Los Angeles, California

One of my most important jobs as President-Elect is to appoint and reappoint members of the College’s committees for the next College year, 2006–2007. These appointments will be effective at the end of the 2006 Annual Meeting in Maui, Hawaii, through the 2007 Annual Meeting in Scottsdale, Arizona. The first step in the process is to find out who is interested in committee membership and on which committee or committees you would like to serve.

If you would like to serve on a committee for the coming year, whether it is a committee you have served on before or one that is new for you, I need to hear from you no later than October 29, 2005. If you do not inform me of your interest, I will not be able to appoint you. If you do tell me, I will do my best to accommodate your preferences.

If you are interested in committee membership, please log on to the private side of the ACTEC website and submit the online committee appointment form (contact Bill Crawford at wlcrawford@actec.org if you need a user name and password), or complete and submit the committee appointment request form that accompanies this issue of the ACTEC Journal. If you are requesting an appointment to a committee on which you have not served, please let me know of any special experience you have that may be helpful to that committee’s work. Send the completed form before October 29, 2005, to:

Gerry A. Vogt, Executive Director
The American College of Trust and Estate Counsel
3415 South Sepulveda Blvd., Suite 330
Los Angeles, California 90034
Fax: (310) 572-7280

Most committees meet three times each year in conjunction with each of the College’s national meetings. For 2006-2007, these meetings will take place in the summer in Los Angeles, California, in the fall in Providence, Rhode Island, and in the spring in Scottsdale, Arizona.

The College reimburses committee members’ expenses at the fall and summer (but not at the spring) meetings up to a maximum of $250 for each meeting. Academic Fellows are entitled to a reimbursement of $600 for all three meetings.

We expect committee members to attend committee meetings and actively participate in committee work. Contributions to committee work and attendance will be considered in evaluating reappointment requests. To that end, I will ask each committee chair for an evaluation of each committee member’s participation and for a recommendation regarding reappointment.

I hope each of you will seriously consider committee participation. The College’s committees play a vital role in the life of the College and add importantly to the College experience of those Fellows who take part. They provide forums for discussion, facilitate the preparation of reports and articles on topics of interest to Fellows, and help produce the College’s educational programs.

ACTEC COMMITTEES

I have listed below each of the committees to which I will appoint members together with the name of the current committee chair, the number of members, and a brief description of the committee’s purpose and activities. The current number of members for each committee may be maintained, increased, or reduced.

Business Planning Committee (95)
Louis A. Mezzullo, Chair
The Business Planning Committee considers planning approaches and techniques under present law with emphasis on income and transfer tax considerations faced by taxpayers whose major assets are in operating businesses. Valuation, succession planning, and liquidity are topics the committee has under review.

Bylaws and Manual Committee (6)
Glen A. Yale, Chair
The Bylaws and Manual Committee updates the Bylaws and Manual. The Bylaws and Manual are living documents and require constant adjustment.

Charitable Planning and Exempt Organizations Committee (92)
Howard M. McCue, III, Chair
The Charitable Planning and Exempt Organizations committee considers all aspects of charitable planning, charitable giving, and exempt organizations.

Editorial Board (20)
Joseph J. Hanna, Jr., Chair
The Editorial Board has responsibility for all publications of the College, including the ACTEC Journal and the ACTEC Studies, the Membership Roster, and additional materials that are published by the College from time to time, such as the annual Pocket Tax Tables. A primary responsibility of the Editorial Board is to locate, write, and update articles of interest to the Fellows.

Elder Law Committee (35)
Gerald L. Cowan, Chair
The Elder Law Committee reviews guardianship legislation and procedure, books and professional literature...
in the elder law area, health law, legal alternatives to guardianship, elder abuse issues, elder law insurance issues, long term care issues, government entitlements, conservatorships and end of life issues.

**Employee Benefits in Estate Planning Committee**
Natalie B. Choute, Chair
The Employee Benefits in Estate Planning Committee considers developments in the employee benefits area, with a special emphasis on the ever changing tax implications.

**Estate and Gift Tax Committee**
Dennis I. Belcher, Chair
The Estate and Gift Tax Committee monitors tax developments in the transfer tax area and has been active in responding to Treasury and congressional proposals and the filing of *amicus* briefs.

**Fiduciary Income Tax Committee**
Laird A. Lile, Chair
The Fiduciary Income Tax Committee reviews the latest developments relating to fiduciary income taxes and considers proposals for reform.

**Fiduciary Litigation Committee**
John L. McDonnell, Jr., Chair
The Fiduciary Litigation Committee focuses on will and trust contests, fiduciary responsibility issues, attorneys’ and fiduciaries’ compensation disputes, evidentiary issues in estate and trust litigation, alternative dispute resolution and liaison with judges, construction, instruction and reformation, and malpractice issues. The committee also sponsors the biennial Sam Smith Memorial Lecture at the ACTEC fall meeting featuring nationally known speakers on estate and trust litigation topics.

**International Estate Planning Committee**
Henry Christensen, III, Chair
The International Estate Planning Committee focuses on the planning issues that face individuals who have (or would like to have) multinational assets and/or multinational families. These issues include taxation, probate and succession, and asset protection.

**Legal Education Committee**
Kevin D. Millard and
Anne-Marie Rhodes, Co-Chairs
The Legal Education Committee focuses on the quality and relevance of the content of trust and estate courses offered in law schools across the country and the role of adjunct professors.

**Practice Committee**
William C. Weinheimer, Chair
The Practice Committee looks at how trust and estate lawyers can expand their practices by adding other areas of expertise, how they can increase the efficiency of their practices through new methods and technologies, and how Fellows should deal with practical and ethical problems in their existing areas of practice.

**Professional Responsibility Committee**
Cynda C. Ottaway, Chair
The Professional Responsibility Committee considers ethical issues faced by Fellows in the trust and estate area. Having finalized for publication the Fourth Edition of the *ACTEC Commentaries on the Model Rules of Professional Conduct*, which provides advisory guidelines for practitioners in the trust and estate field, the committee is now updating the companion *Engagement Letters* project. The committee will continue to study developing ethical issues for the College.

**State Laws Committee**
Marguerite L. Adams, Chair
The State Laws Committee works on topics regulated at the state level, such as state death tax legislation (especially in the wake of the 2001 federal legislation), the prudent investor rule, tax curative statutes, standby guardianship legislation, uniform laws, notice in probate, apportionment of federal estate taxes, environmental issues, rights of creditors and fiduciary accounting.

**Technology in the Practice Committee**
John T. Rogers, Jr., Chair
The Technology in the Practice Committee provides information to the Fellows on computer hardware and software for estate planning and administration and has been actively involved in establishing and maintaining the College’s website.

**Transfer Tax Study Committee**
Joseph M. Dodge, Chair
The Transfer Tax Study Committee studies and reports on changes in the transfer tax law that would improve the tax system.

**COMMITTEE MATERIALS**
If you would like to view the agendas, minutes, and written materials of the committees, you may do so on the private side of the ACTEC website. Navigating the site is easy, and all you need is a user name and password, which you may obtain by contacting Bill Crawford at wlcrawford@actec.org. Once you have logged in, go to the Meetings box on the right side of the page; there you will find a link to the committee agendas, minutes, and handouts for the most recent national College meeting, as well as a link to the committee archives. Thank you for your interest in the work of the College.
Spotlight On Attorneys’ Fees

compiled by Martin A. Heckscher
West Conshohocken, Pennsylvania

This report, which is a regular feature of ACTEC Journal, focuses on significant recent court decisions and rules, legislative enactments and IRS developments bearing on attorney compensation in the trust and estate practice. The report is heavily dependent on the willingness of all the Fellows to furnish material that they think would be suitable for inclusion. Please send Spotlight’s compiling editor a brief write-up (as little as one paragraph will do) about a recent case, rule, statute or ruling which you believe is important in the jurisdiction in question or of widespread interest.

DELAWARE
W. Donald Sparks, II, Wilmington, Delaware

Trustees’/Beneficiaries’ Claim for Attorneys’ Fees Must Be Evaluated by Considering Benefit They Conferred on Trust by Pursuing Litigation and Not Rejected Merely Because They Were Motivated by Self-Interest

In re Trust Agreement of Capaldi, 870 A.2d 493 (Del. 2005), concerned a trust settled by Emilio Capaldi for his wife, Rose, and their three children. By the time certain litigation arose, Capaldi had died and there were five trustees: Rose, the children, Roseanna, Lawrence and Joseph, and Joseph Capano. In 2004, two of the children, Lawrence and Joseph, filed a petition seeking various forms of relief. The vice chancellor removed all of the trustees except Capano and Rose and replaced those removed with two independent trustees. The vice chancellor also awarded Capano attorneys’ fees. However, he denied attorneys’ fees for Lawrence and Joseph, finding that they were motivated by self-interest in initiating and pursuing the litigation. Lawrence and Joseph appealed.

The Supreme Court upheld the vice chancellor’s first two rulings including the retention of Capano as trustee, even though several transactions carried out by Capano with respect to the trust’s principal asset were “questionable,” and the decision to direct payment of Capano’s attorneys’ fees from the trust. The court found that the vice chancellor properly exercised his discretion in awarding fees because Capano’s conduct benefited the trust and his years of service without compensation demonstrated an overall commitment to Rose’s best interests. The court then reviewed the vice chancellor’s denial of attorneys’ fees to Lawrence and Joseph on the basis that they were motivated by self-interest alone in initiating and pursuing the underlying litigation and his rationale that judicial intervention and resulting action, without more, could not constitute a benefit to the trust. The court directed that a proper analysis of the fee claim should assess both the benefit realized by the trust and the motivation behind the litigation instituted by the brothers. In balancing these factors benefit and motivation must be given equal weight. In this case the litigation benefited the trust by reducing its administrative costs and by reconfiguring its governance structure. Thus, the court held that the vice chancellor abused his discretion by failing to consider the benefit to the trust resulting from Lawrence’s and Joseph’s actions and remanded the case to the vice chancellor for proceedings consistent with its opinion.

KANSAS
Heywood H. Davis, Kansas City, Missouri

After Court Rejecting Agreement to Terminate Trust Court Allocated Half of Annuitants’ Attorneys’ Fees At Trial to Charity; Annuitants’ Appeal Fees Were Substantially Reduced and Allocated Solely to Annuitants

In re Estate of Somers v. Firstar Bank, N.A., 89 P. 3d 898 (Kan. 2004), involved the proposed modification of a testamentary trust under the Uniform Trust Code. When decedent died in 1956, she created a trust valued at approximately $120,000 and directed that the trustee (now Firstar Bank) pay $100 monthly to each of her two grandchildren for life and on termination the corpus be distributed to Shriners Hospital (“Shriners”). When the trust grew to approximately $3,500,000 in 2001 the grandchildren and Shriners fashioned an agreement by which $150,000 would be distributed to each grandchild, the balance would be distributed to Shriners, the trust would terminate, and Shriners would continue to make the monthly payments to the grandchildren. The trustee opposed this agreement. The district court rejected the agreement but exercised its equitable powers by directing that all but $500,000 be distributed to Shriners with that amount continuing in trust to fund the grandchildren’s monthly distributions. The Kansas Supreme Court affirmed the district court’s decision on the termination issue. This aspect of the case is annotated at 30 ACTEC Journal 231 (2004).
The grandchildren’s attorneys sought fees and expenses of $117,454.98 at the trial level. The district judge allowed $111,149.93 with payment to be made from the Shriner’s distribution. On cross-appeals by the trustee, Shriner’s and the grandchildren, the Supreme Court reviewed the award of trial fees to the grandchildren’s attorneys, after noting as follows: "The attorneys...billed over 650 hours for six partners and three associates for the proceedings before the district court. Two partners billed 544.10 of these hours. In addition, expenses for computerized legal research totaled over $13,000." While recognizing that attorneys’ fees are not ordinarily awarded to counsel for the unsuccessful party, the court observed that “in some cases,...it is difficult to define success or determine who won and who lost.” Further, after commenting that it did “not consider this litigation complex or contentious in the legal culture that we observe on a daily basis," the court deferred to the district court’s judgment regarding the amount of fees at trial but directed that the fees should be divided equally between Shriner’s and the grandchildren. Lastly, the Supreme Court considered the grandchildren’s attorneys’ application for $45,566.92 in fees and costs for the appeal. Professionals recorded 273.9 hours and the request included expenses of $849.42. The court noted that on one single day the grandchildren’s attorneys who were in a Missouri firm, billed 17.7 hours for services by three partners and one paralegal. After suggesting that some of the attorneys’ time might have been attributable to the fact that the firm was from out of state (although one of its partners was admitted in Kansas), the court reduced their appeal fee to $15,000 and directed that the grandchildren pay the entire amount.

NEVADA
Layne T. Rushforth, Las Vegas, Nevada

Five Percent Attorneys’ Fee for Probate Not Per Se Reasonable; Attorneys’ Fees Must Be Determined In Accordance With Statute and Court Rule; Claim for Extraordinary Services Should Be Considered Along With Attorneys’ Surcharge Liability; Fees on Fees Denied

Section 150.160 of the Nevada Revised Statutes provides that the attorneys for the personal representative in a probate proceeding are entitled to reasonable compensation paid by the estate. The compensation must be fixed by agreement between the personal representative and the attorneys but the compensation is "subject to approval by the court" upon petition and a hearing. Furthermore, the statute enumerates specific information that must be included in a fee petition, including time and hours, the services rendered, claimed extraordinary services, the complexity of the work, and "other information considered to be relevant to a determination of entitlement." For many years attorneys in Clark County, Nevada charged five percent of the value of an estate to handle an uncontested probate, and the courts regularly ignored other factors so long as the personal representative and attorney agreed to the compensation. If the fee did not exceed five percent of the estate, the compensation was deemed reasonable per se.

In In re Estate of Boulws, 102 P.2d 593 (Nev. 2004), the American Cancer Society ("ACS") as primary beneficiary objected to the five percent fee charged by the executors’ attorneys pursuant to their fee agreement for handling decedent’s estate valued at more than $7,000,000. The executors defended the fee agreement with the testimony of another attorney who opined that five percent was the fee routinely charged for probate matters in Clark County and that such fees were per se reasonable. Another Clark County attorney testified that this estate administration was only routine, that the customary five percent was not per se reasonable, and that the attorneys’ fee agreement was unreasonable under § 150.160 and the Supreme Court Rules. The probate commissioner testified that, although the five percent fee agreement was customary in Clark County, such arrangements were not per se reasonable in other districts in the state and he did not believe that the fee was reasonable in this case. Despite its belief that the attorneys failed to earn the five percent fee under their agreement with the executors, the district court ruled that the fee was reasonable per se because of routine local practice and custom. On ACS’ appeal, the Supreme Court overturned the long-standing practice and held that the factors mentioned in the statute must be considered by the court, even if the compensation is set by agreement and does not exceed five percent of the estate’s value. The court not only listed the factors mentioned in the statute, but cited with approval the factors enumerated in Nevada Supreme Court Rule 155. The court observed that customary charges are correlative but not determinative of the reasonableness of a fee and that the fee should be evaluated under other factors enumerated in Rule 155, such as the time and labor involved in settling the estate. Thus, the court overruled the lower court’s decision and held as a matter of public policy that attorneys’ fees in probate matters, when challenged, should be reviewed based on consideration of all the factors in Rule 155. When it approved the five percent fee for ordinary services, the district court rejected the attorneys’ application for extraordinary fees, possibly because of its approval of the basic five percent fee. Upon remanding the case to consider whether the five percent fee was reasonable, the Supreme Court direct-
ed the lower court to consider the application for extraordinary fees as well as all other factors enumerated in Rule 155 "in crafting a reasonable overall compensation package for the estate's attorneys."

The Supreme Court also considered the effect of a surcharge that the district court imposed on the attorneys after determining that the executors had imprudently paid excess brokerage commissions to liquidate the estate's securities. The lower court imposed complete responsibility for the surcharge on the attorneys because they had recommended to the executors which brokers to use. The Supreme Court held that liability for the excess commissions should have been assessed against the executors as well as the attorneys based on evidence that showed, inter alia, that one of the executors had been a licensed stockbroker and was familiar with the ability to negotiate commissions. While the Supreme Court held that the attorneys and executors were jointly and severally liable for the surcharge, it also affirmed the district court's order deducting the excess brokerage commissions from the attorneys' fees. Lastly, the Supreme Court rejected the executors' claim to recover fees on fees. When ACS challenged the attorneys' claim to a five percent fee, the executors engaged another attorney to handle the challenge because of a perceived conflict of interest. Subsequently the executors sought approval to pay the separate attorney's fees from the estate. Because the executors never challenged the validity of the basic attorneys' fee agreement and continued to urge its validity on appeal, the Supreme Court affirmed the district court's decision rejecting their claim for fees on fees, stating that there was no conflict concerning the fee agreement and that retention of a separate attorney was unnecessary. The separate attorney's services did not benefit the estate, only the executors; accordingly, the estate was not required to pay his fees.

PENNSYLVANIA

Bernard Glassman, Philadelphia, Pennsylvania

Estate Awarded Litigation Costs and Attorneys' Fees after Judgment Granted Refund of Estate Tax and Interest; IRS' Position in Prior Litigation Was Not Substantially Justified and Estate's Net Worth Was Less Than Statutory Limit after Deducting Lifetime Transfers

The executrix of an estate brought an action against the United States seeking recovery of federal estate taxes and interest that she alleged were erroneously assessed and collected against the estate by the IRS. Cameron v. U.S., No. Civ. A. 03-1967, 2005 WL 1155134 (W.D. Pa. Mar. 23, 2005). The court held that the estate, as the "prevailing party" (defined as any party which has substantially prevailed with respect to the most significant issues or set of issues presented), was entitled under § 7430 to recover its litigation costs for the prior proceeding because, first, the government's position was not substantially justified and, second, because the estate's date-of-death net worth was below the statutory ceiling of $2,000,000. See 26 U.S.C. § 7430 (c)(4)(D)(i)(I); 28 U.S.C. § 2412(d)(2)(B)(i).

The government's position in the underlying action was not substantially justified because it failed to cite any authority supporting its conclusion and the result it advocated did not follow from the literal language of certain trust documents that were being construed and because its position would have yielded an "absurd result." The court ruled that in such cases the government has the burden of establishing that its position was substantially justified and that the burden to prove all other elements of the claim is on the taxpayer. A position is "substantially justified" if it is justified to a degree that could satisfy a reasonable person or if it has a reasonable basis both in law and fact. Second, the estate qualified as a "prevailing party" because its date-of-death net worth was less than $2,000,000. Although the estate tax return listed the value of the gross estate at approximately $6.4 million and the taxable estate at approximately $4.0 million, both well over the statutory limit, those amounts included transfers decedent made during her lifetime. The court held that the value should be calculated as of the date of death in 1999. Because additional assets on the estate tax return, including an irrevocable trust that decedent established in 1992, were attributed to lifetime transfers which were not part of the "probate estate," the estate was within the statutory limit. The court's opinion does not confirm the apparent fact that the decedent created the 1992 trust for her own benefit, only that it was a transfer she made while living and that it was not an asset of her estate at death. Thus, the court awarded the estate reasonable litigation costs and attorneys' fees.

PENNSYLVANIA

Karen A. Fahrner, Bryn Mawr, Pennsylvania

Fees for Estate Administration Substantially Reduced; Both Attorneys Criticized for Failing to Provide Time Records or Other Proof in Support of Claims

In Novotny Estate, 4 Fid. Rep. 2d 214 (O.C. Mont. 2004), an estate of $9.6 million, the court reduced the
fees of two separate attorneys from $440,000 originally claimed to $175,000. In evaluating the attorneys’ fees, the court pointed out that to justify amounts higher than the guidelines established by the court in a neighboring county in Johnson Estate, 4 Fid. Rep. 2d 6 (O.C. Chest. 1983), the attorneys must present evidence that the estate administration was "in some way extraordinary." The case was complicated by the fact that the attorney who first handled the estate (Goldman) died after the administration was well underway and was replaced by two attorneys (Reiter and Butler) from another firm. The court’s award of total fees of $175,000 was well in excess of the $106,820 fee that would be allowed under Johnson. In allowing the higher amount the court indicated its belief that the Johnson schedule "should be increased to reflect the effect of inflation" but that its "review of Johnson is not yet complete." The court also relied on what it described as "somewhat unusual factors" in the case, presumably referring to Goldman’s death in mid-stream.

Having established a total fee, the court then divided the award between the two separate claims. It pointed out that, although time is not necessarily determinative, neither claimant submitted contemporaneous time records of the services performed and that where fees are being litigated, "properly prepared time records are helpful [to show] what services were performed and by whom." The court criticized Goldman’s claim because he fulfilled only limited responsibilities in administering the estate and also failed to enter into an engagement agreement with the executor that defined their responsibilities and specified the method of attorney compensation. After enumerating numerous tasks that Goldman did not perform over the four years while he was involved, the court reduced his estate’s claim to $50,000 (its own expert recommended that the claim be reduced to $200,000). Butler and Reiter’s firm claimed a flat fee of $175,000, which they established in their engagement letter. After noting that the firm had appropriately taken charge of the estate and provided high quality services, the court observed that a flat fee may be a good approach but only if it is based on “some appropriate measure,” such as an estimate of time, the Johnson schedule, or the factors specified in other Pennsylvania decisions. Without the availability of time records to support their fee, the court reduced Butler’s and Reiter’s award to $125,000.

NEW YORK
Sanford S. Schlesinger, New York, New York

Attorneys’ Paralegal Limited to One-Half Statutory Executor’s Commission Where Disclosure Requirement Was Not Met

Section 2307-a of the New York Surrogate’s Court Procedure Act provides that when an attorney drafts a will appointing the attorney to be an executor, the attorney must disclose to the testator that any person may serve as the executor, that executors are entitled to statutory commissions, and that the attorney is also entitled to counsel fees to be paid by the estate if he or she renders legal services to the estate. The statute also requires that the disclosures be set forth in a writing, which the testator executes in the presence of at least one witness other than the attorney who is designated as the executor. In the absence of such a disclosure statement, the attorney can only receive one-half of the statutory commissions to which he or she would otherwise be entitled for serving as executor.

In In re Matter of Wagoner, 7 Misc. 3d 445 (Sur. Ct. Albany 2005), the surrogate considered the application of this statute to a will that designated a paralegal of the attorney who drafted the will as the executor of the estate and where the attorney was the only witness to the disclosure statement. The court noted that the statute was designed to reduce the possibility that an attorney might attempt to influence a client to appoint the attorney as his executor for the attorney’s own benefit, rather than for the benefit of the client, and expressed its concern that the attorney who drafted this decedent’s will might be attempting to avoid application of the statute by having the client designate the paralegal as the executor, rather than the attorney. The court found that the paralegal became acquainted with the decedent only through employment with the attorney and noted that the paralegal was not a close personal friend of the decedent. The court determined that the paralegal’s relationship with the attorney, combined with her lack of relationship with the decedent, required that disclosure be made in compliance with the statute. Thus, the court held that the statement witnessed only by the attorney would not be treated as having been signed in the presence of a witness other than the designated executor and therefore that the paralegal/executor would be limited to one-half of the statutory commission.
Volume 31, No. 2, Fall 2005

The ACTEC Journal (ISSN 1544-4945) is published quarterly for the Fellows of The American College of Trust and Estate Counsel as a professional service.

Members of the College receive a subscription to ACTEC Journal without charge. Non-members may subscribe to ACTEC Journal for $60 per year. Price for single issue, if available, is $15 per issue.

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