RECENT DEVELOPMENTS
IMPACTING ESTATE AND TAX PLANNING

Presented for

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Prepared By
Douglas W. Duncan, CLU, JD
Shelly E. Nixon, JD

LEFKOFF, DUNCAN, GRIMES, MCSWAIN & HASS
ATTORNEYS AT LAW
A Professional Corporation

Suite 200, Piedmont Place
3520 Piedmont Road, N.E.
Atlanta, Georgia 30305
(404) 262-2000

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RECENT DEVELOPMENTS

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I. The Election Out of the Estate Tax Into Carryover Basis for 2010 Estates

Notices 2011-66 and 2011-76 IRS provided the first substantive guidance regarding carryover basis and the election.

Form 8939 (to elect out of estate tax and allocate basis to estate assets) must be (have been) filed on or before January 17, 2012. Otherwise, a 2010 estate is subject to the "default" application of the estate tax with a $5 million exemption and a full basis step-up on included assets. In general, the IRS will not grant extensions of time to file Form 8939 and will not accept a Form 8939 filed late, and, once made, the Section 1022 Election and basis increase allocations will be irrevocable. There are four explicit exceptions to the finality of a timely filed Form 8939, which Notice 2011-66 calls “relief provisions”:

1. The executor may file supplemental Forms 8939 to make additional allocations of Spousal Property Basis Increase as additional property is distributed to the surviving spouse. Each such supplemental Form 8939 must be filed no later than 90 days after such distribution.

2. The executor may make other changes to a timely filed Form 8939, except making or revoking a Section 1022 Election, on or before July 17, 2012 (six months after January 17).

3. The IRS may grant “9100 relief" allowing an executor to amend or supplement a Form 8939 "to allocate any Basis Increase that has not previously been validly allocated," if assets are discovered, or assets are revalued in an IRS audit, after Form 8939 is filed. Such an audit could occur when an asset is sold many years or even decades after the Form 8939 is filed, which means that most attempted "formula" allocations would be ill-advised (and in any event there can be no "protective" elections).

4. The IRS also retains the discretion, under "9100 relief" procedures, to allow an executor to amend or supplement a Form 8939 or even to file a Form 8939 (and thus make the Section 1022 Election) late. The IRS has made it clear in Notice 2011-66 that its standards for this relief are likely to be very strict.

II. Gift-Giving in 2011 and 2012 -

The availability of a $5 million "exemption" for gifts made before the end of 2012 has greatly increased interest in the use of such gifts to avoid transfer taxes. There is, however, much misunderstanding regarding the impact of such gifts on the ultimately tax burden borne by the family. Consider the following:

The making of a $5 million gift does not (by itself) reduce the total amount of taxable value on which the transfer tax (gift tax and estate tax) is ultimately payable. That is because the gift tax and estate tax form a "unified" tax system, and are cumulative in nature. That is, the total amount of tax ultimately paid is computed on the aggregate amount of all taxable gifts and the size of the taxable estate remaining at death. Therefore, if Taxpayer has an estate of $10 million, she may transfer part of it by gift during her lifetime and the rest by her estate at death, but the ultimate tax liability will be computed on the full $10 million regardless of when it is transferred. That result is affected by computing the estate tax due at death as follows:

1. Determine the value of the estate remaining at death; and
2. Add thereto the amount of all taxable gifts made during life (after 1976); and
3. Compute the tax on the total amount; and
4. Subtract the amount of any tax actually paid on the taxable gifts made during life (or, for decedent's dying after 2009, the amount which would have been payable applying the rates in effect at the decedent's death rather than the rates in effect at the time of the gift (IRC §2001(g)).) (See discussion below under "Claw-Back.")

As a result of this "unified tax system" approach, the making of taxable gifts does not reduce the total amount of tax paid except in a few circumstances.

> First, there are certain "exemptions" available under the Gift Tax laws which allow some gifts to be totally removed from the taxable estate. For example, the gift tax "annual exclusion" allows up to $13,000 per calendar year for each donee to be completely excluded and not counted in computing the estate tax. If H and W have three children and seven grandchildren, that is an annual amount of $260,000 which H and W may give each year with no gift tax and fully excluded from calculation of the estate tax. In addition, amounts paid for school tuition and medical care may be fully excluded without limit.
>
> Second, a gift of property is also expected to transfer to the donees all future appreciation and income on the transferred property and prevent that amount from accruing in Taxpayer's estate. That is especially valuable in an economy in which many family assets (business interests and real estate) currently reflect historically low values, but are expected to regain their value as the economy improves.

Third, certain types of gifts provide substantial "leverage" because they remove more from the taxable estate than the amount of the gift for which you are charged under the Gift Tax law. In a recent case (*Estate of Mitchell v. Commissioner,* T.C. Memo 2011-94) the taxpayer owned two parcels of real estate, beachfront property in Santa Barbara, California, and a ranch in Santa Ynez, California. Seven days before his death, the decedent had gifted a 5 percent interest in both the beachfront property and the ranch to a trust for the benefit of his two teenage sons, while retaining a 95 percent interest in both properties. As a result, both the gifted 5% interests and the retained 95% interests were valued using discounts to reflect the lack of marketability of a fractional interest in real estate. The total value of both properties (about $13.5 million) was reduced to gifts valued at about $375,000 (approximately a 45% discount) and the 95% interests included in the estate at about $8.3 million. About $4.9 million of taxable value was removed from the estate.

It is also important to recognize that some gifts can result in substantially more overall tax liability in the family than simply keeping the property and including it in the taxable estate. In general, property which is included in Taxpayer's gross estate at death receives a "stepped-up" income tax basis in the hands of the beneficiaries equal to the value of the property at Taxpayer's death. Even if Taxpayer had a very low basis during her life and would have faced a substantial income tax on sale of the property, her estate and its beneficiaries can sell the asset after her death with no income tax cost. For instance, if she owns a share of stock which cost her $1.00 and has a market value of $20.00, she would pay income tax on a $19.00 capital gain of she sold it during her life. However, if Taxpayer dies holding the stock, then the stock is included in her estate at its $20.00 market value, and the family gets its cost basis adjusted upward to that $20.00 value. The family could then sell the stock for $20.00 and recognize no capital gain. However, if Taxpayer had given that stock to her children before he death, then they take it with her cost basis, so the $19 capital gain is still taxable if it is ever sold. Therefore, in any gift planning exercise, it is important to compare the anticipated savings in transfer taxes to the potential added income tax liability if the assets are sold.

Spousal Gifts - Recent economic unpleasantness has taught is that we can't always predict the adversities with which we must deal. As a result, many couples worry about divesting themselves of so much wealth when they might later wish they had access to it. As a result, there has been much discussion of making gifts in trust - each spouse for the benefit of the other - so that the total amount of property available for their economic security is not diminished.

For example, H makes a gift of $X million of assets to a trust for the benefit of W, and W makes a separate gift to another trust for the benefit of H. The primary technical challenge is the application of the "reciprocal trust doctrine" (*United States v. Estate of Grace*, 395 U.S. 316 (1969). In general, the two trusts must be sufficiently different that (1) the husband's interest in the trust that the wife established is not identical to the wife's interest in the trust that the husband created and (2) each of them are not in approximately the same objective economic position as they would have been had they each created trusts for themselves.

Self-Settled Asset Protection Trusts - Twelve states have adopted statutory structures which allow a grantor to create a trust under which the grantor is a discretionary beneficiary, which prevent the grantor's creditors from being able to reach the trust assets and prevent the trust assets from being included in the grantor's estate for estate tax purposes. Those states include Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Self-settled trusts, with the grantor and/or the grantor's spouse as a discretionary beneficiary, can overcome the concern of some clients that they will run out of money. [See note on *Mortensen* case from Alaska below.]

Forgiveness of Debt - In many families, parents hold promissory notes receivable from children, grandchildren, or trusts.

In some cases, the loans have been made to enable younger family members to enjoy family wealth where gifting exemptions have already been utilized. Where there is no substantial evidence of debt repayment, the IRS has had success recharacterizing those "loans" as gifts when they appear in Parent's estate. [See discussion of *Todd v. Comr*. below.] Using the $5 million exemption to forgive those loans and avoid that issue may be an attractive alternative.

In other cases, Parents have sold assets to children to a "grantor trust" for the benefit of their descendants. Those loans often bear interest at the applicable federal rate, which is much lower than the "market" rate at which such loans would otherwise be available. That rate differential may enable the gift tax value of the note to be substantially discounted.

Interests in Family Business - A successful family business enterprise which will probably be retained in the family offers an attractive use of the exemption to make gifts. Even with S corporations, the ownership of the business can be "recapitalized" into a small voting interest (e.g. 5%) and a large non-voting interest (e.g. 95%). Gifts and sales of a block of the non-voting interest will generally be valued with substantial discounts for lack of marketability and lack of voting rights. So long as Parents retain at least the majority of the 5% voting interest, they have retained control of the company for as long as they wish. Further, upon subsequent death, the retained interest will represent less than 100% and will also be subject to significant valuation discounts.

Gifts to Facilitate Other Transfers - Various types of "sales" of property to trusts for younger generations offer great opportunities to avoid both the estate tax and the generation-skipping transfer tax. To be honored for tax purposes, however, such sales generally require that the purchasing trust have some amount of other property (other than the assets being purchased.)

Installment Sales - When the sale involves the trust's making payment with an installment note payable over a period of years, it is generally accepted that the purchasing trust should have other equity ("skin in the game") equal to at least 10% of total purchase. The increased exemption will certainly make it easier to make gifts to that trust in an amount sufficient to satisfy that test. Following such a sale, the seller's estate includes the value of the unpaid balance on the installment note, which is fixed and will not appreciate. All future growth in the value of the assets sold to the trust will then accrue to the trust, outside the taxable estate.

Private Annuity - It is also possible, and often very desirable, to sell assets to the trust in exchange for the trust's promise to make annuity payments to the seller for the seller's lifetime. The required interest rate used in computing the amount of the annuity payments will generally be somewhat higher than the rate available with an installment sale note, but there are two potentially great advantages.

First, the seller cannot outlive the annuity payments. If the seller is looking to the installment note payments as an important part of his or her income, then a problem arises if the seller outlives the term of the installment note. Because the annuity is payable for the seller's lifetime, the seller can never outlive his or her right to those payments.

Second, upon the death of the seller the annuity payments cease, so the value of the annuity in the seller's estate for estate tax purposes is zero. Even if the seller dies prematurely, the entire value of the property sold to the trust is removed from the seller's estate for estate tax purposes.

In order to secure those benefits, however, the regulations require that the purchasing trust have much greater equity than is required for an installment note. In general, the trust must have total asset value (including the purchased assets) to be able to continue the annuity payments until the seller's age 110 computed under the IRS tables. (Reg. §20.7520-3(b)(2)) The availability of the $5 million exemption for gifts will enable such transactions to include a larger "gift" component to satisfy this test without incurring any gift tax.

Remove Life Insurance from Estate - Life insurance is included in the insured's estate for estate tax purposes if either (a) the proceeds are payable to the estate, or (b) the insured possesses any incidents of ownership in the policy. (IRC §2042) It is well known that one may create an "irrevocable life insurance trust" (or "ILIT") and have the insured give ownership of the policy to the trust in order to divest herself of incidents of ownership. This is often a very beneficial way to "leverage" the exemption, because the measure of the gift for gift tax purposes is the current value of the policy (generally its reserve value), while the amount removed from the taxable estate is the larger death benefit value. With larger policies and/or older insureds, the increased exemption will make it easier to transfer such insurance policies by gift without any gift tax liability.

However, in an effort to prevent "deathbed transfers" of insurance policies, such gifts will result in the insurance being included in the insured's taxable estate if she dies within three years following that gift. (IRC §2035(a)(2)) It now seems clear that one can avoid that "3 year rule" by making a gift of cash to the trust equal to the current value of the policy, and then selling the policy to the trust. If the trust is a "grantor trust" for income tax purposes, then the insured's sale of the policy to the trust will not cause income tax problems under the "transfer for value" rule of IRC §101 because of the exception for "transfers to the insured" under §101(a)(2)(B). (Rev. Rul. 2007-13) Also, there is an exception to the application of the 3 year rule for "sale" transactions "for adequate and full consideration in money or money's worth." (IRC §2035(d))

"Claw Back" of taxable gifts at the grantor's death has been the attention of much discussion and speculation by planners in this area. It refers to the impact of the application of the unified estate tax rules at death if the unified credit exemption at that time is less than the $5 million exemption available now. For example, assume that Grantor has a total estate of $10 million, and gives $2 million to a trust for children in 2012. The $2 million gift is entirely covered by the $5 million available exemption, so no gift tax is paid. Now, assume that Congress does nothing about the estate tax, allowing the exemption to revert to $1 million in 2013 when Grantor dies. Grantor's remaining estate is ($10 million less the $2 million gift) $8 million. If we add back all "adjusted taxable gifts" then the tax is computed on the $8 million estate plus the $2 million gift - still $10 million - and the estate benefits from only the $1 million exemption available at death in 2013. That is like a "recapture" of the exemption to which Grantor was entitled when the gift was made in 2012. Recent developments in this area seem to make it clear that either:

1. Even if "claw back" occurs, it will not result in a worse tax situation than would have been the case if the gift had not been made; or

2. Looking at the language added by IRC §2001(g) and the instructions included with the new Federal Estate Tax Return (form 706) for decedents dying in 2011, there is not really a recapture after all. That is because the Grantor's estate will receive the benefit of both the exemption available at date of death ($1 million) and a credit for the amount of gift tax which would have been assessed against the $2 million gift if the law in effect at death (in 2013) had applied to the gift ($780,800 - $345,800 = $435,000).

[See following page.]

	No Gift	With Gift
Beginning Estate	$10,000,000	$10,000,000
Amount of Gift	0	2,000,000
Gift Tax Payable	0	0
Estate at Death	10,000,000	8,000,000
Adjusted Taxable Gifts	0	2,000,000
Total Tax Base	$10,000,000	$10,000,000
Gross Estate Tax	5,140,800	5,140,800
Unified Credit	(345,800)	(345,800)
Credit for Gift Tax	(0)	(435,000)
Net Estate Tax Payable	$ 4,795,000	$ 4,360,000

Note here that, in order to prevent "claw back" the donor's estate is given a credit of $435,000 (computed under the law in effect at death) even though no actual gift tax was paid on the $2 million gift.

III. Estate Tax - Exemption Portability

For decedents dying in 2011 and 2012, any of the decedent's unused unified credit exemption may be transferred to the surviving spouse. Many people think it likely that this "portability" provision will remain in any revision of the estate tax system.

Portability is not allowed “unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return.” As a result, the timely filing of an estate tax return (form 706) is required even for estates valued at less than the normal filing limits. Query, what is the executor's responsibility to incur this cost solely to preserve the deceased spouse's unused exemption amount for the future use of the surviving spouse? Thoughtful planning may be needed to avoid family squabbles, especially in second marriages.

The question has naturally been raised whether portability is a substitute for traditional estate tax planning wills and trusts. Can taxpayers now choose the "simple" estate plan, leaving the estate to the surviving spouse, preserving both exemptions through portability, without giving up substantial tax benefits? Perhaps, but consider:

a. Use of the traditional "credit shelter trust" will also shelter all appreciation in value between the first spouse's death and the second. If the surviving spouse lives for 12 years and trust assets appreciate at 3% annually, the taxable value will grow by 40%. The credit shelter trust will protect all of that growth from estate tax. The deceased spouse's portable exemption will, however, not appreciate at all.

b. What is the chance that the surviving spouse will remarry? What is the chance that he or she will have additional children? The traditional credit shelter trust provides certainty as to the eventual distribution of the property to designated beneficiaries.

c. What is the chance that the surviving spouse may have challenges from creditors, unfortunate business circumstances, or subsequent marital problems? The credit shelter trust can protect the assets from such risks.

d. Has the family examined the benefits of multi-generational planning to protect the family wealth? There is no portability of the deceased spouse's unused GST exemption.

e. The future of portability is uncertain, and even under its current structure is potentially lost if the surviving spouse remarries and the new spouse then predeceases him or her.

On the other hand, there are some potential benefits to using portability:

f. Appreciation between first death and second death will get a "basis step-up" at death of the surviving spouse.

g. Portability may offer an attractive way to handle large qualified retirement plan accounts which have special income tax considerations.

h. It is administratively simple (except for having to file the estate tax return) and avoids the cost of maintaining separate accounts for the trust assets, filing trust tax returns, etc.

IV. The Administration's Revenue Proposals The "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" ("Greenbook") was released on February 14, 2011. It includes several proposals which are of interest in the estate planning arena:

1. Make portability of a deceased spouse's unused exemption amount permanent.
2. Eliminate circumstances in which a taxpayer might claim a basis on inherited property which is higher than was reported for estate tax purposes.
3. Modify the rules on intra-family valuation discounts.

4. Require a minimum term for grantor retained annuity trusts. ("GRATs.)

5. Limit the maximum duration of the GST tax exemption regardless of differences in state law governing the maximum duration of trusts.

V. Changes to State Death Tax Laws

Three more states (Illinois, Connecticut, and Oregon) adopted separate estate tax provisions in 2011. For Georgia residents, that is generally irrelevant unless a Georgia resident owns real property in one of the states which imposes a separate estate tax at death. In order to avoid such difficulties, is has become more common to recommend that Georgia residents use an entity (such as an LLC) to hold title to such property.

VI. Final Regulations For Distribution of Income to Charity in Charitable Lead Trusts.

Treasury has announced its intent to finalize the regulations under Section 642(c) governing the character of a Charitable Lead Trust's income which is distributed to charity each year. The Proposed Regulations allow this issue to be controlled by the trust instrument only when the provisions have "economic effect independent of income tax consequences." As a result, the trust may not effectively direct that the "ordinary income" be paid to charity and the tax exempt income and qualified dividends be retained in the trust. As a result, the amount of income distributed to each charitable beneficiary will consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

VII. 2011 Court Decisions and Rulings

There were numerous decisions of various courts, and several formal rulings issued by the IRS, which provide helpful guidance in estate planning cases.

QPRT Property After Trust Terminates - ***Estate of Van v. Commissioner*** (T.C. Memo 2011-22) underscores the importance of having a formal agreement (lease or other contract) where the donor is planning to continue to occupy a residence after the termination of the trust term in the qualified personal residence trust ("QPRT.") Grantor died shortly after trust period ended without vacating the property. Even though there was evidence of an intent to formalize an agreement for her continued occupancy, IRS claimed inclusion in her estate under §2036.

Property Transferred Under Divorce Decree - Letter Ruling 201116006. The IRS continues to struggle with the tax treatment of property transferred incident to a divorce decree or agreement. These cases continue to appear because divorce lawyers insist on creating these transfers without understanding the applicable tax rules. In this case, the property settlement transfer was made into a trust that paid the former wife income for life and principal in the trustee's discretion. The remainder of the trust assets passed upon the spouse's death to the children. The question was estate tax inclusion of the trust in the spouse's gross estate at death. The IRS held no estate tax inclusion, but husband was found to have made a taxable gift when the trust was funded to the extent of the trust assets passing to the children.

Gift Tax QTIP Election. Letter Ruling 201109012. The IRS revoked Letter Ruling 201025021, in which a grantor was given an extension of time to make a gift tax QTIP election. The IRS has now determined that the 2010 ruling was in error and not in accord with the views of the Service. Basically, the Service has reasserted the position that it took in Letter Ruling 9641023, that the failure to make a QTIP election on a timely filed gift tax return is irrevocable and non-curable because the time for filing the gift tax QTIP election is expressly prescribed by section 2523(f)(4).

Gifts of Fractional Interests in Real Estate *Estate of Mitchell v. Commissioner* (T.C. Memo 2011-94.) Lifetime gifts of undivided interests in real estate (7 days before death) were valued with fractional interest discounts; and remaining fractional interests retained by the donor/decedent were valued with fractional interest discounts. (Mentioned above in discussion of tax advantages of making gifts**.)** As a result, relatively small gifts before death resulted in a relatively large reduction in the value of the taxable estate.

Defined Value Clauses in Property Transfers - In *Petter v. Commissioner* (653 F.3d 1012 (9th Cir. 2011), *aff'g* T.C. Memo 2009-280) and *Hendrix v. Commissioner* (T.C. Memo 2011-133) the court again rejected the IRS position that such strategies violate public policy and should not be honored for tax purposes. These decisions provide further support for the use of "defined value clauses" to avoid undesirable gift tax treatment of gifts of hard-to-value property.

In *Petter*, the taxpayer transferred certain LLC interests to trusts for her children, under a document which provided that the portion thereof which "equals a value of $4,085,190 as finally determined for federal gift tax purposes" would be retained in the children's trusts, and the excess over that amount would pass to two charitable community foundations.

In *Hendrix*, the taxpayers transferred shares of the family's closely-held company pursuant to a formula under which: (1) a portion of the assigned shares having a fair market value as of the effective date equal to $10,519,136 was assigned to trustees to be held in equal shares for the benefit of the daughters, and (2) any remaining portion of the assigned shares was assigned to a charitable foundation for the benefit of a donor-advised fund.

The courts rejected the contention of the IRS that the formula clauses were void as contrary to public policy (because they eliminate or minimize the IRS' potential for reward on audit), and refused to find any collusion in the transactions which would render the formula clauses unenforceable.

IRA to Special Needs Trust - PLR 201116005. Father died leaving his disabled Son as the named beneficiary of his IRA account. Son would qualify for public assistance (Medicaid) except for the value of the IRA account which he owns. The IRS ruled that Son could transfer the inherited IRAs to a "special needs trust" to enable him to qualify for Medicaid benefits, and the transfer will not cause the Son to recognize taxable income because the special needs trust was a grantor trust for income tax purposes, so that its assets are deemed to be owned by the Son.

Remainder Interest in QPRT - PLR 201131006 . The taxpayer proposed to modify her qualified personal residence trust ("QPRT") to provide that, upon the expiration of the QPRT term, her children (the remainder beneficiaries) are granted the power to direct the trustee to amend and restate the terms of the QPRT so as to provide a renewable term interest to the settlor as a gift by the children. That term interest will allow the taxpayer to continue to live in the house, without payment of any rent. The value of the use of the home from year to year would be treated as a gift from the children to their mother, and would presumedly qualify for the annual exclusion. The IRS ruled that such an arrangement would not prevent the trust from qualifying as a QPRT. The IRS refused to rule on whether this arrangement might result in inclusion in the mother's estate at death under §2036 (probably because the facts did not allow them to determine whether there was any "pre-arranged agreement" with the children.)

Family Partnership / LLC Cases -

Step Transaction Doctrine - Linton v. United States (630 F.3d 1211 (9th Cir. 2011), *aff'g in part, rev'g in part, and rem'g* 638 F Supp 2d 1277 (D. Wash. 2009)). This decision deals with the IRS assertion of the "step transaction doctrine" to the creation and funding of and FLP shortly before or concurrently with the making of transfers of the FLP interests. If the step transaction doctrine is found to be applicable, then the transferor is treated as having transferred the underlying FLP assets rather than a discounted FLP interest. If applicable, the step transaction doctrine would ignore the transfers of property to the FLP and subsequent gift (or sale) of discounted FLP interests, and treat the transaction as a direct transfer or the underlying property.

In this case, the confusion came largely from the attorney's delay in processing paperwork (deeds, etc.) which had been duly executed earlier. Initially, the district court granted the government's motion for summary judgment, finding that the contributions of cash, securities, and real estate were made to the LLC either simultaneously with or after the gifts of the LLC interests to the children's trusts. It also found that the Lintons made indirect gifts to their children's trusts of the cash, securities, and real property under the step transaction doctrine.

The Ninth Circuit saved the attorney from a certain malpractice claim by looking to state law (Washington) to determine when the transfers had actually been completed, and finding that the taxpayer's intent, coupled with execution of the documents and delivery of them to the attorney for processing, constituted completed transfers to the family LLC before they intended to make the gifts of the LLC interests. To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interests to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That risk would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long period to make the transactions distinct)

Bona Fide Sale Test--*Estate of Jorgensen v. Commissioner (*107 AFTR 2d 2011-2069 (9th Cir. 2011)*, aff'g by unpub'd op.* T.C. Memo 2009-66); *Estate of Turner v. Commissioner* (T.C. Memo 2011-209); *Estate of Liljestrand v. Commissioner* (T.C. Memo 2011-259.) These cases all deal with "family limited partnerships" (or LLCs), and failure to satisfy the "bona fide sale for adequate consideration" test of Section 2036 and/or failure to honor the formalities of the partnership as a separate entity after formation.

In *Jorgensen* and *Turner*, the partnerships were funded with marketable securities, cash, and CDs. The courts found no substantial evidence that the partnerships were formed for any material "legitimate and significant non-tax reason" in order to satisfy the Section 2036 test adopted in *Estate of Bongard v. Commissioner* (124 T.C. 95 (2005). In Turner, the court observed that the reasons for formation stated in the partnership agreement seemed to be "lawyer's boilerplate" and had no direct application to the facts applicable to the Turner family.

In *Jorgensen* the court found a lack of any formality honoring the partnership as a separate entity, including findings that the partnership maintained no books and records other than a checkbook that went unreconciled and monthly brokerage statements; there were no formal meetings between or among the partners; no minutes were ever kept; and Ms. Jorgensen used partnership assets to pay personal expenses and paid partnership expenses with her personal assets. Furthermore, the court noted, the partnership lent $125,000 to the son, on which loan he did not regularly pay interest or principal. The court also noted that Col. Jorgensen formed the partnerships without input from his wife and children. The court also held that Ms. Jorgensen retained the beneficial enjoyment of the partnership assets, noting that (i) Ms. Jorgensen retained sufficient assets outside the partnership for her day-to-day expenses, but not enough to make the gifts she wished to make; and (ii) partnership distributions were used to pay transfer taxes, legal fees, and other obligations of the decedent's estate.

In *Turner*, the court found an implied agreement that Mr. Turner would have access to and use of the partnership assets, which “impression is reinforced by a provision in the partnership agreement that gave Clyde Sr. the right, as general partner, to amend the partnership agreement at any time without the consent of the limited partners." The court also noted that (i) Clyde Sr. transferred most of his assets to the partnership; (ii) although the general partners retained sufficient assets outside of the partnership to meet their living expenses, they opted to receive management fees for few or no management services and took distributions from the partnership at will; (iii) the transferors used the partnership assets to make personal gifts, pay life insurance premiums, and pay legal fees related to their estate planning. Clyde, Sr. also commingled personal and partnership funds when he personally paid the partnership's debt to a bank, bought certain property on behalf of the partnership, and reimbursed the partnership for its purchase of certain notes. Clyde Sr. also received disproportionate distributions from the partnership.

In *Liljestrand* the decedent had transferred to the partnership multiple parcels of real estate located in several states. The court found that the assets were not transferred in a *bona fide* sale for an adequate and full consideration in money or money's worth, and that there did not appear to be a legitimate and significant non-tax reason for creating the partnership. This may have been more a lack of objective evidence, or may have flowed from the court's observations that the partnership failed to follow even the most basic partnership formalities, and that it commingled assets during the first two years of its existence, held only one partnership meeting in over 12 years, had no other formal meetings between the partners, kept no minutes of meetings, used partnership assets to pay the decedent's personal expenses (including his housekeepers and personal secretary, his equity line of credit on his home, his mortgage on a Hawaiian condominium, his grandchildren's tuition, and the taxes and expense of accounting services for his children), failed to make the proportionate distributions required under the partnership agreement, and made numerous loans to partners without receiving promissory notes or repayment. Furthermore, the court noted, the decedent was financially dependent upon partnership distributions to maintain his lifestyle and pay his everyday expenses.

VIII. Estate Tax Deductions -

Administration Expense Deduction- Rev. Proc. 2011-48 (2011-42 I.R.B. 527 (October 14, 2011). New regulations issued under Section 2053 limit the ability of the estate to claim an estate tax deduction for debts and claims against the estate which are not actually paid by the time the return is filed. This Revenue Procedure provides guidance regarding protective claims for refund (promised by the preamble to the final regulations) which may be used to preserve the right to claim the deduction at a later time when the amount of the actual liability is established. The procedural rules are very specific and threaten the loss of the deduction if not followed specifically, both as to the making of the protective claim and the processing of the claim after the amount of the liability is paid or any contingency is resolved.

Interest on Loan to Estate - *Estate of Duncan v. Commissioner (*T.C. Memo 2011-255.) This case dealt with the deductibility for estate tax purposes of interest to be paid on debt incurred by the estate for payment of estate taxes and administration expenses, a *Graegin* loan. The estate (and its companion revocable trust) initially determined that it would have an estate tax liability of about $11.1 million, but that it had only about $5 million in total liquidity. To raise the necessary funds to pay federal estate taxes, the estate/revocable trust borrowed $6.47 million from an irrevocable trust created by the decedent, which trust had the same trustees and same beneficiaries as the estate. The loan used a secured note with a fifteen year term and a 6.7 percent interest rate. When the loan was made, the long-term applicable federal rate was 5.02 percent and the prime rate was 8.25 percent. On the federal estate tax return, the estate claimed a $10.65 million deduction for the interest to be paid on the note.

The IRS denied the deduction and argued that the loan had no economic substance because the borrower and creditor trusts were identical and had the same trustees and beneficiaries. The court believed that the IRS was viewing the irrevocable trust and the estate/revocable trust as a single trust with the trustees free to shuffle money between the two trusts. [Note, that is very similar to the much criticized argument on which the IRS prevailed in *Estate of Black v. Commissioner,*133 T.C. 340 (2009)] The Tax Court rejected this argument. First, state law required the trustees to maintain the individuality of the two trusts and not commingle assets. Second, there was no basis in federal tax law for treating the two trusts as a single trust. Thus, the loan created a bona fide debt. The Tax Court also found that the terms of the loan were reasonable, and allowed the full amount of the deduction.

IX. Irrevocable Life Insurance Trusts -

***Crummey* Withdrawal Powers** - The *Turner* court (see above) also dealt with a challenge to the *Crummey* provisions of a trust. Each of Mr. Turner's children and grandchildren was given a *Crummey* power of withdrawal that was effective after each direct or indirect transfer to the trust that was treated as a gift for federal gift tax purposes. Mr. Turner had made indirect gifts to the trust as a result of having paid the life insurance premiums directly to the insurance company. The IRS argued that the withdrawal rights were illusory because Turner did not deposit money with the trustees, so the money was never actually available to be withdrawn, and because the trust beneficiaries were not given proper notice of their rights to withdraw. The court noted that each beneficiary had the absolute right and power to demand withdrawals from the trust after each direct or indirect transfer to the trust (whether or not the withdrawals could be funded with the actual money transferred), and Turner’s failure to transfer money directly to the trust was therefore irrelevant. The court also found that the fact that some or all of the beneficiaries may not have known of their right to demand withdrawals did not affect their legal right to do so. Therefore, consistent with the original decision in *Crummey*, the annual exclusion was allowed.

Substitution Power- Rev. Rul. 2011-28. A grantor’s retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will not cause insurance policies held in the trust to be includible in the grantor’s gross estate under §2042. Such a "swap power" is provided in IRC Section 675(4)(C) and will classify a trust as a "grantor trust" for federal income tax purposes - which is an often desirable result. Earlier, Rev. Rul. 2008-22 had concluded that such a power (if properly constructed) would not cause inclusion of the trust assets in the grantor's estate under Sections 2036 or 2038. Life insurance, however, is includible under Section 2042, so taxpayers had only the decision in *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975) to address the life insurance issue. It now seems clear that the IRS will not pursue inclusion in the grantor's estate under these circumstances, even though it is difficult to align this ruling with some of the positions taker previously by the IRS regarding incidents of ownership in life insurance policies.

X. Discharge of Indebtedness Income -

Proposed Reg. §1.108-9, 76 FED. REG. 20593 (April 13, 2011). Proposed regulations will treat grantor trusts as synonymous with the grantor for some discharge of indebtedness purposes. Sections 108(a)(1)(A) and (B) exclude from gross income any amount that would be includible in gross income by reason of the discharge of indebtedness of the taxpayer, to the extent that the taxpayer is insolvent when the discharge occurs. The proposed regulations will treat references to the “taxpayer" in those subsections as referring to the owner of the grantor trust. Therefore, a grantor trust or other disregarded entity (such as a single-member LLC) is treated as bankrupt only if the grantor or owner is insolvent or bankrupt. This issue was overlooked or ignored in many "financed life insurance" proposals promulgated over the past several years, and will cause recognition of taxable income by the grantor/insured when the policy values are insufficient to satisfy the full amount borrowed.

XI. Charitable Remainder Trust -

Letter Ruling 201126007. The IRS permits a charitable remainder trust to fund the non-charitable interest with commercial annuities. The taxpayer proposed to create a charitable remainder annuity trust that includes an express provision that the trustee may buy commercial annuity contracts to provide for the annuity payment retained by the taxpayer. If the trust otherwise satisfies the requirements for a CRAT, it will qualify.

XII. Estate/Probate Settlement Agreements -

Estate of Palumbo v. United States, (107 AFTR 2d 2011-1274 (W.D. Pa. 2011)). The decedent's Will, which had been the subject of several modifications, omitted any disposition of the residuary estate because of a scrivener's error admitted by the decedent's lawyer. The decedent's son claimed that he was the ultimate beneficiary of the residue, because he was the sole intestate heir. The trustee of a charitable trust that had been the residuary legatee in previous instruments claimed that it was the actual residuary legatee. After bona fide and arm's-length negotiations, which included all of the potentially interested parties, a settlement agreement was reached under which the charitable trust received $11.7 million of the residuary estate, and the decedent's son received $5.6 million and certain real property. The IRS denied the estate tax deduction for the $11.7 million passing to the charitable trust, arguing that the charitable trust had no legally enforceable right to the residuary estate under the Will, so that there could be no *bona fide* dispute, and so no deduction should be allowed. The court disagreed, noting that the law of will construction seeks to find the testator's intent and does not favor an intestacy. The court held that a state court could reasonably hold that the charity, which had been the residuary beneficiary under all prior instruments and was omitted as the residuary beneficiary only by an admitted scrivener's error, was entitled to the estate. Settlement agreements under applicable state law can often cure defects in a poorly drafted document, and result in property passing to a spouse or charity to qualify for the marital or charitable deduction when it would not have so qualified under the terms of the Will. The IRS will usually accept such results except when it thinks that the contest is not bona fide, the spouse or charity has no real interest in the estate, or the settlement is the result of collusive action.

XIII. Loan or No Loan?

Todd v. Commissioner (T.C. Memo 2011-123.) There are many estate planning strategies which include the extension of credit to family members or entities, and numerous cases where loans have been used to enable children to enjoy family wealth after all gift tax exemptions have been exhausted. The IRS has a clear history of looking at such arrangements to see if a true "debtor - creditor" relationship exists, and this decision provides some guidance as to the factors considered.

The taxpayer was a practicing physician, with a practice in which he created certain employee welfare benefit plans in which cash was accumulated in life insurance policies. The plans allowed plan trustees to permit employees to "borrow" money after a stated period of participation, and the taxpayer "borrowed" $400,000. The plan trustees did not obtain a signed promissory note from the taxpayer for six months, and the loan was at a one percent interest rate. The note also provided that, absent the required quarterly payments, the lender could deduct the outstanding loan balance from any payment or distribution due from the trust to the participant or his beneficiary. The taxpayer quit making payments on the note, relying on the alternate payment provision that would allow the trustees to be repaid from the death benefit. The Service treated the $400,000 as taxable income, and assessed a deficiency and a late payment penalty and accuracy-related penalties.

The court stated that that the distinguishing characteristic of a loan is the intention of the parties that the money advanced be repaid. The court looked at seven factors in determining that this did not represent a bona fide loan:

1. The existence of a note or other instrument is indicative of a debtor-creditor relationship.
2. The payment of interest indicating the existence of a *bona fide* debt. Here, the trust agreement provided that a reasonable rate of interest should be charged, but the rate charged was well under that the trustees would pay the insurer to borrow against the policy, suggesting that there was no real debtor-creditor relationship.
3. A fixed schedule for repayment of the debt.
4. Adequate security evidences a *bona fide* debt.
5. Actual repayment, in accordance with the terms of the note, indicates a *bona fide* loan.
6. A reasonable expectation of repayment in light of the economic realities of the situation.
7. The conduct of the parties may be sufficient to indicate the existence of a debtor-creditor relationship.

XIV. Life Insurance and Annuity Matters -

Income on Surrender / Termination of Policy - *McGowen v. Commissioner* (108 AFTR 2d 2011-6063 (10th Cir. 2011), *aff'g* T.C. Memo 2009-285); *Brown v. Commissioner* (T.C. Memo 2011-83); *Sanders v. Commissioner* (T.C. Memo 2010-279); *Ledger v. Commissioner* (T.C. Memo 2011-183.) In spite of some clever taxpayer arguments to the contrary, the courts found it clear that a taxpayer recognizes income on surrender of a policy to the extent of amounts received over the taxpayer's cost in the contract - and the amount deemed "received" by the taxpayer includes any amounts previously borrowed from the policy values to the extent that the loan is extinguished upon termination of the policy. Further, the taxability flows from Section 72, not from "discharge of indebtedness" under Section 108, and is therefore not subject to the "insolvency" exemption of Section 108.

Exchange of Annuity Contracts - Rev. Proc. 2011-38 2011-30 I.R.B. 66. The IRS has issued favorable guidance on partial exchanges of annuity contracts. The general rule is that any partial exchange of annuity contracts will be treated as a tax-free exchange under section 1035, as long as no "boot" amount is received under either the original or the new contract during the 180 days beginning on the date of the transfer (or, in the case of a new contract, the date the contract is placed in-force). An exception is made for receipt of amounts received as an annuity for one or more lives or for a period of 10 years or more. A later direct transfer of all or a portion of either contract involved in such an exchange will not be taken into account for purposes of applying these rules, if that subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange under section 1035.

Transfer for Value Rule. The "Green Book" explaining proposed 2012 fiscal year changes to the tax law recommended by the Administration contains proposed changes to the transfer for value rule applicable to life insurance policies. The rationale for the change is sated as follows, "Recent years have seen a significant increase in the number and size of life settlement transactions, wherein individuals sell previously-issued life insurance contracts to investors. Compliance is sometimes hampered by a lack of information reporting. In addition, the current law exceptions to the transfer-for-value rule may give investors the ability to structure a transaction to avoid paying tax on the profit when the insured person dies." The Administration's proposal would require expanded reporting when a person or entity "purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000." The proposal would also, "modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies." The proposal would apply to sales or assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2011.

Deferred Annuity. PLR 201124008 deals with a deferred annuity contract owned by a non-grantor trust. The issue is whether the owner will be treated as a "natural person" under § 72(u), so that the income tax liability on investment earnings in the contract may be deferred. The ruling concludes that where such annuity contracts are owned by a trust under which all the beneficial interests are owned by natural persons in a non-employment context, the contracts will be treated as being owned by a natural person for purposes of § 72(u).

XV. Asset Protection Issues -

***Mortensen v. Battley*, 2011 WL 5025288 (Bank. D. Alas. Jan. 14, 2011) (summary judgment denied), 2011 WL 5025249 (Bank. D. Alas. May 26, 2011) (memorandum order), 2011 WL 5025252 (Bank. D. Alas. July 8, 2011) reconsideration denied.)** This asset protection trust created in Alaska was recently subjected to the claims of the grantor's bankruptcy trustee. However, that was not the result of any defect in the Alaska trust law, but was the result of a finding by the Bankruptcy Court that the grantor had expressly created the trust "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted" (applying Sec. 548(e) of the Bankruptcy Code applicable to self-settled trusts created within ten years prior to bankruptcy filing)

XVI. Legislation -

Rep. McDermott (D-WA) has introduced an estate tax bill - **H.R. 3467**, or the **"Sensible Estate Tax Act of 2011"** - which lays down a Democratic marker (which is unlikely to become law anytime soon) for permanent estate tax reform with lower exemptions and higher rates. It makes several needed technical corrections to address potential “clawback” issues and problems with portability, but would also restrict short-term GRATs and valuation discounts. For the first time, legislative language is introduced in this bill to impose a federal limit on perpetual trusts. Would unify the gift tax, estate tax, and GST exemptions at $1 million, with rates again reaching a top level of 55%. With some important exceptions, the bill would be effective for decedents dying and gifts made after December 31, 2011.

The **“America Invents Act”** (Public Law 112-29) was enacted on September 16, 2011. It provides that tax strategies may not be patented because they are “deemed insufficient to differentiate a claimed invention from the prior art.”