Estate Planning by Casner and Pennell, §7.2, Taxation of Completed Gifts

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Notwithstanding the attraction of nontaxable inter vivos transfers, a discussion regarding the economics of prepaying wealth transfer tax[1] reveals that incurring gift tax on a completed, taxable, inter vivos transfer is preferable to holding wealth and incurring an FET instead.

Perhaps the first thing to recognize is the almost too obvious point that it is essential to know what is the subject of the gift. It may be that the typical gift is an outright transfer of property easily identified, with valuation based on accepted principles and easily determined. For example, a transfer of a fixed number of shares of publicly traded securities would be easy to evaluate. Only slightly more difficult would be a gift about which there might be some valuation uncertainty, such as a used automobile, but as to which the principles at work are equally simple, the donee is clear, and the gift tax consequences are unremarkable. Some inter vivos transfers in the estate planning context are this direct and easy, but the ones for which costly advice is employed likely create more uncertainty.

For example, a transaction may not look exactly like a gift — because there is a sale element — but the amount paid is less than full and adequate consideration in money or money's worth. If the bargain element is not just a bad deal among parties dealing at arm's length and without donative intent,[2] then a part-sale, part-gift transfer probably occurred and this would create its own special consequences. These would include valuation of the gift element (the FMV of the transferred property, in excess of the consideration received),[3] capital gain or loss on the sale portion (based on the amount realized in excess of the transferor's full basis in the property transferred), and basis to the transferee (being the greater of the transferee's cost or the transferor's carryover basis, not to exceed FMV for purposes of determining loss).[4]

Harder yet would be a transfer of a temporal interest in property. This would not be a vertically sliced fractional portion, such as half ownership as a tenant in common in that used car, in which case fractional or minority interest discount valuation questions might arise[5] but otherwise the issues would be no more complicated. Instead, it would be a horizontally sliced interest like a life estate or term of years (or the remainder following either), raising yet again more challenging questions of valuation and the proper gift taxation of the transfer.[6]

To illustrate, the regulations provide that standard valuation tables for split interests may not be used to value temporal interests if they may produce unreasonable results because the individual who is a measuring life is known to be terminally ill. "Terminally ill" is defined to mean suffering from an incurable illness or other deteriorating physical condition that would substantially reduce the individual's life expectancy.[7] The same regulations provide in this regard that an individual is "considered terminally ill" if there is at least a 50% probability that the individual will die within one year. If, however, the individual survives for 18 months or longer, then the person "shall be presumed to have not been terminally ill … unless the contrary is proved by clear and convincing evidence." Thus, the valuation of temporal interests will generate difficult factual issues in some circumstances.

Finally, perhaps hardest of all (because it may not be clear that transfer tax consequences are involved at all), a disguised or indirect gift may be involved in a property transfer or transaction, requiring that the gift itself be identified before the nature of that transfer and the relevant valuation rules can be applied. By way of example, a demand loan to a child for less than a market rate of interest[8] or a transfer subject to a price adjustment provision that the government regards as invalid[9] might involve taxable gifts that were not obvious or intended. To properly plan for these transactions requires first that the gift transfer be identified, and then the other valuation and related gift tax issues be addressed and resolved.

§7.2.1 *Strategic Gifting Illustrations*

With this in mind, TAM 9504004 illustrates a number of these gift tax factors. The decedent died within six months after being diagnosed with cancer. Within the last month of the decedent's life and following several unsuccessful therapies and one serious hospitalization, the decedent sold half and redeemed half of a 60% controlling shareholder interest, leaving the decedent with no interest and putting one child in control of the corporation. Each half of the decedent's interest was valued with a minority discount and the private annuity paid by the child for the sale portion was computed on the basis of the decedent's life expectancy determined under the mortality tables rather than on the basis of the decedent's actual life expectancy in light of the cancer.

Only one payment was received before the decedent's death, representing 1.3% of the total purchase price. The redemption portion of the transaction was in exchange for cash and notes issued by the corporation, and those were transferred by the decedent to a CLUT that paid a unitrust interest to a charity for a term measured by the decedent's life, again based on mortality assumptions and not the decedent's actual terminal condition. Total payments made to the charity were 0.8% of the value claimed for §2522 charitable deduction purposes and the value of the gift of the remainder interest reported by the decedent was 34.3% of the total value of the property transferred notwithstanding that the remainder beneficiaries acquired the property one month later.

In this context the government held that the standard mortality tables were not properly employed to value the various annuities, unitrust interests, or remainders for gift tax purposes. Moreover, by regarding the sale and redemption as a single coordinated transaction, the TAM deemed the decedent to have transferred a 60% interest and not two discounted 30% minority interests, thereby disallowing the claimed minority discounts.[10] The whole package of transactions was "aggressive" and if the decedent had lived long enough for the §7520 mortality assumptions to bind the government, then less substantial wealth transfer tax saving would have resulted than the parties anticipated.

Far more dramatic results actually were obtained in Estate of McLendon v. Commissioner,[11] the litigated case that a comparison of the facts reveals almost without question was the situation involved in TAM 9133001. For ease of explanation, and because it illustrates several aspects of the gifting analysis and the government's positions, the TAM is discussed here in some detail, along with the courts' conclusions in *McLendon*. Several aspects of each stand out.

§7.2.1.1 Formula Adjustment Provisions

A saving clause provision was included in the transaction specifying that the purchase price would be adjusted in response to any valuation agreement reached with the government or any determination of value rendered in a final decision of the Tax Court. The TAM characterized the saving clause as making the transfer "void" as to that part of the property transferred that was subject to gift tax.[12] The TAM held that the business transaction exception to the gift tax[13] could not apply because it is reliant on the absence of donative intent underlying the transaction.[14] And the structure of the transaction was deemed to be donative, the TAM stating that, "had the annuity agreement been executed between the decedent and a third party who was not a family member, the estate would have most likely taken action to set the transfer aside . . . ." Indeed, the government's position was that the price adjustment clause indicated that the transaction was not a bona fide arm's length business arrangement because the parties were willing to pay whatever the government or the Tax Court established as the proper value of the underlying assets.

The Tax Court essentially agreed with the government that the adjustment provision was invalid, stating that the taxpayer was "an astute and sophisticated businessman [who] would not have entered into a similar arrangement with an unrelated third party."[15] Consequently, the provision was deemed to lack bona fides and the court concluded that the adjustment provision should be ignored. Nevertheless, provisions of this ilk are not necessarily or even predictably invalid, as more recent litigation reveals.

The price adjustment provision involved in the TAM sometimes is known as a King clause after King v. United States,[16] which held that a provision designed to establish full and adequate consideration based on the government's determination of value is not invalid. The antithesis is a so-called Procter provision, which was regarded by Commissioner v. Procter[17] as a condition subsequent on a gift transfer that must be ignored for public policy reasons. To illustrate the difference, consider the planning involved in FSA 200122011. The provision was designed to dissuade the government from challenging the valuation of an inter vivos transfer. Basically it specified that any increase in the value of difficult to value assets (in that case interests in an FLP) would constitute a gift to charity, such that any increase in value would be matched with a charitable contribution deduction. That would produce a wash to the government and prevent it from benefiting from the valuation challenge in the first instance. For just that reason the government regarded that price adjustment provision as invalid, asserting that it contravenes the public policy pronounced in *Procter*.

McCord v. Commissioner[18] may be the same case as the FSA. In a footnote 47 in a very lengthy and controversial decision the Tax Court dodged the issue by misconstruing the provision itself, and the court on appeal dodged the issue entirely, saying that the government did not pursue it in its arguments, all leaving concern and doubt lingering about this form of planning.

TAM 200245053 similarly regarded a provision as invalid because the government perceived it to be an effort to discourage litigation. That clause was a good bit different, however, and involved a multi-tier transaction with a gift of a 0.1% interest in an FLP, a sale of a 98.9% interest in the same partnership, and a formula provision designed to negate any gift in the sale transaction. The formula keyed off the gift tax value established from the sliver interest gift, the apparent purpose being to negate a *Procter* challenge by giving the government a potential tax to collect if valuation litigation was successful (albeit any gift tax would pale relative to the vastly more valuable sale transaction). The government regarded the formula sale provision as flawed and distinguished *King*[19] because it was an arm's length transfer in the ordinary course of business whereas the taxpayer in the TAM was trustee of two trusts that engaged in the transfers and the partnership itself bespoke an effort to depress values rather than to obtain a fair price from a disinterested outsider.

The TAM distinguished other forms of formula adjustment provisions that are valid because they are not manipulative, unlike the subject provision, citing marital deduction formula bequests that are keyed to values that cannot be known at the time of drafting and that serve a "legitimate" planning purpose, suggesting that formula provisions influenced by the type of mala fides found in a *Procter* type clause or the subject provision should fail. Such a distinction might be meritorious, but TAM 200337012 threw notions of bona fides into confusion in holding that a benign provision that merely specified that the taxpayer "desires to transfer as a gift … that fraction of [taxpayer's] Limited Partnership Interest in Partnership which has a FMV on the date hereof of [$X]" was invalid. It is not readily apparent how this provision operates any differently than the implicit understanding that a customer will return the incorrect amount if a store clerk delivers too much change to that customer, all according to the implied terms of any common sale transaction. If a provision such as this is not good, it is hard to imagine a formula provision that is acceptable. As it turns out, this TAM may have been the situation involved in Petter v. Commissioner[20] and, as noted below, the court did not regard it as improper.

More important than *Petter*, and predicting that result, the Tax Court in Estate of Christiansen v. Commissioner[21] approved the provision over the same *Procter* objection as the government raised in opposition to the formula gift provision in *McCord*, stating:

> We do recognize that the incentive to the IRS to audit returns affected by such disclaimer language will marginally decrease if we allow the increased deduction for property passing to the foundation. Lurking behind the Commissioner's argument is the intimation that this will increase the probability that people . . . will lowball the value of an estate to cheat charities. There's no doubt that this is possible. But . . . executors and administrators of estates are fiduciaries, and owe a duty to settle and distribute an estate according to the terms of the will . . . [and] the state attorney general has authority to enforce these fiduciary duties. . . . We therefore hold that allowing an increase in the charitable deduction to reflect the increase in the value of the estate's property going to the Foundation violates no public policy and should be allowed.

Notwithstanding the suggestion that the government's concern is the incentive to cheat charities, the Tax Court acknowledged earlier in the majority opinion that the real issue is a lowball FET valuation. In cases that do not involve a charitable component it is possible that the lack of state Attorney General involvement could persuade the court to rule otherwise, although the same fiduciary duties would exist regardless of the ultimate beneficiary of the disclaimer.

Following *Christiansen* it was no surprise that *Petter* carefully distinguished an invalid *Procter* type of saving provision (one that "tries to take property back" if the government asserts a gift tax liability), from the formula provision in *Petter* that "gives away a fixed set of rights with uncertain value," defined by a formula that refers to an ascertainable amount. Indeed, the *Petter* gift was quite similar to a formula credit shelter pecuniary bequest, with a residuary marital. The taxpayer's gift (to trusts for children) was of "the number of Units [in an FLP] that equals . . . the [maximum] dollar amount that can pass free of federal gift tax by reason of [the taxpayer's] applicable exclusion amount." The balance of the FLP units were given to charity.

The challenged provision required the trusts to remit to the charity any excess "if the value of the Units . . . is finally determined for federal gift tax purposes to exceed the amount" described in the formula gift of the applicable exclusion amount, and the charity likewise was required to return units to the trusts if a valuation error favored the charity. The *Petter* formula provision was a bona fide effort to effect a legitimate division of a hard-to-value asset between recipients — which happened to include charities. The Tax Court specifically found that the charities "conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests," leaving the court "confident that this gift was made in good faith" — the opposite of the mala fides in *Procter* — and that "we find that this gift is not as susceptible to abuse as the Commissioner would have us believe." Channeling *Christiansen*, the Tax Court also concluded that "[w]e simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax. We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits."

There is a distinction between "adjustment clauses" that alter a gift or purchase price retroactively, and "definition clauses" that work simultaneously with a transfer to establish the amount involved in a transfer ab initio. Arguably only the former should be subject to invalidation arguments under the condition subsequent analysis of *Procter*.[22] *Christiansen* and *Petter* fall on the "definition" side of that distinction and, not in so few words, support that analysis. Such that, today, it seems relatively predictable that a properly crafted formula adjustment provision will pass muster in the Tax Court.[23]

§7.2.1.2 Reliance on Mortality Assumptions

The other controversial aspect of these cases involved taxpayer reliance on mortality assumptions. For example, the taxpayer in *McLendon* sold a remainder interest in various assets that otherwise would have been §2033 includible in the decedent's gross estate at death, including the decedent's general partnership interests in various family enterprises and "the decedent's rights in" the business' pension plan. Valuation for purposes of this transaction was pursuant to the regulation mortality tables that, at the time, presumed that a person the decedent's age would live another 15 years.[24] The transaction was designed to fully capitalize on valuation presumptions based on the decedent's actuarial life expectancy, and the purchase price for this remainder interest sale was payable as an annuity for the decedent's life, also determined using the government's mortality assumptions notwithstanding the decedent's diagnosed terminal illness, which actually resulted in death within seven months.

The TAM stated that:

> The actuarial tables . . . take into account that the health of a particular person may be somewhat better or worse than the health of an "average" person of the same age. But it has been a longstanding position of the Service that, because the actuarial tables are compiled from statistical data of the general population, the tables were never intended to apply to a case in which the measuring life is an individual who is

> afflicted with an advanced stage of an incurable disease.[25] For example, if, on the valuation date, an individual was afflicted with a fatal and incurable disease, and it was apparent that the individual's life expectancy was one year or less, the impending date of the individual's predictable and imminent death would be at considerable variance from the life expectancy factors provided by the valuation tables. In such a case, departure from the valuation tables would be required. Thus, based on the facts and circumstances of the particular case, where, because an individual's death is (1) imminent within a year, and (2) predictable, the actual facts of the individual's condition on the valuation date are so exceptional that departure from the actuarial tables is required, and the present worth of the particular life estate, remainder, or annuity, as the case may be, is determined by the individual's actual life expectancy on the valuation date.[26]

The government thus determined that the mortality assumptions in the tables could not be used. As a consequence, the remainder interest was valued much higher and the annuity much lower than the tables assumed, and the consideration paid for the transfer was deemed to be less than full and adequate, resulting in a gift.[26.1]

The TAM focused extensively on the apparent intent of the parties, particularly in view of the decedent's diagnosis, prognosis, and actual date of death. According to facts detailed at length, the buyers of the remainder interests regarded the transaction as "a gift in lieu of an inheritance" and, probably more importantly, lacked the resources to make the annuity payments if the decedent did not die. For example, having purchased only a remainder interest, they were not able to rely on the purchased asset to provide the cash flow to meet their obligations.

This focus on the parties' apparent intent should have been relevant only with respect to the business transaction exception. Otherwise, under the gift tax donative intent is not required to constitute a transfer as a gift. Instead, unless that exception for transfers in the ordinary course of business lacking in donative intent is applicable, the only requirement for gift tax purposes is a transfer for less than full and adequate consideration in money or money's worth.

On appeal the taxpayer ultimately prevailed, the court finding that the taxpayer's reliance on the mortality tables was justified and that the government could not deviate from its own published criteria for application of them. The transaction involved in *McLendon* predated the adoption of §2036(c) and its replacement Chapter 14 and, as discussed next, the *McLendon* transaction no longer would be viable for affirmative planning, given the effect of §2702 on the sale of a remainder interest transaction. That the transaction was abusive is easy to recognize from the facts involved.

The need for §2702 as remedial legislation is illustrated by the results the taxpayer obtained in *McLendon*. Whether the government successfully could have repelled such results in other litigation with the type of analysis applied in the TAM is unclear, and may never be known. Congress made inquiries into intent and other subjective factors irrelevant with its adoption of §2702. With promulgation of the §7520 regulations[27] the government took further steps to eliminate the abuse in the *McLendon* split interest transaction that depended on life expectancy. Nevertheless, notwithstanding all these changes, planning opportunities remain viable, to the extent the mortality tables are applicable under the new standards, also as discussed next.

As one easy example, the mortality assumptions are based on unisex factors, which overstate the life expectancy of men and understate the life expectancy of women. This means that an interest measured by the life of a man is overvalued (men die on average earlier than do women, and younger than the blended unisex tables predict, meaning that the interest measured by a man's life actually will run for a shorter time than the tables predict) and for the same reason a remainder interest following an interest measured by the life of a woman is overvalued under the tables. Understanding just those glitches in the tables can allow planning that takes advantage of the fundamental inaccuracies in the tables.

§7.2.1.3 Reliance on Income Projections

Before turning to that topic, however, one last illustration shows why §2702 was necessary to address inaccuracies in the evaluation of income entitlements. Although O'Reilly v. Commissioner[28] also was mooted by adoption of §2702, the issues involved have continuing wealth transfer tax significance and illustrate the merits of §2702. The taxpayers created several GRITs to which they transferred stock in a family corporation that historically paid dividends of less than 0.2% of FMV. At issue was whether either the retained income interest or the transferred remainder interest could be valued using the §2512 valuation tables — which assumed (at the time of the gifts involved) a 10% annual income yield (the tables produced a value for the income interest of just over $100,000, but the amount of income actually paid was $1,800).

The position adopted by the §7520 regulations[29] regarding underproductive property was designed to overcome the result reached by the Tax Court in *O'Reilly*. It held that the valuation tables must be used notwithstanding the yield, noting that, to hold otherwise "would be opening up Pandora's box in that we could have to decide, in every case, where the line should be drawn in terms of the dividend potential of stock for the purpose of determining whether the actuarial tables should be used."[30]

In support of its holding, the court noted that *O'Reilly* was distinguishable from cases like Calder v. Commissioner,[31] in which the Tax Court refused to rely on the valuation tables because the gifted property was non-income-producing and there was no assurance it would be sold and the proceeds reinvested in income producing property. In *Calder* the issue was whether the gift tax annual exclusion was available for the gift of a present interest. In *O'Reilly* the issue was only whether the tables or some other method should be used to value the gifted interest.

The Tax Court also took notice in *O'Reilly* of the fact that "there are a substantial number of publicly held corporations whose dividends represent less than a 1-percent yield."[32] It also stated that the valuation tables incorporate a market rate of return based on fixed obligations, such as Treasury bills, and that "a comparison of yield on these two types of securities is like mixing apples and pears."[33]

In reversing on appeal, the court first confirmed that it is only in unusual cases that deviation from the tables is justifiable, but then embraced the principle that:

> whenever use of the tables would produce a substantially unrealistic and unreasonable result, and a more reasonable and realistic means of determining value is available, the statute requires, and decades of case law confirm, that the tables may not be used by either the Commissioner or the taxpayer.[34]

Finding that the tables would produce such a deviant result and that the history of dividends paid on the stock was adequate to allow its use as an alternative, the court remanded to the Tax Court for a redetermination of value based on that evidence. It also ruled that (1) the taxpayer was entitled to rely on the tables for valuation in the first instance and (2) the government bore the "considerable burden" of proving that the tables produced an improper result. In the process the appellate court rejected the government's assertion that, if the tables produce an unreasonable value, the only alternative must be to value the retained income interest at zero.

The precise result advanced by the Commissioner (and rejected) in *O'Reilly* was enacted as §2702. A gift of 100% of the value of the underlying property transferred to the GRIT, as if the retained income interest was valueless. The court's overall conclusion is significant nevertheless, holding that the valuation tables may not be used simply because they facilitate simplified administration of the tax laws. Instead, they must be used only if they do not produce unreasonable and unrealistic results such as those produced in *O'Reilly*.[35]

As with any discussion of the legal aspects that inform inter vivos planning strategies, change is inevitable and a myriad of factors influence proper recommendations. There are so many factors to consider, ranging from the nature of the assets involved and their income or growth potential, the risk tolerance of the transferor, the need or demand to exert continuing control over the transferees or the transferred assets, the presence of charitable motivations, the mortality and income yield assumptions that apply and their reality in terms of the actors and assets involved, and the income and wealth transfer tax landscape and consequences of various alternatives, as well as the potential for change in those laws.

Few recommendations in this forum are reliable for an extended period of time, but cited in the margin is a wonderfully complete (albeit necessarily complex) matrix of decisional criteria that may help readers analyze alternatives and that some might regard as necessary reading in the process of evaluating strategic opportunities.[36]

§7.2.2 *Special Valuation of Temporal Interest Transfers*

Adopted in 1990,[37] §2702 is a special valuation rule that applies to determine whether a gift has been made and its value. It involves retained and transferred interests in trusts or trust equivalents for the benefit of family members,[38] such as the income interest in a GRIT with a child as remainder beneficiary. The perceived abuse in this arena is the form of misvaluation in *McLendon* made possible under the valuation tables that apply to temporal interests.[39] To combat that this rule specifies that the value of any retained temporal interest (like a life estate or term of years) that is not a "qualified interest" is zero for gift tax purposes. Thus, gifts of trust interests are deemed to carry all the value of the trust corpus at original transfer of the remainder interest (and, presumably, at any subsequent transfer of less than all of the retained interest).[40]

§7.2.2.1 Trust Equivalents

A "trust equivalents" rule specifies that §2702 applies to the transfer of any interest in property with respect to which there is one or more term interests, because these are equivalent to a transfer of an interest in a trust.[41] One easy example would be a transfer of property with a reserved legal life estate. Another is an insurance policy beneficiary designation under which the designated beneficiary opts to leave the proceeds on deposit with the insurer with terms that mirror those of a life estate in trust and remainder to a third party. It also is possible that this rule could be applied to a transfer of property in exchange for a private annuity.[42]

On the other hand, there is no definitive guidance on whether the transfer of realty subject to an outstanding lease in favor of the transferor, or a transfer into a joint tenancy or tenancy in common, is subject to §2702. But it seems relatively clear that these transactions were not meant to be covered by the zero valuation rule. For example, a lease and the rental expense thereunder are not ignored under Treas. Reg. §25.2702-4(b) in determining the value of transferred property if the lease is for full and adequate consideration. PLR 9638016 also held that §2702 does not apply to a corporate redemption in which the corporation retained the rental payments but transferred to shareholders the reversion following certain ground leases. It cited legislative history and stated that §2702 need not apply because the shareholders would have substantially identical interests before and after the proposed redemption.[43]

§7.2.2.2 Qualified Interest Exception

The §2702 zero valuation rule does not apply if the interest retained by the transferor is a "qualified interest."[44] The logic behind this exception lies in the defects in the §7520 split interest valuation regime, which the qualified interest rules in §2702 effectively negate.

For example, the value of a straight term interest under §7520 is dependent upon interest rate and mortality assumptions that typically overvalue straight income interests and undervalue the remainder interests that follow them. This occurs because the §7520 interest rate assumption is 120% of the AFR, which seldom (if ever) is attainable by a trust because of prudent fiduciary investment confines. Moreover, §7520 valuation relies on mortality assumptions based on the general population and these transactions typically are engaged in by taxpayers who believe — based on a diagnosis, family history, or just general feelings regarding their physical well-being — that they will "beat the odds" by dying earlier than the tables predict. Further, if the measuring life is a male the unisex mortality assumptions also overstate life expectancy. As a result of these glitches, any retained interest that is based on a mortality component (such as a private annuity) tends to be overvalued and a gift of the following interest is undervalued and therefore subjected to less tax than it should be.

Because it is the remainder interest that is transferred in a GRIT and related transactions, straight §7520 valuation typically produces disadvantageous results to the government in these transactions. So the qualified interest exception imposes requirements that are designed to minimize these misvaluations.

The key to understanding the qualified interest requirements is to recognize that they were modeled after the noncharitable interest in a §664 qualified CRT. Those requirements were created to better assure proper valuation for charitable deduction purposes of the remainder interest in a split interest trust. In this case the requirements assure more accurate valuation of the gifted remainder interest in a typical split interest transfer.

Thus, qualified interests are defined as (1) annuity interests that guarantee distribution of a fixed amount annually, or (2) unitrust interests that guarantee distribution of a fixed percentage of the annually determined FMV of the trust, payable annually. In addition, a qualified interest can be (3) a noncontingent remainder interest following either of the annuity or unitrust qualified interests.[45] Within these boundaries, valuation is more precise (as it is under §664 for charitable deduction purposes), because it reflects the fixed absolute annuity or percentage unitrust distribution.

No provision is made to reflect the potential for delayed payments, and no regime is established for payments that are not made, because these payments *must* be made. This mandatory payment requirement makes a commutation power in a qualified interest trust impermissible.[46] It also explains why TAM 9604005 concluded that payment by issuing notes is not permissible. Involved was an annuity that purportedly was paid by the trust distributing cash that was received from the annuitant (actually involving an intermediary that the TAM ignored) pursuant to interest free loans (that would become interest bearing only if the trust ceased to be a grantor trust) in exchange for notes calling for balloon payments in the future. The TAM characterized this approach as constituting deferred payments in violation of the annual payment requirement.[47]

In addition to the fundamental annuity or unitrust interest requirement, there are a slew of additional technical drafting requirements.[48] For example, in both annuity and unitrusts, income in excess of the annual distribution amounts may be paid to or for the benefit of the transferor[49] (or to any other applicable family member retaining the qualified interest), but this interest is ignored for valuation purposes under §2702. Moreover, no other beneficiary may receive an interest in the trust during the term. Then, by virtue of this, the government in numerous PLRs in the mid-1990s required that these trusts mandate distribution of an additional amount in excess of the retained annuity "to reimburse the grantor for any federal income tax paid by the grantor attributable to any trust income in excess of the [annuity]." These additional payments are ignored in valuing the retained qualified interest (and therefore do not reduce the gift made in the form of the transferred trust remainder interest), all to preclude the grantor's payment of income tax on trust income from constituting a form of constructive addition to the trust that bestows an indirect untaxed increase in the value of the remainder.[50]

Furthermore, unlike a CRUT, the requirements under §2702 do not permit distribution to be limited to just all income earned for the year. Also, in both annuity and unitrusts, the governing instrument must (1) prohibit commutation of the retained interest, (2) contain provisions relating to the computation of the guaranteed payment in a short tax year, and (3) if the guaranteed payment is expressed as a fraction or percentage of the initial FMV of the trust, contain a provision adjusting the guaranteed amount if the initial FMV is determined incorrectly. Further, (4) annuity trusts must prohibit additions to the trust, (5) remainder interest trusts must prohibit payments of income in excess of the guaranteed payment amount, and (6) "each remainder interest must be . . . payable to the beneficiary or the beneficiary's estate in all events."

A fixed payment equal to the greater of $X or a percentage of the trust FMV is permissible and recognized for valuation purposes to the extent of the *greater* of the two payments,[51] and a payment that increases at no more than 20% annually is permitted.[52] But an annual payment limited to the *lesser* of the fixed percentage or a specified dollar amount (or all the trust income) is impermissible.[53] Term interests for the *shorter* of the life of the term interest holder or a specified period are permitted, but those for the *longer* of those periods are forbidden.[54]

Illustrating several of these principles and requirements was the GRAT in PLR 9351005, in which a 15 year grantor retained annuity was supplemented annually (as was the case in PLR 9345035) with an amount equal to any increase in the grantor's income tax attributable to the trust being a §675(4)(C) grantor trust. In addition, the annuity would terminate early on the death of the grantor. The government held that the trust met the requirements of §2702 and the annuity could be subtracted from the value of the property transferred to the trust to determine the amount of the gift on creation. But the Ruling also held that the supplemental amount could not be factored into the determination of the value of that annuity because only the minimum amount guaranteed to be paid annually qualifies for computation purposes.

Collectively, these various rules are meant to preclude beating the government on income yield because the annuity or unitrust amount must be paid regardless of the actual yield in the entity. And mortality assumptions are not a source of abuse under the qualified interest regime because §2036(a)(1) inclusion at the transferor's death will apply if the grantor does not outlive the term annuity or unitrust.[55] Thus, the transferor's premature death is irrelevant, because no value escapes wealth transfer taxation. In addition, life expectancy is irrelevant to the valuation of a term of years.

Other more subtle consequences are generated by the qualified interest requirements and they typically favor the government. For example, the §7520 interest assumption (120% of the annual midterm AFR interest) usually is far greater than the typical trust can produce. If the assumed rate is lower than the retained annuity rate the valuation rules anticipate that trust corpus will be invaded to satisfy the annuity or unitrust payments. That invasion would reduce the amount passing to the remainder beneficiaries, and lowers the value of the gift of that remainder interest. If the trust is expected to produce more income than the rate assumes, then that invasion is not likely, excess income is expected to be accumulated, the remainder is deemed to be worth more, and the valuation rules work to the taxpayer's disadvantage. Put another way, if the assumed rate (remember, 120% of the federal annual midterm rate) is higher than the trust actually can generate, the rules impose more tax on a higher assumed value of the remainder than is proper.

This misvaluation of the remainder does not apply in a GRUT because interest rate assumptions are irrelevant for unitrust valuation.[56] But GRUTs are not favored in most planning for other reasons — most notably because the unitrust amount paid to the transferor grows as the trust grows in value (and, thus, less value is shifted to the remainder beneficiary) and because trust corpus must be revalued annually.

The valuation rules ignore the possibility of corpus valuation fluctuations due to appreciation or depreciation, or due to invasions. They assume the trust corpus is frozen in value (or that it grows due to accumulations), notwithstanding that it actually may decline in value due to invasion. Thus, for gift tax purposes, a transferred remainder interest may be smaller than the valuation rules assume, and more gift tax may be imposed on creation of the trust than is appropriate. But the transferred remainder interest also might prove to be larger than the valuation rules assume, in which case the gift tax is a bargain. Thus, selection of a term the transferor will outlive, a rate the trust can afford to pay, and assets that will grow without incurring gift tax all are fundamental to the economics and ultimate success of this planning.

§7.2.2.2.1 *Zero Gift GRATs*

On occasion the government asserts in the valuation process that a retained qualified interest is worth less than the tables appear to indicate and, therefore, that a gift of a remainder interest following that retained annuity interest is worth more than expected for gift tax purposes.

An annuity that is designed to equal 100% of the value of property transferred to a trust that will pay the annuity may be deemed to be worth less, based on an assumption that the annuity may end prematurely.[57] To illustrate, the taxpayer in PLR 9239015 proposed to create a two year GRAT that would terminate before the two year term expired if the settlor did not survive that entire period. The annuity amount was selected to produce a retained interest valued at 99.171% of the property transferred and a gift of only the balance. In the course of the Ruling the government stated that the annuity amount would exhaust the corpus of the trust prior to expiration of the term, because the payout amount for the term produced a value under the tables of 100% or more.

As a result, "the value of the retained annuity interest [would be] the present value of the right to receive the payments [only] until the fund exhausts or until the prior death of the annuitant, rather than the value computed from the actuarial tables based on the stated term of the trust." An annuity for this shorter term is worth less than the tables otherwise would indicate for the term indicated in the agreement. Therefore, a larger gift of the remainder would be made. Thus, because the fund might be exhausted or the annuitant might die prematurely, the Ruling held that a taxpayer cannot engineer an annuity to produce a retained interest value of exactly 100% of the value of the property transferred and a remainder valued for gift tax purposes at zero.

The Ruling explained that, "[if] the annuity amount will exhaust the funds of the trust precisely at the termination of the trust, the value of the retained interest cannot equal the amount transferred to the trust because of the possibility that the grantor may die before the expiration of the term of the trust." In essence, the government's position is that there must be some value to a remainder interest and, therefore, a gift of some amount.

It may be possible to successfully challenge the government's position, but it also may be prudent to structure transactions on the assumption that the government's position is correct[58] and to recognize that the remainder interest in a GRAT or a GRUT may have a greater gift tax value than a simple determination under the actuarial tables may assume. Difficult problems will arise in reporting the value of such a gift, absent a request for a ruling on a proposed transaction.[59] That will make it difficult to know with precision the amount of unified credit used on a particular transfer or remaining at death. And the possibility for a valuation challenge many years after making a transfer exists due to the government's position on the effect of the gift tax statute of limitation in §2504(c) if no gift tax return is filed, adequately disclosing the transaction.[60] All this may speak in favor of planning that is not dependent on precise determinations, through the use of formula provisions.[61]

The opinion in Estate of Shapiro v. Commissioner[62] should be considered before conceding the government's position. The government raised the issue of valuation of a life annuity for §2013 purposes and argued unsuccessfully in *Shapiro* that the valuation tables could not be used because, if the annuitant lived to age 109 (the greatest attained age recognized in the tables), the trust paying the annuity would be exhausted prior thereto. According to the Tax Court, the potential for invasions of corpus to make the annuity payments and eventual exhaustion of the trust is not grounds for converting the valuation from a straight life annuity to an annuity for a lesser term certain that would produce a lower valuation, stating:

> the mere risk of corpus depletion does not restrict the duration of decedent's interest . . . to a "term certain" for valuation purposes. . . .
>
> Taking [the government's] argument to its theoretical conclusions, *any trust* created with corpus funds equivalent to the present value of a lifetime annuity obligation . . . would have insufficient funds to sustain the annual payments should the annuitant live beyond his or her average life expectancy. In this regard, [the government's] argument contravenes the fundamental purposes and presumptions underlying the actuarial tables.[63]

Promulgated after its loss in *Shapiro*, the government's §7520 regulations indicate that the standard valuation tables will not be used for valuing life estates, terms of years, annuities, and other temporal interests if "the use of standard actuarial tables would produce unreasonable results." As applied in the case of an annuity, the regulations adopt the position directly rejected by the Tax Court in *Shapiro*, stating that:

> an annuity payable from a trust or other limited fund . . . is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate, the annuity is expected to exhaust the fund before the last possible payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110.[64]

As illustrated by an example in the regulations,[65] this means that an annuity payable from a fund that could self-exhaust (because the annuity exceeds the §7520 interest rate and, therefore, the tables must assume that corpus will be invaded to make the annual payment) essentially is treated as a term annuity rather than a life annuity, with the term being 110 years less the starting age of the annuitant. The result is that an annuity that ends upon the annuitant's death before reaching age 110 may be misvalued. As illustrated by an example, this position is not applicable "if the amount of the annuity payment (expressed as a percentage of the initial corpus) is less than or equal to the applicable section 7520 interest rate at the date of the transfer . . ." which may make it harmless in some situations. But in the case of payments from trusts created after the 2008 economic meltdown, when the §7520 rate was very low, the government's position is very significant. And it may need to be litigated to test its validity under the holding in *Shapiro*.

These trusts may be effective for value shifting purposes notwithstanding the government's position if significant growth is expected and annuity (or unitrust) payments can be made without a net decline in the value of trust corpus.

Imagine for discussion purposes that a zero gift GRAT or GRUT *can* be created. How should the adequate and full consideration exception to §2036(a) apply in such a situation? The government addressed this question in the preamble to final Treas. Reg. §20.2036-1(c)(2) by comparing a GRAT or a GRUT to the creation of a trust with retention of the entire income interest, stating that:[66]

> the full and adequate consideration exception . . . does not apply [because] [t]here is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a third party. In a bona fide sale, there is a negotiation and agreement between two parties, each of whom is the owner of a property interest before the sale; each uses his or her own property to provide consideration to the other party in exchange for the property interest to be received from the other in the sale. When the transferor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property to a third party in exchange for an annuity because there is no other owner of property negotiating or engaging in a sale transaction with the transferor. The transferor, instead, is transferring the property subject to a retained possession and enjoyment of, or right to, the income from the property.

These statements are not correct — particularly to the extent the GRAT or GRUT payments exceeded the income that would have been generated before death. Indeed, the government is being completely disingenuous to the extent it would compare a short term GRAT or GRUT to a transfer with a retained income interest for life. For example, the annuity or unitrust payments in a two year GRAT or GRUT would exceed 50% of the value of the trust on creation,[67] making this look totally different from the traditional §2036 transfer with retained income interest.

Even if the adequate and full consideration exception to §2036 does not apply (which is not a concession that taxpayers should make), the result in these regulations is improper for another reason. Inclusion of the annuity amounts already received premortem, plus the value of the right to receive any remaining annuity payments that will be made to the estate postmortem, along with the underlying corpus of the GRAT or GRUT itself, is a form of double inclusion as to which the §2043 consideration offset rule should apply. In these cases, §2043 should purge the estate of the consideration received on creation of the trust (precisely because the adequate and full consideration exception to §2036(a) does not apply), yet there is no mention of §2043 in the regulations or their preamble. This element is illustrated below.

Before turning to these matters, however, consider the *potential* implications of what the government is suggesting in the extract above. It is not uncommon for taxpayers to create IDGTs and then to transfer highly appreciated assets to those entities, usually in exchange for a note (perhaps a SCIN, but not necessarily) or, as most relevant here, for an annuity or unitrust entitlement. Because a grantor trust is involved, the taxpayer claims that the transfer is not a sale for income tax gain or loss realization purposes. And as a transfer in exchange for consideration, the taxpayer also claims that the transaction is not a gift for wealth transfer tax purposes. Is it really possible to craft a transaction that is neither a gift nor a sale? What *is* that? By its grantor trust promulgations[68] the government appears to accede to the notion that there is no income tax realization event in this sale-to-IDGT transaction. It hardly matters whether that position is correct.[69]

Instead, *if* the preamble to these §2036 regulations is predictive, *perhaps* the government is staking out a position that the transfer to any self-settled trust cannot be a transfer for consideration. In the immediate context this would mean that the adequate and full consideration exception to §2036 inclusion at death is inapplicable. It is just conjecture, but it would appear that the same position *might* be applicable to disregard consideration in the sale-to-IDGT context. This would mean that the transfer does not avoid gift tax, because the note, annuity, or unitrust interest used to pay for the alleged sale is not consideration for wealth transfer tax purpose.

As illustrated below, this too is wrong minded. But the overall strategy is what matters, and it appears that the government is forsaking income tax gain or loss realization on the transfer, which is not a major concession if the gain remains locked into the basis of the transferred asset and may be realized on any subsequent sale or exchange by the trust. Meanwhile, is the government asserting wealth transfer tax — presumably gift tax on the initial transaction and potentially FET inclusion at the transferor's death? This would be favorable to the government, because the wealth transfer tax rates typically are higher. *If* this prediction of the government's strategy is accurate, the preamble to these regulations could be the precursor of a major crack down on a transaction that taxpayers have employed for years.

To examine the significance of this in the immediate GRAT or GRUT context, consider a taxpayer who transfers $3 million in cash to a trust in exchange for a 10 year annuity payable at $374,000 per year, and that the AFR at the time of creation is 4.2%. If we round the numbers for illustration purposes only, let's assume that the value of the annuity is equal to the $3 million transferred in exchange for it. Assume death in year eight, after the taxpayer received $2,992,000 in annuity payments. If the trust assets had not grown whatsoever, the balance of the trust would be $8,000 (having paid out $374,000 annually for eight years). Most observers would assume that, together, the two amounts would generate $3 million of inclusion — the $2,992,000 under §2033 (to the extent that money had not been consumed by the taxpayer with no value at death) and the $8,000 under §2036 (as the balance of the trust) — and that the result appropriately would mimic the inclusion had there been no transfer inter vivos (cash worth $3 million at death). This example is unrealistic, because it assumes that there has been no change through investment, appreciation, depreciation, or consumption of the $3 million transferred.

The example also is wrong under §2036, which requires inclusion of the value of the property transferred inter vivos with retained enjoyment until death, and that means inclusion of $3 million of cash, not the $8,000 that remains of it at death. If you don't believe this notion, consider an analogous transaction, in which the taxpayer transfers gold bullion worth $3 million with the same retained enjoyment until death, and the trustee thereafter financed payment of the annuity by borrowing against the bullion as collateral. At death §2036 reaches the value of the bullion transferred by the taxpayer and does not consider the debt that was incurred by the trustee to make the annuity payments.[70]

The correct result under the Code would be inclusion under §2036 of the FET value of the $3 million of cash (or the gold bullion transferred), and then another $2,992,000 under §2033, which is inappropriate, because it generates a form of double inclusion — once as if the transaction never was done (include the $3 million of cash, or the bullion) and again as if it was done (include the $2,992,000) — a result that the §2043 consideration offset rule ameliorates. The Code calls for a subtraction from the gross estate of the $2,992,000 received as consideration for the transfer that §2036 is ignoring. (Indeed, if the annuity would continue for the balance of the 10 year term, also includible would be the right to the last two annual payments of $374,000 each, and the consideration offset would be allowed for the very same amount.)

It may seem silly to include and then subtract, but the Code operates in this way because the amounts includible at death and the consideration received may not be as easy to trace and identify, or value, as in this simplistic example. Saying here that §2036 includes only the remaining value of $8,000 in the trust is a shorthand application of the two steps that actually are required — include the $3 million value transferred and then subtract the $2,992,000 consideration received. But as values change and as consideration received is consumed or reinvested in ways that make tracing difficult — that is to say, in a realistic illustration — it is likely that the numbers illustrated here will not produce an identical result, making the shorthand approach shown here and illustrated in the regulations misleading.

Note also that the §2043 consideration offset rule should apply notwithstanding the government's bona fide sale position in the preamble. That is, some observers may wonder whether neither the adequate and full consideration exception to §2036 *nor* the §2043 consideration offset rule can apply if there is no bona fide sale. In that regard, consider the language of §2043: it applies "if any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038 . . . is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth." That describes this situation. By the government's own admission, this is not a bona fide sale for adequate consideration. Thus, §2043 must apply.

This is not to concede the government's position, nor to even suggest that this illustration involves an exchange that is neither a bona fide sale nor a transfer for consideration. Indeed, the whole position here is identical to a transfer for the exact same annuity done with a commercial annuity issuer or a third party's trust, as to which the government appears to think that the result would be totally different. It is difficult to perceive that the taxpayer receives anything different in any of those three transfers, based on the different identity of the payor of the annuity. And that informs the conclusion here that the government is wrong to deny the §2036 adequate and full consideration exception. It also explains why the government wants Congress to amend §2702 to require that there be some minimal gift in any GRAT — precluding a zero gift GRAT precludes reliance on the full-and-adequate consideration exception to §2036.

Illustrations like this get dicey if the asset transferred is property that changes in value, or if the payments received by the taxpayer are spent in ways that have no value at death, making tracing and valuation convoluted. Yet the principles remain the same — even though their application may be occluded. Run an illustration, for example, in which the $3 million transferred is the stock in a closely held business that explodes in value before the taxpayer dies, or it is Blackacre that the trustee swaps for Greenacre, which the trustee thereafter uses as collateral to borrow the cash to make annual annuity payments. Notice that the logistics of these inclusion and offset provisions get complicated (and there still would be no §2053 deduction for the trust's debt, because the debt is not the taxpayer's obligation). Unfortunately, there is virtually no authority illustrating these kinds of transactions, because taxpayers historically did not make transfers to which §2036 might apply, in exchange for consideration paid in return to which §2043 might apply. Note also that these transactions are nothing like a traditional transfer into a revocable trust with a retained right to income, as alleged by the preamble.

Also remember that taxpayers have long asserted that these transactions are not sales or exchanges — for income tax purposes — based on their objective of avoiding capital gain on the initial transfer of appreciated property into the trust, and later on the trust's use of appreciated property in payment of SCINs or the annual annuity or unitrust in a GRAT or GRUT transaction. In a sense, the government would be simply turning the IDGT notion back on the taxpayer — saying that there is no sale and therefore that the bona fide sale exception to §2036 cannot apply.

Never mind that this confuses income and wealth transfer tax notions of sale or exchange treatment, or that the same annuity, acquired in exchange for a transfer into a trust that a third party created, would be regarded by the government as a candidate for bona fide sale treatment. (Indeed, it would appear that a qualifying GRAT or

GRUT transfer could be made in conjunction with a third party trust, but taxpayers likely would not favor such a transaction because it is very hard to generate defective grantor trust nonrealization treatment in a third party trust context.)

§7.2.2.2.2 *Terms for Life or a Specified Period*

Walton v. Commissioner[71] held that (then) Treas. Reg. §25.2702-3(d)(3) (now -3(d)(4)), as illustrated in Treas. Reg. §25.2702-3(e) Example 5, was "an invalid and unreasonable interpretation" of §2702. As a result of the "historical unity between a taxpayer and the taxpayer's estate," the court held that designating the taxpayer's estate as the alternative payee in the event of the taxpayer's death before expiration of a term annuity was permissible and the full value of that annuity would be considered in determining the value of the gift of the following remainder. "Congress meant to allow individuals to retain qualified annuity interests for a specified term of years, and . . . the proper method for doing so is to make the balance of any payments due after the grantor's death payable to the grantor's estate." In the wake of this loss the government revised that example to permit the entire term interest to qualify. The simple change made by addition of a new Treas. Reg. §25.2702-2(a)(5) was to regard a person and that person's estate as a single qualified recipient. And a revised Example 5 illustrates that change.

In addition, in a new Example 8 the regulation provides that a following annuity in S can be a qualified spousal interest and will be considered in valuing the remainder following both. If S's interest is for a fixed term or until S's prior death. But, by Example 9, the government states that an annuity payable to S (rather than to the grantor's estate) for only the remaining term of the grantor's primary annuity (if the grantor dies within the term) *cannot* qualify because there is no way to know, at inception of the trust, when S's annuity will begin and therefore how long it will last.[72] The way to address this, then, is to make an annuity payable to the grantor's estate if the grantor dies early, and make that annuity payable to S by the grantor's estate.[73]

§7.2.2.2.3 *Payment with Notes*

Another hot button issue for the government was illustrated by TAM 9717008, which involved an annuity that would continue to S if D died during the annuity term, and some payments that were made with notes. The GRAT was for two years only, paying 54.8% of the initial value of the trust annually. Of the over $24 million annuity, almost $11 million was satisfied in the first year with a note that was repaid at termination of the GRAT in the next year. When all payments back to D were tallied, only approximately 57% of the original corpus was returned in the form of the annuity. The remainder beneficiaries received the over $20 million of remaining corpus, meaning that the property transferred into the GRAT had grown pretty substantially during the short two year period. The gift reported on creation of the GRAT was $121,000 (the value of the remainder). To make the government all the more anxious, S did a mirror image GRAT at the same time, using identical corpus, the same term, the same secondary annuity interest, the same valuation, and so on. The government concluded that neither annuity satisfied the requirements of §2702 and therefore each was worth $0 in determining the amount of the gifts made on creation of the GRATs.[74]

The TAM took exception to use of the notes to pay a portion of the annuity in the first year, regarding it as a method to delay distribution of corpus in satisfaction of the annuity obligation and thereby trap more of the extraordinary appreciation in the trust corpus for ultimate distribution to the remainder beneficiaries. The government stated that this was a loan transaction and not an annuity payment and, on that basis, failed to qualify under §2702. The TAM held that "the annuity interests created . . . do not satisfy the §2702 requirements that the annuity be *paid* (1) in a stated dollar amount, and (2) not less frequently than annually. Therefore, the annuity interests . . . do not meet the requirements for a qualified interest, and the interests are valued at zero."[75]
Even with that result, however, it is notable that the donors transferred all the appreciation during the trust term free of gift tax. So, although the gift on creation was larger than expected, the plan still had significant merit.

This form of transaction led to the issuance of Treas. Reg. §§25.2702-3(b)(1)(i), 25.2702-3(c)(1)(i), and 25.2702-3(d)(5) (now -3(d)(6)), in 1999, which are premised on the absolute position stated in the preamble to the proposed regulations that use of debt instruments or other financial arrangements (such as options) does not constitute payment of the requisite annuity or unitrust amount. This wrong-minded position is based on the government's notion expressed in the TAM that qualified interests must be payable annually, by a specified date each year, and that issuance of a note or similar instrument is not tantamount to payment. "A note is merely a promise to pay in the future. Delaying payment by the use of a note . . . alters the true value of the transferor's retained interest, contrary to Congressional intent . . . ."

That conclusion is wrong to the extent of the FMV of the note or other instrument issued, provided that the grantor could sell or otherwise market the trust's instrument and immediately realize cash. Nevertheless, the regulations provide that a trust cannot qualify as a GRAT or GRUT unless it prohibits the trustee from making payment in such a manner. To the government's credit, PLR 201652002 blessed a state-court modification of an otherwise qualified GRAT to add the prohibition on use of a note or other debt instrument and, by virtue of this retroactive reform, avoid application of §2702 for gift tax valuation on creation of the trust.

The preamble to the proposed regulations also stated that the government "will apply the step transaction doctrine where more than one step is used to achieve similar results." The final regulations preamble moderated this only to the extent it provided that a trustee may borrow from an unrelated party to make a payment, but still provided that step transaction treatment would apply if the trustee borrowed cash from the grantor to repay that third party loan, or if the third party lender required the grantor to make a deposit with the lender in an amount equal to the trust's loan. Although it thus does not expressly preclude the use of borrowed cash to make annuity payments, borrowing from a third party to make a cash payment is impossible to distinguish from borrowing from the grantor by issuing a note directly in payment of the annual obligation. Nevertheless, the step transaction statement presumably could prohibit a trust from selling trust assets to a third party on installment payments and distributing the notes received in satisfaction of the annual payment.

Apparently it would be permissible to pledge appreciating assets in the trust as collateral for a market interest loan from a bank or other third party lender and use the borrowed cash to make annual payments. Neither form of making payment is abusive and the regulations appear to be an inappropriate overreaction to the extent consistent application of the position articulated would preclude any form of payment that entails debt or similar instruments. Further, application of the step transaction doctrine would require some form of tracing of the proceeds of any kind of borrowing, which in many cases would be unrealistic. It is odd, perhaps, that the regulations did not just preclude GRATs and GRUTs from being in debt or otherwise having outstanding obligations that might be satisfied against trust assets and the fact that they did not go to those lengths may indicate that the step transaction statement is just saber rattling.

§7.2.2.2.4 *Traditional GRIT Strategy*

The garden-variety or common law GRIT no longer is viable unless the remainder beneficiary is not a family member, as defined in §2704(c)(2), or the settlor is willing to incur a gift tax on 100% of the value of transferred property at the time of creation (in hopes of avoiding wealth transfer taxation on an appreciated value at a later time).[76] Whether the alternative qualified interest GRUT or GRAT is worth implementing depends on appreciation potential in the corpus, the expected income yield relative to the forced payment specified, and whether the transferor is likely to outlive the retained term. In addition, shifting appreciation is not meaningful unless the wealth transfer tax imposes progressive rates, which means that an estate freeze is of no value whenever the highest marginal rate has dropped and the applicable exclusion amount has risen to a point at which the excise essentially is a flat tax.

For example, if a taxpayer has an asset worth $100x that is expected to double in value, and the taxpayer has consumed the applicable exclusion amount and therefore will pay gift tax on an inter vivos transfer of that asset (at, say, a 40% maximum rate), it won't matter if the taxpayer gives the asset and pays a $40x tax, leaving $60x net of tax to double in value to $120x, or holds the $100x asset, allows it to double in value to $200x, and then incurs the same 40% tax of $80x, leaving $120x after tax.[77] Other factors may inform making the gift (such as removing the gift tax dollars from the taxpayer's gross estate at death more than three years later), but shifting appreciation is not one of them.

A qualified interest GRUT or GRAT may be a qualified S Corporation shareholder,[78] so planning involving these trusts is not necessarily precluded even for owners of closely held businesses. The decision whether to utilize this device will require careful calculations and realistic projections. In many cases an outright gift or a §2701 qualified payment freeze will be superior, especially because they will avoid the potential for §2036(a) inclusion if the transferor fails to outlive the term interest in the GRUT or GRAT.

§7.2.2.3 Incomplete Transfer Exception

Not all retained temporal interests are subject to the §2702 retained interest valuation rule. For example, incomplete transfers, as to which the gift tax is not yet applicable and, therefore, as to which §§2036(a)(2) and 2038(a)(1) would apply at the transferor's death, are not subject to §2702.[79] The rationale for this rule is *not* because FET inclusion precludes a tax free shift of future appreciation and makes inter vivos valuation irrelevant (if that was true all GRITs would be exempt until the term expired). Instead, this exception simply recognizes that a gift tax valuation rule cannot apply before the gift tax applies, which requires a completed and therefore taxable gift.

§7.2.2.4 Disclaimer and Nongeneral Power Exceptions

The government provided by regulation[80] that, although "an assignment of an interest in an existing trust" would be subject to §2702, a qualified §2518 disclaimer is not. As illustrated by PLR 200530002, however, a nonqualified disclaimer will be treated the same as a transfer that is fully subject to §2702. Involved in that case was a pre-1977 trust with chronologically exempt generation-skipping provisions and a tardy renunciation of 20% of the taxpayer's remainder interest. Because the disclaimant retained an income interest, the government regarded this renunciation as a transfer that was subject to §2702, as to which the income interest therefore would be deemed to have no value and the remainder disclaimed was therefore a gift of 100% of the value of that 20% portion of the trust.

The same regulation also provides that the exercise, release, or lapse of a nongeneral power of appointment is not a transfer in trust, which means that §2702 cannot apply. Presumably this permits a beneficiary to appoint an interest in trust that the beneficiary could not have given away, had it been transferred to the beneficiary outright, and to exercise a nongeneral power to create interests that could not be created by the beneficiary with the beneficiary's own property.

If these are accurate interpretations, powers of appointment may be a significant planning tool to allow powerholders to engage in planning that neither the donor nor the powerholder could have employed with their own assets. The availability of this planning appears to be confirmed by a statement in the regulations[81] that a retained interest (subject to §2702) is only one that was "held by the same individual both before and after the transfer." If state property law concepts are respected, the holder of a power of appointment is only an agent acting on behalf of the donor and not an owner of the appointive property itself, meaning that §2702 cannot apply.

§7.2.2.5 Spousal Exception

The creation of a trust for the benefit of a spouse for life, remainder to a child, in which the settlor retains no interest, is not subject to §2702 (notwithstanding that the spouse is an applicable family member), because the spouse did not hold an interest in the trust both before and after its creation.[82] Furthermore, election of QTIP treatment does not alter this result because, (1) if the settlor did not elect the marital deduction, a gift tax was incurred on the full value of the property transferred to the trust at its creation (meaning no valuation abuse occurs), and (2) if the settlor did elect marital deduction treatment a tax on the full value of the trust corpus will be incurred when the spouse's interest in the trust terminates, again meaning there is no valuation abuse.[83] The intriguing issue that this exception raises is whether allocation of split interests to marital and nonmarital trusts (for example, allocation of a life estate or term of years to a marital deduction trust and a remainder to a nonmarital trust) is permissible without triggering §2702 because there is no transfer or retention by the spouse that meets the requisites for application of that section. There is no direct answer to this question in either the Code or regulations, but the following analysis may be helpful.

A "joint purchase" rule in §2702(c)(2) appears to be the only relevant authority. It applies if more than one *family member acquires* property in split interest format (for example, a life estate and a remainder interest). It is notable that, although the title of this provision uses the word "purchases," the body of the provision uses the word "acquires." Although it does not appear to have been Congress' intent, this difference in language might allow §2702 to reach acquisitions by purchase or any other method. This probably is the weakest link in this analysis, however, because it seems clear that §2702(c)(2) was not meant to apply if, for example, two family members receive property by gift or devise from a third party in the form of a life estate and remainder. The situation involved here — funding marital and nonmarital trusts after an individual's death — seems to be analogous even if the decision to fund using temporal interests is made by the decedent's personal representative (rather than by the decedent in the form of a specific devise). And that personal representative might be either the spouse or the remainder beneficiary.

Assume, however, just for the sake of argument, that "acquires" does encompass the form of acquisition involved in a split interest funding. The issue then arises whether family members are involved if it is marital and nonmarital trusts that actually acquire title to property. In this respect, §2702(e) is relevant, incorporating by reference §2704(c)(2) for the definition of "member of the family." Although a trust is not a family member under §2702(c)(2), an attribution rule[84] may apply for purposes of all of §2704(c), although this is not expressly stated. That attribution rule[85] appears to apply with respect to a marital deduction trust of any variety authorized under §2056. So it seems fair to assume that split interest funding involving trusts could be regarded as split interest ownership by the trust beneficiaries, rather than by the trusts or their trustees, for purposes of §2702.

Now the question returns to the relevance of the regulation[86] that prompted this digression. Can it be that D's transfer of property to an irrevocable marital deduction trust for the benefit of S is not subject to §2702 but that a personal representative's decision to allocate a temporal split interest to such a trust is? The regulation states that S did not hold an interest in the property both before and after the transfer into trust and, therefore, that §2702 cannot apply. The crux is that the regulations[87] define the "retained" requirement for purposes of §2702(a)(1) to mean that an interest was held by the same individual both before and after the subject transfer. In this case, the result of §2702(c)(4) joint purchase treatment, if applicable, would be that S (by attribution through the marital deduction trust) would be treated as having acquired the entire property and then made a transfer of the remainder interest to the nonmarital trust. This analysis is applicable, however, only if split interest funding is regarded as an "acquisition" for §2702(c)(4) purposes.[88]

An overriding policy oriented question is whether there is any reason to suggest that §2702 was meant to apply to bifurcated enjoyment of this nature. No indication appears in the direct provisions of the Code or the regulations, although the ability to engage in split interest funding would represent an opportunity to engage in postmortem estate planning during S's overlife, which may encourage the government and ultimately the courts to conclude that this provision must be applicable. And yet the regulations[89] seem to indicate that the converse is true.

There should be no question about the validity of funding a marital deduction trust with a naked life estate, provided that S's beneficial interest in that trust is not a nondeductible terminable interest for purposes of §2056(b).[90] As an investment, a naked life estate is like any other asset that might be owned by a marital deduction trust. If the document authorizes the trustee to invest in wasting assets (the life estate) for the marital trust and in non-income-producing assets (the remainder interest) for the nonmarital trust, then this form of investment should not be problematic for marital deduction purposes, any more than it would if the marital and nonmarital trusts took cash and purchased split interests long after the marital deduction was allowed. And if S is likely to die sooner than the government's valuation tables predict, all of this planning translates into estate freezing for S's overlife.

§7.2.2.6 Tangible Property Exception

Also excluded from the reach of §2702 are terminable interests in tangible property (not a defined term)[91] if the failure to exercise rights under the term interest would not have a substantial effect on the value of a remainder interest in that property.[92] By way of example, the failure to exercise a retained right to enjoy collectibles or jewelry for a retained term would not likely alter the value of the collectibles or jewelry itself.[93] The same also might be true of the right to use unimproved realty (such as range or timber lands) for a defined term if holding the property for enjoyment during that term will not alter substantially the value of the property and, therefore, nonexercise of the enjoyment right will not substantially affect the value of the remainder. Curiously, if this tangible property exception is met, the value of a retained term interest in the tangible property is not based on the Treasury tables but, instead, is determined as the amount an unrelated third party would pay to purchase the term interest, presumably considering the illiquidity and, typically, non-income-producing nature of the interest.

The value of a term interest in tangible property that is not ignored under §2702 is said by §2702(c)(4)(B) to be the amount "for which such interest could be sold to an unrelated third party." The regulations[94] adopt a more traditional notion that the value of the term interest is what a willing buyer would pay a willing seller, each having reasonable knowledge of the relevant facts and neither being under any compulsion to buy or sell. Stating that "little weight is accorded appraisals,"[95] this value probably is best established by comparable sales or rentals of similar property held for a similar duration. Unfortunately, comparables may be impossible to garner for many types of term interests in tangible property, and the use of the §7520 tables to value such an interest specifically is denied.[96] This will prevent the type of result reached in TAM 9313005, in which the §7520 tables were used to value the retained three year term interest in non-income-producing artworks and reduced the value of a gift of the remainder to almost half the FMV of the art.

Conversion of tangible property into property that otherwise would not qualify under this exception is treated as a transfer that triggers application of §2702 at that time unless the proceeds are converted into a qualified GRAT.[97] Moreover, an addition or improvement that affects the nature of the property to such an extent that the property would not be treated as meeting the tangible property exception will be regarded as a conversion for this purpose.[98]

§7.2.2.7 Personal Residence Exception

Finally, a term interest in a trust that holds property used as a personal residence by the term interest holder is not subject to the §2702 special valuation rule.[99] This personal residence GRIT exception is interpreted in regulations that establish "personal residence trust" and "qualified personal residence trust" (QPRT) provisions.[100] These regulations:

- Permit the transfer of cash to a trust in that amount needed to pay (within a six month period) either trust expenses (including mortgage payments) or for improvements that will be made.
- Permit retention of proceeds from a sale or from casualty insurance for up to two years if the trustee intends to purchase another personal residence (sale is not a cessation of use as a personal residence if the proceeds are used within two years to purchase a replacement personal residence).

- Require the trust instrument to preclude commutation of the term interest holder's entitlement (commutation being an express prohibition in a QPRT and — based on statements made by Treasury officials informally — an inadvertently omitted but intended prohibition in personal residence trusts too; whether this will be reflected by ruling or announcement is uncertain but prudence probably dictates that a commutation provision not be included in either form of trust).
- If the property ceases to be the term interest holder's personal residence (and no replacement is intended), require termination of the trust or conversion of the trust into a GRAT.[101]
- Preclude any distribution of assets to persons other than the term interest holder.
- Define a personal residence to include the term interest holder's principal residence and one other. The regulations (1) permit the term interest holder to use the property as a principal place of business, (2) permit rental of the residence during a portion of a year in which it is not occupied by the term interest holder, including (in the context of a vacation home) for most of the year if the term interest holder occupies it for a sufficient term to constitute it as the owner's residence under §280A(d)(1), and (3) permit family members to use the property rent free if such use does not preclude §280A treatment.[102]
- Preclude rental of any portion of the property, such as a commercial lodging[103] on a routine basis that belies use primarily as a personal residence.
- Permit inclusion of "appurtenant structures used for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes" but preclude the transfer of personal property (such as furnishings) to the trust.[104] Illustrated[105] is a farm with various structures used for farming. Although the farm did not qualify as a personal residence, presumably the farmhouse alone, and a bit of land around it, could have qualified.[106]
- Permit acquisition of a personal residence by way of split interest purchase by family members without application of §2702 if a QPRT is used as the mechanism.[107]

A very controversial 1997 amendment added a requirement[108] that the governing instrument must prohibit any direct or indirect transfer of the residence for consideration either to the term interest holder or to the holder's spouse, either during the original term of the trust or thereafter while the trust remains a grantor trust for income tax purposes. The intent of this prohibition is to preclude repurchase of the residence by the term interest holder or the holder's spouse without capital gain realization, intentionally to cause inclusion of the residence in the estate of either the holder or the spouse to generate a new basis at death, meanwhile allowing the purchase proceeds to pass from the trust to the remainder beneficiaries while the purchaser remains in possession of the residence after the term expires.[109]

Valuation of the gifted remainder interest in such a transaction should be based on the normal tables used to value temporal interests, which will make these transfers more useful if the property is expected to appreciate in value.[110] The prospect for long-term appreciation is a pretty good gamble whenever residential real estate is depressed in value, although it may not be for a short-term GRIT.

A great many of the PLRs under the QPRT exception relate to factual questions regarding personal residence qualification itself. A few principles or trends developed, and the government has been generous in its interpretation and application of this provision. To illustrate the issues:

- PLR 9609015 allowed a 4000 square foot property to qualify as primarily held for residential purposes notwithstanding that 500 square feet of it constituted "a separate rental unit that is rented on an unfurnished basis to unrelated third parties," because the taxpayer provided no substantial services and the rental use was secondary to use as the taxpayer's personal residence. PLR 9816003 permitted rental of a guest house to an unrelated third party because it was located on a single parcel with the main house and could not be divided due to local zoning and water use restrictions. And PLR 199916030 permitted rental of a caretaker's residence and distribution of the rent as income to the grantor as beneficiary of the QPRT. PLR 200751022 similarly allowed rental of a caretaker's residence, without mention of how the rental income would be enjoyed.

- PLR 9741004 permitted QPRT creation of two lots used as one property notwithstanding that there were two separate rental units in the personal residence itself, finding that the rental use was secondary to the primary use as a personal residence.
- PLR 200039031 permitted partition of a single parcel held as tenants by the entirety into a tenancy in common, followed by each spouse putting their half into a QPRT. PLRs 200825004 and 200822011 both involved property held by spouses as tenants in common, the difference being that only one of them transferred their interest into a QPRT.[110.1]
- PLRs 9448035, 9433016, and 9151046 held that the proprietary lease and shares of stock in a cooperative housing corporation may constitute a personal residence for §2702(a)(3)(A) purposes if the property otherwise meets the personal residence requirements of §1034 or §280A(d)(1).[111]
- PLR 9544018 involved shareholdings in a landholding corporation, not a traditional cooperative, but still permitted qualification.
- PLRs 9433016 and 9425028 state that a QPRT may be accompanied by a separate agreement obligating the remainder beneficiaries to sell or rent the property to the settlor at FMV or rent, without altering the trust's qualification for the exemption from the application of §2702. PLR Rulings 9829002, 9714025, 9626041, and 9448035 went one step further and held that such a leaseback at the end of the term would not constitute a §2036(a)(1) retained interest because it was required to be at a FMV rental.
- PLR 9343034 refused to rule whether adjacent land to the tract on which the principal residence was located would qualify if it was transferred to an otherwise QPRT. Local zoning law required that each parcel consist of a certain minimum acreage and the tract on which the house was located alone did not conform to that requirement. PLR 9328040 did rule that a guest house adjoining the main home on a 1.65 acre parcel used as a vacation property qualified as one personal residence for purposes of the Treas. Reg. §25.2702-5(c)(2)(ii) definition of appurtenant structures in a QPRT.[112] Similarly, PLR 9503025 held that a lot owned by the taxpayer located across the street from a vacation home would qualify as appurtenant to the primary residence because it guaranteed a view of and access to a bay on that side of the road, it had been owned for 30 years along with the residence, and the taxpayer had forgone forever the opportunity to build on or develop that property. According to the government, "distinct parcels of land can, in appropriate circumstances, constitute adjacent land as that term is used in the regulations."
- PLRs 9645010 and 9544018 involved 16.6 acres and 18 acres, respectively, on which single homes were developed and that otherwise mostly was floodplain, wetlands, swampland, and streams. The government concluded in each case that they qualified in their totality as a residence because each property was comparable in size to other properties in the area and had been used for many years consistent with its zoning as a single homesite. This "comparability" test seems to be a touchstone in later Rulings. Using that standard, all the following favorable Rulings were issued:

    — PLR 9739010 involved three parcels of land, totaling four acres on which stood a main house and a guest house, with the balance being unimproved land.
    — PLR 9701046 held that five contiguous lots that contained only a single residence could be treated as one property not in excess of that amount of land reasonably appropriate for residential purposes.
    — PLR 9442019 held that a 10 acre parcel of land qualified as a single property notwithstanding that, on a development map, it consisted of three lots and the residence was located on only one of them, which constituted approximately 70% of the total land. The other two lots had no separate roads, the well for all of the property was located on one of those two lots, the single

10 acre parcel had been used as a single residence for over 20 years, and it appeared as a single parcel on the tax map.

- — PLR 9529035 involved three separate parcels shown on the tax assessor's map as a single tax lot that also had been used for over 20 years as a single residence. There were no additional buildings that were not integral to the residential use and the property was not farmed.
- — PLR 9829026 involved five parcels, four of which were entirely woodlands but all five of which constituting just one parcel on the tax map, three acres of which representing the residential development.
- — PLRs 9735012 and 9735011 permitted a 75% interest in two parcels used as a single residence to be a QPRT property, in part because the resulting property would be smaller than the other residential properties in the area.
- — PLR 9725010 entailed subdivision of property resulting in a single parcel on the tax map that could not be further subdivided and that included a main house, a pool house, a horse barn, and a greenhouse.
- — PLR 9714025 involved three parcels and a main house, a guest house, caretaker's residence, carriage house, pool building, and storage barn.
- — PLR 9729024 involved a split of property carving out of a larger parcel the residence, guest house, caretaker's residence, garage, and pool to create the minimum sized estate allowed by a restrictive covenant.

• In terms of the number and quality of appurtenant structures permitted:

- — PLR 9730013 granted QPRT status to property that consisted of a main house, a guest house, caretaker's residence, detached garage, barn, storage buildings, and an indoor riding barn.
- — PLRs 9718007 and 9705017 permitted vacation properties that consisted of a main house, separate guest facilities, and in the later PLR, a caretaker's house (occupied by the caretaker), and "other appurtenant structures."
- — PLR 9722009 permitted a property that included the main house, a guest cottage, swimming pool and pool house, caretaker's apartment, and a horse barn.
- — PLR 9750048 qualified a house, pool house, guest house and garage that in toto constituted a smaller acreage than required by local ordinance.

It is wise to remember that §2702 is not the only arrow in the government's quiver. For example, the transaction in TAM 9206006 occurred prior to the effective date of §2702,[113] so the government addressed the case instead under §2036(a)(1), employing a theory that the transaction constituted a transfer of property with a retained life estate. The decedent acquired a life estate in a condominium and the primary remainder beneficiary of the decedent's estate acquired the remainder interest.[114] The government focused on the fact that most of the remainder beneficiary's consideration was borrowed (at a market rate of interest) from a trust that this beneficiary would inherit at the decedent's death. With a balloon repayment provision keyed to the decedent's life expectancy, the government ignored the borrowed funds, stating that the borrowed portion of the purchase price "was provided exclusively by the Decedent." No authority was cited for this treatment, which supported the government's conclusion that over 97% of the purchase price was paid by the decedent. With lifetime enjoyment of the purchased property, the government held that 97% of the FET value of the property was includible in the decedent's gross estate under §2036(a)(1) because the purchase involved a transfer with a retained life estate.[115]

Under a proper application of §2036(a)(1), however, the result should have been inclusion of 100% of the FET value of the property, with a §2043 consideration offset for the value of any legitimate independent consideration furnished by the remainder beneficiary at the time of purchase. It may be that, because the decedent died approximately seven months after the date of purchase, the values involved had not changed enough to be a matter of concern to the government, making the inclusion of just 97% of the value of the property a sufficient victory for the government. Under the QPRT exception, however, a subterfuge like that employed in the TAM would not be necessary, although outliving the retained term interest would be necessary to avoid §2036(a)(1) inclusion at death.[116]

That reality and one other reveal that the QPRT is not the most wealth transfer tax effective form of planning involving a personal residence. Rather, it is preferable if the transferor makes a completed gift of the entire fee simple interest in the property and, if continued residence is desired, pays rent to the new owner to lease the premises. Basis is the same carryover as in the QPRT alternative, future appreciation in value still is shifted, the FET inclusion potential of dying during the term interest is avoided, and a greater wealth transfer tax saving is generated by the mere expedient of incurring gift tax during life on the full fee simple interest rather than on just the remainder interest that is transferred.[117]

§7.2.2.8 Sales of Remainders and Joint Purchases

Nontrust property as to which term interests exist is subject to §2702 as if a trust was involved,[118] and §2702 specifically is applicable to joint purchase transactions involving family members.[119] Joint purchases may involve a single transaction or a series of related transactions by which the taxpayer acquires a term interest and a family member acquires the balance of the fee. This rule will apply to either form of transfer. Thus, for example, if Parent and Child purchase property with Parent acquiring a term interest and Child the remainder, Parent will be deemed to have acquired the full fee and transferred the remainder interest to Child in exchange for the amount Child paid to acquire the remainder interest. Normally the result is a gift of the full FMV, less the value of Child's consideration furnished, although the deemed gift may be limited to the total amount paid less Child's consideration furnished if Parent acquired the property for less than its FMV.[120] Curiously, the regulations do not address the possibility that Child's consideration may have been acquired from Parent.

The related transaction involving sale of a remainder interest is not specifically mentioned by §2702, but the regulations[121] illustrate such a transaction and treat §2702 as being applicable. Thus, even if the remainder is transferred for consideration equal to its FMV, the transfer will be treated as a gift for gift tax purposes and the full and adequate consideration exception to §2036 will not apply unless the consideration furnished is equal to the full FMV of the remainder at termination of the retained term interest, which is not likely.[122]

§7.2.2.9 Uncertain Scope of §2702

It is not certain that a private annuity or a sale in exchange for a SCIN[123] is enough like a retained interest in transferred property that §2702(c)(1) should apply. Nevertheless, the annuity or installment payments could be structured to meet the qualified interest exception requirements.[124] Similarly, §2702 may apply if the holder of a retained interest (such as a life estate or a term interest in a trust that is chronologically exempt from application of §2702) transfers a portion of that interest (such as half the income, all income in excess of a certain amount, or all income after a term of years carved out of the life estate). Moreover, §2702 will apply to creation of a short-term trust in which income is transferred to a third party by a transferor who retains a reversion, unless the retained reversionary interest is noncontingent and follows a qualified annuity or unitrust interest.[125] The §2702(a)(3)(A)(i) exception for "incomplete" transfers should be inapplicable in such a case because the gift of the lead interest is subject to gift taxation, notwithstanding that the original transfer is "incomplete" in the sense that FET inclusion will occur because of the retained reversion. FET inclusion should be irrelevant to application of the incomplete transfer exception because it is hard to conjure a case in which the entire transfer would be regarded as complete but a reversionary interest or interests in or powers over the trust are retained.

Finally, a CRUT may be subject to §2702 if a net income with deficiency catch-up provision is employed in a trust in which the donor or any applicable family member enjoys the first lead interest and then a secondary unitrust interest is created in another private individual before the remainder passes to charity.[126] The notion is that the donor may structure the situation such that the lead unitrust interest pays little or nothing because income during the lead interest is artificially low by virtue of trust investment in growth assets versus current income producing assets. This will cause the deficiency account to build up, followed by the donor or other family member's interest ending and the secondary interest becoming entitled to the income deficiency when the trustee subsequently alters the trust investments to begin to produce substantial income.

In such a case the perceived abuse is that the secondary interest holder would receive far more wealth than the tables would predict and more than the amount on which the gift tax otherwise would be imposed. In such a case the primary lead interest is ignored in valuing the gift made to the other private individual beneficiary, unless that secondary gift qualifies for the marital deduction. The charitable remainder interest will not be affected, however, and the donor's gift would be that portion of the FMV that does not qualify for the charitable deduction in creation of the trust, unreduced by any interest retained by the donor.

§7.2.2.10 Adjustment to Avoid Double Taxation

It is hard to determine why retention of a reversion should trigger application of §2702, because there is no estate freeze abuse. For example, if a transferor creates a trust to pay for the support of an elderly relative for life, reversion to the transferor, there is no freeze potential even if the trust principal appreciates and the term interest is not in qualified interest format. Guaranteed exposure to §2033 or §2037 inclusion of the reversion in the transferor's gross estate should preclude application of §2702.

If, however, §2702 requires 100% of the value of trust property to be taxed at creation of the trust (assuming the qualified interest rules were not met and the transfer was complete), subsequent FET inclusion will constitute double taxation unless an adjustment provided in the regulations works properly. Moreover, if creation of the trust was by a split gift, the failure of §2001(e) to apply[127] means that the consenting spouse's prior taxable gifts will not be purged, which also will result in inappropriate double taxation. In each of these cases, the need for adjustment is clear. It therefore is curious that Congress did not mandate that the Treasury Department provide an adjustment. Perhaps even more curiously, however, the government did so anyway.[128]

A reduction of a transferor's prior adjusted taxable gifts for future wealth transfer tax computation purposes may be required if a prior transfer was subject to §2702. A reduction ought to be provided if the §2702 retained interest is sold or otherwise is not includible in the transferor's gross estate at death because it terminates naturally (for example, the transferor retained a term interest that expired before the transferor expired). In each of these cases double taxation will result unless the prior gift is purged, because the proceeds of the sale or the earnings generated and paid to the transferor as owner of the retained interest will be taxable at the transferor's death. In such cases §2702 clearly results in double taxation.

To illustrate, if the transferor retained an income interest in trust for 10 years that was not a qualified interest under §2702, all the income earned and paid to the transferor under that interest would increase the transferor's net worth for subsequent taxation. Without an adjustment that reflects this economic reality, double taxation will result because the value of that income interest was ignored in valuing the transferred interest for gift tax purposes.

The adjustment[129] that applies is improper because it is restricted to the lesser of "(i) [t]he increase in the individual's taxable gifts resulting from the interest being valued [under §2702] at the time of the initial transfer," and "(ii) [t]he increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest." That is, the adjustment is the smaller of the value of the retained interest when the original transfer triggered §2702 and when the retained interest is transferred. Thus, the regulation effectively imposes transfer tax on the higher of those two values.

This limitation precludes taxpayers from overvaluing retained trust interests to reduce the value of transferred interests. But this limitation is problematic in the context of §2702 because most retained trust interests that are subject to §2702 are subject to a legitimate decline in value due to the mere passage of time (such as a retained temporal interest), regardless of any abuse in the valuation process. Thus, the limitation invariably and inappropriately will allow some value to be taxed twice.

To further illustrate, assume that the transferor retained a life income interest with an actual FMV of $40,000 that was ignored under §2702 in valuing a transfer into trust. One year later the transferor relinquished that income interest when it was worth $30,000. The regulations[130] conclude that the adjustment is limited to $20,000, being the lesser value of the original $40,000 and the later value of $30,000 as reduced by the annual exclusion available to the transferor with respect to relinquishment of the income interest. The annual exclusion adjustment is appropriate because that value will not be subject to double tax. The subsequent gift of that amount passes tax free. But the limitation issue arises because the retained income interest had declined in value when it subsequently was transferred, presumably (at least in large part) because a year's worth of income had been paid to the transferor, who was a year older when the subsequent transfer was made. Unless that income was consumed in a manner that reflects no increase in the transferor's net worth, the value of that year's income will be taxable when the transferor subsequently disposes of it (now that it is separate from the retained life estate). Because the adjustment is limited to the lesser value of the retained interest, the $10,000 value differential was subject to tax when the trust was created and will be subject to tax again when the transferor disposes of that increased net worth.

To work properly in this situation, the limitation should reflect reductions in the value of the retained interest that reflect value that will be subject to double taxation. As opposed to those that merely reflect the passage of time (which is a familiar concept under §2032(a)(3)). Without such a refinement, §2702 improperly punishes taxpayers for engaging in transactions that trigger §2702.

§7.2.2.10.1 *Gift Splitting*

A gift splitting provision specifies that any adjustment that reduces the value of prior §2702 gifts may be split equally between the transferor and a consenting spouse, if the transferor so elects when a subsequent split gift transfer is made of the previously retained interest.[131] Regardless of how that subsequent transfer of the retained interest occurs, the regulation requires the adjustment splitting decision to be signified by an attachment to the consenting spouse's Form 709 gift tax return reporting the spouse's share of the split gift, which seems a little odd. Why shouldn't this be on the *transferor's* Form 706 FET or Form 709 gift tax return? It is likely that an inexperienced personal representative or inter vivos gift advisor to the transferor will overlook the election to assign a portion of the adjustment under this proposed procedure.

In addition, the §2702 regulations need to, but do not, elaborate on the interplay of the split gift assignment with §2001(d) (which gives the transferor a credit against FET for any gift tax paid by the consenting spouse on a split gift that subsequently is includible in the transferor's gross estate at death) and the operation of §2001(e) (which applies only if the transferred interest is includible in the transferor's gross estate under §2035(a)). That the original transfer was a split gift is irrelevant under this provision, so these subjects arise only with respect to a subsequent transfer that is split.[132]

§7.2.2.10.2 *Miscellaneous Problems*

The regulations treat a transferor's retention of a power to direct the distribution of income among third parties as an interest for §2702 purposes.[133] As a result, they treat §2702 as applicable upon creation of the trust because this power is not a qualified interest, and further conclude that the transfer of income on an annual basis is not a transfer of the retained interest that would permit an adjustment against double taxation.[134] The net result is that §2702 taxes the value of the transfer into trust as if an easy-to-complete rule was applicable (100% of the value of the transferred property being subjected to gift tax, notwithstanding that the gift of the income interest is subject to the retained power), but no adjustment is provided against gift tax incurred as income is paid in each year. This is improper if there is a taxable gift each year as income is distributed. Indeed, it would appear that income could not be distributed unless the transferor exercised the power, because the example does not specify that income could be accumulated.

An adjustment is permitted if the retained power is relinquished,[135] although the regulations do not indicate how the adjustment limitation would be applied, other than the statement that "the increase in taxable gifts resulting from the transfer of the retained interest" would constitute one of the two limitation amounts. These results are all the more unsettling because they do not indicate how to value that gift, and there is no explanation of the more likely subsequent taxable event of the transferor's death with §§2036(a)(2) and 2038(a)(1) generating inclusion of the value of the entire trust in the transferor's gross estate because of the retained power.

The §2702(a)(1) valuation rule also applies to any trust interest retained by "any applicable family member" of a transferor who created or transferred an interest in a trust. Thus, §2702 would apply if a transferor and an applicable family member owned property and the transferor alone transferred an interest in the transferor's portion, meaning that the applicable family member's interest would be ignored in valuing the interest transferred unless it was a qualified interest. The regulations appear to deny an adjustment in this situation,[136] which is inappropriate.

In addition, if Parent gave a remainder interest to Child and incurred gift tax on 100% of the trust property because Parent's retained interest was not a qualified interest, and if Child thereafter gave that remainder interest to Grandchild, it appears that no rule prevents an inappropriate double taxation of 100% of the value of the trust to Child. For GST purposes, the §2702 value will not govern if Parent gives the remainder to Grandchild directly, incurring a GST, and §2642(f) would preclude allocation of exemption to the remainder interest until Parent's §2036(a)(1) exposure attributable to the retained income interest terminated.

As an extreme example of the inappropriate double taxation that could occur, assume that Parent (P), Child (C), and Grandchild (GC) jointly purchased property from an unrelated third party. P purchased a term interest, C purchased a life estate measured by C's life following P's term interest, and GC purchased the remainder. Because members of the same family have purchased interests in this property, §2702(c) is applicable, making P a deemed transferor to C and to GC, in each case for consideration equal to the amounts each paid. If P's term interest is not a qualified interest, its value will be deemed to be zero and gifts to both C and GC will result. In addition, C will be deemed to have purchased the entire property and sold interests in it to both P and GC for the amount of the consideration they paid. If C's interest is not in qualified form, it too would be treated as having a zero value, resulting in gifts by C to P and to GC. Perhaps some form of net gift[137] treatment would work in this situation, but the gifts made by each of P and C should not double up and will require an appropriate adjustment, which is not provided in the regulation.

§7.2.3 *Special Valuation of Certain Business Interest Transfers*

A second special rule exists in Chapter 14 of the Code,[138] again determining whether a transfer has occurred and its gift tax value when a form of "estate freeze" transaction occurs in the context of planning that involves corporate and partnership interests. This provision reflects the congressional determination that certain "bells and whistles" that can be built into stock or partnership interests may be designed to increase artificially the value of interests in a corporation or a partnership that are retained when other interests are given away. In that manner, these special provisions are used to reduce or distort the gift tax consequences of the transfer.

To preclude such planning, §2701(a)(1) applies a special valuation regime that ignores certain liquidation, put, call, and conversion rights, and noncumulative dividend rights, all for purposes of determining the value of any corporate or partnership interests that are retained by a transferor. This treatment correspondingly affects the value of related corporate or partnership interests that are transferred by the transferor. The net result is to diminish the value of what is retained and correspondingly increase the value of the transferred interests, under a "subtraction" method of determining the value of a transfer. This approach looks to the value of the entire entity (or the transferor's interest in it) and subtracts only the value of what the transferor retains, regarding the balance as the value of the gift.

Technically, the rule in §2701(a)(3)(A) specifies that, in the context of transfers between family members,[139] the value of an "applicable retained interest" that is not a "qualified payment" is zero for purposes of determining the gift tax consequences of a transfer. If this provision applies, other interests in the corporation or partnership are deemed to represent all of the value of the entity for wealth transfer tax purposes.[140] Thus, if a taxpayer transfers an interest in the entity, the result is a gift subject to tax as if the transferor did not retain the applicable retained interest.

To illustrate, if Parent (P) owned all the noncumulative preferred and common stock in Family Corp. and transferred all of that common stock to Child (C), the value of the gift would be computed as if the preferred stock owned by P (which is an applicable retained interest) had no value.[141] In effect, P would be taxed on a gift of 100% of the value of Family Corp. to C, notwithstanding P's retention of the preferred stock.

To make this example a little more interesting, consider §2701(a)(1)(B), which specifies that interests retained by an "applicable family member"[142] of a transferor also are subject to §2701 in valuing a gift. Thus, if C later gives the common stock received from P to C's child (GC), and if at that time P still holds the preferred stock, C also would be deemed to make a gift of 100% of the value of Family Corp., notwithstanding that C owned no other interest in the corporation and engaged in no estate planning activities that might be regarded as strategic.

There is double taxation here, because P and C both incur gift tax on the value of an interest that P still owns and that probably will be subject to tax a third time when P ultimately transfers the preferred stock (such as at P's death). To address this fact, §2701(e)(6) directs the Secretary of the Treasury to promulgate regulations that make adjustments "to reflect the increase in the amount of any prior taxable gift made by the transferor" pursuant to these rules. For example, if P was to give the retained preferred stock to either C or GC, one possible implementation of this mandate would be to presume the preferred stock to be worthless for future wealth transfer tax purposes — the full value of what P originally owned already having been taxed (in this case twice).

Instead, the regulations[143] adopt a different interpretation of §2701(e)(6) that treats P's subsequent gift of the preferred stock as another taxable gift. To avoid double taxation (because the value of that stock was subject to tax when P earlier transferred the common stock to C), this approach reduces P's adjusted taxable gifts base to regard the prior gift as limited to the true FMV of P's common stock. With a proper purge of the deemed gift of P's preferred stock and a credit for any gift tax paid by P on that deemed gift, subsequent taxation of P's actual gift of the preferred stock should not be unfair. But this solution does nothing about the fact that C paid tax on the value of P's preferred stock as well, and no subsequent gift by C necessarily will trigger an opportunity to adjust for this impropriety (for example, if C transfers it after P's death).

The proper end result would be to tax no more than 100% of the value of the entity as ownership in the form of junior and senior equity interests (common and preferred stock) is transferred by P and again on the correct value of the common stock when it is transferred by C. This is not exactly what the mandated regulation provides. It comes close with respect to P, but not with respect to C because, in this case, the prior taxable gift that is inconsistent with 100% taxation when C gives the common stock to GC was made by P, not by C. The regulation does not reflect that both P and C have been assessed a gift tax that ignores the value of P's preferred stock.[144]

In the foregoing examples, if P had owned only 60% of the preferred and common stock in Family Corp. and transferred all of the common stock P owned to C, §2701 would treat P as making a gift of the full value of what P owned — P's 60% controlling interest in the corporation — notwithstanding P's retention of the preferred stock. A control stock premium would be applied in valuing that 60% interest.[145] If, however, P transferred only one-sixth of P's common stock (10% of the total common stock in the corporation) to C, P's preferred stock still would be ignored in its entirety in valuing P's gift, P would be treated as giving C an amount equal to one-sixth of the total value owned by P, and a minority discount would be applied to the sliver actually transferred, after determining that one-sixth amount.[146] In this case, that amount would not be just 10% of the total value of the corporation, adjusted to reflect the minority discount, because the starting point of the computation under the government's interpretation is the value held by P prior to the gift, which includes a control premium.[147]

The general explanation that accompanied the proposed Chapter 14 regulations specifically stated that "sections 2701 and 2702 determine gift tax consequences at the time a transfer is made [but] they do not change the value of the transferred property for other tax purposes. Thus, in general, [they] do not apply for purposes of the generation-skipping transfer tax." The preamble to the final Chapter 14 regulations confirmed this position by stating that "the final regulations reject the argument that section 2701 determines the value of the transferred property" for any other purpose. Thus, a §2701 zero valuation of P's preferred stock presumably would not apply for GST purposes if P made a direct skip transfer of the common stock to GC, or placed it in a trust for the benefit of C for life, remainder to GC.[148]

Otherwise, if it was the case that a transfer has a value of zero, one difficult issue would be whether P could avoid allocation of any part of P's GST exemption to the transfer and still guarantee that it would be exempt for GST purposes when otherwise taxable distributions or terminations later occur.[149] That simply would not be the right result, and the government's interpretation precludes it.

Thus, if P gives common stock to GC and retains preferred stock, P will incur gift tax on 100% of the value of the entity due to §2701 but will incur GST only on the actual FMV of the transferred common stock. A subsequent transfer of the preferred stock to C, or to GC, or to C followed by a second transfer to GC, should trigger the §2701(e)(6) adjustment rules to avoid gift tax or FET on that same value again, but it ought to be subject to GST without regard to §2701 or the prior gift tax incurred. If this is correct, strategic estate planning through the senior and junior equity interest approach remains available for GST purposes even though it is not for gift tax or FET. The benefit of any GST opportunity is diminished, however, because the GST is imposed at a flat rate, and any benefit disappears entirely if growth assets are used to pay the tax.

To illustrate, if Family Corp. is worth $100x today and is expected to double in value before the next taxable event, incurring a 40% GST immediately and paying it with corporate value would leave $60x that would grow to $120x. Incurring the same 40% tax at the next taxable event on $200x would leave the same $120x. Only if the immediate tax could be paid with assets that would not grow at the same rate would this result be improved. Mystifying about all this is that, if §2701 does not apply for GST purposes, then no special §2701(e)(6) adjustment is needed for GST purposes, making the reference in §2701(e)(6) to Chapter 13 a puzzle. Nothing in the regulations addresses this quandary, and questions about the ultimate operation of a §2701(e)(6) adjustment and the interplay with the GST are incapable of being answered on the basis of information now available.

§7.2.3.1 Technical Requirements

Section 2701(a) only applies if there is a transfer of a nonmarketable junior equity interest in a corporation or partnership[150] to or for the benefit of a family member. Moreover, it does not apply if the transferor holds and transfers any part of only one class of interest (ignoring differences in nonlapsing voting power or partnership management rights and limits on liability),[151] if the transferor retains only marketable interests,[152] or if the transferor retains only distribution rights that constitute "qualified payments."[153] These requirements and exceptions are the heart of the statute's application.

A nonmarketable interest is one for which quotations are not readily available on an established securities market.[154] The term "family" is used in several contexts in Chapter 14 and is defined differently in several places. For purposes of §2701(a)(1), which deals with transferees, the term includes the transferor's spouse, lineal decedents of the transferor or of the transferor's spouse, and spouses of those lineal descendants.[155] This is the most narrow definition of "family" found in Chapter 14. The term "transfer" includes recapitalizations, redemptions, capital contributions, and similar transactions[156] or changes in an entity's capital structure[157] if the taxpayer or an "applicable family member" receives or otherwise holds thereafter an "applicable retained interest."[158]

With respect to capital structure transactions, it remains to be seen whether creation of a new business, or a §355 spin off or split up, will trigger §2701. PLR 8936083 may be helpful in this respect. It evaluated a complicated §355 corporate consolidation and distribution that effectively put the stock of several divisions or subsidiaries in the hands of various employees and shareholders. After concluding that the transactions generated no income tax, the Ruling addressed the consequences of the proposed distributions under the since repealed §2036(c) antifreeze provision. The important §2036(c) question was whether a §355 division of an existing corporation, followed by a transfer of all of the stock, both preferred and common, of one of the resulting corporations, avoided the application of §2036(c). The Ruling indicated that such a transfer was copacetic if it was a sale for full and adequate consideration.

More interesting was the question whether a taxpayer could effect a §355 division and gratuitously transfer all rights in one of the resulting corporations. The Ruling gave some pause if the division allocates appreciating assets into one of those divisions.

> Where separate entities are utilized to engage in common or interrelated activities, section 2036(c) may be applicable to the entire enterprise as well as to the separate, isolated activities. For example, where an enterprise is separated into an operating entity and an entity designed to hold appreciating assets, an individual may not avoid the application of section 2036(c) by limiting his holdings to the operating entity.

But what if the transaction merely separates identifiable divisions of a corporation, and the more profitable or growth division is transferred? For example, if Parent owns Furniture Co. with one store in a declining downtown region and another in an affluent suburb, could the operation be divided into two separate entities, followed by a gift to Child of all the stock in the suburban store entity? The regulations under §355 indicate the types of entity divisions that would be income tax free and that might succeed for estate planning purposes.

A transfer is not deemed to occur if the pre- and post-transaction interests of the taxpayer and the applicable family members are substantially the same as before the transaction.[159]

The regulations[160] specify that "section 2701 applies to a transfer that would not otherwise be a gift under Chapter 12 because it was a transfer for full and adequate consideration." For example, it applies to transactions that are treated as transfers for purposes of triggering §2701, including those §2701(e)(5) deemed transfers (capital contributions, redemptions, recapitalizations, or other changes in the capital structure of the entity) — a capital structure transaction — if an applicable retained interest is received or retained in conjunction with it.[161]

A "capital structure transaction" is a transfer if the transferor or an applicable family member (1) thereby receives an applicable retained interest, or (2) held an applicable retained interest before the transaction and, in exchange for the surrender of a subordinate equity interest, receives property other than an applicable retained interest as a result of the transaction, or (3) surrenders a nonsubordinate equity interest, causing the FMV of any applicable retained interest already held to increase.[162] Specifically mentioned are contributions to a start up entity[163] and termination of any interest attributed to the transferor, such as from an entity (another corporation, a partnership, a trust, or the like).[164]

Specifically excluded are three items not anticipated by the statute:[165]

- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[166] For this purpose, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same.[167]
- A shift of rights occurring upon the execution of a §2518 qualified disclaimer.

- A shift of rights occurring upon the release, exercise, or lapse of a power of appointment other than a general power of appointment described in §2514, except to the extent the release, exercise, or lapse otherwise would be a transfer under Chapter 12.

For purposes of determining who retains an interest that will trigger §2701, an "*applicable* family member" includes the taxpayer's spouse, ancestors of the taxpayer or of the taxpayer's spouse, and spouses of those ancestors.[168] And transfers by a partnership, corporation, trust, or other similar entity are attributed to the partners, shareholders, beneficiaries, settlors, or other appropriate individuals who are deemed to hold the entity's interests.[169] Under this entity attribution rule:

- Interests held by a corporation are attributed to shareholders in proportion to the FMV of their ownership of the corporation.
- Interests held in a partnership are attributed on the basis of the FMV of the higher of the partner's interest in profits or capital.
- Interests in trust are attributed to a beneficiary to the extent the beneficiary could receive a distribution of the equity interest or the income or proceeds therefrom in the maximum exercise of the trustee's discretion.
- Trust interests are attributed to the trust's settlor to the extent the trust is deemed owned by the settlor under the grantor trust rules.[170]

Because these rules could cause attribution to more than one person, or cause multiple levels of attribution,[171] ordering rules are imposed to determine which individual should be the "recipient" of attributed amounts,[172] and an interest that is attributed to an individual in more than one capacity is treated as held only once — in the capacity that results in the largest amount being attributed.[173]

Assuming they are correct, the positions stated in PLR 9321046 reveal how convoluted these rules may become. Involved was the multiple attribution rule applicable to stock held in a trust.[174] The situation involved a family held corporation, the stock being owned 47% by the taxpayer, 50% by a nonmarital trust created by the taxpayer's predeceased spouse, and 3% by their descendants. The Ruling addressed the consequences if the corporation was recapitalized so that its existing common stock was replaced with both common and preferred stock. A recapitalization is not a transfer for §2701 purposes if all stockholders in the transferor's family hold substantially the same interest after the transaction as before,[175] and in this case each stockholder would end up with the same percentages of both common and preferred stock as they previously held of common stock alone. As a result, at first blush it appeared that the recapitalization would not trigger §2701.

Then the question arose about how to regard the stock held in the trust, which the attribution rules require to be treated as held by its beneficiaries. That alone would not be a problem, because the relative interests of the beneficiaries would not change in the trust. Upon closer inspection, however, the Ruling stated that different attribution occurs with respect to preferred stock (an applicable retained interest) than with respect to common stock (a subordinate equity interest) under the disparate rules applied by the regulations.[176] Because of this disparity, the Ruling concluded that the taxpayer and the descendants would not be deemed to hold substantially the same interest before and after the recapitalization, which meant that the recapitalization alone would trigger §2701 even though nothing occurred other than issuance of new stock certificates to represent the same percentage ownership of the corporation.

Because of this deemed transfer, the Ruling held that the §2701 valuation rules must be employed to determine the value of what the taxpayer and the descendants were deemed to own before and after the recapitalization, all reflecting deemed ownership under the attribution rules, with a potentially substantial gift tax liability notwithstanding that no transfers of any kind actually occurred. If the Ruling is correct, it also could mean that a postmortem recapitalization by an estate in anticipation of using preferred and common stock to fund, respectively, a marital and a nonmarital trust to accomplish a freeze during S's overlife could result in gift tax liability. This could be the result even before an allocation is made and even though that liability would not apply if the estate made the same allocations of preferred and common stock that was held by D at death. That result does not appear to be correct, and the actual Ruling position may not be either.

§7.2.3.2 Applicable Retained Interests

The primary objective of §2701 is to deny value to certain "applicable retained interests." In determining the value of transferred interests, it ignores the value otherwise attributable to interests such as most liquidation, put, call, and conversion rights.[177] But other interests in the entity — distribution rights that include the right to stock dividends or partnership distributions — are disregarded as applicable retained interests only if, immediately before the transfer, the transferor and applicable family members held control of the entity.[178] This requirement is not imposed with respect to liquidation, put, call, and conversion rights. Excepted from the rule that disregards their value are rights that must be exercised at a specified time and in a specific amount,[179] or rights to convert into a fixed number or percentage of the same class of interest transferred, if the right is nonlapsing and is adjusted to reflect stock splits, accumulated unpaid dividends, and similar changes to the capital structure that should not affect the shareholders' relative ownership interests.[180]

The regulations further refine these concepts in some cases by employing terms that are not found in the statute. There are "qualified payment rights,"[181] "distribution rights" (which include qualified payment rights),[182] and "extraordinary payment rights," which include any retained "put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest."[183] A "mandatory payment right" is a right to receive payments that are fixed as to both time and amount (for example, a preferred stock redemption right), including a right to receive a specific amount on death.[184] But "liquidation participation rights" (just what the name implies) generally are deemed not to exist if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation.[185] Finally, "nonlapsing conversion rights" entitle the owner to convert an equity interest into a fixed number or percentage of shares of the same class as the transferred interest, and all of these are defined as neither extraordinary payment rights nor distribution rights.[186] This means that they are not ignored, their value is deemed to exist for gift tax purposes, and their retention reduces the value of any gift of other interests in the entity.

A "distribution right" that will be ignored as a retained interest is defined as a right to receive corporate or partnership distributions with respect to stock or partnership interests that are not "junior equity." This is logical because the special valuation rule is not necessary if junior equity is retained rather than transferred — junior equity participates in future growth and therefore does not constitute a strategic estate planning instrument.[187] In addition, §2701 does not apply if the applicable retained interest is of the same class as the transferred interest (or is proportionally the same as the transferred interest when differences in nonlapsing[188] voting rights or, in a partnership, in management rights and limited liability are ignored).[189] Thus, the §2701 valuation rule does not apply to distribution rights (1) in a corporation with only one class of stock, (2) to a one tier partnership, or (3) to a multiclass corporation or multitiered partnership if the transferor held only one class of stock or tier of partnership interest.[190]

The regulations contain a statement that "any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest" is not a distribution right.[191] This appears to be the regulatory embodiment of the §2701(c)(1)(B)(i) rule that "a right to distributions with respect to any interest which is junior to the rights of the transferred interest" is not a distribution right. An applicable retained interest is described as any equity interest with respect to which there is either an extraordinary payment right or a distribution right.[192] The result is to exclude rights with respect to junior equity from the class of retained interests that are valued at zero under §2701.

Because §2701(a)(2)(B) excepts retained interests that are of the same class as the transferred interest, and §2701(a)(2)(C) excepts retained interests that are "proportionally the same as the transferred interest," either provision might apply with respect to a multiclass entity in which the transferor owns interests in several classes and transfers the same proportionate share of each holding. For example, §2701 should not apply if the transferor owned 80% of the preferred stock of X Corp. and 50% of the common stock of X Corp. and transferred to a family member one-fifth of each holding (16% of the total preferred stock and 10% of the total common stock in X Corp.). In this respect, the regulations refer to transfers of a "vertical slice" of interests in an entity that effect "a proportionate reduction in each class of interest held by the transferor and all applicable family members in the aggregate." Thus,

> section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P *and* any applicable family members, *in the aggregate,* by 10 percent *even if the transfer does not proportionately reduce P's interest in each class*.[193]

Apparently this means that, of P's 50% ownership of each class, something other than 10% of some classes could be transferred and the proportionate transfer exception could apply.

For example, assume P owned 50% of Class A common, 50% of Class B common, and 50% of the preferred stock, and that applicable family members own another 10% of Class A common, 20% of Class B common, and 40% of the preferred stock. Apparently the proportionate transfer rule will apply if P transfers an amount of Class A common that reduces the aggregate 60% ownership interest by 10%, and transfers an amount of Class B common that reduces that aggregate 70% ownership interest by 10%, and transfers an amount of preferred stock that reduces that aggregate 90% ownership by 10%, even though P's transfers are not proportionately the same slice of the stock interests owned solely by P.

The Secretary of the Treasury is authorized by §2701(e)(7) to promulgate regulations treating a retained interest as two or more separate interests to facilitate qualification for the one class of interest exception, as illustrated by the Conference Committee Report:[194]

> *Example 3.* Mother owns all the stock in a corporation. One class is entitled to the first $100 in dividends each year plus half the dividends paid in excess of $100 that year; the second class is entitled to one half of the dividends paid above $100. The preferred right under the first class is cumulative. Mother retains the first class and gives the second class to Child. Under the conference agreement, Treasury regulations may treat an instrument of the first class as two instruments under the provision: one, an instrument bearing a preferred right to dividends of $100; the other, an instrument bearing the right to half the annual dividends in excess of $100, which would fall within the exception for retained interests of the same class as the transferred interest.

Because control is required with respect to distribution rights, "control" is defined to mean (1) 50% of the vote or value of a corporation's stock, (2) 50% of the capital or profit interests in any partnership or, (3) any general partnership interest, if the partnership is a limited partnership interest.[195] Again, an attribution rule imputes ownership from entities such as corporations, partnerships, and trusts to shareholders, partners, beneficiaries, and settlors.[196]

§7.2.3.3 Qualified Payments Exception

If all the threshold requirements for §2701 to apply are met, there is yet another way to avoid its application to a gift of a junior equity interest, because §2701 does not apply to a retained distribution right that "consists of a right to receive a qualified payment."[197] Such as a periodic cumulative preferred dividend (or similar partnership distribution) payable at a fixed rate or tied to a specific market interest rate.[198] As to these, the special valuation rule is not imposed and normal valuation principles will be applied.

Valuation of the retained interest for purposes of valuing the transferred interest reflects the rate of return specified in the qualified payment and gives "due regard to the corporation's net worth, prospective earning power, and dividend-paying capacity."[199] As to these interests, the Code reflects a degree of assurance that the payments will be made, and this reduces the risk than an untaxed imputed valuation increase to the transferee attributable to undervalued dividends will occur. That is, the transferee does not stand to get richer because the transferor does not receive dividends or other retained enjoyment. Thus, the Code permits a portion of the value of the entity to be assigned to these qualified payment applicable retained interests held by the transferor, and to that extent the transferred interest is worth less and incurs less gift tax liability.

A qualified payment that can be reduced or eliminated because it is subject to a liquidation, put, call, or conversion right will be valued, however, as if each right was exercised in the manner that produces the lowest value for the entire bundle of rights held by the transferor.[200] As illustrated by the Conference Committee Report:[201]

> *Example 1.* Father retains cumulative preferred stock in a transaction to which [§2701] applies. The cumulative dividend is $100 per year and the stock may be redeemed at any time after two years for $1,000. . . . [T]he value of the cumulative preferred stock is the lesser of (1) the present value of two years of $100 dividends plus the present value of the redemption for $1,000 in year two, or (2) the present value of $100 paid every year in perpetuity. If the present values are substantially identical, the stock receives such value.

The regulations posit an illustration in which a transferor has an immediate right to put retained preferred stock to the corporation for $900,000 and a qualified payment right valued at $1 million, resulting in a value being placed on the preferred stock of the lesser amount, reflecting a valuation assumption that exercise of the put right will occur immediately.[202] As so limited, however, the value attributed to a qualified payment reduces the value of any transferred interest for gift tax purposes, which usually is desirable to the transferor.

§7.2.3.3.1 *Unpaid distributions*

Fundamental to ascertaining the proper gift tax value of a retained qualified payment right is that the specified payments must be made. If they are not, §2701(d) dictates that, on future taxable events, the value of the applicable retained interest is deemed to include the value of unpaid qualified payments.[203] This "suspense account" value is determined under a compounding approach that assumes the qualified payment was distributed when due and then invested by the transferor at an annually compounding yield equal to the discount rate originally used to value the stream of qualified payments that constitute the applicable retained interest.[204]

Consistent with the rationale for §2701 — to prevent strategic estate planning but not legitimate transfers — the suspense account increase in value under this unpaid dividend rule cannot exceed the transferor's share of the increase in value of all equity interests that are junior to the applicable retained interest, accruing since the subject transfer.[205] To determine the transferor's maximum unpaid dividend suspense account value, the transferor is deemed to own only a proportionate share of the appreciation in the junior equity interest(s), reflecting the fraction of the class of applicable retained interest owned by the transferor.[206] This is sensible because it is only to the extent of appreciation in the value of junior interests that any strategic planning shift of value has occurred, and only that amount should be subject to wealth transfer tax recapture under this unpaid dividend rule.

For this purpose, amounts paid in redemption of subordinate equity interests are treated as appreciation,[207] the notion being that amounts paid to redeem junior equity interests are growth that this rule was meant to tax. Furthermore, if an individual owns applicable retained interests in more than one class of the entity, the percentage of the entity's growth that constitutes the appreciation limitation is the greater ownership percentage.[208]

Moreover, a four year grace period is granted within which to make cumulative preferred dividend payments before invoking the unpaid dividend rule.[209] No provision specifies whether partial payments can be made at any time within the four year catch-up period, nor does the Code dictate how payments are to be applied against accumulated deficiencies from several years. However, arrearage payments are deemed to satisfy the oldest unpaid qualified payment,[210] which might cause a payment to be regarded as made too late to fall within the four year grace period. And the Code provides no relief from the imposition of tax on an arrearage if the transferor dies or transfers the retained interest within the four year grace period.[211] Thus, the Code taxes the suspense account value as if the deficiency will not be caught up and there is no procedure to file a refund claim if later it is.

Taxable events that will trigger taxation of this suspense account value include death of the transferor, disposition of the applicable retained interest,[212] termination of the interest, or an election by the taxpayer.[213] The rule in §2701(d)(3)(A)(iii) that permits a taxpayer to treat a dividend payment coming after expiration of the four year grace period as a taxable gift (to incur tax immediately on the payment rather than have it increase the annually compounding suspense account), cannot be used in conjunction with the §2701(d)(2)(B) appreciation limitation. The election to immediately incur tax will result in the full distribution being subjected to tax even if there is little or no actual appreciation in the value of the junior equity interests of the entity.[214] This position will preclude a taxpayer from manipulating the timing of late payments (and elections with respect to them) to minimize tax by tracking periodic market value fluctuations. Moreover, a taxpayer who makes this election is treated as making it with respect to every late qualified payment previously made as to which the immediate tax election could have been made but was not.[215]

The statute does not specify who will pay the tax on the occurrence of any of these events. Because there is no federal reimbursement provision dealing with this question, presumably any applicable state law will control. In most cases, any FET attributable to this suspense account value most appropriately would be apportioned to the recipient of the transferred interest because the tax attributable to the suspense account value is invoked by treating the transferred interest as worth more than otherwise it would be. It might be argued, however, that the entity is holding the unpaid dividends generating this suspense account value and liability, and that the entity therefore ought to pay the increased taxes attributable to it. The problem with this approach is that the entity may be unable to pay the tax for the same reasons it is unable to pay the distributions that are in arrears.

Moreover, it is possible that the transferor does not own the applicable retained interest (instead, it may be held by an applicable family member) and that any §2701(d) tax invoked by the transferor's death will relate to an asset not includible in the transferor's estate. Although §2701(d)(1)(A) deems the transferor's estate to increase by virtue of the suspense account value, there would be no actual transfer of the applicable retained interest and, thus, under the tax apportionment rules of most states, no one to whom the tax would be attributable. In such a case, it might be the actual owner of the interest — the applicable family member — to whom the tax should be apportioned.

The specter of this apportionment occurring raises the issue whether this tax is unconstitutional, imposed as it is with no transfer of the applicable retained interest and no transferee. To be valid, the tax under Chapters 11 through 14 must be a wealth *transfer* tax, not a direct (unapportioned) tax on property.[216] Adding to the complexity of this rule is the fact that a gift tax apportionment regime is not likely to exist under state law if the taxable event is an inter vivos transfer of the applicable retained interest or a §2701(d)(3)(A)(iii) election by the holder of the interest. Nor is it clear that this rule applies at all for GST purposes or, if it does, who is the donor or transferee.

The transferor will face double taxation if the §2701(d) taxable event is sale of the applicable retained interest and the buyer pays consideration that reflects the probability that the accumulated preferred dividend will be paid. One tax will be imposed on the full suspense account value as a deemed gift triggered by disposition of the applicable retained interest. The other tax is imposed on the consideration paid in contemplation of the suspense account payments being made. No §2701(e)(6) offset or credit is provided in these circumstances, nor is it clear how to determine whether any consideration received from a transfer is attributable to accumulated dividends that the buyer expects to be paid in the future.

If the accumulation ultimately is paid, double taxation should permit a refund of any tax imposed that is attributable to the suspense account value.[217] Moreover, there also would be an improper double inclusion problem at death if the §2033 value of the applicable retained interest itself reflects the cumulative unpaid dividend. Treas. Reg. §25.2701-4(c)(1)(ii)(C) precludes this double taxation of the suspense account value, once under §2701(d)(1) and again as a part of the value of the underlying stock interest (because the dividend payment accrued but unpaid is a cumulative right that increases the value of the stock to which it adheres). It effectively provides for a reduction of the suspense account value for amounts includible in the gift tax or FET base without regard to §2701(d).

Although there are no basis provisions anywhere in Chapter 14, a §1015 basis adjustment should be permitted (presumably to the holder of the transferred interest, because that person is deemed to have received added value attributable to the overdue dividends) for the gift tax attributable to the suspense account value. In addition, §1014 should apply with respect to that value if a deemed transfer occurs at the transferor's death. In this respect, however, §1014(c) may apply if the taxable event is death of the transferor and the suspense account is treated as IRD for income tax purposes.[218]

In explaining the unpaid dividend rule, the Conference Committee Report provides the following helpful, albeit flawed, illustration:[219]

> *Example 5.* A corporation has four classes of stock. Class A is entitled to the first $10 of dividends each year; Class B is entitled to the second $10 of dividends each year; Class C is entitled to the third $10 of dividends each year; and Class D is entitled to all dividends in excess of those paid to Classes A, B, and C. Classes A, B, and C all have cumulative rights to dividends. In a transaction to which [§2701] applies, Father gives Daughter stock in classes A and C while retaining stock in class B. Class D is owned by an unrelated party. Dividends are not paid on the Class C [*sic* — this should be Class B] stock. The cap on future amounts subject to transfer tax equals the excess of the fair market value of stock in Classes C and D at the date of Father's death over such value at the date of the gift multiplied by a fraction equal to the percentage of Class B stock held by Father.

In applying the unpaid dividend rule the taxable event will be ignored and the spouse will be treated as the transferor for future application of these rules[220] if a transfer is not taxable as a gift because it qualifies for the gift tax annual exclusion or the marital deduction, or constitutes a sale for full and adequate consideration to the transferor's spouse. Again this raises difficult unanswerable questions regarding payment of the tax and the appropriate §2701(e)(6) adjustments.[221]

§7.2.3.3.2 *Qualified payment elections*

Two irrevocable elections are provided by §2701(c)(3)(C), one to waive qualified payment treatment to preclude application of the suspense account compounding rule, and the other to treat any distribution right as a qualified payment to the extent not inconsistent with the underlying legal instrument generating that right. A requirement added by the regulations to the §2701(c)(3)(C)(ii) election into qualified payment status is that the payments elected are permissible under the legal instrument and "are consistent with the legal right of the entity to make the payment."[222] In addition, the regulation specifies that the value of a qualified payment, following an election in, cannot exceed the FMV of that right determined without regard to the election.

Little detail is given as to how this can be accomplished as a practical matter,[223] but the Conference Committee Report provides the following illustrations:[224]

> *Example 2.* Father and Daughter are partners in a partnership to which Father contributes an existing business. Father is entitled to 80 percent of the net cash receipts of the partnership until he receives $1 million, after which time he and Daughter both receive 50 percent of the partnership's cash flow. Father's liquidation preference equals $1 million. [T]he retained right to $1 million is valued at zero, unless Father elects to treat it as a right to receive qualified payments in the amounts, and at the times, specified in the election. If Father elects such treatment, amounts not paid at the times specified in the election become subject to the compounding rules.
>
> *Example 4.* . . . Treasury regulations may treat Father's retained interest as consisting of two interests: (1) a distribution right to $1 million and (2) a 50 percent partnership interest. Father could elect to treat the first interest as a right to receive qualified payments at specified amounts and times; the second interest would fall within the exception for retained interests of the same class as the transferred interest.

Partial elections may be exercised "with respect to a consistent portion of each payment right in the class as to which the election has been made,"[225] which apparently indicates that different retained interests may be the subject of separate inconsistent elections. An election out of qualified payment treatment may be made to treat *all* rights held by the transferor *of the same class* as rights that are not qualified payment rights but a partial election is permitted if "exercised with respect to a consistent portion of each payment right in the class as to which the election has been made."[226] More guidance will be required before the operation of this partial election option is clear.

An election out of the qualified payment rules may be desirable for a number of reasons. One is to avoid the complexity of the suspense account rules in §2701(d). Another is because the compounding rule is likely to subject far more value to tax than if qualified payment treatment did not apply and the gift tax was incurred on the original transfer. This gift tax would be computed tax exclusive, and it would be incurred without any suspense account value and at the value of the applicable retained interest at the time of the gift rather than at a potentially greater value when the applicable retained interest later is transferred.

Electing into qualified payment treatment has the advantage of deferring any gift tax on the value of the applicable retained interest until its subsequent transfer. This tax deferral — usually irresistibly attractive to taxpayers — may be a siren song that should be avoided.[227] It also will be far cheaper, once subjected to a qualified payment regime, to pay a dividend in a timely manner than to pass on it (perhaps in the misguided effort to increase the value of the transferred interest) at the cost of suspense account taxation. Finally, as compared to qualified payment distributions, interest payments on corporate debt also would be more desirable, which may generate interest in preferred debt recapitalizations and raise the stakes of the debt/equity debate common to other corners of the tax world.

§7.2.3.4 Minimum Capitalization Requirement

One final qualified payment requirement for transfer valuation purposes is that the aggregate junior equity interests in the entity (common stock or comparable partnership interests) must represent at least 10% of the total value of the entity and a transferred junior equity interest must be worth at least a pro rata share of that total value. Which is to say that valuation of a retained interest, even reflecting its qualified payments entitlement, cannot exceed 90% of the value of the entity.[228] For this purpose, the entity is deemed to be worth 100% of the value of all equity interests in the entity plus the amount of any debt owed to the transferor or to applicable family members (the transferor's spouse, ancestors of the transferor or of the transferor's spouse, and spouses of these ancestors). The effect of this rule is to preclude assignment of too much value to applicable retained interests in an effort to undervalue junior equity interests that are transferred to family members.

For purposes of computing this 10% of equity and debt requirement, guarantees and qualified deferred compensation obligations are not debt, nor is debt "incurred with respect to the current conduct of [a] trade or business."[229] The regulations refer to amounts payable for "current services" as an example of such business debt and also note that a lease of property is not debt if the lease payments are current and represent full and adequate consideration for use of the property, reflecting "a good faith effort . . . to determine the fair rental value" of the property. But arrearages with respect to a lease are regarded as debt.[230]

§7.2.3.5 Computation of Value

The §2701 method of determining the value of a transferred interest is described as a four step "subtraction" computation.[231] The first step requires a determination of "the FMV of all family-held equity interests in the entity . . . determined by assuming that the interests are held by one individual, using a consistent set of assumptions."[232]

The second computation step reduces this full value of the family held equity interests in the entity by[233]

- the FMV of any family held senior equity interests that are not applicable retained interests[234] and by the FMV of any family held equity interests that are not held by the transferor, members of the transferor's family, or applicable family members of the transferor and that are of the same or any subordinate class to the interest transferred.
- It is further reduced by the family-interest-percentage-adjusted[235] §2701 value of all applicable retained interests held by the transferor or applicable family members.
- Finally, if an interest retained by the transferor or an applicable family member is a qualified payment, its value is subtracted in this step.

The "family-interest-percentage" adjustment[236] in the second computation step is dictated if a family owns a greater percentage of senior equity interests than of junior interests.[237] For example, assume a transferor owned 100% of the preferred stock in a corporation and only 40% of the common stock, with the remaining 60% of the common stock owned by nonfamily members. In such a case any failure to pay dividends on nonqualified payment preferred stock would inure only 40% to the benefit of any family member donees of the common stock owned by the transferor. Thus, the family-interest-percentage adjustment permits valuation of the remaining 60% of the preferred stock as if it was held by a nonfamily member. Its actual FMV (rather than its §2701 deemed zero value) would be reflected in the second step reductions.[238]

The family-interest-percentage adjustment in this illustration would begin by determining the "family-interest percentage," which is the highest ownership percentage held by the transferor and other applicable family members in any single class of equity interest that is subordinate to the interest transferred (or the highest ownership percentage in *all* classes of equity interests that are subordinate). In this case, the family interest percentage is the 40% common stock interest because no applicable family member owned any part of the remaining 60% of the common stock.

The percentage of any class of senior equity interest held by the family (60% in this example) that exceeds this family interest percentage thus "is treated as a family held interest that is not held by the transferor or an applicable family member." This means that its value is determined as a "pro rata share of the FMV of all family-held equity interests of the same class (determined . . . as if all family-held senior equity interests were held by one individual)."[239] This speaks to whether minority discounts or control premiums are to be reflected in this determination.

Under the third computation step the remaining value is allocated pro rata, beginning with the most senior equity interests, among the remaining equity interests held by the transferor, applicable family members, and members of the transferor's family, all as if no special valuation adjustments were required under §2701.[240]

Finally, in the last step the amount allocated to the transferred interest in the third step is reduced by minority or "similar" discounts, by any §2702 retained-term-interest valuation adjustment that might be relevant if the gift triggers that provision, and by any consideration received by the transferor.[241] This final value then constitutes the gift tax value under §2701 of the transferred interest.

§7.2.3.6 Summary of the Rule and Examples of Its Application

The cumulative effect of §2701 in a typical preferred stock recapitalization is to assign a value to any preferred interest retained by senior family members only if it complies with the qualified payment requirements (or some other exception to §2701 applies). Otherwise, the value of any applicable retained interest is deemed to be zero in determining the value of common stock transferred to family members. (Similar results apply to comparable partnership transactions.) In many cases these transferred interests will be deemed for gift tax purposes to carry 100% of the value of the entity owned by the transferor.

This "easy-to-complete" valuation and taxation rule accelerates the wealth transfer tax liability attributable to the transferor's interest and guarantees that no portion of the entity's value slips into a crack between gift tax and FET. Recapitalizations are respected under this regime but taxpayers are put to a choice whether to incur tax at the time of the transfer or to guarantee through the qualified payment structure that the applicable retained interest will have an ascertainable value that is subject to tax at a later taxable event.

An applicable retained interest that is deemed to have zero value for gift tax purposes under this special valuation rule should not generate double taxation for subsequent FET purposes. But the appropriate adjustment regulations fail to completely accomplish that objective.[242] As the following examples illustrate, these adjustment regulations are a key element to the proper functioning of these rules and, because the regulations do not operate properly, sometimes this regime will produce inappropriate results.

In each of the following illustrations, assume that a freeze transaction occurred and that the transferor retained an applicable retained interest that was *not* (and was not elected to be treated as) a qualified payment. The initial transfer constituted a gift of 100% of the value of the transferor's interest because the applicable retained interest was deemed to have zero value, and the possibility of double taxation posed by §2701 arises when the transferor subsequently transfers the applicable retained interest.

Subsequent Transfer of the Applicable Retained Interest: Following a preferred stock recapitalization involving a gift of a junior equity interest (e.g., common stock), a subsequent taxable transfer of the applicable retained interest (e.g., the preferred stock) will trigger a §2701(e)(6) adjustment. Consistent treatment for all wealth transfer tax purposes should provide that the applicable retained interest is worth only the §2701(d) value, if any, attributable to suspense account accumulated unpaid dividends, meaning that a second tax of the underlying retained interest would not occur.

Instead, the regulatory mechanism[243] taxes the subsequent transfer at its actual FMV, determined at the time of the subsequent taxable transaction, plus any suspense account value, as if the value of the applicable retained interest was not subjected to gift tax previously. The regulation then reduces the transferor's adjusted taxable gifts for wealth transfer tax computation purposes by the lesser of (1) the §2701 generated increase in the gift tax value of the initial transfer, and (2) the federal wealth transfer tax value of the underlying retained interest (but not any §2701(d) suspense account value).

Similar to the purge that is directed under §2001(b) if an interest includible at death (for example, under §§2035 — 2038 or §2042) was subject to gift tax because transferred during life,[244] this mechanism is designed to prevent the subsequent transfer from incurring double taxation. Because the transferor also receives a credit for any gift taxes already paid, the net effect should be to impose a tax only on any deemed (suspense account) or actual increase in value between the original and subsequent transfers. To work properly, however, this reduction approach requires that the actual value of the applicable retained interest be determined at the time of the original transfer (perhaps based on hindsight) and that it be determined again when the subsequent taxable transfer occurs. Moreover, it ought not be limited to the *lesser* value of the §2701(d) retained interest at the later transfer.

Sale of Junior Equity: If common stock is sold to a family member rather than given away in a preferred stock recapitalization, the only difference in result would be part-sale, part-gift treatment with respect to the consideration paid. The applicable retained interest still would be deemed to have zero value if no exception to §2701 was applicable, and the transferred interest still would be deemed to carry 100% of the value of the transferor's interest in the entity, making it unlikely that the consideration paid for the common stock would be adequate to avoid gift tax liability on the transaction.[245]

Gift of Applicable Retained Interest to Spouse: An adjustment is allowed if the applicable retained interest is transferred to an applicable family member[246] so that it is not includible in the transferor's gross estate at death.[247] This result is as if the transferor gave it away immediately before death, and the adjustment is not lost in such a case.[248]

Split Gift Freeze Transaction: If the transferor's spouse consents to split the gift in a freeze transaction and the applicable retained interest is not a qualified payment, then when the applicable retained interest subsequently is transferred the §2701(e)(6) regulations should dictate three adjustments. First, the transferor's prior taxable gifts should be reduced under §§2001(b) and 2502 to prevent the inter vivos deemed transfer of the value of the applicable retained interest from being taxed to the transferor twice. Second, under §2001(d), the transferor should receive a credit for any gift tax paid by the transferor's consenting spouse.

Third, §2001(e) ought to reduce the consenting spouse's prior taxable gifts by the value of the applicable retained interest for the consenting spouse's future gift tax and FET purposes, but it is inadequate to accomplish that result.[249] As a consequence, no part of the consenting spouse's unified credit consumed on the split gift will be restored. Although the adjustment regulation could have solved this problem, it capitulated to §2001(e) instead. The real culprit in the split gift situation is the inadequate reach of §2001(e),[250] and that problem has been recognized since its adoption in 1976, with no previous corrective action. Thus, split gifts that invoke §2701 are a very poor planning device.

New Business or Split Purchase: Either §2701(e)(5) (dealing with contributions to capital)[251] or §2702(c)(2) (dealing with split purchases)[252] may be applicable if a client and another family member combine their assets to form a new business or to jointly purchase an existing business. The unanswered question is, if the applicable retained interest is to have a value other than zero, must the qualified payment requirements of §2701 or the qualified interest requirements of §2702 be met? Although these transactions are relatively similar, these rules differ significantly. Without the use of a trust and temporal interests, it would appear that §2702 is not the appropriate provision, although a purchase of term interests presumably would trigger §2702(c)(1).

Negative Freeze: In a negative freeze the value of the transferred interest declines rather than appreciates after the original transfer. The §2701(e)(6) double taxation adjustment is limited to the lesser of (1) the value of the deemed gift when the original transfer occurred and (2) the value of the applicable retained interest on the subsequent taxable transfer that triggers the adjustment.[253] This means that the regulation precludes a refund of tax paid on the basis of a higher value assigned to the transferred interest when the transaction was effected.

These regulations ought to prevent double taxation of the value of the applicable retained interest by purging the full amount of the prior taxable gift of the transferor who retained the applicable retained interest. If the applicable retained interest declined in value, inevitably the transferred interest and the underlying business entity declined in value as well. In that case no freeze occurred and none of the value of the applicable retained interest needed to be taxed at the original transfer. Thus, a §2701(e)(6) adjustment should allow taxation of the applicable retained interest at its now reduced FMV, purge the full previously taxed gift tax value of the applicable retained interest, and give a credit for any gift tax previously paid. Those results effectively would tax the applicable retained interest at the lower subsequent value, which is the right result.

Unfortunately, that is not the result selected by the regulation. The preamble to the final regulation explained that this result is attributable to the government's fear that "a reduction in the value of the entity may occur as the result of indirect (hard to detect) transfers to younger generations." Quaere whether the proper response to this subsequent transfer tax compliance issue would be to disallow the proper adjustment in all cases of diminished value, including those that involve no abusive transfers after the initial transfer. The net consequence is that a taxpayer may want to "undo" a prior transfer, such as by arguing that a string provision (§§2036 — 2038) is applicable, to include the transferred interest at death and trigger the purge and credit mechanisms in §2001(b).[254]

Disposition of the Entity: In a "short freeze" the donee of a junior equity interest and the holder of an applicable retained interest sell the business, or their interests in it, to a third party. The applicable retained interest has zero value under §2701 for gift tax purposes, but that characterization does not apply for income tax purposes. Thus, the transferor might be deemed to have made a gift of the applicable retained interest, and then a sale of the applicable retained interest also might occur, which is inconsistent. The §2701(e)(6) adjustment is meant to apply "if there is any subsequent transfer . . . of any applicable retained interest," which should include a subsequent sale as well as a wealth transfer taxable event.

To accommodate this interpretation, the prior adjusted taxable gift of the applicable retained interest is adjusted whether the applicable retained interest is included in the transferor's gross estate, is gifted during life, or is sold and the consideration received is subject to subsequent taxation,[255] all of which are proper results. Improper about this mechanism is that the consideration received is valued as of the sale or exchange, not at death, and no interest is paid on the amount of tax prepaid under this regime.[256] The consideration received instead should be recognized at its actual subsequent FMV.

Reverse Freeze: The §2701(c)(1)(B)(i) exception from the definition of applicable retained interest for junior equity interests should preclude application of §2701 to a transaction in which the transferor retains the growth interest and transfers the frozen interest. With sufficiently large dividend payments on the preferred interest, it may be possible to prevent growth in the junior equity and shift value to the frozen interest holder, all without application of §2701.

Preferred Debt Recapitalization: §2701 applies only to applicable retained interests, which do not include debt. Thus, debt issued in a recapitalization in lieu of preferred frozen *equitable* interests ought to be reflected in valuing the entity for purposes of determining the value of transferred growth interests. It would be preferable to a qualified payment because the interest on debt would be deductible by the entity. It will, however, affect the §2701(a)(4) minimum capitalization requirement. Even if the debt involved is disguised equity that could meet the definition of an applicable retained interest, it may meet the definition of a qualified payment, in which case its value would not be ignored.

Sale of an interest in an entity for a note, and perhaps also for an annuity, also should not be subject to the valuation rules of §2701 for the same reasons.[257] Nor should retained interests in the form of compensation (salary or deferred payments) or lease payments be subject to §2701, even if each entitles the payee to a percentage of the profits of the entity as part of the negotiated payments.[258] Quaere whether a different result would be argued on the more fundamental debt versus equity issue.

Pro Rata Gift Freeze: A transaction in which the transferor makes a gift or sells a portion of the only ownership interest held will qualify for the §2701(a)(2)(B) exception for one class of equity.[259] This transfer of a *portion* of all future appreciation is an easy and effective way to freeze a portion of the value of the entity without dealing with the complexities of §2701. The same should be true with respect to a transfer of nonvoting stock or a partnership interest that qualifies for the §2701(a)(2)(C) exception while the transferor retains voting interests of the same class or tier.

In either case, discounts for lack of marketability and for minority interests were not affected by §2701. Similarly, any transaction that does not alter the existing ownership percentages of the existing owners of the entity will not trigger §2701.[260] And a gift of a proportionate share of several classes of an enterprise (if, for example, the transferor owns both common and preferred interests and gives the same percentage of the transferor's holding of each) is permissible because there is no freeze abuse in such a transaction.[261]

No Retained Interest Generation-Skipping Freeze: A transferor may give all frozen interests to children and all growth interests to grandchildren, in which case §2701 should not apply (because the transferor retains no interest in the entity). This generation-skipping freeze should continue to work under §2701, although §2701 will apply if a grandchild subsequently transfers a growth interest to a family member while a lineal ancestor (the child) continues to hold the frozen interest.[262]

Split Interest Funding: The definition of family in §2702(e) refers to §2704(c)(2), which incorporates the entity attribution rule of §2701(e)(3). As a result funding a marital and nonmarital trust with frozen and growth interests, respectively, may not escape the joint purchase rules of §2702(a)(1).[263] Although funding is not itself a gift, and §2701 is a gift valuation provision, the entity attribution and joint purchase rules might deem a gift to occur for these purposes.

If this is correct, postmortem freezes through split interest funding or funding with frozen (to the marital) and growth (to the nonmarital) interests will not succeed. To the extent it is predictive of result, however, the regulations indicate that freeze funding will not implicate §2701.[264] A best case scenario for this favorable result would be if S is not the personal representative doing the funding and the junior and senior equity interest were includible in D's estate, so no postmortem recapitalization or other deemed capital structure transaction is required to put freeze funding into motion.

§7.2.4 *Additional Gift Tax Valuation Concepts*

Other valuation concepts may affect the gift taxation of inter vivos transfers in ways that are taxpayer favorable. In some cases these are not distinct from the valuation that would apply for FET purposes. Thus, this discussion does not necessarily inform inter vivos transfers instead of testamentary dispositions.

§7.2.4.1 Blockage Discounts

A taxpayer may own and transfer such a large quantity of a particular asset that the market for that asset would be depressed by an immediate sale of the entire holding. This depressive effect in the willing-buyer, willing-seller valuation context leads to a "blockage" discount and is best illustrated by Calder v. Commissioner,[265] a gift tax case involving artwork that previously was included in the estate of the donor's deceased husband, artist Alexander Calder. The donor made transfers of over 1,000 gouaches (opaque watercolor paintings) to four separate trusts. In valuing the transfer for gift tax purposes, the donor used the value of the gouaches established for FET purposes in the decedent's estate, reflecting a 60% discount for blockage because the art market could not readily absorb a sale of the number of these watercolors involved.[266]

The government wished to increase the gift tax value of these transfers. It argued that the total number of gouaches transferred to the four trusts could not be aggregated for purposes of determining blockage, notwithstanding the fact that the total transfers collectively would depress the market if all the gouaches were sold at one time. The Tax Court agreed with this proposition, citing the government's regulatory position[267] that the value of each gift must be determined separately.

The government attempted to ascertain the value of each gouache, and thereby the value of each of the gifts, using a figure that it estimated as the total number of sales that the market could absorb in a given year, without prorating that total sales figure across the separate gifts made. The Tax Court took exception with this, holding that the market could absorb only a certain number in a given year, whether from a single trust or from several, and that it was improper to value each of the gifts as if *each* trust could sell the *total* number received in a given year.

The end result was a value suspiciously similar to that determined by the government as the FET value of the total number of gouaches in the decedent's estate, giving the impression that the blockage issue with respect to each *separate* gift was a chimera. Whether the same result would obtain in another situation, however, remains subject to the court's admonition that blockage is a question of fact to be decided under the special circumstances of each case.

Similarly to *Calder*, the sole issue in Estate of O'Keeffe v. Commissioner[268] was the appropriate blockage discount for the approximately 400 works of art created and owned by the decedent at death (rather than for gift tax purposes, but the same principles inform both determinations). The court rejected as a matter of law the government's expert witness valuation because it excluded from the blockage consideration all works bequeathed to museums or otherwise unavailable for sale (the government's theory being that they would not be sold, much less all at once), stating that valuation must assume that the entire collection is marketed at the same time.

The court also rejected as unsupported by reason or authority the approach of one expert for the estate who assumed sale of the entire collection at one time to a single purchaser (a syndicate of investors) that would sell the collection piecemeal over a substantial period of time. Eventually the court determined that the collection should be bifurcated into a group that could be sold in a relatively short time and another that would require substantial effort over an extended period.[269]

Blockage discounts can be applied to other types of assets — most commonly collectibles, some types of real estate,[270] or other assets for which there is a relatively thin market[271] — but on occasion can be relevant with respect to even a small percentage of the stock of a publicly traded corporation, if the evidence supports the notion that sale of that holding all at once would move the market.[272]

§7.2.4.2 Fractional Interests

A simple and relatively noncontroversial method to reduce values for wealth transfer tax purposes is to create a fractional interest in property that is not easily severed. For example, splitting a 1000 share holding of IBM stock is easy and no fractional interest discount would be generated by a gift of 50% of that interest. But undivided tenancy in common[273] ownership of Blackacre usually is far different. As a consequence, with select assets the amount a willing buyer would pay a willing seller for an undivided fractional interest is less — in many cases substantially less — than a pro rata portion of the FMV of an undivided property interest. Thus, especially in anticipation of FET liability at death, a transfer inter vivos that bifurcates ownership title in certain assets can be a particularly effective gifting technique.

Mooneyham v. Commissioner[274] is an excellent illustration. The court granted a 15% fractional interest discount in establishing the proper gift tax valuation of a half interest in the taxpayer's interest in development realty that was transferred to the taxpayer's sibling (and, presumably, a similar discount would apply for the retained half if still owned when the taxpayer died).[275] The court sharply rejected the government's argument that the availability of a discount should depend on the relationship of the donor and donee and adopted instead a hypothetical unrelated willing-buyer, willing-seller approach.[276] Apparently no argument was advanced by the government that the donor's transfer of the undivided interest that generated the fractional interest reduction in value constituted an additional gift, much like the transfer of a controlling shareholder's control premium may occur when a sliver interest gift is made,[277] although such an argument would be hard to maintain because that value was not directed at the donee of the ostensible gift.[278]

Citing the gift tax valuation decision in *Mooneyham*, the Tax Court in Estate of Pillsbury v. Commissioner[279] similarly concluded that a hypothetical willing-buyer, willing-seller analysis should apply to value fractional interests in real estate. The government resisted that discount because 100% of the value of the property was owned by two trusts with the same trustee and the taxable portion (flowing out of a marital deduction trust at the death of S) passed to a nonmarital trust that owned the other portion of the property, meaning that the property could be sold as an undivided entirety. The court specifically stated that ownership of the remainder interest and the ultimate disposition of the fractional interest was irrelevant, instead noting that the government's unity of ownership notion is inconsistent with a willing-buyer analysis of the amount that would be paid to purchase only the taxable portion of the property.[280]

Subsequently, and presumably reflecting its losses in *Mooneyham* and *Pillsbury*, the government issued TAM 9336002, in which it took a new position that did not challenge the discount itself. Instead, that position was that the discount should be *limited*, to "the petitioner's share of the estimated cost of a partition of the property,"[281] based on the theory that partition would be the most efficient means to generate the most economic benefit from property owned by multiple parties. But in Estate of Cervin v. Commissioner[282] the Tax Court rejected the very similar position advocated by the government that the estate's fractional interest discount should be limited to 5% *plus* half the cost to partition the property. Instead, the court granted a 20% discount to an undivided 50% fractional interest that was includible in the decedent's gross estate and passed to the owner of the other 50% interest.

Note that the typical fractional interest discount case involves realty. Ludwick v. Commissioner[283] involved a 50% undivided tenant in common interest in a dwelling and limited the discount to 17% (roughly half of what the taxpayer claimed) considering only factors such as the cost to partition, the time it would take to sell, operating costs, and rates of return and appreciation expected during that time. The taxpayer was unable to produce comparable sale figures. Stone v. United States[284] also involved a 50% undivided (probably community property) interest, in that case in art,[285] as to which the estate's expert presented no data regarding sales of undivided interests and the court correspondingly allowed no meaningful discount. It did say that "the costs of a court-ordered partition must be considered" and that "some discount is appropriate to allow for the uncertainties involved in waiting to sell the collection until after a hypothetical partition action is resolved." This was odd, given the court's other conclusion, that a hypothetical seller would not partition the art and then sell an interest. Instead, there would be a sale of the undivided work, followed by partition of the proceeds. In Estate of Elkins v. Commissioner[285.1] the Tax Court similarly granted only a "nominal" discount but rejected the estate's valuation because there was no empirical evidence that owners of fractional interests in fine art ever sell their undivided interests. On appeal the court reversed and granted the discount claimed by the taxpayer because the government failed to produce any evidence to rebut the taxpayer's expert opinions regarding value. The government's litigation position was that no discount is appropriate, which reflects the inability of the estates' experts in both *Stone and Elkins* to present data regarding sales of undivided fractional interests in art. It led the government to argue *Elkins* on a legal principle — that no discount is available — and led the appellate court to reverse the Tax Court and embrace the taxpayer's claimed discount, essentially on the procedural ground that the government had the burden to disprove the taxpayer's claimed valuation, which it failed to do. At bottom *Elkins*, *Ludwick*, and *Stone* may only confirm the need to produce proof to support a discount.

Several other cautions in this arena also may be relevant. One is illustrated by Estate of Casey v. Commissioner,[286] which denied a fractional interest adjustment to a beneficial interest in a liquidating trust (although it did grant a 15% discount that it refused to label, reflecting the anticipated delay in realization of proceeds from the sale of trust property). The fractional interest discount likely will not be available if the ownership interest (in this case the trust corpus) is not a fractional interest, nor is it likely to be applied to a beneficial interest (such as the interest of one of several trust beneficiaries).

A second caution is highlighted by TAM 9146002 in which a taxpayer purported to sell a 5% fractional interest in a personal residence (at 66% of the pro rata FMV of that interest) and then leased it back, reporting on the taxpayer's FET return the 95% interest remaining with a 43% discount that the government rejected on the grounds that the sale and leaseback was not legitimate.

Finally, Estate of Young v. Commissioner[287] concluded that, once death occurs (at least in the two person joint tenancy situation), the co-ownership aspects of joint tenancy disappear and, with it, any impediments to sale that might justify a discount for fractional interests. Notable was the court's final footnote, in which it recognized that in a normal case of qualified joint tenancy between spouses the amount includible and the amount of the marital deduction should produce an FET wash, meaning that income tax basis is the only issue at stake in most situations. It was clear that the court realized that the consequence of its holding will be a higher basis in the traditional §2040(b) qualified joint tenancy situation.

§7.2.4.3 Nonmarketable and Minority Interest Discounts

Valuation of the same asset may differ for gift tax purposes as opposed to for FET purposes,[288] almost without exception favoring inter vivos transfers that involve minority interests. This is best described by the fact that each gift made inter vivos is valued separately, not as the diminution in the donor's net worth nor as the increase in the donee's net worth either, but essentially as the gifted interest travels between the donor and the donee.[289] For example, consider the illustration of the world's largest diamond, being gifted in undivided fractional interests inter vivos. If that diamond was held until death and given in equal shares to the same donees the value for FET purposes would be the undivided diamond owned at death, regardless of the destination of the shares and the number of beneficiaries. But if that diamond was transferred to multiple donees inter vivos the value of the gift would be the value of each separate niblet, multiplied by the number of donees. And the product of that valuation would be lower than the value of the undivided whole.

Care is required in applying these principles, however, and it is easiest to consider the valuation question as if the gifted property was in neither the donor nor the donee's hands. For example, in Citizens Bank & Trust Co. v. Commissioner[290] four taxpayers collectively owned 100% of the voting and nonvoting stock of a corporation. They each created irrevocable trusts that would run for the full period of the Rule, to which three of them transferred their nonvoting stock and all four transferred their voting stock. For valuation purposes, each then alleged that the nonvoting stock was entitled to a 90% discount to reflect the fact that any purchaser from any one trust would acquire no vote and, therefore, could not acquire control of the corporation. Moreover, it was argued that valuation should reflect the reality that a purchaser would realize that acquiring voting stock from the other trusts was unlikely (because the perpetuities term trusts indicated a desire to control the corporations for as long as possible).[291] The government instead granted only a normal discount for lack of marketability and asserted that the irrevocable nature and term of the trusts should be disregarded.

In essence, the court agreed with the government's valuation without regard to the terms of the trusts, holding that restrictions imposed in an instrument of transfer are to be ignored for valuation purposes. But as illustrated in TAMs 9449001 and 9436005,[292] if a donor transfers a control block of stock (to use an easy example) in several noncontrolling interests by gift, the government will value each gift separately, each with a minority interest (and usually also a lack of marketability) discount. As these principles reveal, there are differences in the valuation of property for gift tax and FET purposes that taxpayers may exploit for estate planning purposes.

These valuation issues can be of great significance. Assume, for example, that the taxpayer owned 51% of the stock in a closely held corporation and that two children owned equal amounts of the remaining stock. If the taxpayer gave 1% of the stock to each of those children, the issue would be whether the collective value of those gifts is (1) two times 1% of the total value of the corporation, (2) a discount from that amount because each child receives a minority interest, (3) an amount equal to 2/51 of the value of the taxpayer's 51% controlling interest, or (4) an even greater premium amount because, by virtue of the gifts, the taxpayer relinquishes the control element represented by the 51% interest. It appears that the government recognizes that (2) is correct, notwithstanding that a gift tax that truly served to backstop the FET would impose a tax on (4). Given the difference between these values and the tax they would generate, the inter vivos transfer in this type of situation is vastly preferable.

§7.2.4.4 Concerns under §§2703 and 2704

Both §§2703 and 2704 are significant for FET[293] and gift tax valuations. For example, in a transaction that the government properly regarded as a gift because it was not supported by full and adequate consideration and did not fall within the business transaction exception,[294] the taxpayer in TAM 9352001[295] essentially gave control of a newly created corporation and gave a preference to the corporate earnings in the form of a transfer of the only voting stock in the corporation and an excessively generous employee compensation agreement. The net result was a gift that would be valued under §2704(a) because the transfer of all voting stock effected a loss of the state law ability to liquidate the corporation unilaterally.[296] Because the taxpayer did not lose the right to liquidate the corporation entirely (it was only restricted by the gift of voting common stock), the proper amount of the gift was deemed to be the difference between the value of the taxpayer's ownership prior to and after the transfer and execution of the compensation agreement, rather than just the value of the voting common stock and the right to receive guaranteed payments under the employee compensation agreement.

With respect to the application of §2703, in a series of TAMs[297] the government addressed valuation issues raised by fact situations that typically involve transfers to an FLP followed by transfers of partnership interests. Of several theories advanced by the government in these TAMs, one is based on §2703(a)(2), which provides that restrictions on the sale or use of transferred property will be disregarded for all wealth transfer tax valuation purposes. In this alternative the government asserts that "the series of transactions (the creation and funding of the partnership, and the transfer of the partnership interests) is properly characterized as one integrated [inter vivos] transaction" as to the whole of which §2703(a)(2) is applicable.[298]

In each of these cases the decedent transferred marketable securities or land in exchange for partnership interests that carried certain restrictions on what the decedent could do with respect to the transferred property — the partnership assets. If §2703(a)(2) is applicable those restrictions would be ignored in valuing the partnership interests received in the first transfer. Thus, unless other discounts would account for some reduction in value, the partnership interests received in exchange for the transferred assets would be worth essentially the same amount as the value of the property transferred. To the extent the partnership interests remain in the decedent's estate at death, this result would deny discounts for inclusion purposes except to the extent the partnership interests are discountable for reasons that do not relate to restrictions under state law or the terms of the partnership agreement (that is, for reasons other than those that §2703(a)(2) would ignore for valuation purposes).[299]

Regarding the second step in the integrated transaction (the decedent's transfer of partnership interests), the transfer would be regarded as an inter vivos gift to the extent those transfers are for less than full and adequate consideration — determined without regard to the restrictions on sale or use that are ignored by §2703(a)(2).[300] In each TAM the government asserted that §2703(a)(2) would apply even assuming the transaction steps are not collapsed, correctly noting that those elements of the partnership agreements that reduce value should be ignored, including that the limited partners had no liquidation or withdrawal rights, could not bring an action for partition, and could not terminate the partnership.[300.1]

There is a safe harbor exception in §2703(b) to the application of §2703(a), which the government discussed and rejected in these cases. Under it, §2703(a) will not apply to the extent the taxpayer can establish that the transaction was (1) a bona fide business arrangement, (2) comparable to similar transactions, and (3) not a device to transfer value to family members for less than full and adequate consideration in money or money's worth. The government did not address comparability in these cases — probably because it was aware that the plain vanilla terms of the FLPs resembled other similar transactions.[301] It also gave short shrift to the device element, stating in full only that:

> Even assuming arguendo that there was some legitimate business purpose for these transactions, the facts evidence that the transaction, including the formation of the limited partnership, was contrived

> primarily (if not exclusively) for the purpose of artificially reducing the value of the decedent's gross estate in order to reduce the estate tax liability. Accordingly, the partnership arrangement was a device to transfer property to members of the decedent's family for less than adequate consideration.

This unfortunate lack of detail is telling in that the device test under §2703(b)(2) is the most uncertain, and the TAMs provide no guidance on how the government might assess the issue or the elements of proof that it might accept in making the case that a transaction is not a device.

Case law similarly is devoid of meaningful assistance on that score. Perhaps it is in light of the dearth of authority that the government chose to hang its hat on the bona fide transaction peg of §2703(b)(1), asserting first that intra-family transactions are subject to special scrutiny and are presumed not to be at arm's length, and then more specifically concluding that:

> The transaction in this case can hardly be classified as a bona fide, arm's length, business arrangement. The children, acting in their representative capacities, were essentially dealing with themselves on behalf of the trusts, and the decedent. Rather than attempting to maximize the value of the trusts, the parties structured this transaction to achieve the opposite result.… It is inconceivable that the decedent would have accepted, if dealing at arm's length, a partnership interest purportedly worth only a fraction of the value of the assets she transferred. This is especially the case given the state of her health, because it was impossible for her to ever recoup this immediate loss. Further, it is inconceivable that the decedent (or her representatives) would transfer all her liquid assets to a partnership, in exchange for the limited interest that terminated her control over the assets and their income stream, if the other partners had not been family members.

The later TAMs make note of various business reasons that might support the transaction and say that they do not establish the requisite bona fides of the business *arrangement*, which is what the statute requires. Indeed, one TAM suggested that all the reasons proffered related to the decedent's family and not to the decedent, which presumably ought to be the focus to justify the decedent's participation in these transactions. And notice that the last sentence quoted more appropriately might be directed to the device element. Nevertheless, the point is that the §2703(b) safe harbor was deemed to provide no refuge for the taxpayers in these cases.

Not applicable in every TAM but applied in several is another government alternative argument, based on §2704(b) and the fact that each partnership had terms that were more restrictive than state law.[302] That is a factual hickey that many partnerships avoid with proper selection of the applicable law.

One final aspect of the TAMs is interesting. The government recognized that some discount may be available in failed FLP transactions, as if the assets contributed to the entity were held by the decedent outright at death. As phrased by the first TAM, "attempting to cover the decedent's assets with a partnership wrapper" may not create or increase any available discounts, but it also should not remove discounts that otherwise would apply. In an all-marketable-assets partnership this would be of no use, but presumably some fractional interest discount would be available if partnership assets were held outright and a sliver interest was given away or includible in the decedent's gross estate at death.

In the context of all these pronouncements, the FLP issue finally was joined in court proceedings that have resulted in opinions in Kerr v. Commissioner,[303] holding that §2704(b) was not applicable because the provisions in the *Kerr* partnership agreement were no more restrictive than state law otherwise would impose,[304] and in Church v. United States.[305] Among the arguments made by the government in *Church*, the court summarily rejected a §§2036 — 2038 argument that the parties expressly or impliedly agreed that the decedent would continue to enjoy the partnership property and its income. More immediately significant, the court accepted as true that the partnership agreement met the §2703(b) safe harbor requirements (a bona fide business arrangement, comparable to similar arrangements, and not a device to transfer value for less than full and adequate consideration to natural objects of the decedent's bounty). The court did not, however, explain what the device test means, nor what facts supported these conclusions.

It seems clear that the government presented the §2703 argument that restrictions on assets transferred to the partnership, imposed by the partnership agreement, should be ignored in valuing the partnership interest received by the taxpayer on formation of the partnership. According to the *Church* court, however, §2703 does not support that application because the property owned and subject to valuation at death was the partnership interest itself, not the assets transferred to the partnership, and there were no restrictions on transfer of the partnership interest that Congress meant to reach with §2703. Without authority to cite, the opinion nevertheless held as a matter of law that "no case . . . and nothing in the legislative history, or the regulations adopted by the IRS itself, convince this Court [that] . . . restrictions . . . on the sale or assignment of a partnership interest . . . are [the type] Congress intended to reach in passing" §2703, which the court said was intended to deal only with buy-sell agreements and options that artificially reduce value.

In juxtaposition to *Church* is Holman v. Commissioner,[306] in which the government succeed in using §2703 to disregard a call provision in a partnership agreement and prevented a valuation discount. The opinion focused primarily on three provisions, the last being the right to purchase partnership units following an impermissible assignment. This issue differed from that asserted with mixed success in Smith v. United States[307] that §2703 disregards restrictions on a taxpayer's ability to deal with the assets transferred into an FLP. *Smith* resulted in a trial on value, in which a jury granted a larger refund than the taxpayer sought. *Holman* is more like *Church*, which held that §2703 does *not* disregard restrictions in a partnership agreement on the transfer of partnership units themselves. Note the different applications (and success) of §2703 in these cases.[308]

The Magistrate in *Smith* determined that §2703 disregards partnership agreement provisions that hinder dealing with the underlying assets (common stock of an operating company in that case) of the partnership, based on legislative history to §2703, which establishes that the restrictive provisions in the partnership agreement are "precisely the type of restriction to which §2703 was intended to apply." Senate Finance Comm. Rep. 3209 (1990) specifies that:

> the value of property for transfer tax purposes is determined without regard to . . . any restriction on the right to sell or use such property, unless the . . . restriction meets three requirements. These requirements apply to any restriction, however created. For example, they apply to restrictions implicit in the capital structure of the partnership or contained in a partnership agreement . . . .

That committee report is reflected in Treas. Reg. §25.2703-1(a)(3), which states that a right or restriction that may be subject to §2703 could be contained "in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement." And this application is not limited to FET.

The Tax Court in *Holman* relied primarily on traditional buy-sell agreement jurisprudence in holding that (1) the provisions involved were "not part of a bona fide business arrangement" because "the partnership carried on little activity other than holding shares of . . . stock" and that, although a "restrictive agreement need not directly involve an actively managed business," there must be some "bona fide business purposes" involved. Here "educating [the donees] as to wealth management" and "asset preservation" in the context of discouraging the donees from dissipating the wealth were recognized reasons for the partnership proper but they did not relate to protecting some legitimate business purpose. Which meant that these partnership provisions failed to pass muster under §2703(b)(1). Moreover, (2) they constituted a device "to discourage the [donees] from dissipating the wealth," so they flunked under the "not a device to transfer property" test of §2703(b)(2). The §2703(b)(3) requirement that restrictions be "comparable to similar arrangements entered into by persons in an arms' length transaction" was discussed but the court determined that its holdings under (b)(1) and (b)(2) meant that "we need not (and do not) decide" the (b)(3) comparability question.

Interesting about all of this is the message that the §2703(b) safe harbor only applies to business related rights/restrictions, while §2703(a) denies recognition to restrictions in any context, for any wealth transfer tax ("for purposes of this subtitle" meaning the FET, gift, and GST, in chapters 11, 12, and 13, of Subtitle B of Title 26).

In light of the government's inconsistent success in these cases, it pays to consider other recent pronouncements seeking to impose transfer tax on the voluntary diminution in value that taxpayers allege to occur on creation of FLPs. FSA 199950014 and TAM 9842003 articulate some refinements that indicated that the government was honing its litigation strategy and arguments. Among the more interesting is an assertion in the TAM that there was a gift on creation of a partnership because the taxpayer did not receive the full value of what the taxpayer transferred, in the sense that a 99% partnership interest received was restricted in ways that reduced its value and that differential, along with the 1% interest owned by other partners, constituted a gift on creation of the partnership that would represent most (but not necessarily all) of the claimed discount in value.[309] The FSA addressed the same issue merely by stating that the transferors did not receive back a pro rata interest representing their pro rata contribution to the entity, to the extent they receive limited partner interests.

Also in juxtaposition to these results, the government lost a gift on creation assertion in *Holman*, that the two steps of funding the partnership and then giving partnership units to donees six days later should be collapsed and treated as a single gift of the underlying assets to the donees. The court had little trouble rejecting both an indirect gift and a step transaction theory because the proper steps were taken in the proper order (creation of the partnership, then the transfer of assets to it, followed by transfers of partnership units) and because the ultimate gifts were not made on the same day assets were transferred to the partnership.[310] Although the time delay was a mere six days, the court determined that "a real economic risk of a change in value of the partnership" existed due to "the nature of the [transferred] stock as a heavily traded, relatively volatile common stock. We might view the impact of a 6-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term government bond." The court noted that the government "apparently concedes that a 2-month separation is sufficient to give independent significance to the funding of the partnership and a subsequent gift."

The government asserted, and similarly lost, the same gift on creation argument in Gross v. Commissioner,[311] which also involved publicly traded securities, a short delay (11 days — and the same caveat in a footnote that a different result might obtain in a different situation), but more difficult facts in the sense that it was not clear when the partnership was created under state law, due to the taxpayer's failure to satisfy all state law requirements to establish the partnership. Relying on the notion that conduct may indict the creation of the partnership, the court ruled in the taxpayer's favor and then, relying on the taxpayer's "uncontradicted" expert testimony, accepted the discounts claimed. Which is to say that the government did not invest in an expert's opinion on the valuation issue.

The government yet again asserted the gift on creation argument in Linton v. United States,[312] which relied principally on otherwise avoidable mistakes made by the taxpayer's advisors in the sequencing of a transaction (or at least their proof of that sequence). It was not proven when trusts and an LLC were created or when the gifts were made to those trusts. The government argued that property was transferred indirectly to the trusts and then contributions were made by the taxpayers and the trusts to the entity, which was created after these transfers. That argument allowed for imposition of gift tax without discounts attributable to restrictions in the entity structure. The court distinguished cases such as *Gross* on the ground that the taxpayer in those taxpayer victories created a clear sequence of events that established the entity first, funded the entity second, and then (after an appropriate delay) made gifts of entity interests.

Heckerman v. United States[313] underscores that procedure is critical. The facts reveal a transfer of mutual funds on the very same day as gifts were made of partnership units,[314] as to which the government made the same successful attack as in *Linton*. In *Heckerman* it simply was not clear whether proper adjustments were made to the partners' capital contribution accounts, nor whether it would matter, the court quoting from Senda v. Commissioner[315] that "even if the taxpayers' contributions . . . had been properly reflected in their capital accounts before the gifting, ‘this formal extra step does not matter’ because, under the step transaction doctrine, ‘formally distinct steps are considered as an integrated whole’ [and] . . . ‘liability is based on a realistic view of the entire transaction’." In this regard, the critical element of *Heckerman* was its embrace of the step transaction doctrine, which built off the court's holding in *Linton*, which subsequently was reversed on this score. Which leaves all of this unresolved.

§7.2.4.5 Statute of Limitation for Revaluation

Even before unification of the estate and gift taxes in 1976, the amount of gifts made in a prior year was subject to adjustment for the purpose of computing the gift tax for a current year, even though the statutory period within which an additional gift tax might be assessed for the prior year had expired.[316] The result was that it was impossible to be certain what gift tax would be payable on gifts in the current year if the subject of gifts made in prior years was property that might be revalued at a greater amount than reported in the prior gift tax return. This uncertainty made it unwise in some cases to proceed with what otherwise would have been desirable inter vivos transfers.

Congress corrected this gift tax revaluation problem in 1954 by enacting §2504(c), which eliminated in some cases the significance of a change in the value placed on prior gifts in calculating the tax on current gifts. The value of a gift made in a prior year was not subject to adjustment if a tax was assessed or paid for the prior year and the time had expired within which an additional gift tax could be assessed on the transfer.[317] But §2504(c) did not prevent an adjustment if no tax was assessed or paid for the prior year.[318]

Furthermore, after unification of the estate and gift taxes in 1976, a problem arose because adjusted taxable gifts made after 1976 are reflected in the FET computation and §2504(c) only provided closure for future gift tax calculations.[319] As a result, the government successfully revalued adjusted taxable gifts in FET proceedings even after those gifts were protected from revaluation by §2504(c) for future gift tax purposes.

In 1997 Congress cured this disparity by enacting §2001(f) to extend the §2504(c) gift tax statute of limitation to the FET.[320] Now, reflecting technical changes made in 1998,[321] if a gift is disclosed in a gift tax return that is "adequate to apprise the Secretary of the nature" of the gift,[322] under §6501(c)(9) the value of the gift for both gift tax and FET calculation purposes is the value as finally determined[323] for gift tax purposes. Thus, if the time within which to assess gift tax expires under the §6501(c)(9) gift tax statute of limitation, the government is bound by the value of the asset and cannot revalue it for either tax calculation purpose. Chief Counsel Advice 201643020 applied this preclusive effect to gifts that properly were reported even though prior-year gifts were not properly reported. Although the effect of the prior-year failures meant that calculation of the tax on the later-year gift was improper, the statute of limitation still expired on the later-year gift.

Notable is that this closure is applicable to more than just valuation questions. There is statute of limitation protection that precludes any future investigation and litigation of an issue of qualification for the marital deduction, charitable deduction, or annual exclusion if the adequate disclosure standard is met. Disclosure designed to trigger the running of the statute of limitation may be appropriate if an issue is whether a marital or charitable bequest was funded in the proper amount and that question turns on the value of assets allocated, or if the question is whether creation of an FLP was a gift because the value of interests transferred into the partnership was greater than the partnership interests received, or whether the taxpayer made gifts of difficult to value assets that were worth more than the annual exclusion.

When evaluating disclosure it pays to consider whether information ultimately will be produced in litigation (should things come to that), meaning that it may be wise to produce relevant documents in hopes of garnering statute of limitation protection. Congress altered the §7491 burden of proof rule in 1997, which effectively only shifted the burden of persuasion. The government must produce some reasonable determination upon which an asserted deficiency relies, which the taxpayer must rebut with evidence that is credible enough that a reasonable person *could* believe it (*not* the more rigorous "more likely true than not" standard of prior law), which then shifts the burden to produce evidence back to the government for rebuttal. The burden of persuasion is on the government, however, in the sense that a 50 — 50 equipoise of evidence results in a taxpayer victory. Thus, the taxpayer still carries the burden of production — most notably of documents and proof of valuation. But once the taxpayer has met its obligation to produce credible evidence to support its position, the government then must counter with evidence of its own or risk losing the case under the burden of persuasion. Reflecting the modesty of this change is Tax Court Interim Rule 142, which describes the shift in the burden of going forward with the proof once the taxpayer has provided credible evidence to support the taxpayer's position.

However, the position stated in Interim Rule 217 is that the taxpayer continues to bear the burden of production and of persuasion with respect to §7477 — Tax Court declaratory judgments regarding valuation — which Congress added in 1997 to provide an opportunity for taxpayers to secure a gift tax valuation determination in cases in which a lifetime transfer did not generate a gift tax liability (usually because the gift tax did not exceed the available unified credit). The lack of tax liability meant that, even if the government adjusted the taxpayer's reported valuation, the taxpayer could not pay the tax and sue for a refund, nor would the government assess a deficiency that would allow the taxpayer to challenge the adjustment by a petition to the Tax Court. The result was that, before adoption of §7477, the government could adjust values, which would affect the adjusted taxable gifts base for calculation of future gift tax and ultimately for FET liability, but preclude a resolution of the valuation question until long after the facts had become old and cold. The addition of §7477 allows taxpayers to seek declaratory judgments on valuation questions, notwithstanding that no gift tax is due.

Treas. Reg. §301.7477-1 provides guidance on the declaratory judgment procedure. Relevant only if the government chooses "to put the transfer into controversy," the government will issue a "Preliminary Determination Letter," to which the taxpayer may respond. Essential to the declaratory judgment process is that the taxpayer must exhaust all administrative remedies within the Internal Revenue Service — which means that the taxpayer may not avoid an Appeals office consideration by going straight to court. Indeed, the regulation provides that the taxpayer must participate in any Appeals office consideration offered by the government, even if the case is in docketed status before the Tax Court after filing a petition for a declaratory judgment.

As Example 3 in the regulation posits, if the statute of limitation is about to expire, the taxpayer declines the government's request to extend the limitation period, and the government determines that there is no time for an Appeals consideration, a Notice of Determination of Value Letter 3569 will issue to the taxpayer, which the taxpayer then may challenge by a petition to the Tax Court. In essence, the regulation provides that then the government may require the Appeals conference that it did not have time to conduct before the taxpayer filed, and the taxpayer must fully comply in that Appeals consideration — essentially as if the statute had been extended as originally requested.

In addition, the taxpayer must "participate[] fully in the Appeals consideration process, including, without limitation, timely submitting all information related to the transfer that is requested by the IRS in connection with the Appeals consideration." Which compliance sometimes is the reason a taxpayer refuses to go to Appeals and wishes to force the government to start the litigation process directly. That option is foreclosed by this procedure if the taxpayer wants a Tax Court declaratory judgment determination.

None of this is likely to be relevant unless the taxpayer tolls the gift tax statute of limitation by making the requisite adequate disclosure of a valuation position taken on a gift tax return, forcing the government to make a determination now or lose the ability to contest valuation after the limitation period has expired. Without concern for the gift tax statute of limitation, the government may intentionally choose not to challenge a lifetime valuation, instead preferring to wait until later when hindsight reveals that a transferred asset has appreciated significantly in value, "suggesting" that the taxpayer's gift tax valuation was too low. More importantly, if the taxpayer never starts the statute of limitation to run, and therefore the government never makes an adjustment, then the taxpayer cannot force the declaratory judgment procedure by asking for a Tax Court determination. On the other hand, if the statute is running, a refusal to extend the statute will not be regarded as a failure by the taxpayer to exhaust all administrative remedies, which means that the government cannot knock the taxpayer out of the §7477 process by asking for an extension.

It is well to remember than none of these changes is relevant unless the taxpayer has met the significant administrative proceeding requirement of producing all information reasonably requested by the government in discovery, the case has gone to court, and the taxpayer falls under a $7 million net worth threshold.[324] Clarified by technical correction in 1998 was that this net worth threshold does not apply to estates *or* to revocable inter vivos trusts that make the §645 election, but only during the period of that election.

The §6501(c)(9) statute of limitation *never* prevents a gift tax assessment based on a revaluation if the taxpayer failed to properly disclose the gift, although an amended return may be filed to begin the adequate disclosure statute of limitation running.[325] The resulting lack of §2504(c) or §2001(f) protection for gifts not properly reported (or for transfers made under prior law) permits the government to redetermine the value or taxability of a prior gift, the proper gift tax thereon, the amount of unified credit exhausted thereby, and the effect on the determination of the donor's subsequent gift and FET, all at any time in the future, regardless of how old and cold the facts and basis for determination of these questions may have become in the interim.

For example, if the taxpayer fails to properly report a taxable gift made during life, §2001(f) does not preclude the kind of revaluation results in Estate of Smith v. Commissioner,[326] in which the government increased the value of the gift to compute the taxpayer's adjusted taxable gifts, not to assess a gift tax on that gift but only to determine the taxpayer's FET. The §2001(b)(2) credit against the tentative tax for gift taxes paid is not for the tax *actually* paid on the value originally reported but "the aggregate amount of tax which *would have been payable* under [the gift tax] with respect to gifts made by the decedent . . . if {the rates . . . in effect at the decedent's death . . .} had been applicable at the time of such gifts."[327] Thus, the credit also was recomputed based on revaluation of the gift. The effect of higher valuation was only to begin taxing the estate at a higher level in the FET rate tables.[328]

It is important to note that the §2001(b)(2) credit is not for the tax actually paid on the value originally reported but, instead, the tax that would have been paid on the amount of the gift as revalued by the government at the decedent's death. The effect for FET purposes is to eliminate all but one problem posed by the government's attempts at revaluation. Revaluation does not generate an increase in tax on the prior gift because a larger credit would be generated at the same time. Instead, revaluation only has the potential to push the estate into a higher marginal bracket for computing the FET (and that matters only to the extent progressivity in the rates is applicable). If the gift tax statute of limitation is still open the government may assess an added impost. Otherwise, if only FET liability is involved but the §6501(c)(9) statute of limitation does not bar the government's inquiry, then §2001(b)(2) determines the credit against FET for the amount of gift tax that would have been payable based on the government's assessment, not just for the gift tax actually paid.[329]

An illustration by the dissent in *Smith* showed that the application of §2001(b)(2) does not solve an inequity that favors larger estates that already are taxable in the highest marginal bracket before revaluation of a prior gift. Revaluation of a prior gift generates a higher gift tax credit under §2001(b)(2) in both large and small estates alike, but revaluation of a prior gift only increases total taxes if it boosts the marginal bracket in which the estate is taxed.[330] Any revaluation at death would make no difference at all if the highest marginal bracket already was reached by taxable inter vivos gifts made by the taxpayer, because the increase in tax would be matched by the same increase in the §2001(b)(2) credit. So smaller taxable estates are hurt by revaluation and nontaxable ones or large estates are not.

Another impropriety is illustrated by Estate of Prince v. Commissioner,[331] which denied a §2001(b)(2) adjustment for the amount of gift tax that would have been payable if the gifts involved had been taxed inter vivos. This was because no gift tax would have been payable — the taxpayer's unified credit would have covered that liability. The effect of the court's holding was to consume the estate's unified credit at death as if the gift tax assessment was not time barred. In that respect the court's conclusion was improper. A §2001(b)(2) adjustment should be available even if the taxpayer did not exhaust the unified credit during life and regardless of whether gift tax actually was paid — or should have been paid — on the transfer.

To better illustrate this principle, consider an inter vivos transfer in 2017 that was valued at $4,000,000 for gift tax purposes. The tax at 40% was less than the full unified credit, so no payment actually was made. Assume this taxpayer then died with an estate of $2 million. Computing the FET with the adjusted taxable gift valued at $4,000,000 would produce a payment obligation at death of $2,345,800 before applying any credits. Now assume the government at death successfully revalued the gift at $5,000,000 so that the FET computation was on a tentative tax base of $7 million and the taxpayer owed $2,745,800 before applying the available credits. Allowing the unified credit, but not the §2001(b)(2) adjustment, the taxpayer would pay $400,000 more tax due to revaluation of the lifetime gift (reflecting the additional $1,000,000 assessed at a 40% marginal FET bracket).

Changing the facts, assume the lifetime transfer was reported at $6 million and was revalued at death at $7 million. Lifetime taxes would have consumed the available unified credit and at death the §2001(b)(2) credit for gift tax that *would have* been payable on the gift produces a larger credit to match the larger value and no more tax actually will be paid at death. The difference between this and the first example is that §2001(b)(2) applied in this example because, during life, the taxpayer exhausted the unified credit.

The two illustrations should produce the same increase in tax if the added $1,000,000 is taxed in the same marginal bracket in both cases (as it was, in this example, because the tax system presently imposes a flat tax). A difference in the respective tax rates might apply under different circumstances (if the increase in value pushes the estate into a higher marginal bracket) but that is the only difference that ought to apply in this example. And that difference is overshadowed by the *Prince* court's denial of the §2001(b)(2) adjustment in the first example. The disparity in *Prince* is improper, because the §2001(b)(2) adjustment to reflect the tax that would be payable on the revalued gift should be available in either case. The proper computation would ignore the unified credit in determining the increase in tax attributable to revaluation of the inter vivos transfer, whether the gift tax on the originally valued gift or the revalued gift, on both or on neither, was greater than the unified credit available with respect thereto.

One consequence of these holdings and legislation is that taxpayers must be *more* vigilant in maintaining adequate records upon which they may rely in future challenges, especially for future gift tax purposes with respect to gifts they otherwise would not think they needed to disclose, due to the annual exclusion, the marital deduction or charitable deduction, or the unified credit. Taxpayer vigilance in these cases must be greater than with respect to gifts on which a gift tax actually is assessed and paid. This problem is the exact converse of most taxpayers' expectations. Nevertheless, the 1997 legislation reflects a policy that the limitation period ought to run to protect the taxpayer from stale challenges in cases in which a gift tax return is filed, putting the government on notice and providing it with an opportunity to challenge the facts revealed therein.

§7.2.5 *Liability to Pay Gift Tax*

The federal gift tax cost is the primary liability of the donor[332] but may shift to the donee by agreement with the donor as a condition of the gift[333] or by virtue of transferee liability[334] enforceable by the government through a lien that exists for ten years from the date of the gift (or until the tax is sooner paid).[335] This transferee liability has a longer statute of limitation against the transferee than against the transferor and the government need not assert the tax liability first against the transferor as a prerequisite to assessment against the transferees.[336] Indeed, there is no §6324(b) requirement that the limitation period for assessment of a gift tax against the transferor has not expired, nor does it appear to matter that, at least in theory, there cannot be a transferee liability unless it has been determined that a tax is owing and unpaid.

Rather, it is immaterial that the reason for the transferor not having paid the tax when due is that no deficiency has been determined before the limitation period expired. And the §2504(c) gift tax statute of limitation is no bar — even if a gift tax return adequately disclosing the gift was filed — because §2504(c) only restricts the time within which the government may revalue a gift for purposes of determining the gift tax liability itself. The net result is that some transferees can be forced to litigate questions that the transferor created and that the government could not contest as against the transferor, which can place the government at a distinct advantage by proceeding against parties less able to validate the transferor's tax positions.[337]

This bifurcated system has led to some confusion, even on the part of the government. To illustrate, the decedent whose estate was involved in PLR 9339010 made substantial gifts and paid over $1.8 million in gift tax within three years of death, triggering application of the §2035(b) gross up rule. Inclusion of the gift tax in the decedent's gross estate produced an FET that substantially exceeded the amount of the decedent's probate estate available for payment of that liability. The government opined that "under State law, the federal estate taxes are to be apportioned" among the donees of the gifts.[338] The Ruling did not establish the donee's responsibility to pay the tax as either a gift tax or FET transferee liability under §6324, notwithstanding that §2035(c)(1)(C) indicates that it could.[339] Thus, the lien exists even though it is not accurate to consider the donees as receiving the property that produced the FET (because the federal government received the gift tax upon which the FET was incurred).

Curiously, however, the Ruling did not depend on this analysis. Of the limited sources for payment of the gross up rule FET, it is equitable that the donees who received the gifted assets should pay the tax generated by the property they received, as presumably they would if the decedent had died with that property includible in the gross estate and left it to the donees at death. Without that result in this situation the tax would remain unpaid, and it hardly seems proper that a decedent should be able to make gifts shortly before death that, coupled with the gift tax itself, would diminish the decedent's estate to the point that the gross up rule FET could not be paid and therefore would be avoided entirely.

An interesting question is whether the decedent in this type of situation could impose the gross up rule FET liability on the donees as a form of net gift, applicable as a condition on the gift itself if the decedent dies within three years of the gift. If so, quaere whether this conditional liability would reduce the value of the gifted property for gift tax computation purposes, thereby also reducing the gross up rule FET. Ripley v. Commissioner[340] held that a transferee's potential §6324(b) liability does not affect the gift tax value of a gift because that value is determined under a willing-buyer, willing-seller analysis and a willing buyer for full and adequate consideration in money or money's worth would take free and clear of the lien, which instead would attach to the proceeds of sale in the hands of the donee. Because the transferee liability therefore does not encumber the gifted property, it was deemed not to affect the value of that property for gift tax purposes.

In the context of PLR 9339010, a useful analogy might be to a decedent who made no transfers and instead died with all the gifted property, which passes to the same beneficiaries at the decedent's death. Any tax liability incurred in that case would reduce the amount received by the donees but would not reduce the value of the decedent's gross estate for FET computation purposes. It seems unlikely that a court would accept a different effective result if the decedent made the transfers as death bed gifts, given the fact that the gross up rule is designed to eliminate any advantage of planning to pay gift tax on transfers made in contemplation of death.

On the other hand, in a true net gift in which the donee is obligated to pay the gift tax as a condition of the gift, the value of the gift is the amount of the gift minus the gift tax.[341] Were this not true, a net gift would result in a gift tax being imposed on that portion of the gift that the donee used to pay the gift tax, whereas when the donor pays the gift tax there is no tax on the money used to pay the gift tax.

An important element to remember is the government's position[342] that, even if the gift tax liability is shifted to the transferee, the transferor's unified credit must be exhausted before any gift tax may be paid by either the transferor or the transferee. Also recall that payment of the gift tax by the transferee constitutes the transaction a part-sale, part-gift transfer by which the gifted property is deemed sold to the transferee for an amount realized equal to the gift tax obligation imposed on the transferee, which may generate capital gain to the transferor.[343] Nevertheless, even with any resulting capital gain realized if the gift tax liability is greater than the donor's basis in the transferred property, the part-sale, part-gift result still is favorable due to the part-sale, part-gift basis rules, which allow the transferor to apply his or her full basis against the deemed amount realized net gift payment.

Had the transferor instead sold a portion of the property to finance the gift tax payment, only a corresponding portion of the donor's basis would be available to offset gain on that sale. In addition, the net gift produces no income tax problem if the transferor's basis is greater than the gift tax cost. In such a situation the net gift can be attractive to some transferors who are transferring property that is not marketable or liquid, if the transferor has no cash with which to pay the gift tax but the transferee does. Gifting is possible for the client with the same overall wealth transfer tax costs in such a situation as if a normal gift was made.

This reality is further illustrated by a series of transferee liability cases. In Estate of O'Neal v. United States,[344] after the transferees were obliged to pay the transferor's gift tax[345] they successfully asserted a right of reimbursement against the transferor, who subsequently had died (not within the §2035(b) gross up rule three year period, however). The estate claimed a §2053(a)(3) deduction because the transferees collected from the transferor's estate, essentially as a debt asserted against the decedent. The lower court allowed that deduction, holding that the transferor's estate would have been smaller if the government had sued the transferor for the gift tax liability in a timely manner and collected, or if the transferees had prosecuted their reimbursement claim before the transferor died. Payment by the transferees followed by reimbursement under state law and a deduction for FET purposes produced essentially the same result. On remand the appellate court commanded the lower court to determine the date of death value of that liability without considering postmortem events.[346]

The gift tax paid by the transferee will be taken into account in computing the FET of the transferor if the transferee pays the gift tax and the transferor dies within three years after the gift, all as if the transferor had paid the gift tax personally.[347] Sachs v. Commissioner[348] involved such a net gift transaction within three years of the transferor's death and raised the added complication of a §2513 split net gift. The government required §2035(b) gross up rule inclusion in the donor's gross estate of *all* the gift tax paid by the transferees, even though the decedent's spouse split the gift. According to the Court of Appeals for the Eighth Circuit:

> If Mrs. Sachs had paid the gift tax on her half of the split gift from assets separate from her husband's estate, [the estate tax gross up rule] would not include that payment in [Mr. Sachs'] gross estate. In this case, however, the payment of the gift tax was made entirely from the proceeds of the donated stock, all of which would have been included in [Mr. Sachs'] estate absent the gift. The assets which were used to pay the gift tax would have been part of the gross estate if the gift had never been made, and so the entire amount of the gift tax was properly included under [the gross up rule].[349]

Estate of Morgens v. Commissioner[350] was similar to *Sachs*, involving a QTIP marital deduction trust, as to which S triggered §2519 gift tax liability by assigning the income interest. The gift tax generated was subject to the §2207A QTIP right of reimbursement, which essentially apportions the gift tax liability to the QTIP trust. Because all of this occurs inter vivos, the result is a net gift — the transfer essentially is the §2519 value, reduced by the §2207A reimbursement amount.[351] *Morgens* followed *Sachs*, as if S had withdrawn the amount of the gift tax from the QTIP trust, made a gift of the balance, and paid the tax directly.[352] This result is beneficial to the extent the net gift calculation subjects a smaller amount to gift tax — the tax is less than if S had made the §2519 transfer and paid the tax out of other funds — but it is not as favorable as would be total exclusion of the gift tax amount. As decided, death within three years of the event causes the gift tax dollars to be subjected to §2035(b) FET inclusion in S's estate at death.

In the typical net gift, §2035(a) proper would not cause inclusion of the value of the transferred property in the transferor's gross estate. Only the gift tax paid (or deemed paid) by the transferor would be subject to inclusion under the §2035(b) gross up rule. Thus, the court's logic is suspect, and it seems more reasonable to view a split net gift as if the transferee paid the gift tax liability of the transferor spouse on half the gift and the gift tax liability of the consenting spouse on the other half of the gift, with §2035(b) liability for either spouse being limited to the gift tax that spouse was deemed to have paid through the transferee.[353]

Answers to several of these issues ultimately were provided by the second decision in Steinberg v. Commissioner,[354] which determined that the taxpayer was entitled to a gift tax valuation discount in a net gift context in which the donees agreed to pay (1) the gift tax incurred on the transfer *plus* (2) any estate tax that may be incurred under the §2035(b) gross-up rule if the donor died within three years of the gift (which did not occur). There was no dispute that the donees' assumption of the donor's gift tax liability reduced the value of the gift. But the government denied any added valuation discount for the donees' agreement to pay the additional, contingent liability if the donor had died within the §2035(b) gross-up rule window.

The government argued, as a matter of law, that summary judgment was appropriate, based on McCord v. Commissioner,[355] which held that no discount was allowable for the net net aspect of such an agreement. Because the Tax Court was reversed in McCord on appeal, it held that the question in *Steinberg* could not be resolved via summary judgment and the case proceeded to trial. Because the donor did *not* die within that three year period, the donees did not actually incur an estate tax liability attributable to this added obligation. Nevertheless, the Tax Court allowed an additional discount to reflect their assumption of the additional, contingent liability for the "net net" gift, meaning for both elements of the donees' agreement.

Both concurring opinions in the first *Steinberg* decision suggested that any discount should be de minimis or nil. The rationale for those positions was two-fold: (1) predictions of the donor's mortality inform the likelihood of §2035(b) being triggered by death within the three year period and may support only a very low value for the contingent liability assumed by the donees, and (2) the liability assumed by the donees may be of zero value to the donor because those same individuals would bear the estate tax obligation when the donor died, anyway. That is, if they would pay the increased estate tax either way, then their assumption of the net net obligation did not add any value to the decedent's estate.

Regarding the first factor — based on mortality — Attorney Larry Katzenstein produced the following data that suggests the game may not be worth the candle in many cases, even if the taxpayer wins. He demonstrated the proper calculation and illustrated results in materials prepared for an ALI CLE broadcast on estate planning aired in February 2014. By his calculation, a donor age 85 who gifted $10 million when the §7520 rate was 2% would reduce the gift to $7,142,857 by imposing the gift tax on the donee, and a net net gift agreement would reduce it further to $6,922,055 — only a $220,802 (2.2%) difference. If that donor was only 60 years old the reduction would be to $7,116,068 — only a $26,789 difference (the probability that a person age 60 will die within 3 years is only about 3.4%; the probability of an 85 year old dying before age 88 is only 28.7%). Nevertheless, the Tax Court granted the Steinbergs an added 8.2% discount, based solely on calculations by the taxpayer's appraiser, which the government did not contradict (because it argued the case solely on the law, the government did not hire its own expert appraiser). The appraiser has stated privately that the difference in value is entirely attributable to a higher interest rate assumption and the taxpayer's more advanced age (89) at the time of the transfer.

An interesting issue relates to the state law apportionment of the tax attributable to §2035(b). Apparently the government asserted that applicable state law "would apportion the Federal estate tax attributable to the . . . gross up [rule] to the persons benefited by the gifts, and the statute would require those persons to pay that portion of the estate tax" in all events. The appraiser in *Steinberg* asserted that "in the absence of a direction under the donor's will, most state tax apportionment statutes would allocate the [gross-up tax] liability to the donee." If that is the case, then the only value of the donee's agreement is "any incremental enforcement benefit" that the net net agreement added to the obligation that otherwise would exist in all events. For example, the Steinbergs created an escrow account to guarantee that the funds would be available to satisfy the donees' obligation. And enforcement of their agreement was better guaranteed by the fact that all the parties were represented by independent counsel.

In fact, the law is nowhere near as certain as represented. This is best illustrated by comparing New York law (which was applicable in *Steinberg*) to the law elsewhere in the United States. In New York, the donees are not responsible for estate tax attributable to the gift itself but they may be charged with any estate tax attributable to the gross-up rule.[356] This question has not been addressed in most other states, and Uniform Estate Tax Apportionment Act §2(1) provides that the value of the gross estate for purposes of apportionment of the estate tax is reduced by "any amount added to the decedent's gross estate because of a gift tax on transfers made before death." Which is to say that the Uniform Act is directly contrary to New York precedent.[357]

Obviously this is a subject about which there is a great deal of uncertainty. Indeed, New York may stand alone on the fundamental apportionment concept, which did not harm the taxpayer in *Steinberg* because the court held that (1) the donor could have changed domicile and die in some other jurisdiction, and (2) her will could alter the default state law tax apportionment rule. In the final analysis, it appears that there is no reason to deviate from the *Steinberg* approach, especially if sufficient amounts are involved that the extra valuation discount is worth any litigation costs that may be involved.

Footnotes

1 **§7.2** See §6.2.

2 See the business transaction exception discussed in §7.1.1.

3 See, e.g., Heim v. Commissioner, 52 T.C.M. (CCH) 1272 (1987), and the discussion in §7.0.

4 See §6.4.1 n.6 and accompanying text.

5 See §7.2.4.2.

6 See §7.2.2 dealing with §2702.

7 See Treas. Reg. §§1.7520-3(b)(3), 20.7520-3(b)(3)(i), 25.7520-3(b)(3).

8 See §6.3.3.5 dealing with §7872.

9 See §7.2.1 n.16 dealing with so-called King clauses.

10 See also TAM 8906002 (sale of stock by controlling shareholder to another corporation controlled by that shareholder's children, the government describing the factors to consider in determining whether the transaction involved a gift and whether a death terminating provision and the risk premium for a note should be considered in determining whether the sale constituted a transfer in an ordinary business transaction). See §6.4.2 regarding SCINs.

11 66 T.C.M. (CCH) 946 (1993), rev'd and rem'd in an unpublished opinion, 96-1 U.S. Tax Cas. (CCH) ¶60,220 (5th Cir. 1995), on remand, 72 T.C.M. (CCH) 42 (1996), rev'd, 135 F.2d 1017 (5th Cir. 1998) (Tax Court's finding that a partnership interest was transferred rather than an assignee interest in the partnership was deemed improper, and an essential conclusion regarding use of the decedent's mortality as determined under the tables was "ambiguous and ambivalent" and therefore required clarification that, once given, was reversed to hold that the tables must be used).

12 Citing Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), and Rev. Rul. 86-41, 1986-1 C.B. 300, in the process mischaracterizing the provision and failing to distinguish King v. United States, 545 F.2d 700 (7th Cir. 1976), or explain why it was not the better analogy.

13 Treas. Reg. §25.2512-8, discussed in §7.1.1.

14 Citing Harwood v. Commissioner, 82 T.C. 239 (1984).

15 66 T.C.M. at 969, stating that this case did not present an arm's length transaction free of donative intent.

In TAM 9309001, the provision (used in a transfer that would be subject to §2701 today) at issue specified: "If the value . . . is determined to be different than [assumed], pursuant to any agreed settlement . . . or any final determination of bona fide disputes by a court of competent jurisdiction, then the finally agreed or determined value shall control . . . , it being intended that the value of this gift be [$X]." According to the TAM, this provision "was designed to permit the Donor to avoid paying gift tax on a valuable property interest by taking advantage of the proverbial 'audit lottery,'" because the gift element would be adjusted away if the government audited the gift tax return and any unreported gift value would escape tax if the government did not audit the return. The government also held that, although it may be reasonable that a final sale price in a transaction between unrelated parties might be subject to adjustment (based for example on an appraisal that was not completed at the time of closing), it would not be reasonable to find an adjustment provision that would operate a long time in the future after extended litigation is resolved. Therefore, the TAM held that the adjustment provision was invalid "[b]ecause it is apparent that the valuation contingency imposed by the Donor would only arise if the Internal Revenue Service were to dispute the value for gift tax purposes." This may be the first occurrence in which the government used the "audit lottery" rationale as its justification. Note that increased FET exclusion amounts mean that fewer estates are taxable and fewer FET returns therefore are selected for audit, which allows the government to select more gift tax returns for audit.

16 545 F.2d 700 (7th Cir. 1976).

17 142 F.2d 824 (4th Cir. 1944).

18 120 T.C. 358 (2003), rev'd on other grounds, 461 F.3d 614 (5th Cir. 2006).

19 Relying on Procter, Ward v. Commissioner, 87 T.C. 78 (1986), and Rev. Rul. 86-41, 1986-1 C.B. 300.

20 93 T.C.M. (CCH) 534 (2009), aff'd, 653 F.3d 1012 (9th Cir. 2011).

21 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009) (a unanimous reviewed opinion involving a formula disclaimer that passed to charity any added value flowing from a successful government valuation challenge).

22 See McCaffrey, Tax Tuning the Estate Plan by Formula, 33 U. Miami Inst. Est. Plan. ¶400 (1999); McCaffrey, Formulaic Planning to Reduce Transfer Tax Risks, 45 U. Miami Inst. Est. Plan. ¶700 (2011). Graev v. Commissioner, 140 T.C. 377 (2013), highlights an important distinction involving *Procter*-style clauses. First, the *taxpayer* (not the government) argued that the provision in question was invalid under *Procter*, seeking to avoid denial of a deduction for a conservation easement because a "side letter" from the grantee promised to return cash and remove a façade easement if the taxpayer's charitable deduction was reduced. Second, the court stated that *Procter* only applies if the provision discourages the collection of tax by the government or causes a court to decide a moot case — such as because a purported gift would be retracted if challenged as taxable by the government. In *Graev*, the government's efforts generated income tax due to denial of the charitable deduction, regardless of whether the easement was removed or the cash was returned to the taxpayer. *Petter* and *Christiansen* were distinguished from invalid *Procter* conditions because their effect was only to alter the amount of property received by charity and not to undo or make a transfer or challenge moot. In this respect, a saving clause in Belk v. Commissioner, 774 F.3d 221 (4th Cir. 2014), was deemed to be invalid, notwithstanding the taxpayer's effort to characterize it as "interpretive" as opposed to a "condition subsequent." The clause specified that the trust to which the property was transferred "shall have no right or power to agree to any amendments . . . that would result in this Conservation Easement failing to qualify . . . ." In that sense it was not unlike a trust that must satisfy certain qualification conditions (such as a marital deduction trust) and specifies that nothing in the trust document that otherwise would disqualify that transfer shall be deemed to apply to that trust. According to the court this provision retroactively sought to alter the interest transferred to the charity and therefore was invalid. It could not have been helpful to the taxpayer that the court deciding *Belk* was the same court that decided *Procter* (a fact that the taxpayer probably appreciated when it did not suggest that *Procter* was incorrectly decided).

23 As confirmation see Hendrix v. Commissioner, 101 T.C.M. (CCH) 1642 (2011) (valid defined value formula clause divided closely held stock between trusts for descendants and a donor advised fund; it involved arm's length negotiation and did not contravene public policy); and Wandry v. Commissioner, 103 T.C.M. (CCH) 1472 (2012), nonacq., AOD 2012-04, 2012-46 I.R.B. 1 (inter vivos formula gifts defined by the gift tax annual exclusion and the gift tax applicable exclusion amount). According to the *Wandry* court, the "only gifts . . . that [the taxpayers] ever intended to give were of dollar amounts equal to the Federal gift tax exclusions." And, as such, the court determined that nothing about the formula provision would undo the gift. Meaning that the formula provision was not an invalid effort to take back any part of the gifts that were made. The court cited and followed *Christiansen* and *Petter*, made reference to *McCord*, but did not cite or refer to *Hendrix*.

An important distinction between *Wandry* and all of these other cases is that *Wandry* did not have a charitable component. Language in *Petter* caused some observers to wonder whether the charitable element made the difference in result. *Wandry* confirmed that it does not: "In Estate of Petter we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative." And, further, "In Estate of Petter . . . we held that there is no well established public policy against formula clauses."

Only a rare taxpayer will pay tax and sue for a refund in district court or the Federal Claims Court, rather than relying on defined valuation formula clause precedent in the Tax Court. As a result, notwithstanding that *Hendrix* and *Wandry* are only Tax Court Memorandum decisions, it seems reasonably reliable to plan in accordance with the conclusions reached in all of these cases. Note, however, that the government originally filed an appeal in *Wandry*, subsequently withdrew that action, and issued the action on decision, stating that it does not acquiesce in the result. This may indicate that it seeks a better circumstance in which to again litigate the issue of defined valuation formulas, which may suggest that this planning will attract government scrutiny.

Lyman, The Death of Procter and Rise of Wandry: A New Era of Formula Clauses in Estate Planning, 66 Tax Law. 803 (2013) is a useful and succinct historical analysis and defense of *Wandry*.

24 Applicable at the time was Treas. Reg. §25.2512-5, which since has been replaced with the regulations in Treas. Reg. §25.7520-3.

25 Rev. Rul. 66-307, 1966-2 C.B. 429.

26 Rev. Rul. 80-80, 1980-1 C.B. 194; Continental Illinois Nat'l Bank and Trust Co. v. United States, 504 F.2d 586 (11th Cir. 1974); Miami Beach First Nat'l Bank v. United States, 443 F.2d 116 (5th Cir. 1971); Estate of Fabric v. Commissioner, 83 T.C. 932 (1984); Estate of Jennings v. Commissioner, 10 T.C. 323 (1948) (holding that the use of established mortality tables must give way to proven facts when, in view of the condition of an individual, the individual's actual life expectancy, on the valuation date, was not greater than one year).

26.1 Cf. ILM 201330033 (widely acknowledged as a memorandum in support of the government's case involving the Estate of Davidson) alleging that life expectancy for a SCIN may not be based on the §7520 tables and, instead, advocating a willing-buyer, willing-seller valuation of notes, which in that case would result in a lack of adequate and full consideration for transfers proximate to the decedent's demise, generating transfer tax liability in the billion dollar range. Tax Court litigation in *Davidson* was settled in July 2015 with the taxpayer agreeing to pay $555 million in tax, with no indication of how the settlement numbers were determined nor which issues were raised or agreed upon by either party. Curiously, in that litigation a panel of four medical experts — two appointed by each side — unanimously agreed that the decedent's life expectancy was greater than one year, meaning that the §7520 tables would predict the life expectancy used by the taxpayer, unless those tables cannot be used at all in valuing a SCIN. For added insight regarding the *Davidson* case see *Aaron v. Deloitte Tax LLP*, N.Y. Sup. Ct., No. 653203/2015 (filed Sept. 24, 2015), which is the complaint in a malpractice case brought, shortly after the settlement agreement, by the estate against its tax advisors.

27 See §7.2.1.2 n.29.

28 973 F.2d 1403 (8th Cir. 1992), rev'g 95 T.C. 646 (1990).

29 Treas. Reg. §25.7520-3(b)(2)(ii)(A), effective after 1989. The preamble to the proposed §7520 regulations contained information that may help determine which interest rate and regulation provision is applicable for valuation purposes, depending on the date of the transaction.

30 95 T.C. at 652 — 653.

31 85 T.C. 713 (1985). See §7.1.1.1 n.19.

32 95 T.C. at 653.

33 95 T.C. at 653.

34 973 F.2d at 1408.

35 Similarly, TAM 9232002 involved a pre-§2702 GRIT that also no longer would be viable planning today but illustrated a valuation principle of enduring importance in a total portfolio investment performance and principal and income environment that permits (and may even command) adjustments between fiduciary accounting income and principal of the variety discussed in §5.3.3. The issue was the proper valuation of the donor's retained income interest for computing the gift tax on property transferred to the trust. Because the trust instrument authorized a deviation from the state principal and income act, the government held that normal valuation approaches that presume compliance with state principal and income principles could not be applied. Reasonable and reasonably consistent deviations will be permitted under the regulations defining income for fiduciary income tax purposes and should be respected as well for valuation and other purposes. See, e.g., Treas. Reg. §20.2056(b)-5(f) as discussed in the context of marital deduction qualification in §§13.5.2.1, 13.6.2.1.

36 Abbin, [S]he Loves Me, [S]he Loves Me Not — Responding To Succession Planning Needs Through A Three Dimensional Analysis Of Considerations To Be Applied In Selecting From The Cafeteria Of Techniques, 31 U. Miami Inst. Est. Plan. ¶1300 (1997).

37 Effective with respect to transfers made after October 8, 1990. Revenue Reconciliation Act of 1990 §11602(e). With respect to effective dates in general, consider PLR 200502035, extending the safe harbor of the effective date to the proceeds, investments, and reinvestments of a trust created prior to October 8, 1990, and TAM 9408005, in which the transferor released a reversion in several trusts in response to the government's Notice 89-99, promulgated under §2036(c), causing a gift and incurring a gift tax; when §2036(c) was repealed retroactively the taxpayer requested restoration of the status quo by refund of the gift tax incurred, which the government refused because Congress did not provide that form of relief. In Neal v. United States, 151 F.3d 1201 (W.D. Pa. 1998), the court permitted that recovery, on the grounds that, "if a taxpayer may be required to pay retroactively enacted taxes on events that were not taxable . . . when they occurred, . . . the government must refund taxes paid on events that became nontaxable when Congress retroactively repealed §2036(c)."

38 The term "family member" is defined in §2704(c)(2) and incorporated by reference by §2702(e). It includes an individual's spouse, lineal ancestors and descendants of the individual and the spouse, siblings of the individual (but not the spouse's siblings), and spouses of all these individuals (other than any other spouse of the individual's spouse).

39 See §7.2.1.1 n.23 and accompanying text.

40 §2702(a)(2). Under this rule, a qualified interest GRIT with a retained reversion or general power of appointment if the transferor dies before the term expires would be permissible, but the reversion or general power of appointment would not be considered in determining the value of the gift made upon creation of the trust.

41 §2702(c)(1).

42 PLR 9151045 involved deferred payment to a withdrawing partner of the consideration specified under a buy-sell agreement, which the government stated was "best . . . characterized as a private annuity or a similar form of debt rather than an interest in the entity." It then concluded that §2701 would not apply, because neither the taxpayer nor any applicable family member retained any other interest in the entity after withdrawal. Presumably this indicates that the private annuity itself is not a sufficient retained interest in an entity to trigger the application of §2701 and it should not be regarded as a temporal interest in a larger entity for §2702 purposes either.

43 Cf. PLR 8943079 (owner of operating facility leased to a corporation at arm's length for FMV did not retain a prohibited §2036(c) interest in the corporation's income).

44 §2702(a)(2). Instead, normal §7520 valuation is applicable.

45 §2702(b). It is not altogether clear why this third element was added to the Code, other than to recognize that, if the lead interests are not susceptible to valuation abuses, then neither is the remainder, and a transferor of the remainder ought to be able to rely on the same valuation regime.

Although planning involving these retained reversionary interests is allowable, it is unlikely that taxpayers will find this planning attractive, because the taxpayer reacquires the trust corpus at its (presumably) appreciated value at the end of the transferred term. Because lead interests in such trusts must comply with the fixed annuity or percentage unitrust rules, a reverse freeze using this alternative also should not work.

46 See Treas. Reg. §25.2702-3(d)(5).

47 Treas. Reg. §25.2702-3(b)(1). It also regarded the interest free nature of each note as constituting an economic benefit to the trust remainder beneficiaries that constituted an additional contribution to the trust in violation of Treas. Reg. §25.2702-3(b)(4). See §7.2.2.2.3 with respect to payment of annuities with financial instruments such as notes.

48 Imposed under Treas. Reg. §25.2702-3.

49 See, e.g., PLR 9519029.

50 See §5.11.9 nn.242 — 245 and accompanying text. PLR 200846001 confirmed that neither the existence nor the exercise of a power to substitute assets will disqualify a grantor's retained interest trust.

51 See Treas. Reg. §25.2702-3(d) and examples contained in Treas. Reg. §25.2702-3(e).

52 The authority for which is found in Treas. Reg. §§25.2702-3(b)(1)(ii)(A), 25.2702-3(c)(1)(ii). Calculation of the value of a graduated annuity is illustrated in Treas. Reg. §§20.2036-1(c)(2)(ii) and 20.2036-1(c)(2)(iii) Example 7.

53 Treas. Reg. §25.2702-3(d)(1).

54 Treas. Reg. §25.2702-3(d)(4).

55 See Badgley v. United States, 2018 WL 2267566 (N.D. Cal.) (involving a GRAT and holding that the valuation method in Treas. Reg. §20.2036-1(c)(2) is reasonable), Rev. Rul. 76-273, 1976-2 C.B. 268, Rev. Rul. 82-105, 1982-1 C.B. 133, and PLR 9448018 regarding inclusion upon the death of a beneficiary of an annuity or unitrust interest for a term.

Treas. Reg. §20.2036-1(c)(2)(ii) gives an algebraic formula for determining the portion of a trust that is §2036(a) includible in the estate of a grantor of a trust paying the annuity. It is the annual annuity divided by the §7520 assumed rate of return in effect when the decedent died (or on the alternate valuation date, if §2032 is elected). So, if a retained annuity payment is $100,000 annually from a trust of $2 million and the applicable §7520 rate is 6%, the amount includible is $1,666,666 — that being the amount of the trust, producing income at 6%, that is needed to generate an annual payment of $100,000. As the regulation states, "the portion of the trust's corpus includible in D's gross estate bears the same ratio to the entire corpus as D's income interest in the trust bears to the entire income interest in the trust." Here "income interest" means the annuity amount and the entire income interest is a function of the §7520 assumed rate of return. So, at 6% the $2 million trust is deemed to generate $120,000 annually, of which the decedent receives $100,000 or 83.33%, generating inclusion of just $1,666,666 of the total $2 million.

The regulation illustrates a term annuity that the decedent did not outlive and shows that the amount includible is not the discounted present value of the balance of that annuity. This is because the annuity is not includible. Rather, like a trust in which enjoyment did not end before death, the amount includible is the value of the trust portion in which enjoyment was retained — making the value of the remaining term of the retained enjoyment irrelevant.

Many trusts continue to pay the annuity to the grantor's estate if death occurs before expiration of the term. A few trusts may revert to the grantor's estate, reflecting a desire to have the trust corpus available to pay FET (and perhaps to govern disposition of the wealth if the tax objective of creating the trust is defeated by that premature death). With §2036 inclusion the §2207B right of reimbursement is available, which guarantees access to the trust for tax payment purposes, making the reversion unnecessary (and harmful if the reversion returns more than the portion that otherwise would be §2036 includible). Also note that §2036 inclusion means that §2035(a) three-year-rule exposure also exists if, for example, the annuitant seeks to transfer or relinquish the inclusion-generating interest in anticipation of an impending death. (Further, note that basis adjustment issues attendant to partial inclusion also are not explained or illustrated by the regulation.)

All of this §2036(a) application raises the question why anything should be includible in the gross estate of a taxpayer who created a no-refund, single life annuity, such that no entitlement continues past death. On the issue of the full and adequate consideration exception in this context see §§7.2.2.2.1 and 9.2 n.9 and accompanying text.

56 In recognition of this and notwithstanding the clear rule in §2702(a)(2)(B) that "[t]he value of any . . . qualified interest shall be determined under section 7520," Treas. Reg. §25.2702-2(b)(2) specifies that the value of a qualified unitrust interest is determined as if it was a §664 CRUT interest and specifically limits valuation of qualified interests under §7520 to the qualified annuity and remainder interests. This deviation reflects the fact that the unitrust tables under §664 do not rely directly on the §7520 interest rate valuation approach that is utilized for qualified annuity and remainder trusts.

57 Based on Rev. Rul. 77-454, 77-1 C.B. 351. A computer search revealed that the government's position had not been litigated prior to 1993 and has been addressed only in an oblique manner that did not cite Rev. Rul. 77-454.

58 The government's position also may be helpful if Congress amends §2702 to require that there be a gift of some amount in every GRAT. See the discussion of this notion later in this section.

59 And a ruling may not issue. See §4.01(58) of Rev. Proc. 2019-3, 2019-1 I.R.B. 130 (updated annually), in which the government states that ruling letters ordinarily will not issue if the annuity payable annually exceeds 50% of the initial FMV of the trust or the remainder interest following the annuity is less than 10% of the initial FMV of the trust. For an excellent rejoinder to the government's arguments against zero-gift GRATs, see Lee, Zero-Out GRATs and GRUTs — Can Still More Be Done, 115 Tax Notes 637 (2007).

60 See §7.2.4.5.

61 Like those routinely used to create marital deduction or credit shelter bequests and in the creation or severance of trusts for allocation of the GST exemption. See §§11.4.5.5, 13.2.7, and 13.7.1.

62 66 T.C.M. (CCH) 1067 (1993).

63 66 T.C.M. at 1074 (emphasis in original).

64 Treas. Reg. §§1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), and 25.7520-3(b)(2)(i).

65 Treas. Reg. §25.7520-3(b)(2)(i) Example 5.

66 T.D. 9414, 2008-2 C.B. 454.

67 See §7.2.2.2.1 n.59. These are precisely the situations the government loathes, to the point that it will not grant PLRs regarding them.

68 See Rev. Rul. 85-13, 1985-1 C.B. 184, recently confirmed in Rev. Rul. 2007-13, 2007-1 C.B. 684.

69 A notion discussed in §5.11.9 n.216 et seq. and accompanying text, because it is unlikely that the government will reverse itself on this income tax issue.

70 This rule may differ in a trust involving investment and reinvestment, making tracing impossible. See Estate of Kroger v. Commissioner, 145 F.2d 901 (6th Cir. 1944). But that is not this illustration.

71 115 T.C. 589, 603 — 604 (2000), acq., Notice 2003-72, 2003-2 C.B. 964 (a unanimous reviewed opinion involving a taxpayer who created two "substantially identical" two year GRATs with the annuity payable to the settlor's estate if death occurred before the term annuity ended).

72 See Schott v. Commissioner, 319 F.3d 1203 (9th Cir. 2003); Estate of Focardi v. Commissioner, 91 T.C.M. (CCH) 936 (2006) (explaining that the problem with recognizing the value of the spousal annuity component was because it "is dependent on when the grantor dies and, in particular, on how much of the term remains at the grantor's death" and also stating that "[t]he possibility of . . . an abuse is present where, as here, it is not certain at the outset of the trusts that payments will ever be made under a survivorship annuity," although the court did not explain why that matters if, between the grantor and the spouse, the full annuity will be paid).

73 See McCaffrey, Plaine, & Schneider, The Aftermath of *Walton*: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT, 95 J. Tax'n 325 (2001), regarding ancillary planning implications of *Walton*, and see §13.5.6.7 regarding transfer of the remaining annuity term interest from the estate to S and qualification for the marital deduction.

74 Citing Treas. Reg. §§25.2702-3(e) Examples 5 and 6 (which the government has done before) and 25.2702-2(d)(1) Examples 6 and 7 (which was not clear or explained), the government also denied all value to the secondary annuity interest in the respective spouses of the donors. Examples 5 and 6 subsequently were amended in the wake of *Walton*, as discussed in §7.2.2.2.2. Also consider §7.3.2 regarding the reciprocal trust doctrine as it may apply in the context of "parallel" or "mirror image" GRATs created by spouses, each with a short term retained annuity for the grantor followed by a much longer term annuity for the grantor's spouse, which is regarded by some as a more desirable form of §2702 planning because it limits the retained term exposure to §2036 of an early death of the respective grantors.

Cook v. Commissioner, 115 T.C. 15 (2000), aff'd, 269 F.3d 854 (7th Cir. 2001), involved spouses who created GRATs subject to §2702, with S to receive the balance of D's grantor annuity if D died during the annuity term. Based on Treas. Reg. §25.2702-3(e) Examples 5 and 6 (prior to subsequent post-*Walton* amendments, which are not relevant here), the Tax Court held that only the value of each annuity for the respective grantor's life or the specified term, whichever ended first, would be respected as a reduction from the full FMV of the trusts for gift tax valuation purposes. Walton v. Commissioner, 115 T.C. 589 (2000), acq., Notice 2003-72, 2003-2 C.B. 964, concluded in its final footnote that, although the court declared Example 5 to be invalid, its decision in *Cook* would not change and the government's post-*Walton* revision of Example 5 would not alter that reality. See n.57.3. To the same effect see Schott v. Commissioner, 81 T.C.M. 1600 (2001), rev'd, 319 F.3d 1203 (9th Cir. 2003) (involving a two life GRAT, payable to S if death occurred within the term), which concluded that S's secondary annuity (which was revocable by the grantor) would be ignored under §2702 for valuation of the grantor's gift upon creation of the trust. Thus, only a 15 year or single life annuity interest was regarded as retained in determining the value of the remainder following that transfer. According to the Tax Court, under then Treas. Reg. §25.2702-2(a)(5) (now -2(a)(6) due to post-*Walton* revisions), "retention of a power to revoke a qualified annuity interest . . . of the transferor's spouse is treated as the retention of a qualified annuity interest" by the grantor, but S's secondary annuity was not a qualified annuity interest. More recently, see also TAM 200230003 (reciprocal, mirror image, laddered, and graduated GRATs created by spouses for each of them for life or the specified term with a secondary annuity to S or S's estate and, if the spouse did not survive the grantor, giving the original grantor a general power to appoint with default in the reminder to the grantor's estate; the government still rejected the secondary spousal annuity because it was contingent on surviving the grantor and was not for the lesser of life or the term of years but, instead, for the full term regardless of death). Notwithstanding the acquiescence to *Walton* and reversal of *Schott* the government did not revise the regulations regarding these two-spouse GRATs.

75 Emphasis in original; citations omitted. See §7.2.2.2 n.47 and accompanying text regarding delayed payment and the use of notes.

76 Presumably deemed gift problems attributable to a trust holding non-income-producing property can be avoided if the trust authorizes retention of such property and gift taxation on creation as a consequence thereof is irrelevant because, in a nonqualified interest GRUT or GRAT, 100% of the trust corpus is taxable as a gift at creation anyway. See TAM 8723007 and PLRs 8932083, 8932082, 8905045, 8844008, 8805029, and 8642028.

77 See §7.2.3 at text following n.149.

78 One hundred percent grantor trust status is available with a §673 reversion or under §675(4)(C), among other sections. See §5.11. For example, PLR 9152034 illustrated the proper computation of the value of a 12% annuity for eight years in a GRAT and concluded that the trust was a grantor trust because the grantor retained a reversion in the trust if death occurred within the eight year term and the value of that reversion exceeded 5% of the value of the trust. Based on this conclusion, the Ruling then held that the trust was a qualified shareholder of S Corporation stock. To the same effect see PLR 8945006, involving 100% grantor trust status under §§673(a) and 677(a)(1).

79 I.R.C. §2702(a)(3). The §2702(a)(3)(A)(i) exception "to the extent [a] transfer is an incomplete transfer" is deemed to apply only to a transfer "no portion of which would be treated as a completed gift" under Chapter 12; it is available, however, to the extent a transfer "is wholly incomplete as to an undivided fractional share of the property transferred (without regard to any consideration received by the transferor) . . . ." See Treas. Reg. §§25.2702-1(c)(1), 25.2702-2(d)(1) Examples 4 — 5. §2702(a)(3)(B) specifies that an incomplete transfer means "any transfer which would not be treated as a gift whether or not consideration was received for such transfer," which is not necessarily inconsistent with this regulatory position.

80 Treas. Reg. §25.2702-2(a)(2)(ii), which is similar to the same rule in Treas. Reg. §25.2701-1(b)(3)(ii).

81 Treas. Reg. §25.2702-2(a)(3).

82 See Treas. Reg. §25.2702-2(d)(1) Example 3.

83 Treas. Reg. §25.2702-2(d)(1) Example 3.

84 §2704(c)(3).

85 Which is an incorporation by reference of the entity attribution rule in §2701(e)(3).

86 Treas. Reg. §25.2702-2(d)(1) Example 3.

87 Treas. Reg. §25.2702-2(a)(3).

88 Another question may be appropriate: if §§2701 and 2702 are in pari materia, in the sense that each is designed to preclude valuation abuses through freezing transactions that bifurcate ownership interests, would it be proper to apply §2702 in a situation in which §2701 does not apply? In this respect, §2701(a)(1) is relevant, it speaking of a transfer of an interest to a member of a decedent's family with an applicable retained interest held by the transferor or an applicable family member. If entity attribution applies here to treat the beneficiaries of marital and nonmarital trusts as holding the interests transferred to those trusts, it may be possible for the government to argue that §2701 applies to freeze-funding of marital and nonmarital trusts. And because S could be defined as both a family member (as beneficiary of the nonmarital trust) and an applicable family member (as beneficiary of the marital deduction trust), it seems possible that §2701 could apply to freeze-funding as well. Perhaps the most difficult aspect of this analysis is figuring out who has made a gift to whom, if S is a (perhaps the only current) beneficiary of both trusts in which S has only a life estate.

89 Treas. Reg. §25.2702-2(d)(1) Example 3.

90 See §13.7.13.

91 This rule is not limited to tangible *personal* property, the Senate Finance Committee Report at 67 specifically referring to undeveloped realty. That same report says it would not apply to depletable

property, however. Curiously, depreciable property was not mentioned. In any event, the tangible property exception is made available under Treas. Reg. §25.2702-2(c)(2)(i)(A) only for property that is *neither* depreciable nor depletable, although a de minimis exception is granted in Treas. Reg. §25.2702-2(c)(2)(ii) for appurtenant depreciable property that has a FMV not exceeding 5% of the FMV of the entire property. The example given in the general explanation is a fence surrounding rangeland that was the subject of a split interest trust.

92 §2702(c)(4).

93 See, e.g., PLR 8951065 (transfer of art to trust that reserved to settlor any income from the art — which never had been offered for sale or rent — and rent free possession of the collection; the trustees had the power to lend the art to museums or galleries and to sell it).

94 Treas. Reg. §25.2702-2(c)(1).

95 Treas. Reg. §25.2702-2(c)(3).

96 Treas. Reg. §25.2702-2(c)(3).

97 Treas. Reg. §25.2702-2(c)(4).

98 Treas. Reg. §25.2702-2(c)(5).

99 §2702(a)(3)(A)(ii).

100 Treas. Reg. §25.2702-5. In addition, Rev. Proc. 2003-42, 2003-2 C.B. 993, provides sample QPRT declaration of trust forms. With this promulgation the government also established that rulings generally will not be issued on whether a trust otherwise will qualify (unless the subject of a ruling request is a provision other than those contained in the Procedure). As is true for all government sample forms, users need to be aware that the provisions authorized are not always the most favorable to taxpayers, and options otherwise permissible are not always illustrated. By way of example, the sample provided does not illustrate a reversion to the settlor's estate if death occurs within the retained term, notwithstanding that a reversion in the case of a §2036(a)(1) inclusion (death within the term) is harmless, it will reduce the value of the gift made on creation, and it will permit the settlor's estate to use the property to qualify for the marital deduction if, for example, S survives the settlor. It also addresses the §2207B reimbursement issue discussed in the tax payment material at §3.3.5.

101 Treas. Reg. §§25.2702-5(c)(7)(i) and 25.2702-5(d) Example 5 clarify that residence is not deemed to terminate if the term interest holder ceases to reside in the home because of ill health that forces a move to a nursing home, unless the property no longer is held available for the exclusive enjoyment of the term interest holder and his or her spouse and dependents.

102 Shared enjoyment may, however, constitute a gift, as to which the annual exclusion ought to apply.

103 Treas. Reg. §25.2702-5(c)(2)(iii) uses the example of a hotel or a bed and breakfast establishment.

104 Treas. Reg. §25.2702-5(b)(2)(ii).

105 Treas. Reg. §25.2702-5(d) Example 3.

106 Indeed, PLR 9717017 permitted division of farm property that separated the personal residence and eight acres of surrounding land that became a QPRT, notwithstanding that the minimum zoning acreage requirement was three acres; in partial justification for this result was that eight acres was too small to subdivide in the future. And PLR 9739024 involved a 40 acre parcel on which a barn and several pens were located, along with a manager's house, all used in a commercial horse breeding operation on another parcel but permitted to be part of a QPRT based on representations that the manager spent half-time working on the residential property and the barn and pens would no longer be used in the commercial activity.

107 PLR 9841017. See Schwartz, IRS Approves Split-Purchase Qualified Personal Residence Trust, 13 Prob. & Prop. 55 (Mar./Apr. 1999), and Blattmachr, Split Purchase Trusts vs. Qualified Personal Residence Trusts, 138 Trusts & Estates 56 (Feb. 1999). See also §6.3.3.9. This position is odd in light of reports that the government believes that the Treas. Reg. §25.2702-5(c)(7)(i) exclusive possession of

property requirement precludes the use of concurrent ownership property, such as a tenant in common interest. See Hartog & McCall, QPRTs for Co-Tenancy Interests — Do They Work?, 6 California Trusts & Estates Quarterly 4 (Fall 2000). The authors surmise that the same impediment could prevent laddered trusts that own slivers of the property for varying lengths of time, although perhaps the use of grantor trusts would cause the government to ignore the trusts for purposes of the exclusive possession requirement.

108 See Treas. Reg. §§25.2702-5(b)(1) and 25.2702-5(c)(9).

109 The regulation does not, however, preclude the term interest holder's spouse from being the ultimate remainder beneficiary of the trust at expiration of the retained term interest (either by a premature death or by natural expiration of the retained interest), because the abusive objective perceived by the government cannot be accomplished by a gratuitous distribution that leaves no proceeds in the trust for other remainder beneficiaries. Thus, the regulations permit a terminating distribution of the remainder in the personal residence to the spouse, either under the original terms of the trust or pursuant to any exercise of a retained power of appointment by the term interest holder.

Nor did §2702 preclude planning such as in PLRs 201131006, 201129017, 201039001, 201024012, 201019012, 201019007, 201029006, 201014044, 200935005, 200935004, 200920003, 200904023, 200904022, 200901019, 200848008, 200848007, 200848003, 200816025, and 200814011, in each of which a parent originally created a QPRT and survived the term, and thereafter wished to remain in possession. The parents could rent the dwelling back from the remainder beneficiaries — children in each case — or the remainder beneficiaries could transfer the dwelling to a new trust or exercise a power of appointment over the trust (created in some cases by a judicial modification) to provide a short term (such as one year) interest in the parent (motivated, perhaps, by the parent's inability or unwillingness to continue paying rent).

110 Because the property is valued for its personal use, the failure to produce income equal to the assumed rate of return employed by §7520 should not be relevant. Nevertheless, the transferor might include a provision in the document that transfers the remainder and retains the term interest, requiring sale of the property and reinvestment of the proceeds in a reasonable income producing asset if the term interest holder insists. See Treas. Reg. §25.7520-3(b)(2)(ii)(A), discussed in §7.2.1 n.29.

110.1 Regarding the wisdom of this planning, however, see Narang v. Ranjan, 377 P.3d 376 (Ariz. Ct. App. 2016) (spouses each contributed their undivided community property interests in a single dwelling to separate QPRTs with terms of 20 and 30 years, respectively; they required legal action to partition their separate QPRT interests by sale following their divorce 11 years later).

111 Since repealed. See §121(d)(4), applicable with respect to stock in a cooperative and qualified for the exclusion from capital gain on sale of a qualifying principal residence. PLRs 199925027 and 9447036 involved an unusual but still acceptable application of this principle; because the cooperatives would not allow transfer of the shares to the trust, the grantors remained the owner of record as nominees of the trusts and transferred all beneficial interests in the property and the shares to the trusts, which the government held to be acceptable.

112 The government noted that the guest house was used by friends and family members and was not rented to outsiders and, therefore, was not incompatible with use of the vacation home as a personal residence.

113 Although presumably it would have avoided application of §2702 because it involved a joint purchase of a personal residence condominium.

114 There was a dispute over the proper actuarial factor to value the respective interests, because a down payment was made several years before closing on the purchase of the unit, and the actuarial factor for valuation of each interest changed in the interim, but this aspect of the TAM was not determinative.

115 Gradow v. United States, 87-1 U.S. Tax Cas. (CCH) ¶13,711 (Ct. Cl. 1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990) (involving sale of a remainder interest for less than full and adequate consideration),

and Gordon v. Commissioner, 85 T.C. 209 (1985) (involving the income tax consequences of a joint purchase of property), were mentioned but the government did not rely on their holdings in concluding that inclusion was required. Although it is unclear from the TAM, it seems likely that the government would have concluded under *Gradow* that full and adequate consideration to avoid §2036(a)(1) inclusion should be measured against the full value of the property, rather than the value of the interest purchased by the remainder beneficiary, which would require FET inclusion even if the remainder beneficiary provided independent funds in an amount that properly reflected the value of the interest purchased. See, e.g., Estate of Magnin v. Commissioner, 71 T.C.M. (CCH) 1856 (1996), rev'd and rem'd, 184 F.3d 1074 (CCH) ¶60,347 (9th Cir. 1999), on remand, 81 T.C.M. (CCH) 1126 (2001) (government argument originally confirmed notwithstanding its holding that, even under the taxpayer's argument in *Gradow*, the consideration received was not full and adequate).

116 See §7.3.1 and Estate of D'Ambrosio v. Commissioner, 105 T.C. 252 (1995), rev'd on other grounds, 101 F.3d 309 (3d Cir. 1996), for a discussion of the full and adequate consideration exception to the application of §2036(a)(1).

117 As discussed in §6.2.1, the more wealth transfer tax that is incurred under the tax exclusive gift tax than under the tax inclusive FET, the lower the overall burden, regardless of the bankrupt time value of money notion. That this is true in this context is ably illustrated by comparing a QPRT to an outright inter vivos transfer of the entire property, all subject to gift tax. See Melcher & Rosenbloom, How Well Do QPRTs Really Work, 77 Taxes 27 (Feb. 1999).

118 §2702(c)(1).

119 §2702(c)(2).

120 Treas. Reg. §25.2702-4(d) Example 4.

121 Treas. Reg. §25.2702-4(d) Example 2.

122 Although Gradow v. United States, 897 F.2d 516 (Fed. Cir. 1990) (involving sale of a remainder interest, effectively precluding application of the full and adequate consideration exception for estate and gift taxation), is wrongly decided, Congress clearly meant to codify its results in §2702 to preclude gaming with temporal interests that abuse the valuation tables using split interests of all types, including sales of remainder interests, split purchases, and most grantor retained interest trusts. For a critique of *Gradow*, see Estate of D'Ambrosio v. Commissioner, 101 F.3d 309 (3d Cir. 1996), rev'g 105 T.C. 252 (1995), and Pennell, Sale of Remainder Interest Triggers Section 2036(a)(1) Inclusion, 13 Prob. Notes 188 — 192 (1987). *Gradow* was followed in Estate of Magnin v. Commissioner, 71 T.C.M. (CCH) 1856 (1996), rev'd and rem'd, 184 F.3d 1074 (9th Cir. 1999), on remand, 81 T.C.M. (CCH) 1126 (2001), in a mindless decision in Pittman v. United States, 878 F. Supp. 833 (E.D. N.C. 1994), and again it was followed in Wheeler v. United States, 77 A.F.T.R.2d (P-H) 1405 (W.D. Tex. 1996), because facts indicated a disguised gift, and in Parker v. United States, 894 F. Supp. 445 (N.D. Ga. 1995), aff'd without opinion (11th Cir. 1995), because the taxpayer failed in its burden of proof, the court in *Parker* stating without specification that it had "some reservations about the correctness of *Gradow*." The facts also indicated that the consideration allegedly received in *Parker* may have belonged to the taxpayer and therefore would not be consideration at all.

123 SCINs are not subject to FET at the seller's death if the self-canceling feature is supported by an appropriate premium. See §6.4.2.

124 See, e.g., PLR 9253031 (private annuity arrangement was deemed subject to §2702 but the annuity payments met the qualified interest exception under §2702(b)(1)). And see PLRs 9535026 and 9436006 (simple sales for straight installment notes were not subject to §2702).

125 §§2702(a)(1) and 2702(b)(3).

126 Treas. Reg. §25.2702-1(c)(3). This provision does not apply, however, to a fixed percentage unitrust (without the net income limitation) or to any annuity trust.

127 See §7.3.7 nn.241 — 244 and accompanying text.

128 Treas. Reg. §25.2702-6, which is like the analogous but mandated adjustment provisions in Treas. Reg. §25.2701-5.

129 Treas. Reg. §25.2702-6(b)(1).

130 Treas. Reg. §25.2702-6(c) Example 1.

131 Treas. Reg. §25.2702-6(a)(3).

132 See, e.g., Treas. Reg. §25.2702-6(c) Example 5 (if §2001(e) also purges the tax base of the consenting spouse in the limited circumstance that the subsequently transferred interest is included in the transferor's gross estate under §2035(a), a "double" adjustment is precluded by the limitation imposed on the Treas. Reg. §25.2702-6 adjustment).

133 Treas. Reg. §25.2702-6(c) Examples 6 and 7.

134 Notwithstanding a statement in Treas. Reg. §25.2702-6 Example 7 alluding to "the increase in taxable gifts resulting from the exercise of the same retained right," suggesting that transfer tax is generated only by an affirmative exercise of that retained power.

135 Treas. Reg. §25.2702-6 Example 7.

136 See Treas. Reg. §25.2702-6(a)(1) (parenthetical).

137 See §§7.2.5 n.341 and 7.3.7 n.237 and accompanying text.

138 Applicable to transfers made after October 8, 1990.

139 Defined in §2701(e)(1) to mean lineal descendants of the transferor, with the added aspect that spouses are treated as one, so spouses of descendants, descendants of the transferor's spouse (and their spouses), and the transferor's spouse also are included.

140 §2701(a)(3).

141 This statement is oversimplified because, as defined, any value attributable to voting power of the preferred stock would not be ignored even if all other rights of the stock fell within the §2701(b)(1) definition of an applicable retained interest. See Treas. Reg. §25.2701-1(e) Example 2, in which preferred stock is deemed to have a zero value. Although no indication is given whether the stock in that example is voting preferred stock, the regulation states that only the preferred dividend right is valued at zero and all "other rights in the preferred stock are valued as if [the] dividend right does not exist but otherwise without regard to section 2701." See, e.g., Estate of Simplot v. Commissioner, 112 T.C. 130 (1999), rev'd and rem'd, 249 F.3d. 1191 (9th Cir. 2001) (the Tax Court held for valuation purposes that a slight premium should be accorded to voting stock because it would give the buyer "a seat at the table" in the inner circle with the other decision makers and might at some future date acquire swing vote potential; over a strong dissent the court on appeal concluded that voting and nonvoting stock should be valued the same). Because the stock in this illustration is noncumulative it would not be a qualified payment as defined in §2701(c)(3) unless an election was made under §2701(c)(3)(C) to be treated as a qualified payment. See §§7.2.3.3 and 7.2.3.3.2, respectively.

142 This term is defined in §2701(e)(2) to mean ancestors of the transferor, with the added aspect that spouses are treated as one, so spouses of ancestors, ancestors of the transferor's spouse (and their spouses), and the transferor's spouse also are included.

143 Treas. Reg. §25.2701-5.

144 The explanation offered for this deficiency when these regulations originally were proposed was "[b]ecause the transferor [C] will often acquire an applicable retained interest initially held by an applicable family member [P] and because of the administrative complexity inherent in allowing assignability [of an adjustment] . . . ." The final regulations did not correct this defect. The original statement was not persuasive; no assignment of an adjustment is needed to make C whole in this example. Instead, P should pay tax on the value of the preferred stock when P transfers it, and *both* C and P should receive an adjustment, not share or assign one between them. The only issue of complexity is when and by how much C's prior taxable gifts should be adjusted to reflect this ultimate

taxation to P. Nevertheless, the preamble to the final regulations stated that, after careful consideration, "the IRS and the Treasury have determined that . . . the administrative complexity involved in tracking the adjustment would far outweigh the additional benefit that would be gained therefrom." This is improper and should be challenged.

145 Disregarding any value attributable to the voting power of P's preferred stock, the statute properly is read by the government as ignoring the value of P's preferred stock but not the value attributable to the remaining 40% of the preferred stock held by shareholders who are not applicable family members and as to whom §2701(e)(3) attribution does not apply. P's gift of 60% of the common stock is valued accordingly. Thus, if Family Corp. was worth $10 million and P's 60% controlling interest in it was worth $7.2 million, the gift would be $7.2 million computed under the four step computation method adopted in Treas. Reg. §25.2701-3(b).

146 Again disregarding any value attributable to the voting power of P's preferred stock, Step 4 in the computation under Treas. Reg. §25.2701-3(b)(4)(ii) calls for a reduction to the pro rata portion of the value determined ($1.2 million in the example in note 127) by the straight allocation directed in Step 3 of that computation "if the value of the transferred interest (determined without regard to section 2701) would be determined after application of a minority or similar discount with respect to the transferred interest."

147 See TAM 8907002. The computation methodology established by the regulations is discussed and illustrated in more detail in §7.2.3.5.

148 Although §2642(b) relies on gift tax or FET values for purposes of allocating the GST exemption, the taxable amount and valuation rules in §§2622 through 2624 establish no such linkage, and §2701 does not dictate universal application for all wealth transfer tax purposes. Although §2623 provides that the taxable amount in a direct skip is the "value of the property received by the transferee," this is designed to produce the tax exclusive character of the direct skip tax and not to establish a valuation rule for GST purposes, so it does not speak to whether §2701 is applicable for all wealth transfer tax purposes. Thus, the government was not precluded from taking the position that the deemed valuation rule of §2701 does not apply for GST purposes.

149 Also unanswered are the consequences if C subsequently gives the common stock to GC, again triggering the application of §2701 because P is an applicable family member and continues to hold the applicable retained interest. The regulations could have applied §2701(e)(6) to purge P's adjusted taxable gifts base of the original gift or to prevent a second tax from being imposed on the same value when C makes this transfer. The drafters of Treas. Reg. §25.2701-5 chose not to address the issue, the preamble to the regulation citing unspecified administrative complexity as the justification. See §7.2.3 n.144.

150 No definition is given of a corporation or partnership, although the familiar definitions in §§7701(a)(2) and 7701(a)(3) should suffice. Some pressure may be put on the use of trusts in lieu of associations taxed as corporations if §2701 can be avoided in such a facile manner, but efforts of this nature will likely generate attacks of the type in Bedell v. Commissioner, 86 T.C. 1207 (1986), seeking to tax a trust as a corporation. Such treatment may not be required, however, if the rules in §2702 are adequate to combat that abuse.

151 §§2701(a)(2)(B) and 2701(a)(2)(C).

152 §2701(a)(2)(A).

153 §§2701(c)(1)(B) and 2701(c)(3).

154 §2701(a)(2)(A).

155 §2701(e)(1).

156 A number of authorities have concluded that a gift can be made in the context of a change in corporate capital structure. See, e.g., Estate of Maggos v. Commissioner, 79 T.C.M. (CCH) 1861 (2000), rem'd in unpublished opinion, 2002-1 U.S. Tax Cas. (CCH) ¶60,433 (9th Cir. 2002) to evaluate a valuation issue,

but otherwise aff'd (redemption of stock worth $4.9 million in exchange for $3 million deemed a gift of the difference to a child who became the sole shareholder by virtue of the redemption); Estate of Bosca v. Commissioner, 76 T.C.M. (CCH) 62 (1998) (exchange of voting common stock for nonvoting common stock was a gift to children who owned the remaining voting common stock); Furman v. Commissioner, 75 T.C.M. (CCH) 2206 (1998) (redemption of common stock in exchange for preferred was a gift to other shareholders of common stock); Estate of Trenchard v. Commissioner, 69 T.C.M. (CCH) 2164 (1995) (gift attributable to government's application of a 40% lack of marketability discount with respect to stock received in an exchange). But see Estate of Anderson v. Commissioner, 56 T.C.M. (CCH) 553 (1988) (no gift attributable to contribution of common stock in exchange for preferred stock because the values were approximately equal).

157 §2701(e)(5).

158 §2701(b).

159 PLR 9451051 addressed the effect of a capital restructuring transaction that involved a conversion of debt into Class A preferred stock. The issue was whether Class A and Class B common stock should be treated as different from the Class A preferred stock for purposes of the substantially identical interest rule. The government held that the Class A preferred was substantially the same as the Class B common stock because the dividend right on the Class A preferred was the same as the dividend right on the Class B common stock, and because the nonlapsing and nondiscretionary liquidation preference of the Class A preferred stock was only $10 per share. Therefore, the Ruling held that §2701 would not apply to the conversion as if it was a capital contribution. And see PLR 9848006, treating convertible preferred as a junior equity interest.

160 Treas. Reg. §25.2701-1(b)(1).

161 Treas. Reg. §25.2701-1(b)(2).

162 Treas. Reg. §25.2701-1(b)(2)(i)(B).

163 Treas. Reg. §25.2701-1(b)(2)(i)(A).

164 See §2701(e)(3) and Treas. Reg. §25.2701-6.

165 Treas. Reg. §25.2701-1(b)(3).

166 See, e.g., PLRs 199947034 (multiclass stock corporation being converted to an LLC and all classes of stock being replaced with units of the same structure and rights will qualify for this exception) and 9427023 (a partnership in which each partner contributed capital proportionate to the partner's prior ownership interest in the partnership met this exception).

167 See Treas. Reg. §25.2701-1(b)(3)(i) and PLR 200026011. Similar perhaps are PLRs 199952012 and 199927002, which held that the transfer of options is not the same as a transfer of stock and that the transferee does not hold an equity interest, such that §2701 cannot apply. To the extent the options are exercisable to acquire stock of the same class, "substantially the same interest" treatment ought to apply.

168 §2701(e)(2).

169 §2701(e)(3).

170 To illustrate, PLR 9253018 involved a sale of common stock to an ESOP in which a family member of the seller had an interest and held that this constituted a transfer subject to §2701. Because the underlying facts in the Ruling were not clear it is difficult to ascertain the conclusion reached, but it appears that the value of the transferred common stock for gift tax purposes was greater than the FMV consideration paid for it. Treas. Reg. §25.2701-6(a)(4)(ii)(C). If all the other requisites for §2701 application are met it may be that changes in toggle switch grantor trust status (discussed in §5.11) will constitute a transfer under Treas. Reg. §25.2701-1(b)(2)(i)(C)(1).

171 As, for example, if attribution is to a trust and then from the trust to its beneficiaries.

172 Treas. Reg. §25.2701-6(a)(5).

173 Treas. Reg. §25.2701-6(a)(1).

174 Treas. Reg. §25.2701-6(a)(5).

175 Treas. Reg. §25.2701-1(b)(3)(i).

176 See Treas. Reg. §§25.2701-6(a)(5)(i) and 25.2701-6(a)(5)(ii).

177 §2701(b)(1)(B), to the extent not excepted under §2701(c)(2)(B) or (C).

178 §2701(b)(1)(A), with attribution under §2701(e)(3). Control is relevant only with respect to distribution rights; liquidation, put, call, and conversion rights are subject to this rule even if the transferor's family does not control the entity.

179 §2701(c)(2)(B).

180 §2701(c)(2)(C). See, e.g., PLRs 9417024 and 9241014. Many conversion features fail to adjust as required and will be treated mistakenly as excluded from §2701 by inattention to this requisite.

181 Treas. Reg. §25.2701-2(b)(6).

182 Treas. Reg. §25.2701-2(b)(3).

183 Treas. Reg. §25.2701-2(b)(2). PLR 9848006 involved certain "tag along" (certain shareholders were entitled to participate if others exercised put options) and "drag along" (institutional investors who chose to sell could require certain shareholders also to sell) and rights of first refusal, all of which the government held to be not extraordinary payment rights because they did not affect the value of transferred junior equity interests.

184 Treas. Reg. §25.2701-2(b)(4)(i). See, e.g., PLR 9848006 (preferred stock redemption rights).

185 Treas. Reg. §25.2701-2(b)(4)(ii).

186 Treas. Reg. §25.2701-2(b)(4)(iv).

187 See §2701(c)(1). "Junior equity" is defined in §2701(a)(4)(B)(i) as any common stock and the most junior partnership interest. Liquidation, put, call, and conversion rights are not distribution rights because they are separately defined as applicable retained interests and are specially valued in their own right under §2701(b)(1)(B). And §707(c) rights to receive guaranteed partnership fixed payments are excluded from the zero valuation rule because these payments are outside the normal partnership distribution regime.

188 According to the Staff of the House Ways and Means Comm., 101st Cong., 2d Sess., Conference Committee Report No. 964, Statement of the Managers (1990) at 151:

> Except as provided in Treasury regulations, a right that lapses by reason of Federal or State law generally would be treated as nonlapsing under this exception. The conferees intend, however, that Treasury regulations may give zero value to rights which lapse by reason of Federal or State law that effectively transfer wealth that would not pass in the absence of a specific agreement. Such regulations could, for example, give zero value to a management right that lapses by reason of the death of a partner under the Uniform Partnership Act as adopted in a State if the decedent had waived in the partnership agreement the right to be redeemed at fair market value under that Act.

And see §2704, discussed in §7.2.4.4.

189 §§2701(a)(2)(B) and (C).

190 See, e.g., PLRs 9414013, 9414012, and 9229028, also stating that the exception for proportional partnership interests is denied if the transferor, or an applicable family member, can alter the transferee's liability as a partner. §2701(a)(2) (flush language). PLR 9415007 held that the Treas. Reg. §25.2701-1(c)(3) same class requirement was deemed met in a limited partnership setting in which the transferor was a general partner who transferred limited partnership interests, because rights in the retained and the transferred interests were the same except for nonlapsing differences in management and liability limitations, which do not affect the one class of stock definition. But TAM 199933002 concluded that

limited and general partnership interests in that case did not qualify under the same class or proportional interests exceptions because capital transaction distributions would be made to the limited partners first, followed by the general partners, rather than pro rata to each.

191 Treas. Reg. §25.2701-2(b)(3)(i).

192 Treas. Reg. §25.2701-2(b)(1).

193 Treas. Reg. §25.2701-1(c)(4) (emphasis added).

194 Staff of the House Ways and Means Comm., 101st Cong., 2d Sess., Conference Committee Report No. 964, Statement of the Managers (1990) at 154.

195 §2701(b)(2); Treas. Reg. §25.2701-2(b)(5)(ii)(A). For this purpose, §25.2701-2(b)(5)(ii)(B) provides that "[e]quity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting rights," and contingent rights are ignored unless the holder has control over the contingency.

196 §2701(e)(3). In this context only, "applicable family member" includes the transferor's spouse, ancestors of the transferor or of the transferor's spouse, and spouses of such ancestors, under §2701(e)(2). It also includes, by attribution, lineal descendants of the parents of the transferor or of the transferor's spouse. §2701(b)(2)(C). For purposes of determining whether an entity is a controlled entity, Treas. Reg. §25.2701-2(b)(5) limits the attribution to an individual to only those interests held by the transferor, applicable family members, and the lineal descendants of the parents of the individual and of the individual's spouse. This alters the Code as drafted if it means that attribution will not impute a holding to a family member that then would be counted for purposes of determining control under this test. Excluded, for example, would be attribution from descendants and siblings of an ancestor's spouse to the ancestor and then to the transferor. Caution is required, however, because multiple attribution will apply under §2701(e)(3) from an entity to an individual and from that individual to others. See Treas. Reg. §25.2701-6(a)(1).

197 §2701(c)(3). According to PLR 200114004, a qualified payment may be prepaid but not entirely commuted, without running afoul of Treas. Reg. §25.2701-2(b)(6)(i)(B). The prepayment term was not stated but the Ruling posited that the document precluded prepayment by more than a certain term.

198 §2701(c)(3). According to PLR 200114004, a qualified payment may be prepaid but not entirely commuted, without running afoul of Treas. Reg. §25.2701-2(b)(6)(i)(B). The prepayment term was not stated but the Ruling posited that the document precluded prepayment by more than a certain term.

199 As illustrated in Treas. Reg. §25.2701-2(d) Example 5.

200 §2701(a)(3). See also Treas. Reg. §25.2701-2(a)(3).

201 Staff of the House Ways and Means Comm., 101st Cong., 2d Sess., Conference Committee Report No. 964, Statement of the Managers (1990) at 153.

202 Treas. Reg. §25.2701-2(a)(5).

203 It is not clear whether this deemed increase in value will apply for GST purposes other than for exemption allocation under §2642(b). See §7.2.3 n.148.

204 §2701(d)(2).

205 §2701(d)(2)(B).

206 §2701(d)(2)(B). To determine the transferor's maximum unpaid dividend suspense account value, the transferor is deemed to own only a proportionate share of the appreciation in the junior equity interest(s), reflecting the fraction of the class of applicable retained interest owned by the transferor.

207 Treas. Reg. §25.2701-4(c)(6)(i)(A)(2).

208 Treas. Reg. §25.2701-4(c)(6)(iii).

209 §2701(d)(2)(C).

210 Treas. Reg. §25.2701-4(c)(4).

211 If the donee on either event is the transferor's spouse and the transfer qualifies for the gift tax annual exclusion or the marital deduction, §2701(d)(3)(B) allows a carryover to the spouse of the suspense account value and thus acts like a marital deduction provision, deferring tax on the suspense account until a taxable event occurs involving the surviving spouse. Treas. Reg. §25.2701-4(b)(3)(ii)(B) provides guidance in determining whether S is the donee if the stock is or will be used to satisfy a marital deduction bequest or if S will purchase the interest from D's estate.

212 §§2701(d)(3) and (d)(5). Under Treas. Reg. §25.2701-4(b)(2), a transfer during the transferor's life to a trust that would be includible in the transferor's gross estate for FET purposes will not trigger the deemed gift rule.

213 The mechanics for making a §2701(d)(3)(A)(iii) election to treat a late payment coming after expiration of the grace period as a taxable event are established by Treas. Reg. §25.2701-4(d)(3). Expected is a statement on a timely filed gift tax return for the year in which the payment was received. If made on a return that is not timely filed for that year, the payment is deemed received on the first day of the month immediately preceding the month in which the return was filed (or, if this late filed election is made after the interest holder's death, on the date of death, if later) rather than on the date it actually was received, which will affect the computation of the compounding cumulative dividend arrearage.

214 Treas. Reg. §25.2701-4(d)(2).

215 Treas. Reg. §25.2701-4(d)(1).

216 See §6.2.3 n.30 and accompanying text.

217 Treas. Reg. §25.2701-5. These problems would be exacerbated if the transferor's spouse agreed under §2513 to split any gift that triggered taxation of the suspense account value (assuming gift splitting is permitted with respect to such a deemed transfer; it should be automatic if other gifts for the year are split by the spouses). See §7.1.3.

218 See §5.10.2.

219 Staff of the House Ways and Means Comm., 101st Cong., 2d Sess., Conference Committee Report No. 964, Statement of the Managers (1990) at 155.

220 §2701(d)(3)(B). Apparently consideration paid by the transferor's spouse will not alter future operation of this suspense account rule and does not alter the immediate income tax consequences of the transfer to the spouse because, under §1041, gain is not realized on that transfer. Thus, the only potential benefit attributable to the spouse making a payment for the transferred interest is a higher basis if cost is greater than carryover basis under the part-sale, part-gift transaction rules of Treas. Reg. §1.1015-4(a). See §6.1 n.2.

221 Treas. Reg. §25.2701-4(b)(3)(ii)(B) provides rules to determine whether the transfer qualifies for this marital deduction exception to the taxable event rule if allocation of the qualified payment to S is discretionary, particularly if it does not occur before the transferor's FET return is filed.

222 Treas. Reg. §25.2701-2(c)(2)(ii).

223 The mechanism for making §2701(c)(3)(C) elections into or out of qualified payment treatment is established by Treas. Reg. §25.2701-2(c)(5). Required is a statement containing specified information and attachment to the gift tax return filed by the transferor to report the transfer. Unlike §2701(c)(3)(C)(i), which distinguishes between interests held by the transferor and those held by an applicable family member (creating a presumption *in favor of* qualified payment treatment unless the *transferor* elects out but a presumption *against* qualified payment treatment unless the *applicable family member* elects in), §2701(c)(3)(C)(ii) does not distinguish the two holders and appears to indicate that a transferor may make the election even if the applicable retained interest is held by another applicable family member.

224 Staff of the House Ways and Means Comm., 101st Cong., 2d Sess., Conference Committee Report No. 964, Statement of the Managers (1990) at 154 — 155.

225 Treas. Reg. §25.2701-2(c)(2).

226 Treas. Reg. §25.2701-2(c)(1) (emphasis added).

227 See §6.2.

228 §2701(a)(4)(A).

229 Treas. Reg. §25.2701-3(c)(3).

230 Treas. Reg. §25.2701-3(c)(3)(ii).

231 Treas. Reg. §25.2701-3(b). For an illustration, see TAM 9447004.

232 Treas. Reg. §25.2701-3(b)(1)(i).

233 Treas. Reg. §25.2701-3(b)(2).

234 As that concept is defined in §2701(b) and Treas. Reg. §25.2701-2(b).

235 Treas. Reg. §25.2701-3(b)(5), described next.

236 Treas. Reg. §25.2701-3(b)(5).

237 "If the percentage of any class of applicable retained interest held by the transferor and by applicable family members . . . exceeds . . . the highest ownership percentage (determined on the basis of relative fair market values) of family-held interests" in subordinate equity interests.

238 Treas. Reg. §25.2701-3(b)(2)(i)(A). Technically, the Treas. Reg. §25.2701-3(b)(5) adjustment specifies that the interest held in excess of the family interest percentage is "treated as a family-held interest that is not held by the transferor or an applicable family member," which qualifies as a reduction in Step 2 as the "fair market value of all family-held senior equity interests (other than applicable retained interests held by the transferor or applicable family members)."

239 Treas. Reg. §25.2701-3(b)(5)(i)(A).

240 Treas. Reg. §25.2701-3(b)(3).

241 Treas. Reg. §25.2701-3(b)(4). See PLR 9848006, holding that minority interest, lack of marketability, and other discounts should be reflected in the first step of the calculation and could not be duplicated in this fourth step.

242 See Treas. Reg. §25.2701-5, discussed in §7.2.3.

243 Treas. Reg. §25.2701-5(b).

244 See §7.3.

245 See Treas. Reg. §25.2701-3(b)(4)(iv).

246 A transfer of the applicable retained interest normally would be a taxable event if the applicable retained interest meets the qualified payment requirements, causing the transferor to incur tax under §2701(d)(3) on the suspense account value of any qualified payment arrearages. But §2701(d)(3)(B) precludes that deemed taxable event if the transfer qualifies for the gift tax annual exclusion or the marital deduction and, instead, specifies that the spouse acquires the applicable retained interest with a carryover liability as if the spouse was the transferor. Treas. Reg. §25.2701-4(b)(3) establishes rules by which it is determined whether a pecuniary marital bequest will be satisfied with the applicable retained interest and thus qualifies for the §2701(d)(3)(B) exception.

247 Treas. Reg. §25.2701-5(c)(3)(ii).

248 Quaere whether the government chose this premortem valuation technique because it understood that for gift tax purposes a lower value likely would apply. See §6.2.

249 §2001(e) only applies if the interest is includible in the transferor's gross estate under §2035. This structural flaw should be corrected by Congress and probably cannot be cured by regulation (although taxpayers would not challenge a regulation that was improperly favorable in this context).

250 See §7.1.3 n.146 and accompanying text and §7.3.7 at text following n.244.

251 As noted in Treas. Reg. §25.2701-1(b)(2)(i)(A).

252 Treas. Reg. §25.2702-4(c).

253 Treas. Reg. §27.2701-5(b).

254 See §7.3.

255 Treas. Reg. §§25.2701-5(a)(2) and 25.2701-5(c)(3)(i).

256 Valuation of the consideration received at the time of the exchange is consistent with §2043, but both provisions are improper. Moreover, Treas. Reg. §25.2701-5(c)(3)(iii) values any like kind replacement property for adjustment purposes at its FET value, which is the proper result but is inconsistent with the result in §25.2701-5(c)(3)(i). Inconsistent gift and income tax treatment of an applicable retained interest might permit the transferor to claim the same type of relief available under the concept of equitable recoupment, which would allow application of the gift tax previously paid against the subsequent income tax even if the limitation period for challenging the §2701 valuation had expired. See, e.g., United States v. Dalm, 494 U.S. 596 (1990), rev'g 867 F.2d 305 (6th Cir. 1989), rev'g 89-1 U.S. Tax Cas. (CCH) ¶13,807 (W.D. Mich. 1987), discussed at §3.3.23. Success under such a theory does not seem likely, however.

257 See PLRs 9535026 and 9436006.

258 Treas. Reg. §25.2701-3(c)(3) designates what counts as debt for purposes of the minimum value rule, and deferred compensation and lease payments not in arrears specifically are excluded.

259 See Treas. Reg. §25.2701-1(c)(3).

260 See, e.g., PLR 9309018 (involving a reverse stock split). See the exception found in Treas. Reg. §25.2701-1(b)(3)(i).

261 Treas. Reg. §25.2701-1(c)(4). See, e.g., PLR 9226063, replaced by PLR 9248026.

262 §2701(a)(1)(B).

263 See §7.2.2.8.

264 Treas. Reg. §25.2702-2(d)(1) Example 3.

265 85 T.C. 713 (1985).

266 Dribble-out sales of the remaining works left by a deceased artist is the preferred method to preserve the market value of the artist's entire portfolio, which all may increase in value upon the artist's death because (presumably) there will be no more works created by that artist.

267 Treas. Reg. §25.2512-2(e).

268 63 T.C.M. (CCH) 2699 (1992).

269 The court accepted the estate's opinion with respect to one of these groups, the government's opinion with respect to the other, and concluded that, "for want of a more reliable breakdown," half the value of the collection would fall into each category. It then applied a discount of 75% to one group, 25% to the other, and determined the value of the entire collection at 50% of the agreed FMV of the collection before any discounts.

270 See, e.g., Estate of Auker v. Commissioner, 75 T.C.M. (CCH) 2321 (1998) (stating that the court will use the term "market absorption" discount when it refers to blockage as applied to assets other than stock, in this case involving apartment complexes; the court also stated that property owned by an entity that is not slated for liquidation would not qualify for such a discount in valuing the entity).

271 Although the blockage adjustment was not involved in the case, an excellent illustration is provided in Hunt v. Commissioner, 57 T.C.M. (CCH) 919 (1989) (failed attempt to corner the silver market yielded disastrous results when the taxpayers liquidated their substantial holdings to repay loans incurred in the endeavor). See also Estate of Sturgis v. Commissioner, 54 T.C.M. (CCH) 221 (1987) (timberland).

272 See generally Moore, "Blockage" Redux: The Challenge Posed by Blockage, 131 Trusts & Estates 35 (Feb. 1992).

273 See §7.2.4.2 n.287 and accompanying text to illustrate that joint tenancy with right of survivorship is *not* the right approach because co-ownership disappears at death (assuming just two co-owners) and this valuation option is lost. And see §10.5.4 in general with respect to discounts for fractional interests.

274 61 T.C.M. (CCH) 2445 (1991).

275 The court cited favorable precedent in Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982) (15% discount); Estate of Campanari v. Commissioner, 5 T.C. 488 (1945) (12.5% discount); Estate of Henry v. Commissioner, 4 T.C. 423 (1944) (10% discount); Stewart v. Commissioner, 31 B.T.A. 201 (1934) (15% discount); and Estate of Youle v. Commissioner, 56 T.C.M. (CCH) 1594 (1989) (12.5% discount). See also Estate of Wildman v. Commissioner, 58 T.C.M. (CCH) 1006 (1989) (15% fractional interest discount aggregated with other adjustments to constitute a total 40% discount for a 20% undivided interest). Cf. Estate of Babbitt v. Commissioner, 87 T.C. 1270 (1986) (distinguishing cases in which an undivided fractional interest in realty was worth less than a proportionate share of the FMV of the whole).

276 Citing Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982); Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); and Minahan v. Commissioner, 88 T.C. 492 (1987). Both *Bright* and *Minahan* were cited with approval in rejecting a "family aggregation" theory proposed by the government to combine various properties (some owned by the decedent and others owned by an entity that was owned by the decedent and various family members) for estate tax valuation in Estate of Pulling v. Commissioner, 110 T.C.M. (CCH) 93 (2015).

277 TAM 8907002 involved a gift of a sufficient percentage of a donor's stockholding that the donor's prior control interest was reduced to a minority position; the government held that the control premium relinquished by that transfer was taxable as a gift in addition to the value that a willing buyer would have paid for the sliver of stock actually transferred.

278 In theory value is transferred in the sense that the donor no longer has it. See Pennell, Wealth Transfer Taxation: Transfer Defined, 128 Tax Notes 615 (2010); Pennell, Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice, 30 U. Miami Inst. Est. Plan. ¶903.5 (1996) (using the example of division of the world's largest diamond into niblets, causing the next largest diamond to increase in value). That is not how even the government views the situation, however. See CCA 201020009.

279 64 T.C.M. (CCH) 284 (1992) (15% discount allowed from the pro rata portion of the total property's FMV).

280 Cf. §13.7.3.1.1 n.25 and accompanying text discussing aggregation of fractional interests in property includible in S's gross estate, one part owned by a QTIP marital deduction trust and another part owned by S outright or by a revocable inter vivos trust of S's creation that is includible in S's gross estate under a provision like §2036 or §2038. The reason for aggregation is to deny fractional interest discounts to each portion that is includible.

281 Citing Estate of Fittl v. Commissioner, 804 F.2d 1332 (7th Cir. 1986).

282 68 T.C.M. (CCH) 1115 (1994) (the facts revealed that the property was such that partition would destroy its value because of issues relating to access, presence of a creek dividing the property, the number of acres needed to run a profitable agricultural operation, soil conditions in various locations, and the like).

283 99 T.C.M. (CCH) 1424 (2010).

284 2007-1 U.S. Tax Cas. (CCH) ¶60,540 (N.D. Cal.); 2007-2 U.S. Tax Cas. (CCH) ¶60,545 (N.D. Cal.) (granting a 5% discount because the government conceded as much "in a spirit of compromise").

285 Fractional interests in tangible personal property also raise interesting charitable deduction issues under §170(o), as noted in §14.3.1 n.18.

285.1 140 T.C. 86 (2013) (granting a 10% discount without articulation of how the court reached that number, explaining only that the cost to partition and the delay involved justify a modest discount), aff'd in part & rev'd in part, 767 F.3d 443 (5th Cir. 2014).

286 71 T.C.M. (CCH) 2599 (1996) (trust was to liquidate a personal residence and distribute its proceeds among multiple beneficiaries).

287 110 T.C. 297 (1998), followed by Estate of Fratini v. Commissioner, 76 T.C.M. (CCH) 342 (1998). *Young* involved a noncitizen S and a joint tenancy exclusively between D and S that could not qualify for the §2040(b) qualified joint tenancy 50% inclusion rule by virtue of §2056(d)(1)(B). The government apparently did not recognize this until the eve of trial, however, so to avoid unfairness it conceded that the amount includible under the default rule in §2040(a) should be only half the value of the property, as if S provided half the consideration for acquisition of the property. With that concession, the case essentially was the same as if the jointly owned property was 50% includible under §2040(b), and the court made no distinction based on the source of the fractional amount includible.

288 See the discussion in §6.2.3.

289 Notwithstanding the holding in Rev. Rul. 67-230, 1967-2 C.B. 352, that the value of a gift for gift tax purposes is not determined by the measure of enrichment of the donee but, rather, by the value of the property passing from the donor. In that case the gift was in trust and trustee fees would diminish the amount the donees would receive, which the government held could not be considered. Cf. Rev. Rul. 81-230, 1981-2 C.B. 186, which held that a gift of property that had been valued under §2032A was not reduced in value by the amount of recapture tax the donee might incur under §2032A(c). See the comparable issues listed in §15.3.3.3 n.298.

290 839 F.2d 1249 (7th Cir. 1988).

291 The court recognized that the existence of some of the trusts could have an effect on the value of any other owner's transfer of stock, if all the trusts were not created at once, but declined to consider such an effect in this case because all the trusts were created as part of a single "package" transaction conducted by all the owners at essentially the same time. Estate of Davis v. Commissioner, 110 T.C. 530 (1998), embraced the similar notion that other family members would not go along with an outside, hypothetical, willing-buyer and that this fact should be reflected in the valuation of transferred property. As discussed in §15.3.1.3, Congress added §2704 in 1990 to deny the consideration of restrictions imposed on the transferability of property for wealth transfer tax valuation purposes. If applicable, presumably it would preclude the argument advanced by the taxpayers in *Citizens Bank*.

292 As discussed in §6.2.3.

293 They are discussed in much greater detail in the FET context. See §§15.3.1.2 and 15.3.1.3, respectively.

294 See Treas. Reg. §25.2512-8 and §7.1.1.

295 The taxpayer acted through a child, who possessed a durable power of attorney.

296 Because the employee compensation agreement was a priority claim on the corporate earnings, it was treated as a priority interest like preferred stock. The taxpayer's retained nonvoting stock was treated as a subordinate interest, thereby meeting the requirements of Treas. Reg. §25.2704-1(c)(1).

297 TAMs 9842003, 9736004, 9735003, 9730004, 9725002, 9723009, and 9719006.

298 It may be that the government collapsed the two steps involved in most of these transfers into a single transaction because it is unsure of how §2703(a)(2) is meant to apply to the creation and funding of the partnership, and the §2703(a)(2) reference to "any restriction on the right to sell or use *such property*" is not entirely clear. But the government's theory would apply even if the two steps of the transaction were looked at separately, which may be important to a proper interpretation of §2703.

299 That possibility would require the government to allege that the transfer of assets in exchange for the partnership interests constituted a gift for gift tax purposes, which raises an issue the government articulated in TAM 9842003 that the initial transfer into the partnership may constitute a gift. This appears to be the thrust of an argument first articulated by the government in FSA 200143004 that "property" for §2703(a)(2) purposes means the assets transferred into the entity, subject to the restrictions of the agreement establishing the entity.

300 It may be that the government does not like that result because the transferred interests in the partnerships would be entitled to some discount for minority interest — even without considering any valuation discounts that are attributable to restrictions on sale or use that are ignored by §2703(a)(2) — so the TAMs' allegations that the two steps (the transfer of property to the partnership and then the transfer of partnership interests) in reality are only one transaction may be based on its effort to preclude any gift tax discount at all. That portion of the TAMs is questionable.

300.1 Cf. Estate of Elkins v. Commissioner, 140 T.C. 86 (2013), finding that §2703(a)(2) does apply to restrictions in a cotenants' agreement (involving fractional ownership interests in fine art) that restrict partition or sales of owners' interests.

301 Proving comparability may be difficult, in terms of locating a data set or expert testimony. One source suggested by Burns, Ratliff, & Rowe, Valuing Limited Partnership Interests, 149 Trusts & Estates 33 (Oct. 2010), is Securities and Exchange Commission filings of publicly available partnership agreements.

302 See also TAM 9804001.

303 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002) (on the different ground that the family alone could not remove the restrictions imposed, and not because those restrictions were no more restrictive than state law, which was the finding below).

304 In the process the court rejected a government argument that restrictions on disposition of partnership interests or withdrawal by a partner from the partnership were relevant under §2704(b), finding that these were not limitations on the ability of the entity to liquidate, as required by §2704(b)(2)(A). The court also decided that it need not address the taxpayer's contention that the interests transferred to charity demonstrated that the family did not have the requisite unilateral ability to lift the restrictions on liquidation, within the meaning of §2704(b)(2)(B)(ii).

305 2000-1 U.S. Tax Cas. (CCH) ¶60,369 (W.D. Tex. 2000) (an opinion that is only marginally useful because it is merely a string of numbered paragraphs of fact and law conclusions that are terse, conclusory, and lacking in legal analysis).

306 130 T.C. 170 (2008), aff'd, 601 F.3d 763 (8th Cir. 2010) (dealing with a single issue of marketable stock; on the major gift involved the taxpayer obtained a 22.4% discount from net asset value for gift tax valuation of transfers of limited partner units in a family partnership that the court held to have no business plan, no employees, only the one asset, no income, prepared no annual statements, and never filed a federal income tax return). Cf. Estate of Streightoff v. Commissioner, 116 T.C.M. (CCH) 437 (2018) (18% lack of marketability discount allowed in a §2031 valuation of an interest in a limited partnership that held only marketable assets).

307 2004-2 U.S. Tax Cas. (CCH) ¶60,488 (W.D. Pa. 2004) (a Magistrate's recommendation to the District Judge hearing the case), and 2004-2 U.S. Tax Cas. (CCH) ¶60,490 (W.D. Pa. 2004) (the District Judge's order accepting that recommendation).

308 *Holman* was followed in Fisher v. United States, 2010-2 U.S. Tax Cas. (CCH) ¶50,601 (S.D. Ind. 2010) (involving undeveloped property on Lake Michigan as to which there was no evidence that the taxpayers had any investment strategy, nor did they seek to improve the commercial value of the property or acquire added investment properties and therefore they failed to satisfy the safe harbor requirement that there be a bona fide business for §2703(b)(1) purposes).

309 Curiously, on the gift on creation issue, the TAM and FSA both state that the 1% general partners do not make a gift because any diminution in the value of what they receive in exchange for what they transfer is exempt under the business transaction exception: they enter into the deal to acquire the added value coming from the decedent as limited partner.

310 Distinguishing Senda v. Commissioner, 88 T.C.M. (CCH) 8 (2004), aff'd, 433 F.3d 1044 (8th Cir. 2005). See §7.3.4.1.

311 96 T.C.M. (CCH) 187 (2008) (decided by the same judge as *Holman*, with substantial reliance on that earlier opinion).

312 638 F. Supp. 2d 1277 (W.D. Wash. 2009), rev'd and rem'd, 630 F.3d 1211 (9th Cir. 2011).

313 2009-2 U.S. Tax Cas. (CCH) ¶60,578 (W.D. Wash. 2009) (decided by a different judge on the same court as decided *Linton*).

314 A transfer of realty into the partnership two weeks prior to the gift of partnership units was not challenged by the government.

315 88 T.C.M. (CCH) 8 (2004), which was a gift tax case and not really in the same category as these FET decisions. A partnership was involved, the interests in which ostensibly were transferred to trusts for the taxpayers' children, but no trust agreements existed and those trusts never filed income tax returns. The government stipulated that the partnerships were valid for state law purposes and agreed to discounts of a relatively generous amount, if discounts were available at all. But the Tax Court simply found that the alleged contribution of assets to the partnerships followed by gifts of partnership interests to the trusts for the children were in reality just indirect gifts of the underlying assets directly to the children, to be valued on the basis of the value of those assets proper, and not the alleged value of the partnership interests ostensibly transferred.

As an aside, the *Senda* opinion stated that gifts should be measured by what the donor relinquished rather than by what the donees received. This is a major determination in its own right, the court citing Treas. Reg. §25.2511-2(a), which is seldom even mentioned in cases of this nature, but this was not the court's primary holding and thus it was unimportant in *Senda*. Judge Goeke merely referenced the rule in Huber v. Commissioner, 91 T.C.M. (CCH) 1132 (2006), but he relied upon it in Koblick v. Commissioner, 91 T.C.M. (CCH) 959 (2006), to reduce a lack of control discount and thereby increase the value of a taxpayer's part-sale, part-gift transfer of a 45% stock interest to a charity as part of a prearranged transfer of 100% ownership involving simultaneous transfers by two other shareholders. For a full citation of similar authority, see §6.2.3 n.12.

316 See S. Rep. No. 1622, 82d Cong., 2d Sess. 479 (1954).

317 As noted below, the requirement that a gift tax was assessed or paid for the preceding calendar period no longer exists. Thus, the significance of Rev. Rul. 79-398, 1979-2 C.B. 338, that use of the unified credit with respect to taxable gifts made after 1976 is mandatory before a gift tax may be paid is largely eliminated. See, e.g., Rev. Rul. 84-11, 1984-1 C.B. 201 (use of unified credit to eliminate the actual payment of a gift tax did not mean that a tax was assessed or paid for purposes of §2504(c), leaving those gifts open to revaluation, a result that was perverse because it permitted revaluation of the gifts for which most taxpayers would not be inclined to keep records).

318 Now Treas. Reg. §§20.2001-1(b) and 25.2504-2(a) preclude reconsideration of any issues that may impact on the taxation of prior gifts. Once the limitation period has expired the government will not challenge any aspect of the adequately disclosed gift except to the extent that a completed gift otherwise may be subject to FET inclusion (such as under the string rules of §§2036 — 2038). Compare the results under prior law, reported in §7.2.4.5 n.283 (6th ed.).

319 In Daniels v. Commissioner, 68 T.C.M. (CCH) 1310 (1994), the government was rebuffed in its effort to assert a gift tax notwithstanding §2504(c). Because the government failed to assess a deficiency within the normal §6501(a) three year statute of limitation period for revaluing gifts for which a return was filed, it asserted a novel argument that contradicted its own Treas. Reg. §301.6501(e)-1(b)(2), that the differential between the value reported by the taxpayers and the value as determined by the government was a separate gift that was substantial and unreported and thus allowed the government to assess a deficiency under the six year §6501(e)(2) limitation for substantial unreported gifts. The Tax Court properly and summarily rejected this argument.

320 The 1997 legislation also amended §6501(c)(9) to provide that the government may assess a gift tax at any time if a gift should have been returned but it was not, or if the transfer was not disclosed in a manner adequate to apprise the government of the nature of the transfer. See, e.g., Small v. Commissioner, 56 T.C.M. (CCH) 1189 (1989), which previously held that the §6501(a) statute of

limitation was not tolled in a case in which the donor's estate could not prove that the donor filed a return. The government prepared a proposed return based on the value of the asset at the time of the gift and assessed a gift tax based on that proposed return, all after the donor's death.

In re Tax Liabilities of John Does, 2012-1 U.S. Tax Cas. (CCH) ¶50,104 (E.D. Cal. 2011), granted the government a "John Doe" summons against the California State Board of Equalization, seeking information that may reveal intra-family transfers of real property that were not properly returned for gift tax purposes. Its petition revealed that the government is using state tax records to identify taxpayers who have made transfers without filing the requisite gift tax returns. A statement disclosed "that between 60% and 90% of taxpayers that transfer real property for little or no consideration to family members fail to file a Form 709 . . . ." Also revealed is that the government already had obtained voluntary disclosure of property transfer information from authorities in Connecticut, Florida, Hawaii, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Tennessee, Texas, Virginia, Washington, and Wisconsin. The requested summons in California was to provide protection to authorities because of their concern about violating state disclosure restrictions. With the grant of its summons, the government now may have an open road to gather information to pursue nonfilers in every state.

321 §2001(f) was amended to specifically require closure under §6501, which applies if a "return" is required to be filed "(without regard to section 2503(b))." This means that (even though no return is required because the gift qualifies for the annual exclusion), a return filed for an annual exclusion gift can start the gift tax statute of limitation. The upshot is that returns filed to generate closure for FET calculation purposes are effective for both gift tax and FET purposes, even with respect to gifts covered by the gift tax annual exclusion and therefore not required to be reported in the first instance.

322 Treas. Reg. §301.6501(c)-1(f)(2) describes adequate disclosure "to apprise the Service of the nature of the gift and the basis for the value reported" by requiring a description of the relationship of the parties, a "detailed" description of the method used to determine the FMV, including any relevant financial data and any discounts claimed. The regulation specifically requires disclosure regarding the value of 100% of an entity or interest determined without discounts and then the pro rata portion of the entity or interest subject to the transfer. Nested entities or pyramiding discounts must be revealed with the appropriate information at each level for each entity or asset held. In addition, disclosure must articulate any restrictions on the transferred property considered in the valuation and a "statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulation or revenue rulings published at the time of the transfer." As illustrated in Estate of Sanders v. Commissioner, 107 T.C.M. (CCH) 1493 (2014), whether a gift tax return adequately disclosed a gift is a question of fact that will preclude summary judgment to accelerate a final determination when a valuation challenge is brought by the government, in that case after the taxpayer had died. Thus, disclosure may be desirable, but it is not a total panacea in terms of avoiding the costs and delays of postmortem challenges and litigation.

323 Changes made in 1998 further specified in §2001(f)(2) (and added a cross reference in §2504(c) to that specification) that "final determination" of value means any of (1) the taxpayer's uncontested value as stated on the return, (2) a court's determination if the value is litigated, (3) a negotiated value if the Secretary of the Treasury contests the value and the taxpayer settles with the government, or (4) the Secretary's determination of value, but only if the value is not reported on a return and the taxpayer does not timely contest the Secretary's determination.

324 See §7491(a)(2)(C), which refers to §7430(c)(4)(A)(ii), which refers to 28 U.S.C. §2412(d)(2)(B), which contains the $7 million threshold.

325 See Rev. Proc. 2000-34, 2000-2 C.B. 186, which addressed the situation in which a gift tax return was filed but did not satisfy the adequate disclosure requirements (either because the gift was not reported on that return or the information provided was not adequate). This pronouncement reasonably provides that an amendment to the original return may be filed. If prominently labeled on the top of the first page "Amended Form 709 for gift(s) made in [year] — In accordance with Rev. Proc. 2000-34, 2000-34 I.R.B.

186" the amendment will put the government on notice and the adequate disclosure protection will begin to run with the amended return as if the statute of limitation for the gift began to run with the amendment. *Not* covered by this Procedure is the situation in which *no* return was timely filed, the rationale being that no permission or special rules are required to file a late return that will start the statute with adequate disclosure at that time. Also excluded from the amended return Procedure is any gift tax return that was false or a willful evasion, for which no subsequent protection may be had through the filing of an amendment.

326 94 T.C. 872 (1990), acq., 1990-2 C.B. 1, a reviewed opinion with nine judges concurring and eight dissenting.

327 §2001(b)(2) (emphasis added), with the {language} now appearing in §2001(g), to which current §2001(b)(2) refers. That language originally appeared in §2001(b)(2) and was moved and expanded upon in 2010 to clarify (but not to alter) Congress' intent.

328 See also Estate of Lenheim v. Commissioner, 60 T.C.M. (CCH) 356 (1990), (same); and Stalcup v. United States, 91-2 U.S. Tax Cas. (CCH) ¶60,086 (W.D. Okla. 1991) (same), and see Estate of Prince v. Commissioner, 61 T.C.M. (CCH) 2594 (1991), aff'd sub nom., Levin v. Commissioner, 986 F.2d 91 (4th Cir. 1993) (§2001(b)(2) adjustment for gift tax paid was denied for the amount of gift tax that would have been payable if gifts had been taxed properly inter vivos because no gift tax would have been payable — the taxpayer's unified credit would have covered that liability; the effect was to improperly consume the unified credit at death as if the gift tax assessment was not time barred); TAM 9141008 (same). If it applies, §2001(f) essentially codifies Boatman's First Nat'l Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988) (decedent died after the §2504(c) gift tax limitation period had run; government's attempt to revalue the gift in computing FET was rejected because it indirectly would be imposing an additional tax on the gift in violation of the spirit of §2504(c) if the government could increase the gift in determining the tentative FET and then reduce that tax by only the gift tax paid on the lower previously reported gift tax value; the court did not consider the §2001(b)(2) credit issue properly resolved in *Smith*, *Lenheim*, and *Stalcup*).

329 The government acquiesced to this point in AOD 1990-032.

330 Although the dissent's example showed a smaller tax attributable to a larger valuation increase, the same tax would be payable if the taxpayer made all transfers at death or some during life and some at death, and does not speak to whether §2504(c) should provide protection against valuation disputes long after a gift was complete.

331 61 T.C.M. (CCH) 2594 (1991), aff'd sub nom., Levin v. Commissioner, 986 F.2d 91 (4th Cir. 1993).

332 Under §2502(c) the gift tax cost incurred on a taxable transfer "shall be paid by the donor."

333 See, e.g., Estate of Morgan v. Commissioner, 316 F.2d 238 (6th Cir. 1963); Estate of Sheaffer v. Commissioner, 313 F.2d 738 (8th Cir. 1963). Cf. §6.3.3.10 at text accompanying n.82 and the income tax cases involving net gifts, such as Diedrich v. Commissioner, 457 U.S. 191 (1982); Owen v. Commissioner, 652 F.2d 1271 (6th Cir. 1981); Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980); and authorities cited in each.

334 Although §2502(c) imposes primary gift tax liability on the donor, §6901(a)(1)(A)(iii) imposes transferee liability on the donees for any unpaid gift tax the donor does not pay.

335 §6324(b). See, e.g., Tilton v. Commissioner, 88 T.C. 590 (1987) (donee-transferees liable for unpaid gift tax attributable to transfers from their parents to the extent of the value of the transfers; also considered was a gift to a family corporation and the possible liability of the shareholders for the gift tax as donee-transferees).

United States v. MacIntyre, 2012-1 U.S. Tax Cas. (CCH) ¶60,642 (S.D. Tex. 2012), involved unpaid gift tax liability with respect to stock held in a trust. The question was whether the trust, or its income or remainder beneficiary (both deceased before the question arose), should pay that gift tax, which the court stated was a question of first impression. The court imposed the liability on the income beneficiary, which was error because timely payment from corpus would have amortized that cost (a reduced corpus would have produced less income, and the corpus remaining at termination of the trust also would have been less, reflecting the appropriate amortization against the value of both interests), and because the state law Principal and Income Act also likely dictated that this transfer tax be paid from corpus, not income. See, e.g., Uniform Principal and Income Act §502(a)(6) ("A trustee shall make the following disbursements from principal: . . . estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust").

336 In O'Neal v. Commissioner, 102 T.C. 666 (1994), having failed to assert liability against the transferor within the §6501(a) statute of limitation period, the government brought a §6324(b) transferee liability action against the transferees within the §6901(c) one year period after the limitation period for assessment against the transferor expired, the court holding that §6501 does not protect the transferees at all. Accord, United States v. Estate of Davenport, 159 F. Supp. 2d 1330 (N.D. Okla. 2001), rev'd in part but aff'd sub nom. on this issue, U.S. v. Botefuhr, 309 F.3d 1263 (10th Cir. 2002); Sather v. Commissioner, 78 T.C.M. (CCH) 456 (1999).

Additional litigation in the *Davenport/Botefuhr* saga includes (but is not limited to) United States v. Davenport, 327 F. Supp. 2d 725 (S.D. Tex. 2004), which involved the taxpayer and several cousins, each of whom received stock by gift from the same transferor. The transfer to the taxpayer was by sale for installment notes that the transferor later forgave. The transfer to another cousin was by pure gift. The sale and forgiveness were deemed adequately revealed to the government by the transferor's income tax returns, which caused the statute of limitation to run on any gift tax liability relating to the taxpayer's transaction. But no gift tax return was filed on the pure gift until many years later, so gift tax liability attributable to it was not barred. Moreover, the taxpayer had transferee liability for *any* gift tax incurred on any gift made in the same year as the transfer to the taxpayer. Thus, although the taxpayer was not responsible for any gift tax attributable to the taxpayer's sale and forgiveness transaction, the taxpayer *was* liable for gift tax attributable to the cousin's pure gift.

337 For example, the period for gift tax records retained by the transferor is permanent under Treas. Reg. §25.6001-1, but the transferees may have no such records and may not be privy to those held by the transferor.

338 The Ruling cited no authority for this result, which made it impossible to verify the government's conclusion; a computer assisted search as well as discussions with several commentators who have extensive knowledge in this area were unsuccessful in determining that any state had a tax apportionment rule that is on point. Today §102(1)(C) of the Uniform Estate Tax Apportionment Act would apply (and is contrary to the result dictated by the Ruling) but the amendment that produces that result was not promulgated until a decade after the Ruling.

339 The tax is not a gift tax imposed by Chapter 12 as required for application of §6324(b) gift tax transferee liability. But FET transferee liability under §6324(a)(2) is applicable to any beneficiary who receives, or has on the date of the decedent's death, property included in the gross estate under §§2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property. And §2035(c)(1)(C) provides that the gifted property is deemed includible in the gross estate for this purpose. See Armstrong v. Commissioner, 114 T.C. 94 (2000) (imposing §6324(a)(2) liability on the transferees of the gifted property, applying the provision now in §2035(c)(1)(C) under the number by which it was identified prior to 1997 revisions), and Estate of Armstrong v. Commissioner, 119 T.C. 220 (2002) (also denying the transferee's argument that their gross up tax liability constitutes §2043 consideration furnished to qualify for the offset, the court holding that the gross up rule merely requires the gross estate to be increased, rather than describe a "transfer" as to which a full and adequate consideration exception could apply or the consideration offset rule in default).

340 105 T.C. 358 (1995), rev'd on other grounds, 103 F.3d 332 (4th Cir. 1996), followed in Estate of Armstrong v. United States, 277 F.3d 490 (4th Cir. 2002) (also relevant was the court's finding that the transferees' liability was speculative and a net gift agreement by which they assumed the transferor's

gift tax liability was "illusory," as revealed by postmortem facts), which itself was cited in McCord v. Commissioner, 120 T.C. 358 (2003), rev'd, 461 F.3d 614 (5th Cir. 2006) (the Tax Court stated, among other things, that the agreement was consideration to the beneficiaries of the decedent's estate and not to the decedent, but the court on appeal held that the amount of this tax payment obligation properly was considered and reasonably susceptible of calculation, and therefore ought to be reflected in valuing any gift involved), and FSA 200122011, which also rejected a discount in the context of a similar donees' agreement to assume transferee liability. See also the comparable issue of built in income tax liability in valuing items of IRD, as discussed in the context of marital deduction funding in §13.7.3.2.4 n.80, and special use valuation recapture tax liability in Rev. Rul. 81-230, discussed in §15.3.3.3 n.298 and accompanying text.

341 See Rev. Rul. 71-232, 1971-1 C.B. 275, for the formula to calculate the value of the gift when the donee is required to pay the gift tax. Rev. Rul. 75-72, 1975-1 C.B. 310, restated Rev. Rul. 71-232 with an expansion of Example 2, which relates to valuation of a gift subject to the condition that the donee pay the gift tax. The gift is considered as made half by the donor and half by the donor's spouse, each of whom may be in a different gift tax bracket by reason of one or both spouses having made prior taxable gifts. Rev. Rul. 76-49, 1976-1 C.B. 297, adds a state gift tax for a donor who previously made taxable gifts but the donor's spouse did not. Two more computations are found in Rev. Rul. 76-104, 1976-1 C.B. 301, and Rev. Rul. 76-105, 1976-1 C.B. 304. Rev. Rul. 80-111, 1980-1 C.B. 208, computed the value of the gift when the state gift tax cost is imposed on the donee as a condition of the gift, holding that the state gift tax paid by the donee reduces the value of the gift for federal gift tax purposes but only to the extent the donor would have been liable for payment of that tax. The state gift tax involved was a liability of the donor and donee jointly (one who pays all the tax is entitled to contribution from the other for half the tax) so the agreement by the donee to pay all the tax only reduced the value of the gift by an amount equal to half the state gift tax.

342 Rev. Rul. 79-398, 1979-2 C.B. 338; PLR 7842068. Rev. Rul. 81-223, 1981-2 C.B. 189, illustrated the calculation involving use of the transferor's unified credit as the actual amount transferred, reduced by an annual exclusion and the gift tax liability payable by the transferee, and that payment reflected a gift tax computed under the tables on the taxable gift, reduced by the transferor's then available unified credit.

343 In addition, payment of the gift tax by a trust as transferee may generate grantor trust consequences. In both respects see §6.3.3.10 at text accompanying nn.80 — 82.

344 81 F. Supp. 2d 1205 (N.D. Ala. 1999), aff'd, vac'd, and rem'd, 258 F.3d 1265 (11th Cir. 2001).

345 For the original transferee liability case see n.336.

346 Estate of O'Neal v. United States, 228 F. Supp. 2d 1290 (N.D. Ala. 2002), held on remand that the §2053(a)(3) deduction for the value of the claim at the decedent's death should not consider postmortem developments. The government's gift tax claim was in excess of $16.0 million in gift tax, interest, and penalties. The taxpayer's experts valued the claim at $5.8 million in consideration of the hazards of litigation. The estate was valued at only $5.3 million, so the deduction on that basis eliminated all FET value and the taxpayer won a full refund. The government did not put on any evidence, perhaps because, to win, it needed to persuade the court that its $16.0 million assessment was way too high for §2053 purposes. In the estate of that decedent's predeceased spouse the same District Court ultimately held that at the earlier death there were no facts that would support a deduction for any claim and granted the government's motion for summary judgment. Basically the court held that no §2053(a)(3) deduction is available for a *potential* claim by donees for reimbursement of gift tax that those donees might be liable to pay as transferee liability, because at the decedent's death there was no gift tax litigation yet and therefore no claim. Estate of O'Neal v. United States, 291 F. Supp. 2d 1253 (N.D. Ala. 2003). A similar rejection of such a built in liability for gift tax valuation is found in *McCord* but, as noted in §7.2.5 n.340, that holding at the Tax Court level was reversed on appeal. Most notable is that the issue in *McCord* was the proper valuation discount attributable to this obligation, but in *O'Neal* the issue was deduction under §2053(a)(3) for the amount as a claim against the estate. As discussed in

§15.5.2.2 (6th ed.), the issue now is addressed by Treas. Reg. §§20.2053-1(d)(2), which essentially denies any deduction for claims that are not actually paid. It would be inconsistent to reflect such a liability for valuation purposes that would not be reflected for §2053(a)(3) deduction purposes.

347 §2001(d); Rev. Rul. 74-363, 1974-2 C.B. 290. See §7.3.7 n.238 and accompanying text.

348 856 F.2d 1158 (8th Cir. 1988), aff'g in part and rev'g in part 88 T.C. 769 (1987).

349 856 F.2d at 1165.

350 133 T.C. 402 (2009), aff'd, 678 F.3d 769 (9th Cir. 2012).

351 See Treas. Reg. §25.2519-1(c)(4) (which was promulgated after this taxpayer's death).

352 Two issues make that analogy shaky. First, because a "normal" case precludes the spouse from doing what the court analogized, because a typical QTIP would not permit the spouse to make a withdrawal of the amount of the gift tax to hold back to pay the tax. (Indeed, state law also may provide that a spendthrift provision would preclude the initial assignment of income.) Second, because the §2519 gift is of only the value of the remainder interest in the QTIP trust.

353 For example, PLR 9214027, also involving a split gift, held that §2035(b) will not apply if the transferor spouse dies within three years of the gift, if the consenting spouse paid all the gift tax. If the consenting spouse dies within three years of the gift, however, all tax paid by the consenting spouse would be subject to the gross up rule in the consenting spouse's gross estate. In a related situation involving a split gift in close proximity to death, the decedent transferred funds to the decedent's spouse, who wrote a check in the same amount to fund a trust for the decedent's children. The decedent and the spouse elected to split that gift for §2513 gift tax purposes. Ostensibly, then, the decedent was the consenting spouse. When the gift tax on that transfer was coming due, the decedent again transferred the full amount of the gift tax on both halves of that split gift to the spouse who wrote a single check to pay all the gift tax on both halves of the split gift. The decedent's spouse otherwise had insufficient funds to make either the gifts or to pay the gift tax. On these facts, the government concluded in TAM 9729005 that the gross up rule would apply to require inclusion in the decedent's gross estate of the full gift tax paid by the spouse within three years of the decedent's death. The theory was that the decedent transferred the funds to the spouse with the understanding that the spouse would use the money to make the gifts and then to pay their gift tax liabilities. Quaere, however, legislative history of §2035(b), which makes it clear that any gift tax paid by a consenting spouse on the consenting spouse's share of any gifts made by the decedent and split by the spouse is not includible under the gross up rule. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 14 (1976), 1976-3 C.B. 735, 748. Should only half the gift tax be returned to the decedent's gross estate, leaving excluded the spouse's payment of half the tax on the half that the consenting spouse was deemed to have given by virtue of the gift splitting election? By all appearances this was the case litigated in the government's favor in Brown v. United States, 329 F.3d 664 (9th Cir. 2003). The government's litigation position was that the decedent paid all the gift tax on the split gifts and that the spouse effectively made none of the gifts and paid none of the tax. See §§7.3.7 n.232 and 13.4.2.3.3 n.59 .

354 141 T.C. 258 (2013), a reviewed opinion (with one dissent), which denied the government's motion for summary judgment, and then 145 T.C. 184 (2015), which was the case that proceeded to trial and determined that the taxpayer was entitled to a valuation discount for the donees' agreement to pay any §2035(b) estate tax liability if the donor died within three years of the gift.

355 120 T.C. 358 (2003), rev'd and rem'd, 461 F.3d 614 (5th Cir. 2006).

356 See In re Kennedy, N.Y.L.J., October 10, 2001, at 21, col. 6 (Surr. Ct.), and In re Application of Rhodes, 22 Misc. 3d 766 (Surr. Ct. 2008).

357 According to Gerzog, Equitable Apportionment: Recent Cases and Continuing Trends, 41 Real Prop. Prob. & Tr. J. 671 (2007), the drafters of the Uniform Estate Tax Apportionment Act specifically considered whether the donees of gifts made within three years of a decedent's death should be apportioned estate tax liability attributable to §2035(b) inclusion of the gift tax paid. Citing Kahn, The

2003 Revised Uniform Estate Tax Apportionment Act, 38 Real Prop. Prob. & Tr. J. 613, 630 (2004) (Prof. Kahn was the Reporter for the Uniform Act), Gerzog states that the drafting committee "decided not to apportion any tax liability to the donees." §2035(c)(1)(C) only establishes transferee liability on the donee of a gift on which §2035(b) gift tax was paid, which means that those donees are on the hook to pay the estate tax if the lien rules under §6324 become applicable because the estate otherwise is inadequate to pay the tax, which is a one-off (or more distant) application of this topic. See §3.3.1 n.14 and accompanying text.