WEEK 3 MATERIALS
(2/1/16)

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WEEK 2 SUMMARY

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1. Use words like "sum" or "amount" when describing a pecuniary amount.

2. Use words like "percentage", "portion", "part", or "fraction" when describing a fractional share.

3. In the fractional formula, the denominator must be the assets from which the bequest can be paid:

   "Residuary estate" or "residue"

   NOT

   "gross estate" or "taxable estate"

4. Numerator for fractional formula should be the same language used for the pecuniary formula.

5. If specific reference is made to "applicable exclusion amount", add the qualifying language: "available to my estate".

6. Make sure formula adds all assets which are not included in gross estate to the tax free bequest.

7. Be sure you understand how your formula works, as well as the income tax consequences upon funding the formula bequest. A fractional pick and choose formula is the safest and most versatile formula if you can get comfortable with the possible capital gain realization due to the pick and choose feature.

8. In our office we have used a pecuniary Rev. Proc. 64-19 formula due to our lingering concern about the capital gain issues with a fractional pick and choose formula, but we are getting more comfortable with a fractional formula as time

passes. Many knowledgeable estate planners have been using fractional pick and choose formulas for years.

9. Avoid saying things in triplicate, like:

   "give, devise, bequeath" and "rest, residue, and remainder" – just say "give" and "residue".

10. Avoid legalese, like: "hereby", "hereinafter", "seized or possessed", "whatever nature and wherever situate". Modern, sophisticated estate planners around the country have been writing in plain English for some time now. We should join them.

11. "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed" (Morgan v. Commissioner).

12. Federal authorities are not bound by determinations as to property interests by state trial court – they are bound only by decisions of highest court in the state (Commissioner v. Bosch's Estate). But they must give "due regard" to lower court decisions.

13. Be sure to determine whether decedent inherited assets within ten years prior to (or two years after) death. The IRC § 2013 credit for tax on prior transfers may provide a substantial tax savings. Remember that it is not always wise to make a federal QTIP election for an elderly decedent.

14. Similarly, if foreign sitused property is subject to foreign death taxes and is included in decedent's gross estate, be sure to calculate the IRC § 2014 credit for foreign death taxes.

Bedrock Principle

States determine property rights. The federal government determines how those rights are taxed.

Essential Cases

Citation	Holding
Morgan v. Commissioner, 309 U.S. 78 (1940)	State law creates legal interests. Federal government decides how they are taxed.
Commissioner v. Bosch's Estate, 387 U.S. 456 (1967)	Federal authorities are not bound by state trial court – only bound by highest court in state.

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Pecuniary Formula Clause for Consideration

I give to my daughter, Mary, (i) all assets that cannot qualify for the federal estate tax marital deduction and (ii) in addition, the largest pecuniary amount, if any, that if transferred to Mary would not increase the federal estate tax payable by reason of my death. I give the remainder of my assets to my wife, Jane.

Fractional Formula Clause for Consideration

I give to my daughter, Mary, a fraction of my residuary estate determined by dividing (i) the largest pecuniary amount, if any, that if transferred to Mary would not increase the federal estate tax (numerator) by (ii) the value of my residuary estate as finally determined for federal estate tax purposes (denominator).

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WEEK 3

KEY PRINCIPLES IN FEDERAL TRANSFER TAX VALUATION

A. First Principle: Start With the Constitution 1

B. Second Principle: "Easy to Value" Assets Are Valued In Accordance With Readily Available Information 3

C. Third Principle: "Hard to Value" Assets Are Valued Under The "Willing Buyer – Willing Seller" Construct 5

D. Fourth Principle: Valuation Is Determined By the Interest that Passes 7

E. Fifth Principle: Valuation Is Primarily a Question of Fact 8

F. Sixth Principle: Valuation Is Based Upon Information Known Or Foreseeable On The Valuation Date 9

G. Seventh Principle: Value Is Based Upon the "Bundle of Rights" and Specific Characteristics 12

H. Eighth Principle: Non-Public Business Interests Are Subject to Specific Guidance 14

I. Ninth Principle: Privately Held Assets Valued By Comparison To Publicly Traded Assets Must Be Adjusted Downward For Lack of Marketability 16

J. Tenth Principle: A Non-Control Interest Valued By Reference To A Controlling Interest Must Be Adjusted Downward For Lack of Control 18

K. Eleventh Principle: Other Specific Factors May Also Produce Valuation Adjustments 21

L. Twelfth Principle: Valuation For Deduction Purposes Is Different Than Valuation For Inclusion Purposes 24

A. First Principle: Start With the Constitution

1. U.S. Const. art. I, section 8 gives Congress the power to "lay and collect Taxes, Duties, Imposts and Excises . . . but all Duties, Imposts and Excises shall be uniform throughout the United States . . ."

2. U.S. Const. art. I, section 2 requires that "direct Taxes shall be apportioned among the several states . . . according to their respective Numbers . . ."

3. U.S. Const. art. I, section 9 prohibits a "Capitation, or other direct, Tax . . . unless in Proportion to the Census or Enumeration . . . directed to be taken."

4. In *Pollack v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895), the Court held that:

    a. Taxes on rents or income from real estate were direct taxes because taxes on real estate itself were indisputably direct.

    b. Taxes on personal property or on income from personal property were also direct.

5. After the *Pollack* decision, an effort was made to amend the Constitution, and in February, 1913, the Sixteenth Amendment was ratified, reading as follows:

    > "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

    But the Amendment says nothing about transfer taxes.

6. Transfer taxes remain subject to the original language of the Constitution.

    a. Are they "Taxes," "Duties," "Imposts," or "Excises"?

    b. Are they direct or indirect?

    c. Are they apportioned among the several states?

d. Are they uniform?

7. *Knowlton v. Moore*, 178 U.S. 41 (1899) is the seminal case in this area. While it dealt with a legacy tax, its reasoning was later applied to transfer taxes. The Court's key observations were as follows:

   a. Direct taxes bear immediately upon persons – indirect taxes are levied upon an event.

   b. The right to inherit property is a privilege, and the tax is levied on the privilege of transferring property from the dead to the living.

   c. The legacy tax was an indirect excise and was "uniform" because it required the "same plan and the same method to be operative throughout the United States."

8. *New York Trust Company, et al. v. Eisner*, 256 U.S. 345 (1921) extended the reasoning of *Knowlton* to the estate tax, emphasizing that estate and inheritance taxes had always "been regarded as the antithesis of a direct tax" and had always been "treated as a duty or excise" because of the occasion which triggers it. The Court added that "[u]pon this point a page of history is worth a volume of logic."

9. Transfer taxes pass muster under the Constitution because they are indirect excise taxes on the privilege of transferring property, and they are geographically uniform throughout the United States.

10. If the *Eisner* court had applied a "volume of logic" instead of a "page of history" the result might have been different. While transfer taxes are constitutional, they must be applied in a carefully circumscribed manner, so that direct taxation of property is avoided. Appreciation of this limitation will enhance understanding of the remaining principles.

B. Second Principle: "Easy to Value" Assets Are Valued In Accordance With Readily Available Information

1. Marketable stocks and bonds are valued at the mean between the high and the low on the valuation date.

   a. If there were no sales on the valuation date, value is based upon a weighted average of the means on the nearest dates before and after the valuation date.

   b. If a stock or bond is listed on more than one exchange, the principal exchange should be used for valuation purposes.

   c. An exception is provided for large blocks of stock that cannot be sold in a reasonable time without depressing the market. These holdings may be valued at a price that could be obtained by sale to an underwriter, which will be less than the market price per share. This reduction is commonly called a "blockage discount."

   Treas. Reg. §§ 20.2031-2, 25.2512-2.

2. Mutual Funds are valued at the redemption price.

   a. There is no averaging of the bid and the asked prices.

   b. If there is no quoted redemption price on the valuation date, value is based upon the most recent prior redemption price.

   c. *U.S. v. Cartwright*, 411 U.S. 546 (1973) invalidated a prior regulation basing valuation upon the offering price, since a seller could never obtain such price.

   Treas. Reg. §§ 20.2031-8(b), 25.2512-6(b).

3. Annuity and Insurance policies on the life of someone other than decedent are valued by reference to sale prices of comparable contracts.

4. Promissory Notes, secured or unsecured, are valued at the unpaid principal plus accrued interest, unless the executor establishes a lower value.

   a. The executor should often be able to establish a lower value.

   b. *See* discussion of "willing buyer – willing seller" valuation method at section C.

   Treas. Reg. §§ 20.2031-4, 25.2512-4.

5. Annuities, interests for life or term of years, and remainder or reversionary interests are valued under prescribed tables using the I.R.C. section 7520 rate.

   a. Some tables are included in Treas. Reg. sections 20.2031-7(d)(6) and (7); however, note that new tables have been issued for transfers after April 30, 2009.

   b. Section 7520 rates are published monthly by the IRS.

   c. Regulations prohibit the use of the tables if the individual who is the measuring life is terminally ill on the date of the transfer. A person is "terminally ill" if such person has an incurable illness and there is at least a 50% probability that the person will die within one year. But, if the person survives the transfer by 18 months or longer, the IRS will presume that the person was not terminally ill, unless clear and convincing evidence proves otherwise.

   d. The federal Circuits are split concerning the proper valuation of a stream of lottery installments. The Fifth and Sixth Circuits insist on use of the actuarial tables, while the Second and Ninth Circuits permit departure from the tables because of the severe anti-assignment restrictions imposed by state law.

   Treas. Reg. §§ 20.2031-7, 25.2512-5, 25.7520-3. *Shackleford v. U.S.*, 262 F.3d 1028 (9th Cir. 2001), *Estate of Gribauskas v. Comm'r*, 342 F.3d

85 (2nd Cir. 2003), *Cook v. Comm'r*, 349 F.3d 850 (5th Cir. 2003), *Negron v. U.S.*, 553 F.3d 1013 (6th Cir. 2009).

6. Cash, whether in possession of decedent or another or deposited in the bank, is included in full.

   Treas. Reg. § 20.2031-5.

C. Third Principle: "Hard to Value" Assets Are Valued Under The "Willing Buyer – Willing Seller" Construct

1. I.R.C. section 2031(a) includes in the gross estate "the value" of decedent's property.

2. I.R.C. section 2512(b) also refers to "the value" of the property transferred.

3. Applicable Regulations provide that "the value" is the "fair market value" on the valuation date.

4. "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

   Treas. Reg. § 20.2031-1(b).

5. Case law makes it clear that the willing buyer and willing seller are hypothetical. *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981); *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Mellinger v. Comm'r*, 112 T.C. 26 (1999). The hypothetical buyer and seller are not real; they are imaginary.

   a. In *Simplot v. Comm'r*, 249 F.3d 1191 (9th Cir. 2001), the Court of Appeals criticized the Tax Court for constructing "particular possible purchasers".

   b. In *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990), the Tax Court explained that "[t]he willing buyer is a purely hypothetical figure and valuation does not take into account

the personal characteristics of the actual recipients of the stock."

c. This concept was well established more than 50 years ago when the well known Rev. Rul. 59-60, 1959-1 C.B. 237, referred to "the hypothetical buyer and seller."

6. Note that the construct refers to the "price at which property would change hands . . . ", thereby assuming that a transaction will take place. In *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), the Supreme Court said "the absence of market price is no barrier to valuation."

7. Neither party is under a compulsion to buy or sell.

a. Forced sales, like sales in bankruptcy, are disregarded.

b. Similarly, neither party should be considered as desperate to buy or sell.

8. Both the buyer and the seller have reasonable knowledge of relevant facts. Consider the type of investigation that a typical buyer would undertake before agreeing to purchase an asset. This level of knowledge should be presumed.

9. But the parties will not have knowledge that is unavailable in the marketplace at the time of the transaction. In *Estate of Millie Langley Wright*, 43 B.T.A. 551 (1941), the Court upheld stock exchange prices as the "value" of the subject stock even though the prices may have been influenced by misrepresentation and concealment.

a. The Court said "[i]f it were always necessary to discover whether every material fact was known to the public before stock exchange prices could be relied upon . . . it would . . . be impossible for administrative officers or taxpayers to make an intelligent approximation of their own situation."

b. Unknown facts which are discovered after the fact, will rarely alter the value of a price determined in an open and public market.

10. In an unusual decision, the Ninth Circuit determined that in valuing stock subject to securities law restrictions in the hands of the decedent, but not the estate, the "willing buyer – willing seller" method offered no guidance and the stock should therefore be valued in the hands of the decedent. *Estate of McClatchy v. Comm'r*, 147 F.3d 1089 (9th Cir. 1998). It is hard to reconcile this decision with the well established law to the contrary.

D. Fourth Principle: Valuation Is Determined By the Interest that Passes

1. In *Young Men's Christian Ass'n v. Davis*, 264 U.S. 47 (1924), the Supreme Court explained the nature of the estate tax as follows:

    a. "What was being imposed here was an excise upon the transfer of an estate upon death of the owner."

    b. "It was not a tax upon succession and receipt of benefits under the law or will."

2. The Fifth Circuit in *U.S. v. Land*, 303 F.2d 170 (5th Cir. 1962) said:

    a. "[I]t is a fallacy, therefore, to argue value before -- or -- after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins."

    b. "Instead, the valuation is determined by the interest that passes . . ."

3. The *Bright* Court observed that "[b]oth parties agree that the estate tax is an excise tax on the transfer of property at death, and that the property to be valued is the property which is actually transferred, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death."

4. The Tax Court accepted this principle in *Estate of Chenoweth v. Comm'r*, 88 T.C. 1577 (1987) by acknowledging that "[i]t has been generally held, and is now accepted, that the estate tax is laid only on that which passes at death, not what was owned before death or what the legatee receives after death . . ."

E. Fifth Principle: Valuation Is Primarily a Question of Fact

1. The Ninth Circuit in *Propstra* said "[t]he valuation of interests in property for federal tax purposes is a question of fact."

2. The Eleventh Circuit in *Estate of Watts v. Comm'r*, 823 F.2d 483 (11th Cir. 1987) said the same thing: "The valuation of an interest in property for federal tax purposes is a question of fact."

3. In *Newhouse*, the Tax Court observed that "[t]he determination of the fair market value of property is a question of fact."

4. This means that valuation cases will be decided primarily upon factual evidence.

   a. Appraisals prepared by competent experts are essential, and a well reasoned report is crucial.

   b. Rule 143(g) of the Tax Court Rules of Practice and Procedure provides that the written report of an expert witness will serve as the direct testimony of the witness.

   c. Many cases turn on the quality of the valuation expert. As an example, in *Gross v. Comm'r*, 78 T.C.M. (CCH) 254 (1999), *aff'd, Gross v. Comm'r*, 272 F.3d 333 (6th Cir. 2001), Judge Halpern said he had "no confidence" in the analysis of the taxpayer's expert; but he found the testimony of the Commissioner's expert to be "thorough and convincing."

   d. Insist that your clients obtain competent appraisals in transactions where fair market value may be a contested issue. An appraisal report, contemporaneous with the transaction, is something that only the taxpayer can obtain. The IRS expert is always giving a retrospective opinion. It is unwise to yield that advantage.

   e. Every valuation case has a unique set of facts, and the value determinations in one case will most often be irrelevant in determining value in the next case.

F. Sixth Principle: Valuation Is Based Upon Information Known Or Foreseeable On The Valuation Date

1. For gift tax purposes the valuation date is the date of the gift. I.R.C. § 2512.

2. For estate tax purposes, the valuation date is the date of death or, at the election of the executor, the alternate valuation date, which is determined as follows:

   a. If an asset is "distributed, sold, exchanged, or otherwise disposed of, within 6 months" after death, the valuation date for that asset will be the date of such disposition.

   b. If an asset is still held on the 6 month anniversary of decedent's death, the valuation date for that asset will be the 6 month anniversary.

   c. If an asset's value is affected by "mere lapse of time," the date of death value shall be used.

   d. The election is made by the executor on the estate tax return and once made, the election is irrevocable. The election cannot be made on a return that is filed more than one year after the due date, taking extensions into account.

   I.R.C. §§ 2031-2032.

3. Courts disagree concerning the admissibility of post-valuation date events for valuation purposes.

a. *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929), is often cited for the proposition that post-death events cannot be considered. The Supreme Court said that "[t]he estate so far as may be is settled as of the date of the testator's death," concluding that "the value of the thing to be taxed must be estimated as of the time when the act is done." *Ithaca* involved use of actuarial tables to determine a charitable deduction, and it has been argued that its application should be limited. Wendy C. Gerzog, *Annuity Tables Versus Factually Based Estate Tax Valuation:* Ithaca Trust *Re-visited*, 38 A.B.A. Real Prop. Prob., & Tr. J. 745 (2004).

b. In *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), the Fifth Circuit lambasted the Tax Court for considering post-gift events and "confecting sua sponte its own methodology..."

   i. The Tax Court "violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits."

   ii. The Court of Appeals then quoted from Judge Foley's dissenting Tax Court opinion:

   "Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law."

   iii. Leaving no question about their decision, the Court of Appeals summed up, stating that "Judge Foley's well-established legal precedent includes without limitation, constant jurisprudence that has established the immutable rule that, for inter vivos gifts and post-mortem bequests or inheritances alike, fair market value is determined, snapshotlike, on the day that the donor completes that gift (or the date of death or alternative valuation date in the case of a testamentary or intestate transfer)."

c. The Sixth Circuit decision in *Gross v. Comm'r*, 272 F.3d 333 (6th Cir. 2001) is an example of the other point of view.

i. The Court said that the Tax Court could consider "post-valuation data if relevant to shed light on facts existing on the date of the valuation."

ii. As a part of his valuation analysis, the government's appraiser considered other transactions that occurred after the valuation date. The Court determined that the transactions could be "reasonably contemplated on the valuation date."

iii. Ironically, the inclusion of the post-valuation date transactions produced a more favorable result for the taxpayers. It is not clear how much influence this fact had in the decision of the Court.

iv. Courts permitting consideration of post-valuation date facts generally limit the consideration to information which was foreseeable on the valuation date. These courts deny that the valuation date is being extended; rather, they contend that the later information is probative of the value on the earlier date.

d. In *Kohler v. Comm'r*, T.C.M. (RIA) 2006-152, Judge Kroupa acknowledged that "the value of unlisted stock is best determined by considering actual sales at arm's length in the normal course of business within a reasonable time before or after the valuation date."

e. In *Estate of Noble v. Comm'r*, T.C.M. (RIA) 2005-2, Judge Laro took into account the sale of the decedent's stock occurring 14 months after death, holding that post-valuation date events, "even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller . . ."

f. And, in *Levy Est. v. U.S.*, 402 Fed. Appx. 979 (5th Cir. 2010), the Court considered a sale of the subject real estate where the contract to sell was signed two years after death and the sale was contingent on rezoning.

G. Seventh Principle: Value Is Based Upon the "Bundle of Rights" and Specific Characteristics

1. The value of an asset lies in the rights it carries with it. The sum total of those rights is often called the "bundle of rights". As the "bundle" expands, the property value generally increases. There are also certain specific characteristics that tend to increase or decrease the value of an asset.

2. Some of the important rights and characteristics that may or may not be in the "bundle" are as follows:

a. Control.

i. In a business entity, voting control will enable the owner to hire and fire, set salaries and bonuses, determine dividends and cash distributions, make acquisitions and divestitures, establish benefit programs, and make many other important decisions.

ii. With personal use property, control means the ability to use the property as and when desired, to lease the property to others, to improve the property, and to make many other important decisions.

b. Income stream.

i. A regular and dependable income from an asset is important to many buyers.

ii. In evaluating the income stream, the potential buyer will investigate the creditworthiness of the payor, whether there is security for the stream of payments, whether or not the payments are likely to increase over time, and the payor's past payment record.

iii. These factors are important whether the asset is common stock, a promissory note, a royalty or patent interest, an oil or gas well, or any other asset that is capable of producing income.

c. Liquidity or Marketability.

i. The ability to convert an asset to cash quickly is a valuable feature. Buyers generally like the idea of an exit strategy so they will not be stuck with an asset they no longer need or want.

ii. Many assets lack this feature, which will tend to reduce value.

d. Tax attributes.

i. Built in capital gains in a C Corporation can be a negative because the buyer knows that a tax will be incurred when the underlying low basis asset is sold.

ii. On the other hand, carryover losses can be a positive since future income can be offset by the losses.

iii. Subchapter S status can also be a plus, because there is only one layer of taxation.

e. Litigation risks.

i. If an asset is likely to be the subject of litigation in the future, the value may be negatively affected. Very few buyers relish the idea of buying into a lawsuit.

ii. If an asset has low litigation potential, this will be a positive feature.

f. Stability.

i. If the asset is a business interest, the buyer will see a stable industry and work force, secure product lines, binding contracts for key employees, and consistent profit margins as positive attributes.

ii. And if any key component of the business is subject to instability, its value will be negatively affected.

g. Appreciation Potential.

i. The likelihood of an asset increasing in value over time is a good thing.

ii. The likelihood of little or no growth will depress the value unless offset by reliable income.

h. Enjoyment.

i. Assets that can be enjoyed by the owner may have substantial value even though other positive elements are absent.

ii. Buyers of assets like this are using different criteria than they use when purchasing investment assets.

H. Eighth Principle: Non-Public Business Interests Are Subject to Specific Guidance

1. I.R.C. section 2031(b) requires that the value of unlisted stock and securities of a corporation "shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange."

2. Treas. Reg. section 20.2031-2(f)(2) requires consideration of:

a. Company's net worth.

b. Prospective earning power.

c. Dividend paying capacity.

d. Good will of the business.

e. Economic outlook in the particular industry.

f. Company's position in the industry and its management.

g. Degree of control represented by block of stock to be valued.

h. Values of securities of corporations engaged in the same or similar lines of business which are listed on an exchange.

i. Nonoperating assets.

j. Proceeds of life insurance payable to company.

3. The valuation of a non-corporate business interest will also take into account the factors listed in H.2., above, to the extent applicable. *See* Treas. Reg. § 20.2031-3(c).

4. The well known Rev. Rul. 59-60 states that "[t]he following factors, although not all-inclusive are fundamental and require careful analysis in each case:

a. The nature of the business and the history of the enterprise from its inception.

b. The economic outlook in general and the condition and outlook of the specific industry in particular.

c. The book value of the stock and the financial condition of the business.

d. The earning capacity of the company.

e. The dividend-paying capacity.

f. Whether or not the enterprise has goodwill or other intangible value.

g. Sales of the stock and the size of the block of stock to be valued.

h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter."

I. Ninth Principle: Privately Held Assets Valued By Comparison To Publicly Traded Assets Must Be Adjusted Downward For Lack of Marketability

1. Residence property is commonly valued by reference to sales of other property (usually called "comparable sales" or "comps"). The appraiser researches recent sales in the neighborhood and then determines the degree of comparability to the subject property. One property may have a larger lot, or more rooms, or a newer kitchen, or a swimming pool. One may be older, or it may lack central air conditioning, or it may be constructed of different materials. Each difference will produce a price adjustment up or down.

2. One can readily see that the initial comparison is to something that is different than the asset being appraised.

3. So it is with non-public business interests that are determined by reference to publicly traded business interests.

4. Publicly traded business interests may be sold on an established market and liquidated to cash almost immediately. Non-public business interests have no established market, and it may take a long time to find a private buyer.

5. In *Mandelbaum v. Comm'r*, 69 T.C.M. (CCH) 2852 (1995), Judge Laro said that a "marketability discount reflects the absence of a recognized market for closely held stock and accounts for the fact that closely held stock is generally not readily transferable."

6. The amount of the downward adjustment is a factual determination, and Judge Laro provided a non-exclusive list of factors:

a. difference between price of private and public stock of subject company or similar company.

b. analysis of financial statements.

c. dividend paying capacity.

d. history of paying dividends.

e. amount of prior dividends.

f. nature of the corporation.

g. history of the corporation.

h. position in the industry.

i. economic outlook for the business.

j. management of the business.

k. degree of control in the subject block of stock.

l. restriction on transferability of the stock.

m. holding period necessary to realize a sufficient profit.

n. corporate redemption policy.

o. cost of effecting a public offering.

7. But in another Tax Court case, when the subject interest was valued without reference to comparable public companies, Judge Laro decided that a downward adjustment for lack of marketability was inappropriate. *Estate of Cloutier*, 71 T.C.M. (CCH) 2001 (1996).

8. In *Cloutier*, the Judge said that a "marketability discount" might apply even if 100 percent of the non-public stock is held by one shareholder, but

"a discount for lack of marketability is inapplicable when the value of the unlisted stock is not determined by reference to the price of listed stock."

9. There is no rule of thumb for determining the amount of the marketability adjustment. It is a question of fact – not a question of law. And a proper analysis requires a careful analysis of the *Mandelbaum* factors in an effort to determine the price that would be reached by the hypothetical willing buyer and seller. The actual percentage adjustments vary widely from case to case.

10. When valuing a minority interest in a business by reference to publicly traded interests, a downward adjustment for lack of control is not appropriate because the publicly traded interests already reflect minority values.

J. Tenth Principle: A Non-Control Interest Valued By Reference To A Controlling Interest Must Be Adjusted Downward For Lack of Control

1. There are different methods used in business valuation, and some produce an initial value of the business as a whole. If the subject of the valuation is a minority interest, a downward adjustment of the control value will be required.

2. The minority adjustment is well established and was advanced by the government in *Cravens v. Welch,* 10 F. Supp. 94 (S.D. Cal. 1935).

    a. The government was arguing for a low stock value at the inception of the income tax in 1913 in order to minimize the taxpayer's claimed capital loss.

    b. In accepting the government's proposed value, the Court referred to the "very apparent fact that minority stock interests in a 'closed' corporation are usually worth much less than the proportionate share of the assets to which they attach."

3. In *Estate of Murphy v. Comm'r,* T.C.M. (RIA) 1990-472, the court denied a minority discount because the taxpayer transferred a very small percentage of voting stock 18 days before death with the sole purpose of putting herself in a minority position. There were very bad facts in this

case, including letters from the taxpayer's accountant explaining the estate tax benefits and the fact that the taxpayer would remain in control.

4. But in *Estate of Frank v. Comm'r*, T.C.M. (RIA) 1995-132, the court respected a stock transfer effected by an attorney-in-fact two days before the decedent's death, reducing the decedent's ownership percentage from 50.3 to 32.1.

5. It has been held that QTIP assets included under I.R.C. section 2044 are not aggregated with similar assets owned outright by a decedent.

    a. So, if a decedent owns 30% of an asset outright and another 30% is included under section 2044, each 30% holding will be valued separately as a minority holding.

    b. Generally, assets included in the gross estate are aggregated, and the ultimate disposition to numerous beneficiaries is irrelevant; but the QTIP cases represent exceptions to the rule. *See Estate of Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996) and *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999).

6. But the key point in both *Bonner* and *Mellinger* is the surviving spouse's lack of control over the ultimate disposition of the QTIP assets.

    a. While this is often the case, it is not always the case. A spouse can have a limited power of appointment in a QTIP trust, and it could be very broad (e.g. "to anyone except the spouse or the spouse's estate").

    b. The consequence of this type of power regarding aggregation is unknown.

7. Assets of a General Power of Appointment type Marital Trust (I.R.C. § 2056(b)(5)) included in a decedent's gross estate under I.R.C. section 2041 will be aggregated with decedent's other assets. In *Estate of Fontana v. Comm'r*, 118 T.C. 318 (2002), the Tax Court focused on the spouse's power to appoint the trust assets, saying that he "alone controlled the ultimate disposition of both blocks of stock."

8. While *Fontana* went the other way, the key point was still control.

a. In a General Power of Appointment type Marital Trust under I.R.C. section 2056(b)(5), the surviving spouse must have the power to appoint the assets to himself or herself or to his or her estate. The degree of control in that situation is high.

b. But, if a non-marital trust is included in a decedent's estate under I.R.C. section 2041 by reason of a power to appoint to the creditors of decedent's estate, the degree of control is lower, and aggregation might be avoided.

9. Inclusion under I.R.C. section 2044 or I.R.C. section 2041 may not be the determining factor, and thinking in those terms may result in missed opportunities. The courts have based their decisions on the degree of control held by the decedent – not the code section causing inclusion.

10. Gifts are treated differently and are not aggregated with similar assets retained by the donor or other gifts made at the same time.

a. Each gift is valued as a separate transfer, and if the gift represents a minority interest, it will be valued accordingly.

b. For many years, the Internal Revenue Service took a contrary position (*see* Rev. Rul. 81-253, 1981-2 C.B. 187), but in Rev. Rul. 93-12, 1993-1 C.B. 202, it revoked the 1981 Ruling and held that a simultaneous transfer of 100% of the single class of stock in a corporation in equal shares to five children will be valued as five separate transfers of a 20% minority interest.

11. Similar to a downward minority adjustment, courts have also recognized a downward adjustment for fractional interests in real estate.

a. Owning property with one or more other parties presents a number of potential problems, and these problems produce a lower price. The value of a fractional interest is less than a proportionate share of the value of the entire property. *See Propstra*, above, and *Mooneyham*, 61 T.C.M. (CCH) 2445 (1991).

b. Because real estate may be divided or sold in a partition suit, the IRS has said that the reduction in value of a fractional interest in real estate should be limited to the interest's share of the partition costs. I.R.S. Tech. Adv. Mem. 199943003 (June 7, 1999).

12. The Internal Revenue Service takes the position that a "swing vote" block of stock may be enhanced in value such that the minority discount would be offset.

a. In I.R.S. Tech. Adv. Mem. 9436005 (May 26, 1994), the Donor gave 30% of the stock in his wholly owned corporation to each of his three children.

b. The IRS ruled that the owner of a transferred block could join with another and control the corporation, and this "swing vote" attribute must be taken into account.

K. Eleventh Principle: Other Specific Factors May Also Produce Valuation Adjustments.

1. Tax attributes can produce valuation adjustments. There is now ample authority for a downward adjustment in C Corporation stock value where the Corporation owns low basis assets that would produce capital gains within the C Corporation if sold.

a. The amount of the adjustment depends on the facts of the case, and the courts have taken different approaches.

b. The adjustment can range from the full amount of hypothetical tax on the imbedded gain to a modest adjustment based upon realization of the gain over many years.

c. The ultimate decision will rest on the shoulders of the hypothetical buyer and seller.

d. Several cases that have developed the rationale for this adjustment are *Eisenberg v. Comm'r*, 155 F.3d 50 (2nd Cir. 1998); *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998); *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001); *Estate of Welch v. Comm'r*, 208 F.3d 213 (6th Cir. 2000); *Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002); and *Jelke v. Comm'r*, 100 AFTR 2d 2007-6694 (11th Cir. 2007), cert. denied, 129 S. Ct. 168 (2008).

e. In *Dunn*, the Court held that when valuing a business by reference to the value of its assets, a downward adjustment must be made for 100% of the potential tax on built in gains. But, if the business is valued based on its earnings, the built in gains adjustment would not apply. In an asset-based valuation, the Court said "the hypothetical assumption that the assets will be sold is a foregone conclusion – a given . . ."

f. It is important to carefully consider the valuation methodology and assumptions when considering the propriety and amount of this adjustment.

2. A downward adjustment in the value of an IRA because income taxes will be incurred upon withdrawal of the underlying assets has been rejected by the courts.

a. In *Estate of Smith v. U.S.*, 391 F.3d 621 (5th Cir. 2004), the Court explained that the tax liability will not transfer to the hypothetical buyer. The transaction, from the buyer's perspective, will be treated as a purchase of the underlying assets. An IRA cannot be sold, but the assets in the IRA can be sold.

b. A similar decision was reached in *Estate of Kahn v. Comm'r*, 125 T.C. 227 (2005).

c. The difference between the IRA cases and the built in gains cases is this: When a purchaser buys C Corporation stock in a company with built in gains, the potential gains stay with the company; but when a buyer purchases IRA assets, tax is incurred only by the seller and does not transfer to the buyer.

3. In the *Gross* case, Judge Halpern accepted the value of S Corporation stock determined by the appraiser testifying for the Commissioner. The appraisal did not reduce the corporation's earnings by hypothetical income taxes that would have been paid by a C Corporation, even though the IRS had endorsed this "tax affecting" in internal training manuals. By a vote of two-to-one, the Sixth Circuit affirmed, finding that the Tax Court's conclusions were not "clearly erroneous." Also see *Dallas v. Comm'r*, T.C.M. (RIA) 2006-12.

4. The death of a key person in the business can negatively affect the value. In *Estate of Rodriguez*, 56 T.C.M. (CCH) 1033 (1989), the Court said that in valuing the business based upon earnings, there should be a reduction in the projected earnings where "a traumatic event shakes the business so that its earning power is demonstrably diminished."

5. The prospect of litigation can have a major negative effect on value. The *Newhouse* case is a legendary Tax Court case with nearly one billion dollars of tax and penalty at issue.

   a. Providing input to the Court were Goldman Sachs & Co.; Chemical Bank; the prestigious law firms of White and Case and Cravath, Swain & Moore; noted corporate lawyers, Landau & Lipton; four professors; and two deans.

   b. The experts disagreed on the relative rights and duties of different classes of stock, and the Court observed that "the experts cite substantially the same cases to support their diametrically opposed positions." The Court then said that "no expert's views were patently unreasonable."

   c. Finding for the taxpayer, the Tax Court said that profound disagreement among noted experts would cause uncertainty in the mind of the buyer about the rights of the common shareholder. The Court then found that the hypothetical buyer and seller "would take into account the likelihood of protracted and unpredictable litigation in negotiating a purchase price."

   d. The irony here is that a corporate structure that was so mixed up that the top experts in the country could not agree on the rights of the shareholders ended up saving the taxpayer a fortune.

6. The IRS has ruled that restricted management accounts (RMAs) have no effect on fair market value of underlying assets. Rev. Rul. 2008-35.

L. **Twelfth Principle: Valuation For Deduction Purposes Is Different Than Valuation For Inclusion Purposes.**

1. I.R.C. section 2053(a)(3) permits deduction of "amounts for claims against an estate."

   a. Reg. section 20.2053-1(b)(3) permits estimates if the amount is "ascertainable with reasonable certainty, and will be paid."

   b. There has been much litigation where the deduction taken on the return later proves to be too high or too low based upon events occurring after the valuation date.

   c. The *Ithaca Trust* line of cases rejects evidence of post-valuation date events. *Propstra*, cited above, *Estate of Smith v. Comm'r*, 198 F.3d 515 (5th Cir. 1999), *Estate of McMorris v. Comm'r*, 243 F.3d 1254 (10th Cir. 2001), *Estate of O'Neal v. U.S.*, 258 F.3d 1265 (11th Cir. 2001).

   d. An older line of cases follows *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), which permits evidence of post-valuation date events in determining uncertain deductions.

   e. In an effort to achieve consistency, Regulations effective for decedents dying after 10/20/09 prohibit uncertain deductions over $500,000 that have not been paid at the time the return is examined. In such a case, a protective claim for refund may be filed to preserve the estate's right to a refund if the claim is finally paid. Reg. section 20.2053-1.

   f. Under the Regulations, if there is a pending action against decedent's estate seeking $1,000,000 in damages, a deduction would not be permitted until payment is made.

2. Under I.R.C. section 2056(a), a marital deduction is allowed for assets which pass "from the decedent to his surviving spouse."

a. In *Chenoweth*, the court observed that for inclusion purposes under I.R.C. section 2031 "we were concerned only with the value of the assets to be included in the decedent's gross estate as a whole, and without reference to the destination of those assets ..." But with respect to I.R.C. section 2056, the court said "for the first time, we are concerned with the destination of the asset and the nature and value of that interest which passes."

b. Since decedent left 51% of his stock to his wife, the Tax Court allowed the addition of a control premium to the marital deduction.

c. Beware of the flip side where the marital or charitable disposition receives a minority interest of a business that was included in the gross estate at a majority value.

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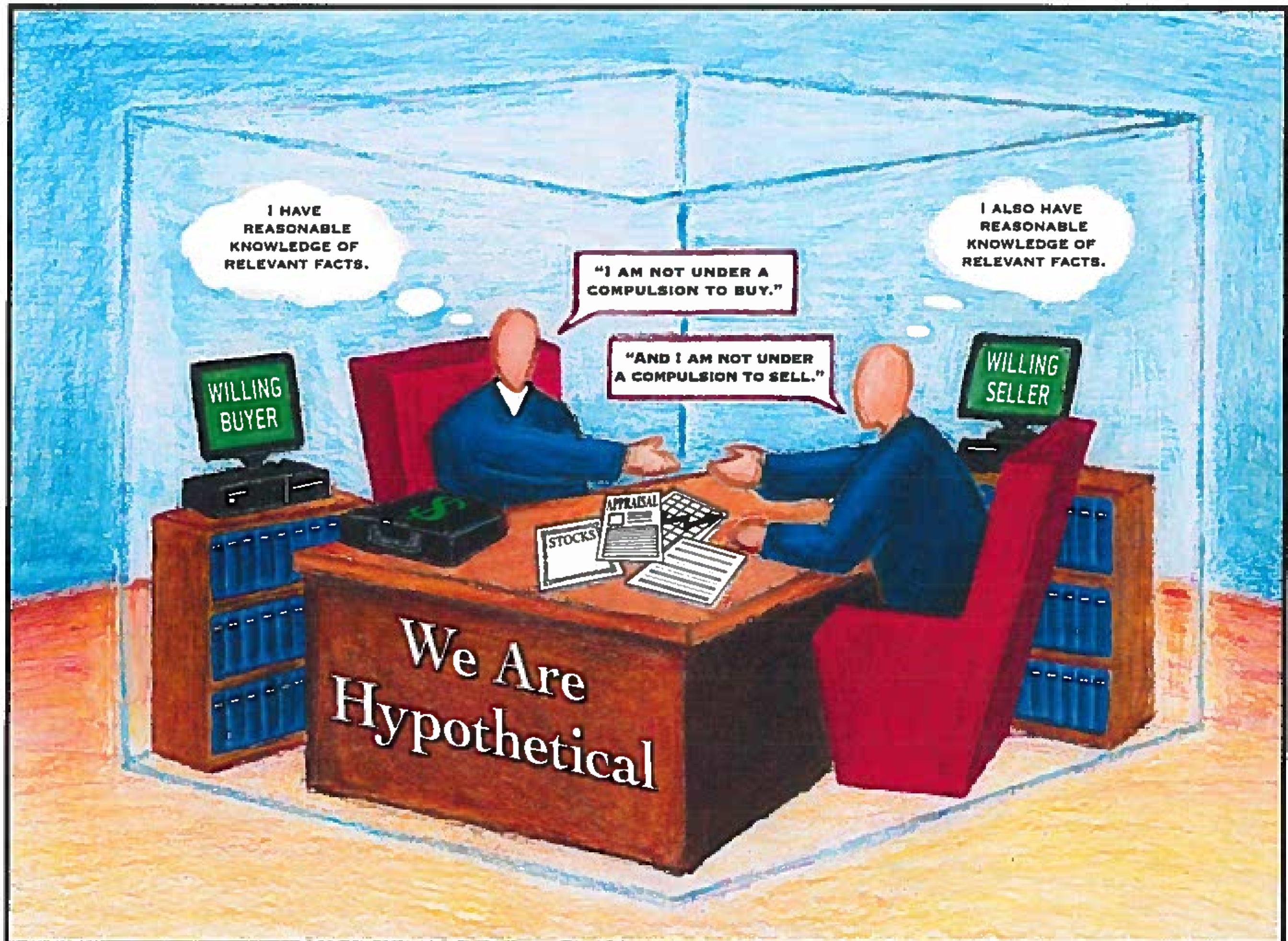
[THINKING INSIDE THE BOX]

LEGAL CONSTRUCT

To Determine Fair Market Value ("FMV")



FMV = Price at which asset would change hands.

"CONSTRUCT" *def.*	"HYPOTHETICAL" *def.*
(n.) an intellectual or logical construction: an operational concept	(adj.) of or depending on supposition: conjectural—contrasted with actual

Estate Planning and Drafting Series 6th Edition

VALUATION EXERCISES

1. Cincinnati Enterprises, Inc., has 300 shares of common voting stock issued and outstanding. No other classes of stock are authorized. Shareholders are as follows:

    Father ....100 shares
    Son ....100 shares
    Daughter...100 shares

    Father dies and leaves 51 shares to Daughter and 49 shares to son. Six months before Father's death, the company was appraised on a 100% basis for $10,000,000. No significant changes have occurred. How do we value Father's shares for estate tax purposes?

2. Same facts, except Father leaves all of his shares to his wife.

3. Same facts, except Father leaves 20 shares to each of his 5 grandchildren (3 children of son and 2 children of daughter).

4. Same basic facts about corporation, except shareholders are:

    Father ....100 shares
    Father's Brother ....100 shares
    Unrelated Party ....100 shares

    And, Father leaves shares 50/50 to his son and daughter.

5. Same basic facts about corporation, except shareholders are as follows:

    Father ....100 shares
    20 Unrelated parties.......................10 shares each

    And, Father leaves shares 50/50 to his son and daughter.

6. River City Company has 100 shares of common voting stock issued and outstanding. No other classes of stock are authorized. Shareholders are as follows:

   Al ....49 shares
   Bob..49 shares
   Charles ....2 shares

   Bob dies and leaves his shares to Charles. Six months before Bob's death, the company was appraised on a 100% basis for $10,000,000. No significant changes have occurred. How do we value Bob's shares for estate tax purposes?

7. Same facts, except Charles dies and leaves his shares to Al.

8. Same facts as item 7 with one additional fact: It is common knowledge in the industry that River City's main business rival has been after Charles to sell his 2 shares, and he has been promised a substantial premium for the shares.

9. Alice, Betsy, and Cindy own a vacation home as equal tenants in common. It was recently appraised for $1,000,000. Betsy dies and leaves her 1/3 interest to her husband. How do we value Betsy's interest for estate tax purposes?

10. Same facts as item 9, except the property is held by a limited liability company, and Alice, Betsy, and Cindy each owns 1/3 of the issued and outstanding Units.

11. Father dies and leaves his $2,000,000 Rollover IRA to son and daughter in equal shares. Since all IRA assets will be subject to income tax upon distribution to the beneficiaries, how should the IRA be valued for estate tax purposes?

12. Father is the plaintiff in a patent infringement case against a major software company. The Complaint seeks $25,000,000 in damages. He dies and leaves his rights in the case to son and daughter. How is Father's interest in the litigation valued?

Revenue Rulings

Rev. Rul. 59-60, 1959-1 CB 237, IRC Sec(s). 2031

Headnote:

Rev. Rul. 59-60, 1959-1 CB 237 -- IRC Sec. 2031 (Also Section 2512.) (Also Part II, Sections 811 (k), 1005, Regulations 105, Section 81.10.)

[CAUTION: This Rev Rul has been modified by Rev Rul 65-193, 1965-2 CB 370, and amplified by Rev Rul 77-287, 1977-2 CB 319, Rev Rul 80-213, 1980-2 CB 101, and Rev Rul 83-120, 1983-2 CB 170.]

Reference(s): Code Sec. 2031; Reg § 20.2031-2

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

Full Text:

1. Purpose.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

2. Background and Definitions.

.01. All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512 (a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02. Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as

well as willing, to trade and to be well informed about the property and concerning the market for such property.

.03. Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."**<Page 238>**

3. Approach to Valuation.

.01. A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02. The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03. Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

4. Factors To Consider.

.01. It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all- inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.**<Page 239>**

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

.02. The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other **<Page 240>** offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other

facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be **<Page 241>** noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control **<Page 242>** as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

5. Weight To Be Accorded Various Factors.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.**<Page 243>**

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

6. Capitalization Rates.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

7. Average of Factors.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

8. Restrictive Agreements.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative **<Page 244>** of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

9. Effect on Other Documents.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

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American Federal Tax Reports

CRAVENS v. WELCH, Cite as 15 AFTR 452, 01/28/1935

CRAVENS v. WELCH (two cases).

Case Information:

Code Sec(s):	
Court Name:	U.S. District Court, Southern Dist. of California, Central Division.
Docket No.:	Nos. 5254, 5255.
Date Decided:	01/28/1935
Disposition:	
Cites:	15 AFTR 452, 10 F Supp 94, 35-1 USTC P 9181.

HEADNOTE

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Reference(s):

OPINION

M. F. Mitchell and George G. Witter, both of Los Angeles, Cal., for plaintiffs.

Peirson M. Hall, U. S. Atty., by Alva C. Baird, Asst. U. S. Atty., and Eugene Harpole, Sp. Atty., Bureau of Internal Revenue, all of Los Angeles, Cal., for defendant.

Separate actions by Mildred Myers Cravens and by John S. Cravens against Galen H. Welch, Collector of Internal Revenue.

Judgment in accordance with opinion.

Judge: JAMES, District Judge.

Plaintiffs in the actions above entitled have sued to recover for overpayment of federal income tax for the year 1928. They allege that in the returns originally made by them they failed to take credit for loss sustained on an investment in the corporate stock of Chino Land & Water Company.

The single issue has been submitted to the court as to what was the value of that stock in the basic year 1913?

The corporation in question, prior to the year 1913, was engaged in the holding and selling of several thousand acres of land, located about forty-five miles more or less from the city of Los Angeles. Some of it they subdivided, and some was already subdivided, and there was left unsubdivided, until after the year 1913, a large acreage. Five persons held all of the corporate stock, John S. Cravens being one. He

was allotted one-fifth of the total issue of 900,000 shares. Mildred Cravens was his wife and he transferred to her 98,750 shares, retaining 81,250 shares. Ranch operations were begun by the five owners in 1905. By 1913 they had disposed of a considerable portion of the property and had made return to the stockholders at least twice the amount of their investment. The claim is that the value of the stock greatly depreciated between 1913 and the tax year of 1928, with ensuing loss on the investment.

There was opinion evidence as to the value of the assets as of March, 1913, on both sides. Under evidence produced by the government the stock value as of 1913 would not exceed $1.21 per share. The value experts offered by the plaintiffs would give to the stock a value of at least $2.25 per share. One of the latter witnesses had been the president of the corporation, and [pg. 453] one of the original five owners. As such president he had, in the years 1916 and 1917, reported a less value for the corporate stock than that admitted to be fair by the defendant. These reports were made to the Revenue Department of the United States on corporate tax account. The books of the company showed a much less value assigned to the property than that now claimed by the plaintiffs. While the statements referred as having been made by the president were not for the year 1913, and some property had been sold in the interim, allowing consideration to all elements proper to be used as deductions, the net value cannot, in my opinion, be made to approach that claimed as for the year 1913. It is my view that the great lessening in the value of the assets had occurred before March 1, 1913, by reason of the large sales made by the company of its real estate. And in this view, no consideration is given to the very apparent fact that minority stock interests in a "closed" corporation are usually worth much less than the proportionate share of the assets to which they attach. The defendant produced a witness experienced in stock handling who verified this view. Value of assets capable of being liquidated is not the sole measure to be applied. And even though the opinion of expert witnesses be relied upon by the parties, such opinions are not conclusive on the court. There are usually great variations in the testimony of such witnesses, as here. As the Supreme Court of the United States said, in the case of Dayton Power & Light Company v. Public Utilities Commission of Ohio, 292 U. S. 290, 54 S. Ct. 647, 652, 78 L. Ed. 1267 (decided April 30, 1934), when commenting on the weight to be given the testimony of valuation experts: "But plainly opinions thus offered, even if entitled to some weight, have no such conclusive force that there is error of law in refusing to follow them. This is true of opinion evidence generally, whether addressed to a jury, *** or to a judge, *** or to a statutory board. *** To these perturbing tendencies, all operating to weaken the persuasive force of their opinions, there must be added still another, that of interest or bias, conscious or unconscious."

The burden in these cases is upon the plaintiffs to establish the value claimed. Confronted with the exceedingly difficult task of endeavoring to arrive at the fair market value of the stock shares held by the plaintiffs, I am unable to satisfactorily conclude that the value of March 1, 1913, was any greater than defendant's counsel accepts, to wit, the value of $1.21 per share. There would seem to be no reason to conclude that the value should be fixed at any different amount as between the two plaintiffs. All objections interposed at the trial as to which ruling was reserved, are overruled, and an exception is noted in favor of the objecting party.

Counsel shall prepare such findings and judgment as are required, considering the manner of the submission of the issues in the respective cases, and exception will be noted thereto.

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Estate Planning and Drafting Series 6th Edition

THE OTHER STRING PROVISIONS

I. The Other String Provisions: 2035, 2037, and 2038

A. Sections 2035 through 2038 deal with interests in property transferred by the decedent during the decedent's life under such circumstances as to bring the interests within the decedent's gross estate.

B. It should be noted that there is considerable overlap in the application of sections 2035 through 2038 with respect to reserved powers, so that transferred property may be includible in the decedent's gross estate in varying degrees under more than one of those sections.

II. Transfers Made within Three Years of Death: IRC §2035

A. The General Rule. Gross estate includes (i) disposition of a retained right or interest within three years of death that would have been includible under 2036, 2037, 2038, or 2042, and (ii) gift tax paid by the decedent or his or her estate on any gift made by the decedent or spouse within three years prior to death.

B. The Intent. To include the value that property would have had if retained by decedent and interests that "balloon" in value such as life insurance. For example, the release of a life estate with respect to previously transferred property would have a value much lower than the property itself. Therefore, the value of the property itself is included.

C. The Exception. A bona fide sale for adequate and full consideration.

D. The Rest of the Story

1. Transfer from revocable trust that is treated as owned by the decedent under section 676 is treated as a transfer made by the decedent.

2. Gift tax paid by the donee treated as paid by the donor and is included in gross estate. *Estate of Sachs* 88 T.C. 769 (1987).

3. Determination of whether 2035(a)(2) applies is made immediately before death. Rev. Rul. 79-62.

4. Full and adequate consideration is measured against the value that would be included in the estate if no transfer were made, not against the interest

or power relinquished. *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961).

5. Split gifts: No addition to gross estate for taxes paid by the other spouse. Rev. Rul 82-198. Section 2513 only applies for gift tax purposes. Thus, no inclusion for consenting spouse if death occurs within three years of split gift.

6. Post-transfer income not included. See Rev. Rul. 80-336 regarding stock dividends.

7. The value of the transferred property as of the proper valuation date is the amount includible in the decedent's gross estate. Any increase resulting from action of the donee is not taken into consideration. If property has been dissipated, the amount includible is the present value of the property originally transferred. The purpose is to get the same result as if the decedent had kept the property. Rev. Rul. 72-282.

8. If transfer involves a trust, the amount includible is the value of the trust. *Estate of Kroger v. Commissioner*, 145 F.2d 901 (6th Cir. 1944).

9. If 2035 applies, all ownership interests are aggregated for valuation purposes.

III. Transfer Taking Effect at Death: IRC §2037

A. The General Rule: If a decedent transferred property during his or her lifetime and retained a reversionary interest in the property, the value of the transferred property is includible in the gross estate if two conditions are met: (i) possession or enjoyment of the property subject to the reversionary interest could be obtained only by surviving the decedent, and (ii) the value of the reversionary interest immediately before the decedent's death exceeded 5% of the value of the entire property.

B. The Intent. Prevent avoidance of the estate tax through lifetime transfers that are essentially testamentary in nature.

C. The Exceptions.

1. Bona fide sale for adequate and full consideration.

2. Possession or enjoyment of the property could have been obtained by any beneficiary during the decedent's life through the exercise of a general power of appointment which was exercisable immediately before the decedent's death.

3. Transfers made on or before September 7, 1916.

D. The Rest of the Story.

1. If the decedent's reversionary interest does not terminate on his or her death, then the value of the reversionary interest will be included in the decedent's gross estate under section 2033.

2. In determining whether value of the reversionary interest exceeds 5%, the interest is compared with the entire value of the transferred property, including interests which are not dependent upon survivorship of the decedent.

3. The value of the reversionary interest is not the amount to be included in the gross estate. The amount to be included has no connection with the value of the reversionary interest.

4. Section 2037(b) provides that the decedent's death is to be disregarded and usual valuation methods are to be employed to value the decedent's reversionary interest. The state of a decedent's health immediately prior to death is disregarded. Regulation §20.7520-3(b)(3)(ii).

IV. Revocable Transfers: IRC §2038

A. The General Rule: The gross estate includes property:

1. transferred by the decedent by trust or otherwise,

2. as of the decedent's date of death,

3. the decedent retained the right either alone or in conjunction with any other person,

4. to control the enjoyment through the exercise of a power to alter, amend, revoke, or terminate the transfer.

B. The Intent: To include property in the gross estate where the decedent could either revoke the transfer or exercise rights of ownership through retained powers.

C. The Exception:

1. A bona fide sale for adequate and full consideration.

2. Transfers made before June 22, 1936.

D. The Rest of the Story

1. Applies to any change in enjoyment. For example, if a trust gave A the right to income for 10 years and the remainder at the end of that time, but the settlor could terminate the trust earlier and turn the corpus over to A or A's estate, the decedent has retained the right to control enjoyment and §2038 applies.

2. Transfers by power of attorney. Where a transfer is made on a decedent's behalf pursuant to a power of attorney, or by a court appointed fiduciary, its effectiveness is determined by local law.

3. Retention of administrative or managerial powers over trust assets do not constitute powers to alter beneficial interests in the trust within §2038. *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970).

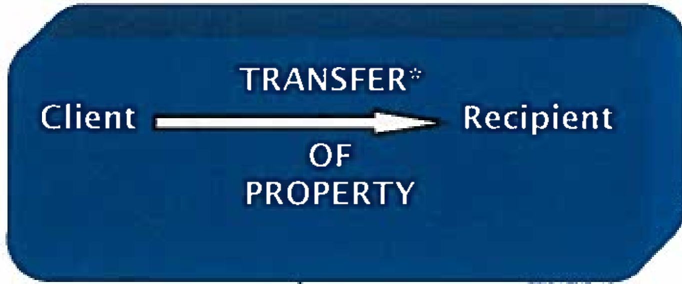
4. But, if an individual has the unrestrained power to allocate capital gains either to principal or to income, the status of the remainder person is rendered so tenuous as to be regarded as "subject to change." *Commissioner v. Estate of Hagar*, 173 F.2d 613 (3rd Cir. 1949).

5. Assets held in a Uniform Gifts to Minors Act account are includible in the decedent's gross estate if the decedent was the donor and custodian. Rev. Rul. 70-348.

6. Power retained as a trustee that is subject to a standard does not result in inclusion. *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

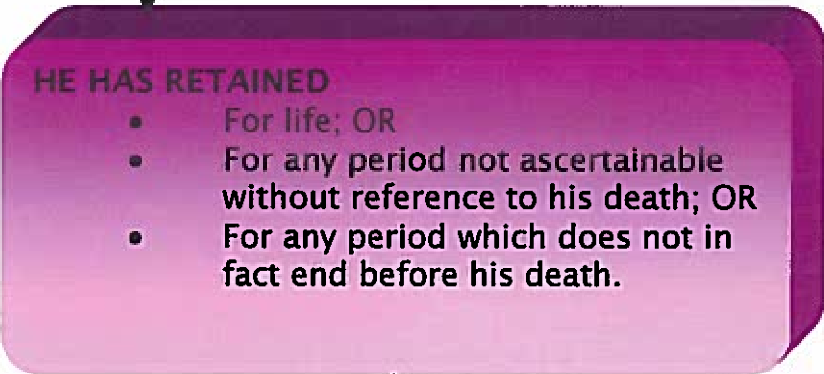
7. The power must exist at the decedent's death and notice requirements are ignored. IRC §2038(b).

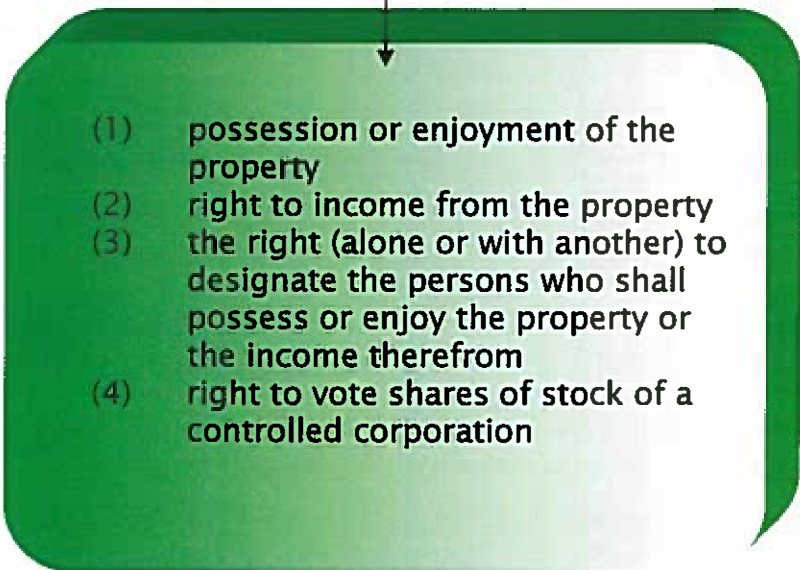
IRC § 2036



EXCEPTION:

EXCEPT BONA FIDE SALE FOR AN ADEQUATE AND FULL CONSIDERATION IN MONEY OR MONEY'S WORTH





Estate Planning and Drafting Series 6th Edition

§ 2036 EXERCISES

1. Client transfers ownership of her house to her daughter but continues to live in the house rent free until her death. Daughter paid all expenses and taxes after the transfer. Any §2036 problems?

2. Client gives 1000 shares of P&G stock to son on the condition that son sign over all dividend checks to Client. This arrangement continues until Client's death. Any §2036 problems?

3. Client gives 100 shares of Family Business, Inc. to son on the condition that Client continue to vote the shares. All shares are owned by Client and Client's children. Any §2036 problems?

4. Client gives 1000 shares of P&G stock to daughter on the condition that Client continue to vote the shares. Any §2036 problems?

5. Client owns 100 shares of CloseCo, Inc. which constitute all of the issued and outstanding shares. Client gives 40 shares to son but retains 60 which constitute voting control. Client retains no rights with respect to the 40 shares. Any §2036 problems?

6. Client creates a single member LLC and exchanges $1,000,000 worth of marketable securities for 100 Units in the LLC. Has client made a "transfer" for §2036 purposes?

7. Client transfers $990,000 worth of stocks, bonds, real estate, and cash to a limited liability company for 99% of the Units. Daughter contributes $10,000 for 1% of the Units. Client pays all of his personal bills from the LLC, but nothing is paid to or for the benefit of daughter. When he dies, will there be a §2036 problem?

8. Client transfers $2,000,000 worth of marketable securities to Trustcorp, N.A., as trustee. The beneficiaries of the trust are Client, Client's spouse, and Client's descendants. Trustee may make distributions of income and principal to any beneficiary as trustee sees fit, in its sole discretion. No beneficiary has a right to

get anything. Assuming Ohio law applies to the trust, will the trust assets be included under §2036 when Client dies?

9. Client sets up a trust for daughter and names Trustcorp, N.A. as trustee with full discretion to distribute income and principal as trustee sees fit. The trust will end when daughter is 50. Client has the right to remove trustee and name anyone else, including Client, as successor. If Client dies before daughter is 50, will trust assets be included in Client's gross estate under §2036? What happens if Client dies after daughter is 50? What if Client cannot appoint himself as successor but can appoint only another bank or trust company?

10. Mother transfers ocean-front house to daughter in 1985; its FMV at that time is $500,000 and its basis is $250,000. She continues to live in the house rent free, but she pays all the expenses. She dies in 2014 when the FMV of the house is $2,500,000. Her assets (other than the house that she transferred) are worth $2,000,000. What planning opportunity is present in this fact pattern?

214290.1

Rev. Rul. 95-58, 1995-2 CB 191 -- IRC Sec(s). 2036; 2038, 8/04/1995
Revenue Rulings (1954 - Present)

Revenue Rulings

Rev. Rul. 95-58, 1995-2 CB 191, 8/04/1995, IRC Sec(s). 2036; 2038

Transfers with retained life estate

Headnote:

Grantor's reservation of unqualified power to remove trustee and appoint new trustee (other than grantor) isn't reservation of trustee's discretionary distribution power by grantor that would cause inclusion of trust property in gross estate under Code Sec. 2036; and Code Sec. 2038; . Retained power wasn't equivalent to power to affect beneficial enjoyment of trust property, and didn't effect completed nature of gift to trust. Rev Rul 79-353 and Rev Rul 81-51 are revoked; Rev Rul 77-182 is modified.

Reference(s): ¶ 20,365.02(5); ; ¶ 20,385.01(5); Code Sec. 2036; ; Code Sec. 2038;

Full Text:

The Internal Revenue Service has reconsidered whether a grantor's reservation of an unqualified power to remove a trustee and appoint a new trustee (other than the grantor) is tantamount to a reservation by the grantor of the trustee's discretionary powers of distribution. This issue is presented in Rev. Rul. 79-353, 1979-2 C.B. 325, as modified by Rev. Rul. 81-51, 1981-1 C.B. 458. An analogous issue is presented in Rev. Rul. 77-182, 1977-1 C.B. 273. The reconsideration is caused by the recent court decisions in Estate of Wall v. Commissioner, 101 T.C. 300 (1993), and Estate of Vak v. Commissioner, 973 F.2d 1409 [70 AFTR 2d 92-6239] (8th Cir. 1992), rev'g T.C. Memo 1991- 503.

Section 2036(a) of the Internal Revenue Code, in general, provides that the value of the gross estate includes the value of all property to the extent of any interest in the property that was transferred by the decedent (for less than adequate consideration) if the decedent has retained for life the right, alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1), in general, provides that the value of the gross estate includes the value of all property to the extent of any interest in the property that was transferred by the decedent (for less than adequate consideration) if the decedent held a power, exercisable alone or in conjunction with any person, to change the enjoyment of the property through the exercise of a power to alter, amend, revoke, or terminate.

Section 25.2511-2(c) of the Gift Tax Regulations provides that a gift of property is incomplete to the extent that the donor reserves the power to revest the beneficial title to the property in himself or herself or the power (other than a fiduciary power limited by a fixed or ascertainable standard) to name new beneficiaries or to change the interest of the beneficiaries among themselves. See also section 25.2511-2(f).

For purposes of sections 2036 and 2038, it is immaterial in what capacity the power was exercisable by the decedent. Thus, if a decedent transferred property in trust while retaining, as trustee, the discretionary power to distribute the principal and income, the trust property will be includible in the

decedent's gross estate under sections 2036 and 2038. The regulations under sections 2036 and 2038 explain that a decedent is regarded as having possessed the powers of a trustee if the decedent possessed an unrestricted power to remove the trustee and appoint anyone (including the decedent) as trustee. Sections 20.2036-1(b)(3) and 20.2038-1(a) of the Estate Tax Regulations.

Rev. Rul. 79-353 concludes that, for purposes of sections 2036(a)(2) and 2038(a)(1), the reservation by a decedent-settlor of the unrestricted power to remove a corporate trustee and appoint a successor corporate trustee is equivalent to the decedent-settlor's reservation of the trustee's discretionary powers.

Rev. Rul. 81-51 modifies Rev. Rul. 79-353 so that it does not apply to a transfer or addition to a trust made before October 29, 1979, the publication date of Rev. Rul. 79-353, if the trust was irrevocable on October 28, 1979.

Rev. Rul. 77-182 concludes that a decedent's power to appoint a successor corporate trustee only in the event of the resignation or removal by judicial process of the original trustee did not amount to a power to remove the original trustee that would have endowed the decedent with the trustee's discretionary control over trust income.

In Estate of Wall, the decedent had created a trust for the benefit of others and designated an independent corporate fiduciary as trustee. The trustee possessed broad discretionary powers of distribution. The decedent reserved the right to remove and replace the corporate trustee with another independent corporate trustee. The court concluded that the decedent's retained power was not equivalent to a power to affect the beneficial enjoyment of the trust property as contemplated by sections 2036 and 2038. See also Estate of Headrick v. Commissioner, 93 T.C. 171 (1989), aff'd 918 F.2d 1263 [66 AFTR 2d 90-6038] (6th Cir. 1990).

In Estate of Vak, the decedent had created a trust and appointed family members as the trustees with discretionary powers of distribution. The decedent reserved the right to remove and replace the trustees with successor trustees who were not related or subordinate to the decedent. The decedent was also a discretionary distributee. Three years later, the trust was amended to eliminate both the decedent's power to remove and replace the trustees and the decedent's eligibility to receive discretionary distributions.

The issue considered in Estate of Vak was whether the decedent's gift in trust was complete when the decedent created the trust and transferred the property to it or, instead, when the decedent relinquished the removal and replacement power and his eligibility to receive discretionary distributions. The Eighth Circuit concluded that the decedent had not retained dominion and control over the transferred assets by reason of his removal and replacement power. Accordingly, the court held that under section 25.2511-2(c) the gift was complete when the decedent created the trust and transferred the assets to it.

In view of the decisions in the above cases, Rev. Rul. 79-353 and Rev. Rul. 81-51 are revoked. Rev. Rul. 77-182 is modified to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income.

Effect on Other Documents

Rev. Rul. 79-353 and Rev. Rul. 81-51 are revoked. Rev. Rul. 77- 182 is modified.

Drafting Information

The principal author of this revenue ruling is Deborah Ryan of the Office of Assistant Chief Counsel

(Passthroughs and Special Industries). For further information regarding this revenue ruling contact Deborah Ryan on (202) 622-3090 (not a toll-free call).

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American Federal Tax Reports

LOBER v. UNITED STATES, Cite as 44 AFTR 467 (74 S.Ct. 98), 11/09/1953

LOBER et al. v. UNITED STATES.

Case Information:

[pg. 467]

Code Sec(s):	
Court Name:	U.S. Supreme Court.
Docket No.:	No. 30.
Date Argued:	10/16/1953
Date Decided:	11/09/1953
Disposition:	
Cites:	44 AFTR 467, 346 US 335, 74 S Ct 98, 98 L Ed 15, 53-2 USTC P 10922.

[pg. 468]

HEADNOTE

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Reference(s):

OPINION

Mr. David Stock, New York City, for petitioners.

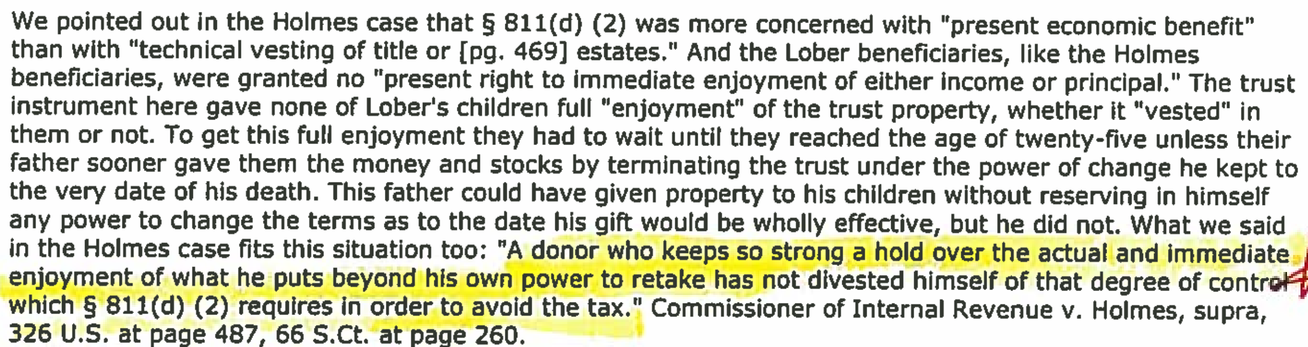
Mr. Charles K. Rice, New York City, for respondent.

Judge: Mr. Justice BLACK delivered the opinion of the Court.

This is an action for an estate tax refund brought by the executors of the estate of Morris Lober. In 1924 he signed an instrument conveying to himself as trustee money and stocks for the benefit of his young son. In 1929 he executed two other instruments, one for the benefit of a daughter, the other for a second son. The terms of these three instruments were the same. Lober was to handle the funds, invest and reinvest them as he deemed proper. He could accumulate and reinvest the income with the same freedom until his children reached twenty-one years of age. When twenty-one they were to be paid the accumulated income. Lober could hold the principal of each trust until the beneficiary reached twenty-five. In case he died his wife was to be trustee with the same broad powers Lober had conveyed to himself. The trusts were declared to be irrevocable, and as the case reaches us we may assume that the trust instruments gave Lober's children a "vested interest" under state law, so that if they had died after creation of the trusts their interests would have passed to their estates. A crucial term of the trust instruments was that Lober could at any time he saw fit turn all or any part of the principal of the trusts over to his children. Thus he could at will reduce the principal or pay it all to the beneficiaries, thereby terminating any trusteeship over it.

Lober died in 1942. By that time the trust property was valued at more than $125,000. The Internal Revenue Commissioner treated this as Lober's property and included it in his gross estate. That inclusion brought this lawsuit. The Commissioner relied on § 811(d) (2) of the Internal Revenue Code, 26 U.S.C. § 811 (1946 ed.), 26 U.S.C.A. § 811. That section, so far as material here, required inclusion in a decedent's gross estate of the value of all property that the decedent had previously transferred by trust "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power *** to alter, amend, or revoke *** ." In Commissioner of Internal Revenue v. Holmes' Estate, 326 U.S. 480, 66 S.Ct. 257, 261, 90 L.Ed. 228, we held that power to terminate was the equivalent of power to "alter, amend, or revoke" it, and we approved taxation of the Holmes estate on that basis. Relying on the Holmes case, the Court of Claims upheld inclusion of these trust properties in Lober's estate. 108 F.Supp. 731, 124 Ct.Cl. 44. This was done despite the assumption that the trust conveyances gave the Lober children an indefeasible "vested interest" in the properties conveyed. The Fifth Circuit Court of Appeals had reached a contrary result where the circumstances were substantially the same, in Hay's Estate v. Commissioner of Internal Revenue, 5 Cir., 181 F.2d 169, 172-174. Because of this conflict, we granted certiorari. 345 U.S. 969, 73 S.Ct. 1111.

Petitioners stress a factual difference between this and the Holmes case. The Holmes trust instrument provided that if a beneficiary died before expiration of the trust his children succeeded to his interest, but if he died without children, his interest would pass to his brothers or their children. Thus the trustee had power to eliminate a contingency that might have prevented passage of a beneficiary's interest to his heirs. Here we assume that upon death of the Lober beneficiaries their part in the trust estate would, under New York law, pass to their heirs. But we cannot agree that this difference should change the Holmes result.



We pointed out in the Holmes case that § 811(d) (2) was more concerned with "present economic benefit" than with "technical vesting of title or [pg. 469] estates." And the Lober beneficiaries, like the Holmes beneficiaries, were granted no "present right to immediate enjoyment of either income or principal." The trust instrument here gave none of Lober's children full "enjoyment" of the trust property, whether it "vested" in them or not. To get this full enjoyment they had to wait until they reached the age of twenty-five unless their father sooner gave them the money and stocks by terminating the trust under the power of change he kept to the very date of his death. This father could have given property to his children without reserving in himself any power to change the terms as to the date his gift would be wholly effective, but he did not. What we said in the Holmes case fits this situation too: "A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which § 811(d) (2) requires in order to avoid the tax." Commissioner of Internal Revenue v. Holmes, supra, 326 U.S. at page 487, 66 S.Ct. at page 260.

Affirmed.

Mr. Justice DOUGLAS and Mr. Justice JACKSON dissent.

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American Federal Tax Reports

U.S. v. BYRUM, Cite as 30 AFTR 2d 72-5811 (408 U.S. 125), 06/26/1972

U.S., PETITIONER v. Marian A BYRUM, Executrix Under the Last Will and Testament of Milliken C. Byrum, RESPONDENT.

Case Information:

Code Sec(s):	
Court Name:	U.S. Supreme Court,
Docket No.:	No. 71-308,
Date Decided:	06/26/1972
Prior History:	Sixth Circuit, 27 AFTR 2d 71-1744, affirmed.
Tax Year(s):	Date of death, 1964.
Disposition:	Decision for taxpayer.
Cites:	30 AFTR 2d 72-5811, 408 US 125, 92 S Ct 2382, 33 L Ed 2d 238, 72-2 USTC P 12859.

HEADNOTE

1. ESTATE TAX—Transfers with retained life estate—retention of right to income, possession or enjoyment—retention of right to designate possession or enjoyment. Reservation of right for life to vote unlisted stock and to remove and substitute corporate trustee didn't cause stock transferred to corporate trustee in irrevocable trust for children to be includible in decedent's gross estate, even though reserved voting rights helped to give decedent control of companies. Decedent's voting control of stock didn't amount to retention of enjoyment of transferred stock because he had irrevocably transferred title and right to income. And because of legal and business constraints applicable to payment of dividends and the trustee's sole discretion to pay out or withhold income, decedent's right to vote majority stock didn't amount to a right to designate enjoyment by regulating the flow of income to trust.

Reference(s): 1972 P-H Fed. ¶120,364; 120,365(5); 147,482; 147,558.

OPINION

Certiorari To The United States Court of Appeals For The Sixth Circuit *Official Supreme Court Syllabus* Decedent transferred to an irrevocable trust for the benefit of his children (and if they died before the trust ended, their surviving [pg. 72-5812] children) stock in three unlisted corporations that he controlled, retaining the right to vote the transferred stock, to veto the transfer by the trustee (a bank) of any of the stock, and to remove the trustee and appoint another corporate trustee as successor. The right to vote the transferred stock, together with the vote of the stock decedent owned at the time of his death, gave him a majority vote in each of the corporations. The Commissioner of Internal Revenue determined that the transferred stock was includable in decedent's gross estate under §2036 (a) of the Internal Revenue Code of 1954, which requires the inclusion in a decedent's gross estate of the value of any property he has transferred by*inter vivos* gift, if he retained for his lifetime "(1) the ... enjoyment of ... the property transferred, or (2) the right, either alone or in conjunction with any

person, to designate the persons who shall ... enjoy ... the income therefrom." The Commissioner claimed that decedent's right to vote the transferred shares and to veto any sale by the trustee, together with the ownership of other shares, made the transferred shares includable under §2036(a)(2), because decedent retained control over corporate dividend policy and, by regulating the flow of income to the trust, could shift or defer the beneficial enjoyment of trust income between the present beneficiaries and remaindermen, and under §2036(a)(1) because, by reason of decedent's retained control over the corporations, he had the right to continue to benefit economically from the transferred shares during his lifetime. Held:

(1.) Decedent did not retain the "right," within the meaning of §2036(a)(2), to designate who was to enjoy the trust income. Pp. 6-17.

((a)) A settlor's retention of broad management powers did not necessarily subject an inter vivos trust to the federal estate tax. Pp. 6-10.
((b)) In view of legal and business constraints applicable to the payment of dividends, especially where there are minority stockholders, decedent's right to vote a majority of the shares in these corporations did not give him a de facto position tantamount to the power to accumulate income in the trust. Pp. 10-17.

(2.) Decedent's voting control of the stock did not constitute retention of the enjoyment of the transferred stock within the meaning of §2036(a)(1), since the decedent had transferred irrevocably the title to the stock and right to the income therefrom. Pp. 17-22. 440 F. 2d 949 [27 AFTR 2d 71-1744] affirmed.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

POWELL, J., delivered the opinion of the Court, in which BURGER, C. J., and DOUGLAS, STEWART, MARSHALL, and REHNQUIST, JJ., joined. WHITE, J., filed a dissenting opinion, in which BRENNAN and BLACKMUN, JJ., joined.

Judge: Mr. Justice POWELL delivered the opinion of the Court.

[1] Decedent, Milliken C. Byrum, created in 1958 an irrevocable trust to which he transferred shares of stock in three closely held corporations. Prior to transfer, he owned at least 71% of the outstanding stock of each corporation. The beneficiaries were his children or, in the event of their death before the termination of the trust, their surviving children. The trust instrument specified that there be a corporate trustee. Byrum designated as sole trustee an independent corporation, Huntington National Bank. The trust agreement vested in the trustee broad and detailed powers with respect to the control and management of the trust property. These powers were exercisable in the trustee's sole discretion, subject to certain rights reserved by Byrum: (i) to vote the shares of unlisted stock held in the trust estate; (ii) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; (iii) to approve investments and reinvestments; and (iv) to remove the trustee and "designate another corporate Trustee to serve as successor." Until the youngest living child reached age 21, the trustee was authorized in its "absolute and sole discretion" to pay the income and principal of the trust to or for the benefit of the beneficiaries, "with due regard to their individual needs for education, care, maintenance and support." After the youngest child reached 21, the trust was to be divided into separate trusts for each child, to terminate when the beneficiaries reached 35. The trustee was authorized in its discretion to pay income and principal from these trusts to the beneficiaries for emergency or other "worthy needs," including education. [1] [pg. 72-5813]

When he died in 1964, Byrum owned less than 50% of the common stock in two of the corporations and 59% in the third. The trust had retained the shares transferred to it, with the result that Byrum had continued to have the right to vote not less than 71% of the common stock in each of the three corporations. [2] There were minority stockholders, unrelated to Byrum, in each corporation.

Following Byrum's death, the Commissioner of Internal Revenue determined that the transferred stock was properly included within Byrum's gross estate under §2036 (a) of the Internal Revenue Code of 1954, 26 U.S.C. §2036 (a). That section provides for the inclusion in a decedent's gross estate of all property which the decedent has transferred by inter vivos transaction, if he has [pg. 72-5814] retained for his lifetime "(1) the possession or enjoyment of, or the right to the income from, the property" transferred, or "(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." [3] The Commissioner determined that the stock transferred into the trust should be included in Byrum's gross estate because of the rights reserved by him in the trust agreement. It was asserted that his right to vote the transferred shares and to veto any sale thereof by the trustee, together with the ownership of other shares, enabled Byrum to retain the "enjoyment of ... the property," and also allowed him to determine the flow of income to the trust and thereby "designate the persons who shall ... enjoy ... the income."

The executrix of Byrum's estate paid an additional tax of $13,202.45, and thereafter brought this refund action in District Court. The facts not being in dispute, the court ruled for the executrix on cross motions for summary judgment. Byrum v. United States, 311 F. Supp. 892 [26 AFTR 2d 70-5967] (SD Ohio 1970). The Court of Appeals affirmed, one judge dissenting. 440 F. 2d 949 [27 AFTR 2d 71-1744] (CA6 1971). We granted the Government's petition for certiorari. 404 U.S. 937 (1971).

I

The Government relies primarily on its claim, made under §2036 (a)(2), that Byrum retained the right to designate the persons who shall enjoy the income from the transferred property. The argument is a complicated one. By retaining voting control over the corporations whose stock was transferred, Byrum was in a position to select the corporate directors. He could retain this position by not selling the shares he owned and by vetoing any sale by the trustee of the transferred shares. These rights, it is said, gave him control over corporate dividend policy. By increasing, decreasing, or stopping [pg. 72-5815] dividends completely, it is argued that Byrum could "regulate the flow of income to the trust" and thereby shift or defer the beneficial enjoyment of trust income between the present beneficiaries and the remaindermen. The sum of this retained power is said to be tantamount to a grantor-trustee's power to accumulate income in the trust, which this Court has recognized constitutes the power to designate the persons who shall enjoy the income from transferred property. [4]

At the outset we observe that this Court has never held that trust property must be included in a settlor's gross estate solely because the settlor retained the power to manage trust assets. On the contrary, since our decision in Reinecke v. Northern Trust Co., 278 U.S. 339 [7 AFTR 8841] (1929), it has been recognized that a settlor's retention of broad powers of management does not necessarily subject an intervivos trust to the federal estate tax. [5] Although there was no statutory analogue to §2036 (a)(2) when Northern Trust was decided, several lower court decisions decided after the enactment of the predecessor of §2036 (a)(2) have upheld the settlor's right to exercise managerial powers without incurring estate tax liability. [6] In Estate of King v. Commissioner, 37 T.C. 973 (1962), a settlor reserved the power to direct the trustee in the management and investment of trust assets. The Government argued that the settlor was thereby empowered to cause investments to be made in such a manner as to control significantly the flow of income into the trust. The Tax Court rejected this argument, and held for the taxpayer. Although the court recognized that the settlor had reserved "wide latitude in the exercise of his discretion as to the types of investments to be made," it did not find this control over the flow of income to be equivalent to the power to designate who shall enjoy the income from the transferred property.

Essentially the power retained by Byrum is the same managerial power retained by the settlors in Northern Trust and in King. Although neither case controls this one—Northern Trust, because it was not decided under §2036 (a)(2) or a predecessor; and King, because it is a lower court opinion—the existence of such precedents carries weight. [7] The holding of Northern Trust, that the settlor of a trust may retain broad powers of management without adverse estate tax consequences, may have been relied upon in the drafting of hundreds of inter vivos trusts. [8] The modification of this principle now

sought by the Government could have a seriously adverse impact, especially upon settlors (and their estates) who happen to have been "controlling" stockholders of a closely held corporation. Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted [pg. 72-5816] when the departure could have potentially far-reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

The Government argues, however, that our opinion in United States v. O'Malley, 383 U.S. 627 [17 AFTR 2d 1393] (1966), compels the inclusion in Byrum's estate of the stock owned by the trust. In O'Malley, the settlor of an inter vivos trust named himself as one of the three trustees. The trust agreement authorized the trustees to pay income to the life beneficiary or to accumulate it as a part of the principal of the trust in their "sole discretion." The agreement further provided that net income retained by the trustees, and not distributed in any calendar year, "shall become a part of the principal of the trust estate." The Court characterized the effect of the trust as follows:

> "Here Fabrice [the settlor] was empowered, with the other trustees, to distribute the trust income to the income beneficiaries or to accumulate it and add it to the principal, thereby denying to the beneficiaries the privilege of immediate enjoyment and conditioning their eventual enjoyment upon surviving the termination of the trust." 383 U.S., at 631. As the retention of this legal right by the settlor, acting as a trustee "in conjunction" with the other trustees, came squarely within the language and intent of the predecessor of §2036 (a)(2), the taxpayer conceded that the original assets transferred into the trust were includable in the decedent's gross estate. 383 U.S., at 632. The issue before the Court was whether the accumulated income, which had been added to the principal pursuant to the reservation of right in that respect, was also includable in decedent's estate for tax purposes. The Court held that it was.

In our view, and for the purposes of this case, O'Malley adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is now §2036 (a)(2). That section requires that the settlor must have "retained for his life ... the right ... to designate the persons who shall possess or enjoy the property or the income therefrom." O'Malley was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.

It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in O'Malley. [9] Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term. [10]

Byrum did retain the legal right to vote shares held by the trust and to veto investments and reinvestments. But the corporate trustee alone, not Byrum, had the right to pay out or withhold income and thereby to designate who among the beneficiaries enjoyed such income. Whatever power Byrum may have possessed, with respect to the flow of income into the trust, was derived not from an enforceable legal right specified in the trust instrument, but from the fact that he could elect a majority of the directors of the three corporations. The power to elect the directors conferred no legal right to command them to pay or not to pay dividends. A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. [11] Moreover, the directors also have [pg. 72-5817] a fiduciary duty to promote the interests of the corporation. [12] However great Byrum's influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely

unrelated to the needs of the trust or to Byrum's desires with respect thereto.

The Government seeks to equate the de facto position of a controlling stockholder with the legally enforceable "right" specified by the statute. Retention of corporate control (through the right to vote the shares) is said to be "tantamount to the power to accumulate income" in the trust which resulted in estate tax consequences in O'Malley. The Government goes on to assert that "through exercise of that retained power [Byrum] could increase or decrease corporate dividends, and thereby shift or defer the beneficial enjoyment of the trust." [13] This approach seems to us not only to depart from the specific statutory language, [14] but also to misconceive the realities of corporate life.

There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises—bad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy—prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control.

Even where there are corporate earnings, the legal power to declare dividends is vested solely in the corporate board. In making decisions with respect to dividends, the board must consider a number of factors. It must balance the expectation of stockholders to reasonable dividends when earned against corporate needs for retention of earnings. The first responsibility of the board is to safeguard corporate financial viability for the long term. This means, among other things, the retention of sufficient earnings to assure adequate working capital as well as resources for retirement of debt, for replacement and modernization of plant and equipment, and for growth and expansion. The nature of a corporation's business, as well as the policies and long range plans of management, are also relevant to dividend payment decisions. [15] Directors of a closely-held, small corporation [pg. 72-5818] must bear in mind the relatively limited access of such an enterprise to capital markets. This may require a more conservative policy with respect to dividends than would be expected of an established corporation with securities listed on national exchanges. [16]

Nor do small corporations have the flexibility or the opportunity available to national concerns in the utilization of retained earnings. When earnings are substantial, a decision not to pay dividends may result only in the accumulation of surplus rather than growth through internal or external expansion. The accumulated earnings may result in the imposition of a penalty tax. [17]

These various economic considerations are ignored at the directors' peril. Although vested with broad discretion in determining whether, when, and what amount of dividends shall be paid, that discretion is subject to legal restraints. If, in obedience to the will of the majority stockholder, corporate directors disregard the interests of shareholders by accumulating earnings to an unreasonable extent, they are vulnerable to a derivative suit. [18] They are similarly vulnerable if they make an unlawful payment of dividends in the absence of net earnings or available surplus, [19] or if they fail to exercise the requisite degree of care in discharging their duty to act only in the best interest of the corporation and its stockholders.

Byrum was similarly inhibited by a fiduciary duty from abusing his position as majority shareholder for personal or family advantage to the detriment of the corporation or other stockholders. There were a substantial number of minority stockholders in these corporations who were unrelated to Byrum. [20] Had Byrum and the directors violated their duties, the minority shareholders would have had a cause of action under Ohio law. [21] The Huntington National Bank, as trustee, was one of the minority stockholders, and it had both the right and the duty to hold Byrum responsible for any wrongful or negligent action as a controlling stockholder or as a director of the corporations. [22] Although Byrum had reserved the right to remove the trustee, he would have been imprudent to do this when confronted by the trustee's complaint against his conduct. A successor trustee would succeed to the rights of the one removed.

We conclude that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the "right" to designate who was to enjoy the income from trust property. His ability to affect, but not control trust income, was a qualitatively different power from that of the settlor in O'Malley, who had a specific and enforceable right to control the income paid to the beneficiaries. [23] Even had Byrum managed to flood the trust with income, he had no way of compelling the trustee to pay it out rather than accumulate it. Nor could he [pg. 72-5819] prevent the trustee from making payments from other trust assets, [24] although admittedly there were few of these at the time of Byrum's death. We cannot assume, however, that no other assets would come into the trust from reinvestments or other gifts. [25]

We find no merit to the Government's contention that Byrum's de facto "control," subject as it was to the economic and legal constraints set forth above, was tantamount to the right to designate the persons who shall enjoy trust income, specified by §2036 (a)(2). [26]

II

The Government asserts an alternative ground for including the shares transferred to the trust within Byrum's gross estate. It argues that by retaining control, Byrum guaranteed himself continued employment and remuneration, as well as the right to determine whether and when the corporations would be liquidated or merged. Byrum is thus said to have retained "the enjoyment of ... the property" making it includable within his gross estate under §2036 (a)(1). The Government concedes that the retention of the voting rights of an "unimportant minority interest" would not require inclusion of the transferred shares under §2036 (a)(1). It argues, however, "where the cumulative effect of the retained powers and the rights flowing from the shares not placed in trust leaves the grantor in control of a close corporation and assures control for his lifetime, he has retained the 'enjoyment' of the transferred stock." [27]

It is well settled that the terms "enjoy" and "enjoyment," as used in various estate tax statutes, "are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates." Commissioner v. Estate of Holmes, 326 U.S. 480, 486 [34 AFTR 308] (1946). [28] For example, in Reinecke v. Northern Trust [pg. 72-5820] Co., 278 U.S. 339 [7 AFTR 8841] (1929), in which the critical inquiry was whether the decedent had created a trust "intended to take effect in possession or enjoyment at or after his death," [29] the Court held that reserved powers of management of trust assets, similar to Byrum's power over the three corporations, did not subject an inter vivos trust to the federal estate tax. In determining whether the settlor had retained the enjoyment of the transferred property, the Court said:

> "Nor did the reserve powers of management of the trusts give to decedent any control over the economic benefits or the enjoyment of the property. He would equally have reserved all these powers and others had he made himself the trustee, but the transfer would not for that reason have been incomplete. The shifting of the economic interest in the trust property which was the subject of the tax was thus complete as soon as the trust was made. His power to recall the property and of control over it for his own benefit then ceased and as the trusts were not made in contemplation of death, the reserved powers do not serve to distinguish them from any other gifts inter vivos not subject to the tax." 278 U.S., at 346-347.

The cases cited by the Government reveal that the terms "possession and enjoyment," used in §2036 (a)(1), were used to deal with situations in which the owner of property divested himself of title but retained an income interest or, in the case of real property, the lifetime use of the property. Mr. Justice Black's opinion for the Court in Commissioner v. Estate of Church, 335 U.S. 632 [37 AFTR 480] (1949), traces the history of the concept. In none of the cases cited by the Government has a court held that a person has retained possession or enjoyment of the property if he has transferred title irrevocably, made complete delivery of the property and relinquished the right to income where the property is income producing. [30]

The Government cites only one case, Estate of Holland v. Commissioner, 1 T. C. 564 (1943), [31] in which a decedent had retained the right to vote transferred shares of stock and in which the stock was included within the decedent's gross estate. In that case, it was not the mere power to vote the stock, giving the decedent control of the corporation, which caused the Tax Court to include the shares. The court held that "on an inclusive view of the whole arrangement, this withholding of the income until decedent's death, coupled with the retention of the certificates under the pledge and the reservation of the right to vote the stock and to designate company officers" subjects the stock to inclusion within the gross estate. Id., at 565. The settlor in Holland retained a considerably greater interest than Byrum retained, including an income interest. [32]

As the Government concedes, the mere retention of the right-to-vote shares does not constitute the type of "enjoyment" in the property itself contemplated by §2036 (a)(1). In addition to being against the weight of precedent, the Government's argument that Byrum retained "enjoyment" within the meaning of §2036 (a)(1) is conceptually unsound. This argument implies, as it must under the express language of §2036 (a)(1), that Byrum "retained for his life ... the possession or enjoyment" of the*"property"* transferred to the trust or the*"income"* therefore. The only property he transferred was corporate stock. He did not transfer "control" (in the sense used by the Government) as the trust never owned as much as 50% of the stock of any corporation. Byrum never divested himself of control, as he was able to vote a majority of the shares by virtue of what he owned and the right to vote those placed in the trust. Indeed, at the time of his death he still owned a majority of the shares in the largest of the corporations and probably would have exercised control of the other two by virtue of being a large stockholder in each. [33] The statutory language plainly contemplates [pg. 72-5821] retention of an attribute of the property transferred—such as a right to income, use of the property itself, or a power of appointment with respect either to income or principal. [34]

Even if Byrum had transferred a majority of the stock, but had retained voting control, he would not have retained "substantial present economic benefits." The Government points to the retention of two "benefits." The first of these, the power to liquidate or merge, is not a present benefit; rather, it is a speculative and contingent benefit which may or may not be realized. Nor is the probability of continued employment and compensation the substantial "enjoyment of ... [the transferred] property" within the meaning of the statute. The dominant stockholder in a closely held corporation, if he is active and productive, is likely to hold a senior position and to enjoy the advantage of a significant voice in his own compensation. These are inevitable facts of the free enterprise system, but the influence and capability of a controlling stockholder to favor himself are not without constraints. Where there are minority stockholders, as in this case, directors may be held accountable if their employment, compensation and retention of officers violates their duty to act reasonably in the best interest of the corporation and all of its stockholders [35] Moreover, this duty is policed, albeit indirectly, by the Internal Revenue Service, which disallows the deduction of unreasonable compensation paid to a corporate executive as a business expense. [36] We conclude that Byrum's retention of voting control was not the retention of the enjoyment of the transferred property within the meaning of the statute.

For the reasons set forth above, we hold that this case was correctly decided by the Court of Appeals and accordingly the judgment is Affirmed.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

Mr. Justice WHITE, with whom Mr. Justice BRENNAN and Mr. Justice BLACKMUN join, dissenting.

I think the majority is wrong in all substantial respects.

I

The tax code commands the payment of an estate tax on transfers effective in name and form during life if the now deceased settlor retained during his life either (1) "the possession or enjoyment of" the property transferred or (2) the right to designate the persons who would enjoy the transferred property

or the income therefrom. 26 U.S.C. §§2036 (a)(1) and (2). Our cases explicate this congressional directive to mean that if one wishes to avoid a tax at death he must be self-abnegating enough to totally surrender his property interest during life.

> "[A]n estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property." Commissioner v. Estate of Church, 335 U.S. 632, 645 [37 AFTR 495] (1949).

In this case the taxpayer's asserted alienation doesn't measure up to this high standard. Byrum enjoyed the continued privilege of voting the shares he "gave up" to the trust. By means of these shares he enjoyed majority control of two corporations. He used that control to retain salaried positions in both corporations. To my mind this is enjoyment [pg. 72-5822] of property put beyond taxation only on the pretext that it isn't enjoyed.

Byrum's lifelong enjoyment of the voting power of the trust shares contravenes §2036(a)(2) as well as §2036(a)(1) because it afforded him control over which trust beneficiaries —the life tenants or the remaindermen— would receive the benefit of the income earned by these shares. He secured this power by making the trust for all intents and purposes exclusively dependent on shares it could not sell in corporations he controlled. [1] Thus by instructing the directors he elected in the controlled corporations that he thought dividends should or should not be declared Byrum was able to open or close the spigot through which income flowed to the trust's life tenants. When Byrum closed the spigot by deferring dividends of the controlled corporations, thereby perpetuating his own "enjoyment" of these funds, he also in effect transferred income from the life tenants to the remaindermen whose share values were swollen by the retained income. The extent to which such income transfers can be effected is suggested by the pay-out record of the corporations here in question, as reflected in the trust's accounts. Over the first five years of its existence on shares later valued by the Internal Revenue Service at $89,000, the trust received only a total of $339 in dividends. In the sixth year, Byrum died. The corporations raised their dividend rate from 10¢ a share to $2.00 per share and paid $1,498 into the trust. See "Income Cash Ledger," App., pp. 41-42.

Byrum's control over the flow of trust income renders his estate scheme repugnant to §2036 (a)(2) as well as §2036 (a)(1).

To me it is thus clear that Byrum's shares were not truly, totally, "absolutely, unequivocally" alienated during his life. When it is apparent that if tolerated Byrum's scheme will open a gaping hole in the estate tax laws, on what basis does the majority nonetheless conclude that Byrum should have his enjoyment, his control, and his estate free from taxes?

II

I can find nothing in the majority's three arguments purporting to deal with §2036 (a)(1), which might justify the conclusion that Byrum did not "enjoy" a benefit from the shares his estate now asserts are immune from taxation.

The majority says that in Reinecke v. Northern Trust, 278 U.S. 339 [7 AFTR 8841] (1929), "the Court held that reserved powers of management of trust assets, similar to Byrum's power over the three corporations, did not subject an inter vivos trust to the federal estate tax." This reading of Northern Trust is not warranted by the one paragraph in that antique opinion on the point for which it is now cited, see 278 U.S. 339, 346-347, [7 AFTR 8841], nor by the circumstances of that case. No one has ever suggested that Adolphus Bartlett, the settlor in Northern Trust, used or could have used the voting power of the shares he transferred to a trust to control or indeed exercise any significant influence in any company. A mere glance at the nature of these securities transferred by Mr. Bartlett (1,000 shares of the Northern Trust Co., 784 shares of the Commonwealth Edison Co., 300 shares of the Illinois Central R. Co., 300 shares of the Illinois R. Co., 200 shares of the Chicago and North Western R. Co., etc.) [2] shatters any theory which might lead one to believe that the Court in Northern Trust was

concerned with anything like the transactions in this case. On what basis then does the majority say that Northern Trust involved a decision on facts "similar to Byrum's power over the three corporations?" And on what basis does it say that the Government's position that Byrum's use of trust shares to retain control renders those shares taxable is "against the weight of precedent?"

2. The majority implies that trust securities are taxable only if the testator retained title of the right to income from the securities until death. But this ignores the plain language of the statute which proscribes "enjoyment" as well as "possession or ...the right to income."

3. The majority concludes with the assertion that Byrum secured no "substantial present economic benefits" from his retention of control. [3] It is suggested that control isn't important, [pg. 72-5823] that it either cannot be held by a private shareholder or that it is of so little use and relevance the taxpayer can hardly be said to have "enjoyed" it. This view of corporate life is refuted by the case law; [4] by the commentators; [5] and by every day transactions on the stock exchange where tender offers and other trades repeatedly demonstrate that the power to "control" a corporation will fetch a substantial premium. [6] Moreover, the majority's view is belied by Byrum's own conduct. He obviously valued control because he forbade the bank which served as trustee to sell the trust shares in these corporations within his—Byrum's approval, whatever their return, their prospects, their value, or the trust's needs. Trust Agreement ¶5.15, App., p. 27.

In sum, the majority's discourse on §2036 (a)(1) is an unconvincing rationalization for allowing Byrum the tax free "enjoyment" of the control privileges he retained through the voting power of shares he supposedly "absolutely" and "unequivocally" gave up.

III

I find no greater substance in the greater length of the majority's discussion of §2036(a)(2).

A

Approaching the §2036 (a)(2) problem afresh one would think United States v. O'Malley, 383 U.S. 627 [17 AFTR 2d 1393] (1966), would control this case. In O'Malley the settlor "had relinquished all of his rights" to stock, but he appointed himself one of three trustees for each of the five trusts he created, and he drafted the trusts agreement so that the trustees had the freedom to allocate trust income to the life tenant or to accumulate it for the remainderman "in their sole discretion." The District Court held that the value of securities transferred was includable in the settlor's gross estate under §811 (d) of the Internal Revenue Code of 1939, the identically worded predecessor of §2036(a)(2), because the settlor had retained the power to allocate income between the beneficiaries without being constrained by a "definite ascertainable standard" according to which the trust would be administered. O'Malley v. United States, 220 F. Supp. 30, 33 [12 AFTR 2d 6258] (1963). The court noted "plaintiff's contention that the required external standard is imposed generally by the law of Illinois," but found this point to be "without merit."

> "The cases cited by plaintiff clearly set out fundamental principles of trust law: that a trust requires a named beneficiary; that the legal and equitable estates be separated; and that the trustees owe a fiduciary duty to the beneficiaries. These statements of the law are not particular to Illinois. Nor do these requirements so circumscribe the trustee's powers in an otherwise unrestricted trust so as to hold such a trust governed by an external standard and thus excludable from the application of §811 (c) and (d)." 220 F. Supp. 30, at 33-34 [12 AFTR 2d 6258].

It was another aspect of that case which brought the matter to the Court of Appeals, 340 F. 2d 930 [14 AFTR 2d 6269] (CA7 1964), and then here. We were asked to decide whether the lower court's holding should be extended and the accumulated income as well as the principal of the trust included in

the settlor's taxable estate because the settlor had retained excessive power to designate the income beneficiaries of the shares transferred. We held that though capable of exercise only in conjunction with one other trustee, the power to allocate income without greater constraint than that imposed "is a significant power ... of sufficient substance to be deemed the power to 'designate' within the meaning of [the predecessor of §2036 (a)(2)]." 383 U.S., at 631.

O'Malley makes the majority's position in this case untenable. O'Malley establishes that a settlor serving as a trustee is barred [pg. 72-5824] from retaining the power to allocate trust income between a life tenant and a remainderman if he is not constrained by more than general fiduciary requirements. See also Commissioner v. Estate of Holmes, 326 U.S. 480 [34 AFTR 308] (1946) [7] and Loper v. United States, 346 U.S. 335 [44 AFTR 467] (1953). Now the majority would have us accept the incompatible position that a settlor seeking tax exemption may keep the power of income allocation by rendering the trust dependent on an income flow he controls because the general fiduciary obligations of a director are sufficient to eliminate the power to designate within the meaning of §2036(a)(2). [8]

B

The majority would prop up its untenable position by suggesting that a controlling shareholder is constrained in his distribution or retention of dividends by fear of derivative suits, accumulated earnings taxes, and "various economic considerations ... ignored at the director's peril." I do not deny the existence of such constraints, but their restraining effect on an otherwise tempting gross abuse of the corporate dividend power hardly guts the great power of a controlling director to accelerate or retard, enlarge or diminish, most dividends. The penalty taxes only take effect when accumulations exceed $100,000, 26 U.S.C. §535 (c); Byrum was free to accumulate up to that ceiling. The threat of a derivative suit is hardly a greater deterrent to accumulation. As Cary puts it:

> "The cases in which courts have refused to require declaration of dividends or larger dividends despite the existence of current earnings or a substantial surplus or both are numerous; plaintiffs have won only a small minority of the cases. The labels are 'business judgment'; 'business purpose'; 'non-interference in internal affairs.' The courts have accepted the general defense of discretion, supplemented by one or more of a number of grounds put forward as reasons for not paying dividends, or larger dividends, ... Cary, Cases and Materials on Corporations, 4th ed. (1969), p. 1587.

and cf. Commissioner v. Sunnen, 333 U.S. 591, 609 [36 AFTR 611] (1948).

The ease with which excess taxes, derivative suits and economic vicissitudes alike may be circumvented or hurdled if a controlling shareholder chooses to so arrange his affairs is suggested by the pay-out record of Byrum's corporations noted above.

C

The majority proposes one other method of distinguishing O'Malley. Section 2036 (a)(2), it is said, speaks of the right to designate income beneficiaries. O'Malley involved the effort of a settlor to maintain a legal right to allocate income. In the instant case only the power to allocate income is at stake. The Government's argument is thus said to depart from "the specific statutory language" [9] and to stretch the statute beyond endurance by allocating tax according to the realities of the situation rather than by the more rigid yardstick of formal control. [10]

This argument conjures up an image of congressional care in the articulation of §2036 (a)(2) which is entirely at odds with the circumstances of its passage. The 1931 Revenue Act which first enacted §2036 (a)(2) in language unamended since that date, passed both houses of Congress in one day—the last day of the session.

There was no printed committee report. Substantial references to the bill appear in only two brief sections of the Congressional Record. [11] Under the circumstances I see no warrant [pg. 72-5825] for reading the words in a niggardly way.

Moreover, it appears from contemporary evidence that if the use of the word "right" was intended to have any special meaning it was to expand rather than to contract the reach of the restraint effected by the provision in which it appeared. The House Report on the Revenue Act of 1932 notes in relation to amendment of the predecessor of §2036 (a)(1) that:

> "The insertion of the words 'the right to income' in place of the words 'the income' is designed to reach a case where the decedent had the right to the income, though he did not actually receive it. This is also a clarifying change." House Report No. 798, 72d Cong., 1st Sess. Reprinted in Revenue Acts 457, 491, and see the Senate Report, at p. 532, to the same effect.

I repeat the injunction of Mr. Justice Frankfurter, 25 years ago: "This is tax language and should be read in its tax sense." United States v. Ogilvie Hardware Co., 330 U.S. 709, 721 [35 AFTR 768] (1947; dissenting opinion).

Lest this be considered not alone enough to refute the majority's approach, I must add that it is quite repugnant to the words and sense of our opinion in O'Malley to read it as though it pivoted on an interpretation of "right" rather than power. The opinion could hardly have been more explicitly concerned with the realities of a settlor's retained power rather than the theoretical legal form of the trust. Thus we said:

> "Here Fabrice [the settlor] was*empowered*..... This is a significant power... of sufficient substance to be deemed the *power* to 'designate' within the meaning of [the predecessor of §2036 (a) (2)].... 383 U.S., at 631 (emphasis supplied).

And we said:

> "With the creation of the trusts he relinquished all of his rights to income except the *power* to distribute that income to the income beneficiaries or to accumulate it and hold it for the remaindermen of the trusts." 383 U.S., at 632 (emphasis supplied).

And we spoke of:

> "This *power* he exercised by accumulating and adding income to principal and this same *power* he held until the moment of his death...." 383 U.S., at 634 (emphasis supplied).

Other passages could be quoted.

IV

Apparently sensing that considerations of logic, policy and recent case law point to the inclusion of Byrum's trust in his estate, the majority would blunt these considerations by invoking the principle that courts should refrain from decision detrimental to litigants who have taken a position in legitimate reliance on possibly outdated, but once established, case law.*This principle* is said to bring great weight to bear in Byrum's favor.

I need not quarrel with the principle. I think, however, that its application in this context is inappropriate.

The majority recites these facts: This Court has never held that retention of power to manage trust

assets compels inclusion of a trust in a settlor's estate. In fact, Reinecke v. Northern Trust, 278 U.S. 339 [7 AFTR 8841] (1929), specifically held a trust arrangement immune from taxation though the settlor retained power to decide how the trust assets were to be invested. Though Northern Trust was decided before the passage of §2036 (a)(2), it has been followed by "several" more recent lower court decisions. Though most of the lower court decisions provide only the most oblique reference to circumstances like those of this case, a 1962 unappealed Tax Court decision, Estate of King v. Commissioner, 37 T. C. 973 (1962), is squarely on point. [pg. 72-5826]

On the basis of these two authorities, a 1929 Supreme Court decision and an unreviewed 1962 Tax Court decision, the majority concludes that there exists a "generally accepted" rule that Byrum might do what he had done here. It is said that the hypothesized rule, "may" have been relied upon by "hundreds" of others; if so, its modification "could" have a serious impact, especially upon settlors who "happen" to have been controlling shareholders in closely held corporations and who "happen" to have transferred shares in those corporations to trusts while forbidding the trustee to sell the shares without approval and while retaining voting rights in those shares. Therefore the rule ought not to be "modified" by this Court.

A

The argument, apparently, is that what "appear[s] to be established" should become established because it has appeared. Judges can and will properly differ on the questions of what deference to accord reliance on a well-established rule, but I doubt that we are prejudiced from reaching what would otherwise be a right result simply because in the minds of some litigants a contrary rule had heretofore "appeared to be established." If the majority's approach were widely accepted, artful claims of past understanding would consistently suffice to frustrate judicial as well as administrative efforts at present rationalization of the law and every precedent—even at the tax court level—might lay claim to such authority that the Government and the tax bar could afford to leave no case unappealed.

B

Of course, the reliance argument is doubly infirm if the majority's rule cannot be said to have "appeared to be established." Did Byrum have a sound basis for calculating that there was no substantial risk of taxation when he persisted in retaining the powers and privileges described above?

1. Again the majority turns to Reinecke v. Northern Trust, but it is no more credible to use Northern Trust as a foundation for Byrum's §2036 (a)(2) position than it was to use it as a basis for the Court's §2036 (a)(1) argument. Northern Trust was decided on January 2, 1929, two years and three months before Congress passed the first version of §2036 (a)(2). Section 402 (c) of the Act of 1921, the provision under which Northern Trust was decided, proscribed only transfers in which the settlor attempted to retain "possession or enjoyment" until his death. It is thus not surprising that Northern Trust focused on the question of the settlor's "power to recall the property and of control over it *for his own benefit*," 278 U.S., at 347 (emphasis added), and made no mention of possible tax liability because of a retained power to designate which beneficiaries would enjoy the trust income. A holding in this context cannot be precedent of "weight" for a decision as to the efficacy of a trust agreement made—as this trust was—27 years after §2036 (a)(2) was enacted.

I note also that Northern Trust rests on a conceptual framework now rejected in modern law. The case is the elder sibling of May v. Heiner, 281 U.S. 238 [8 AFTR 10904] (1930), a three-page 1930 decision which quotes Northern Trust, at length. May in effect held that under §402 (c) a settlor may be considered to have fully alienated property from himself even if he retains the very substantial string of the right to income from the property so long as he survives. The logic of May v. Heiner is the logic of Northern Trust. As one authority has written:

> "When retention of a life estate was not taxable under the rule of May v. Heiner, it followed that mere retention of a right to designate the persons to receive the income during the life of the settlor was not taxable ...." 1 Beveridge, Law of Federal Estate Taxation, §8.06,

p. 324.

That logic no longer survives. When three Supreme Court per curiams affirmed May on March 2, 1931, and thus indicated that this view would not be confined to its facts, the treasury, on the next morning, wrote Congress imploring it to promptly and finally reject the Court's lenient view of the Estate Tax system. Congress responded by enacting §2036 (a)(2) that very day. The President signed the law that evening. Thus the holding of May and the underlying approach of Northern Trust has no present life. I note further that though Congress has refused to permit pre-1931 trusts to be liable to a rule other than that of May, in 1949 this Court itself came to the conclusion that May was wrong, and effected "a complete rejection" of its reasoning. Commissioner v. Estate of Church, 335 U.S. 632, [12] 645 [37 AFTR 495] (1949). [pg. 72-5827]

I seriously doubt that one could confidently rely on Reinecke v. Northern Trust when Byrum drafted his trust agreement in 1958. This Court is certainly not bound by its logic in 1972. I do not mean any disrespect, but as Mr. Justice Cardozo said about another case, Northern Trust is a decision "as mouldy as the grave from which counsel ... brought it forth to face the light of a new age." Cardozo, The Growth of the Law, p. 132 (1924); Collected Writings, p. 244.

2. The majority argues that there were several lower court cases decided after the enactment of §2036 (a)(2) upon which Byrum was entitled to rely and it is quite true that cases exist holding that a settlor's retention of the power to invest the assets of a trust does not by itself render the trust taxable under §2036 (a)(2). But the majority's emphasis of these cases as a proper foundation for Byrum's reliance is doubly wrong. First, it could not have evaded Byrum's attention and should not escape the majority that all cited prior cases—save King (the tax court case written four years after Byrum structured his trust)—involved retention of power to invest by the settlor's appointment of himself as a trustee; that is, they posed instances in which the settlor's retained power was constrained by a fiduciary obligation to treat the life tenant beneficiaries and remainderman beneficiaries exactly as specified in the trust instrument. Thus the "freedom" to reallocate income between life tenants and remaindermen by, e.g., investing in wasting assets with a high present return and no long-term value, was limited by a judicially enforceable strict standard capable of invocation by the trust beneficiaries by reference to the terms of the trust agreement. See Jennings v. Smith, 161 F. 2d 74 [35 AFTR 1203] (CA2 1947), the leading case. Byrum must have realized that the situation he was structuring was quite different. By according himself power of control over the trust income by an indirect means, he kept himself quite free of a fiduciary obligation measured by an ascertainable standard in the trust agreement. Putting aside the question of whether the situation described should be distinguished from Byrum's scheme, surely it must be acknowledged that there was an apparent risk that these situations could be distinguished by reviewing courts.

Second, the majority's analysis of the case law skips over the uncertainty at the time Byrum was drafting his trust agreement about even the general rule that a settlor could retain control over a trust's investments if he bound himself as a trustee to an ascertainable method of income distribution. While Byrum and his lawyer were pondering the terms of the trust agreement now in litigation, the First Circuit Court of Appeals was reconsidering whether a settlor could retain power over his trust's investments even when he bound himself to a fiduciary's strictest standards of disinterested obligation to his trust's beneficiaries. Early in 1958 the United States District Court for the District of Massachusetts had ruled that a settlor could not maintain powers of management of a trust even as a trustee without assuming estate tax liability. State Street Trust Co. v. United States, 160 F. Supp. 877 [1 AFTR 2d 2124] (1958). The estate's executor appealed this decision and argued it before the First Circuit panel on October 7, 1958. Byrum's trust agreement was made amidst this litigation, on December 8th. On January 23d the First Circuit affirmed the District Court. State Street Trust Co. v. United States, 263 F. 2d 635 [3 AFTR 2d 1764] (CA1 1959) [13]

The point is not simply that Byrum was on notice that he risked taxability by retaining the powers he retained when he created his trust—though that is true. It is also that within a month of the trust's creation it should have been crystal-clear that Byrum ran a substantial risk of taxation by continued retention of control over the trust's stock. Any retained right can be resigned. That Byrum persisted in holding these rights can only be viewed as an indication of the value he placed upon their enjoyment,

and of the tax risk he was willing to assume in order to retain control.

The perception that a settlor ran substantial risk of estate tax if he insisted on retaining power over the flow of trust income is hardly some subtle divination of a latter-day observor of the 1958-1959 tax landscape. Contemporary observors saw the same thing. A summary of the field in the 1959 Tax Law Review concluded: "Until the law is made more definite, a grantor who retains any management powers is proceeding at his own risk.... [T]here is no certainty...." Gray and Covey, State Street—A Case Study of Sections 2036 (a)(2) and 2038, 15 Tax Law Review 75, 102 (1959). The relevant subcommittee of the American Bar Association Committee on Estate and Tax Planning hardly thought reliance appropriate. It wrote in 1960 that: [pg. 72-5828]

> "The tax-wise draftsman must now undertake to review every living trust in his office intended to be excluded from the settlor's estate in which the settlor acts as a trustee with authority to:
>
> "1. Exercise broad and virtually unlimited investment powers ... ." Tax-Wise Drafting of Fiduciary Powers, 4 Tax Counsellor's Quarterly, 333,336 (1960).

More could be said, but I think it is clear that that the majority should find no solace in its reliance argument.

V

The majority, I repeat, has erred in every substantial respect. It remains only to note that if it is wrong in any substantial respect—i.e., either in its §2036 (a)(1) or (a)(2) arguments—Byrum's trust is by law liable to taxation.

1

The Trust Agreement in pertinent parts provided:

"Article IV. Irrevocable Trust.

"This Trust shall be irrevocable and Grantor reserves no rights, powers, privileges or benefits either as to the Trust estate or the control or management of the trust property, except as set forth herein.

"Article V. Powers Of The Trustee.

"The Trustee shall have and possess and may exercise at all times not only the rights, powers and authorities incident to the office or required in the discharge of this trust, or impliedly conferred upon and vested in it, but there is hereby expressly conferred upon and vested in the Trustee all the rights, powers and authorities embodied in the following paragraphs in this Article, which are shown by way of illustration but not by way of limitation:

"Sell. 5.02 To sell at public or private sale, to grant options to sell, to exchange, re-exchange or otherwise dispose of all or part of the property, real or personal at any time belonging to the Trust Estate, upon such terms and conditions and for such consideration as said Trustee shall determine, and to execute and deliver all instruments of sale or conveyance necessary or desirable therefor.

"Investments. 5.05 To invest any money in the Trust estate in stocks, bonds, investment trusts, common trust funds, and any other securities or property, real or personal, secured or unsecured, whether the obligations of individuals, corporations, trusts, associations, governments, expressly including shares and/or obligations of its own corporation, or otherwise, either within or outside of the State of Ohio, as the Trustee shall deem advisable, without any limitation whatsoever as to character of

investment under any statute or rule of law now or hereafter enacted or existing regarding trust funds or investments by fiduciaries or otherwise.

"Voting. 5.06 To vote by proxy or in person any stock or security comprising a part of the trust estate, at any meeting, except that during Grantor's lifetime, all voting rights of any stocks which are not listed on a stock exchange, shall be exercised by Grantor, and after Grantor's death, the voting rights of such stocks shall be exercised by Grantor's wife during her lifetime.

"Leases. 5.09 To make leases for any length of time, whether longer or shorter than the duration of this Trust, to commence at the present time or in the future; to extend any lease; to grant options to lease or to renew any lease; it being expressly understood that the Trustee may grant or enter into ninety-nine year leases renewable forever.

"Income Allocation. 5.13 To determine in its discretion how all receipts and disbursements, capital gains and losses, shall be charged, credited or apportioned between income and principal.

"Limitation. 5.15 Notwithstanding the powers of the Trustee granted in paragraphs 5.02, 5.05, 5.09 and 5.11 above, the Trustee shall not exercise any of the powers granted in said paragraphs unless (a) during Grantor's lifetime said Grantor shall approve of the action taken by the Trustee pursuant to said powers, (b) after the death of the Grantor and as long as his wife, Marian A. Byrum, shall live, said wife shall approve of the action taken by the Trustee pursuant to said powers.

"Article VI. Distribution Prior To Age 21.

"Until my youngest living child reaches the age of twenty-one (21) years, the Trustee shall exercise absolute and sole discretion in paying or applying income and/or principal of the Trust to or for the benefit of Grantors child or children and their issue, with due regard to their individual needs for education, care, maintenance and support and not necessarily in equal shares, per stirpes. The decision of the Trustee in the dispensing of Trust funds for such purposes shall be final and binding on all interested persons.

"Article VI. [sic] Division At Age 21.

"Principal Disbursements. 6.02 If prior to attaining the age of thirty-five (35), any one of the children of Grantor shall have an emergency such as an extended illness requiring unusual medical or hospital expenses, or any other worthy need including education of such child, the Trustee is hereby authorized and empowered to pay to such child or use for his or her benefit such amounts of income and principal of the Trust as the Trustee in its sole judgment and discretion shall determine.

"Article VIII. Removal of Trustee.

"If the Trustee, The Huntington National Bank of Columbus, Columbus, Ohio, shall at any time change its name or combine with one or more corporations under one or more different names, or if its assets and business at any time shall be purchased and absorbed by another trust company or corporation authorized by law to accept these trusts, the new or successor corporation shall be considered as the said The Huntington National Bank of Columbus, Ohio, and shall continue said Trusts and succeed to all the rights, privileges, duties and obligations herein conferred upon said The Huntington National Bank of Columbus, Ohio, Trustee.

"Grantor, prior to his death, and after the death of the Grantor, the Grantor's wife, Marian A. Byrum, during her lifetime, may remove or cause the removal of The Huntington National Bank of Columbus, Ohio, or any successor Trustee, as Trustee under the Trusts and may thereupon designate another corporate Trustee to serve as successor Trustee hereunder.

"Article IX. Miscellaneous Provisions.

"Discretion. 9.02 If in the opinion of the Trustee it shall appear that the total income of any beneficiary of any Trust fund created hereunder is insufficient for his or her proper or suitable support, care and comfort, and education and that of said beneficiary's children, the Trustee is authorized to pay to or for such beneficiary or child such additional amounts from the principal of the Trust Estate as it shall deem advisable in order to provide suitably and properly for the support, care, comfort, and education of said beneficiary and of said beneficiary's children, and the action of the Trustee in making such payment shall by binding on all persons."

2

The actual proportions were:

	Percentage Owned by Decedent	Percentage Owned by Trust	Total Percentage Owned by Decedent and Trust
Byrum Lithographing Co., Inc.	59	12	71
Graphic Realty, Inc.	35	48	83
Bychrome Co.	42	46	88

3

26 U.S.C. §2036 provides:

"(a) General rule.

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

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

4

United States v. O'Malley, 383 U.S. 627 [17 AFTR 2d 1393] (1966).

It is irrelevant to this argument how many shares Byrum transferred to the trust. Had he retained in his own name more than 50% of the shares (as he did with one corporation), rather than retaining the right to vote the transferred shares, he would still have had the right to elect the board of directors and the same power to "control" the flow of dividends. Thus, the government is arguing that a majority shareholder's estate must be taxed for stock transferred to a trust if he owned at least 50% of the voting stock after the transfer or if he retained the right to vote the transferred stock and could thus vote more than 50% of the stock. It would follow also that if a settlor controlled 50% of the voting stock and similarly transferred some other class of stock for which the payment of dividends had to be authorized by the directors, his estate would also be taxed. Query: what would happen if he had the right to vote less than 50% of the voting stock but still "controlled" the corporation? See n. 10, infra.

5

The Court has never overturned this ruling. See McCormick v. Burnet, 283 U.S. 784 [9 AFTR 1000] (1931); Helvering v. Duke, 290 U.S. 591 (1933) [12 AFTR 1459; 1460] (affirmed by an equally divided Court). In Commissioner v. Estate of Church, 335 U.S. 632 [37 AFTR 495] (1949), and Estate of Spiegel v. Commissioner, 335 U.S. 701 [37 AFTR 459] (1949), the Court invited, sua sponte, argument of this question, but did not reach the issue in either opinion.

6

See, e.g., Old Colony Trust Co. v. United States, 423 F.2d 601 [25 AFTR 2d 70-1549] (CA1 1970); United States v. Powell, 307 F. 2d 821 [10 AFTR 2d 6242] (CA10 1962); Estate of Ford v. Commissioner, 53 T.C. 114 (1969), aff'd, 450 F. 2d 878 [28 AFTR 2d 71-6288](CA2 1971); Commissioner v. Wilson's Estate, 13 T.C. 869 (1949) (en banc), aff'd, 187 F.2d 145 [40 AFTR 265] (CA3 1951); Estate of Budd v. Commissioner, 49 T.C. 468 (1968); Estate of Pardee v. Commissioner, 49 T.C. 140 (1967); Estate of King v. Commissioner, 37 T.C. 973 (1962).

7

The dissenting opinion attempts to distinguish the cases, holding that a settlor-trustee's retained powers of management do not bring adverse estate tax consequences, on the ground that management of trust assets is not the same as the power retained by Byrum because a settlor-trustee is bound by a fiduciary duty to treat the life tenant beneficiaries and remainderman as the trust instrument specifies. But the argument that in the reserved-power-of-management cases there was "a judicially enforceable strict standard capable of invocation by the trust beneficiaries by reference to the terms of the trust agreement," post, at—, ignores the fact that trust agreements may and often do provide for the widest investment discretion.

8

Assuming, arguendo, that MR. JUSTICE WHITE is correct in suggesting that in 1958, when this trust instrument was drawn, the estate-tax consequences of the settlor's retained powers of management were less certain than they are now, this Court's failure to overrule Northern Trust, plus the existence of recent cases such as King and the cases cited in n. 6, have undoubtedly been relied on by the draftsmen of more recent trusts with considerable justification. Our concern as to this point is not so much with whether Byrum properly relied on the precedents, but with the probability that others did rely thereon in good faith.

9

Although Mr. Justice White's dissent argues that the use of the word "power" in O'Malley implies that the Court's concern was with practical reality rather than legal form, an examination of that opinion does not indicate that the term was used other than in the sense of legally empowered. At any rate, the "power" was a right reserved to the settlor in the trust instrument itself.

10

The "control" rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances. See n. 13, infra. Neither the Government nor the dissent sheds light on the absence of an ascertainable standard. The Government speaks vaguely of drawing the line between "an unimportant minority interest" (whatever that may be) and "voting control." The dissenting opinion does not address this problem at all. See Comment, Sale of Control Stock and the Brokers, Transaction Exemption—Before and After the Wheat Report, 49 Tex. L. Rev. 475, 479-481

(1971).

11

Such a fiduciary relationship would exist in almost every, if not every State. Ohio, from which this case arises, is no exception:

"[I]f the majority undertakes, either directly or indirectly, through the directors, to conduct, manage, or direct the corporation's affairs, they must do so in good faith, and with an eye single to the best interests of the corporation. It is clear that the interests of the majority are not always identical with the interests of all the shareholders. The obligation of the majority or of the dominant group of shareholders acting for, or through the corporation, is fiduciary in nature. A court of equity will grant appropriate relief where the majority or dominant group of shareholders act in their own interest or in the interest of others so as to oppress the minority or commit a fraud upon their rights." 13 Ohio Jurisprudence 2d. § 662, at 90-91 (footnotes omitted).

See Overfield v. Pennroad Corp., 42 F. Supp. 586 (ED Pa. 1941); rev'd on other grounds, 146 F. 2d 889 (CA3 1944).

12

"The directors of the corporation represent the corporation, not just one segment of it, but all of it. The fiduciary nature of the directors' obligation requires that, in the management of the corporation's affairs, they do not presume to play favorites among the shareholders or among the classes of shareholders." 12 Ohio Jurisprudence, 2d, §497, at 618.

13

The Government uses the terms "control" and "controlling stockholder" as if they were words of art with a fixed and ascertainable meaning. In fact, the concept of "control" is a nebulous one. Although in this case Byrum possessed "voting control" of the three corporations (in view of his being able to vote more than 50% of the stock in each), the concept is too variable and imprecise to constitute the basis per se for imposing tax liability under §2036 (a). Under most circumstances, a stockholder who has the right to vote more than 50% of the voting shares of a corporation "controls it" in the sense that he may elect the board of directors. But such a stockholder would not control, under the laws of most States, certain corporate transactions such as mergers and sales of assets. Moreover, control—in terms of effective power to elect the Board under normal circumstances—may exist where there is a right to vote far less than 50% of the shares. This will vary with the size of the corporation, the number of shareholders and the concentration (or lack of it) of ownership. See generally 2 L. Loss., Securities Regulation, 770-783 (1961). Securities law practitioners recognize that possessing 10% or more of voting power is one of the factors on which the Securities and Exchange Commission relies as an indicia of control. SEC, Disclosure to Investors—The Wheat Report, 245-247 (1969).

14

In advocating this de facto approach, the Government relies on our opinion in Commissioner v. Sunnen, 333 U.S. 591 [36 AFTR 611] (1948). Sunnen was a personal income tax case in which the Court found the taxpayer had made an assignment of income. The reasoning relied on the de facto power of a controlling shareholder to regulate corporate business for his personal objectives. This case is an estate tax case, not an income tax case. Moreover, unlike assignment of income cases, in which the issue is who has the power over income, this case concerns a statute written in terms of the "right" to designate the recipient of income. The use of the term "right" implies that restraints on the exercise of power are to be recognized and that such restraints deprive the person exercising the power of a "right" to do so.

15

The spectrum of types of corporation businesses, and of permissible policies with respect to the retention of earnings, is broad indeed. It ranges from the public utility with relatively assured and stable income to the new and speculative corporation engaged in a cyclical business or organized to exploit a new patent or unproved technology. Some corporations pay no dividends at all, as they are organized merely to hold static assets for prolonged periods (e.g., land, mineral resources, and the like). Corporations which emphasize growth tend to low dividend payments, whereas mature corporations may pursue generous dividend policies.

16

Thomas v. Matthews, 94 Ohio St. 32, 55-56, 113 N.E. 669 (1916):

"[I]t is the duty of the directors, in determining the amount of net earnings available for the payment of dividends, to take into account the needs of the company in its business and sums necessary in the operation of its business until the income from further operations is available, the amount of its debts, the necessity or advisability of paying its debts or at least reducing them within the limits of the company's credit, the preservation of its capital stock as represented in the assets of the company as a fund for the protection of its creditors and the character of its surplus assets, whether cash, credits or merchandise."

17

Internal Revenue Code of 1954, Subch. G, pt. I §§ 531-537, 26 U.S.C. §§ 531-537.

18

Had Byrum caused the Board to follow a dividend policy, designed to minimize or cut off income to the trust, which resulted in the imposition of the penalty for accumulated earnings not distributed to shareholders, there might be substantial grounds for a derivative suit. A derivative suit also would have been a possibility had dividends been paid imprudently to increase the trust's income at the expense of corporate liquidity. Minority shareholders in Ohio may bring derivative suits under Ohio R. Civ. P. 23.1.

19

In most States, the power to declare dividends is vested solely in the directors. 11 Fletcher Cyclopedia Corporations, c. 58, §5320. Ohio is no exception, and it limits the authority of directors to pay dividends depending on available corporate surplus. 17 Page's Ohio Code Ann. §1701.33. Although liability generally exists irrespective of a statute, nearly all States have statutes regulating the liability of directors who participate in the payment of improper dividends. 12 Fletcher Cyclopedia Corporations; c. 58, §5432. Again, Ohio is no exception. 17 Page's Ohio Rev. Code Ann. §1701.95.

20

Appendix, 30-32. In Byrum Lithographing Co., Inc., none of the other 11 stockholders appears to be related by name to Byrum. In Bychrome Co. five of the eight stockholders appear to be unrelated to the Byrums; and in Graphic Realty Co. 11 of the 14 stockholders appear to be unrelated.

21

See Wilberding v. Miller, 90 Ohio St. 28, 42, 106 N.E. 665 (1914):

"An arbitrary disregard of the rights of stockholders to dividends or other improper treatment of the assets of the company will be relieved against."

22

The trust instrument, n. 1, supra, explicitly granted the trustee the power "To enforce, abandon, defend against, or have adjudicated by legal proceedings, arbitration or by compromise, any claim or demand whatsoever arising out of or which may exist against the Trust Estate."

23

The Government cites two other opinions of this Court, in addition to O'Malley, to support its argument. In both Commissioner v. Estate of Holmes, 326 U.S. 480 [34 AFTR 308] (1946), and Lober v. United States, 346 U.S. 335 [44 AFTR 467] (1953), the grantor reserved to himself the power to distribute to the beneficiaries the entire principal and accumulated interest of the trust at any time. This power to terminate the trust and thereby designate the beneficiaries at a time selected by the settlor, is not comparable to the powers reserved by Byrum in this case.

24

While the trustee could not acquire or dispose of investments without Byrum's approval, he was not subject to Byrum's orders. Byrum could prevent the acquisition of an asset, but he could not require the trustee to acquire any investment. Nor could he compel a sale, although he could prevent one. Thus, if there were other income-producing assets in the trust, Byrum could not compel the trustee to dispose of them.

25

In purporting to summarize the basis of our distinction of O'Malley, the dissenting opinion states:

"Now the majority would have us accept the incompatible position that a settlor seeking tax exemption may keep the power of income allocation by rendering the trust dependent on an income flow he controls because the general fiduciary obligations of a director are sufficient to eliminate the power to designate within the meaning of §2036 (a)(2)." Post, at—.

This statement, which assumes the critical and ultimate conclusion, incorrectly states the position of the Court. We do not hold that a settlor "may keep the power of income allocation" in the way Mr. Justice White sets out; we hold, for the reasons stated in this opinion, that this settlor did not retain the power to allocate income within the meaning of the statute.

26

The dissenting opinion's view of the business world will come as a surprise to many. The dissent states:

"Thus by declaring or not declaring dividends in the controlled corporations Byrum was able to open or close the spigot, through which the income flowed to the trust's life tenant." Post, at—.

This appears to assume that all corporations including the small family type involved in this case, have a regular and dependable flow of earnings available for dividends, and that if there is a controlling stockholder he simply turn the "spigot" on or off as dividends may be desired. For the reasons set forth in this opinion, no such dream world exists in the life of many corporations. But whatever the situation may be generally, the fallacy in the dissenting opinion's position here is that the record simply does not support it. This case was decided on a motion for summary judgment. The record does not disclose anything with respect to the earnings or financial conditions of these corporations. We simply do not know whether there were any earnings for the years in question, whether there was an earned surplus in any of the corporations, or whether—if some earnings be assumed—they were adequate in light of other corporate needs to justify dividend payments. Nor can we infer from the increase in dividend payments in the year following Byrum's death that higher dividends could have been paid previously. The increase could be explained as easily by insurance held by the corporations on Byrum's life.

27

At one point Mr. Justice White seems to imply that Byrum also retained the enjoyment of the right to the income from the transferred shares:

"When Byrum closed the spigot by deferring dividends of the controlled corporations, thereby perpetuating his own 'enjoyment' of these funds, he also in effect transferred income from these life tenants to the remaindermen." (Emphasis added.) Post, at—.

But, of course, even if dividends were deferred, the funds remained in the corporation; Byrum could not use them himself.

28

See 26 CFR §20.2036-1 (b)(2):

"The 'use, possession, right to the income, or other enjoyment of the transferred property' is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit."

Although Mr. Justice White questions the Court's failure to interpret "possession or enjoyment" with "extreme literalness," post, at—n. 3, apparently the Commissioner does not do so either. Reflection on the expansive nature of those words, particularly "enjoyment," will demonstrate why interpreting them with "extreme literalness" is an impossibility.

29

Northern Trust was decided under the Revenue Act of 1921, c. 136, §402 (c), 42 Stat. 278.

30

Helvering v. Hallock, 309 U.S. 106 [23 AFTR 1054] (1940); Commissioner v. Estate of Church, 335 U.S. 632 [37 AFTR 480, 495] (1946); Lober v. United States, 346 U.S. 335 [44 AFTR 467] (1953); United States v. Estate of Grace, 395 U.S. 316 [23 AFTR 2d 69-1954] (1969); Estate of McNichol v. Commissioner, 265 F. 2d 667 [3 AFTR 2d 1838] (CA3), cert. denied, 361 U.S. 829 (1959); Guynn v. United States, 437 F. 2d 1148 [27 AFTR 2d 71-1653] (CA4 1971). In all of these cases, as in Church, the grantor retained either title or an income interest or the right to use real property for his lifetime.

Despite Mr. Justice White's suggestion post, at—, we have not "ignored the plain language of the statute which proscribes 'enjoyment' as well as 'possession or the right to income.'" Rather, the cases we have cited clearly establish that the terms "possession" and "enjoyment" have never been used as the dissent argues.

31

The cited opinion supplemented an earlier opinion of the Board of Tax Appeals in the same case, 47 B. T. A. 807 (1942).

32

A more analogous case is Yeazel v. Coyle, [21 AFTR 2d 1681] 68-1 U.S. T.C. ¶ 12,524 (ND Ill. 1968), in which a settlor-trustee, who transferred 60% of the shares of a wholly-owned corporation to a trust,

was found not to have retained the enjoyment of the property for her lifetime.

33

The Government, for the reasons discussed in n. 5, supra, makes no distinction between retention of control by virtue of owning 50% or more of the voting shares and such retention by a combination of stock owned and that with respect to which the right to vote was retained.

34

The interpretation given §2036 (a) by the Government and by Mr. Justice White's dissenting opinion would seriously disadvantage settlors in a control posture. If the settlor remained a controlling stockholder, any transfer of stock would be taxable to his estate. See n. 4 supra. The typical closely held corporation is small, has a checkered earning record, and has no market for its shares. Yet its shares often have substantial asset value. To prevent the crippling liquidity problem that would result from the imposition of estate taxes on such shares, the controlling shareholder's estate planning often includes an irrevocable trust. The Government and the dissenting opinions would deny to controlling shareholders the privilege of using this generally acceptable method of estate planning without adverse tax consequences. Yet a settlor whose wealth consisted of listed securities of corporations he did not control would be permitted the tax advantage of the irrevocable trust even though his more marketable assets present a far less serious liquidity problem. The language of the statute does not support such result and we cannot believe Congress intended it to have such discriminatory and far reaching impact.

35

Directors of Ohio corporations have been held liable for payment of excessive compensation. Berkwitz v. Humpherey, 163 F. Supp. 78 (ND Ohio 1958).

36

26 U.S.C. §162 (a)(1) permits corporations to deduct "reasonable" compensation as business expenses. If the Internal Revenue Service determines that compensation exceeds the bounds of reason, it will not permit a deduction. See, e.g., Botany Worsted Mills v. United States, 278 U.S. 282 [7 AFTR 8847] (1929).

Moreover, there is nothing in the record of this case with respect to Byrum's compensation. There is no showing that his control of these corporations gave him an "enjoyment" with respect to compensation that he would not have had upon rendering similar services without owning any stock.

1

The trust held $89,000 worth of stock in Byrum controlled corporations and only one other asset: three Series E United States Savings Bonds worth a total of $300 at maturity. See "Yearly List of [Trust] Assets," at App., p. 45. Consequently I do not accord much weight to the majority's point that Byrum could not prevent the trustee from making payments "from other trust assets."

2

Transcript of the District Court record, p. 3, as filed in this Court in Reinecke v. Northern Trust Co., 278 U.S. 339 [7 AFTR 8841] (1929).

3

I am constrained to note that nowhere in the statute (which the majority elsewhere in its argument would read with extreme literalness) do the words "substantial" and "present"—or suggestions to that

effect—appear. The phrase "substantial present economic benefit" does appear in Commissioner v. Estate of Holmes, 326 U.S. 480, 486 [34 AFTR 308] (1946), from which it is quoted by the majority. But there the Court held Holmes' estate liable to taxation on the corpus of an irrevocable trust because the settlor (Holmes) had kept the power for himself as trustee to distribute or retain trust income at his discretion. The Court held that this power enabled the settler to retard or accelerate the beneficiaries' "enjoyment" at his whim. The donor had thus kept "so strong a hold over the actual and immediate enjoyment of what he [allegedly had put] beyond his own power" that he could not be said to have "divested himself of that degree of control which [a predecessor of §2036 (a)(2)] requires in order to avoid the tax." 326 U.S., at 487. Holmes is thus strong precedent contrary to the majority's §2036 (a)(2) argument. See also Loper v. United States, 346 U.S. 335 [44 AFTR 467] (1953); it certainly is not a case in which the Court intended or attempted to narrow the meaning of §2036(a)(1)

4

See, e.g., Honigman v. Green Giant Co., 208 F. Supp. 754, aff'd, 309 F. 2d 667 (CA8 1962), cert. denied, 372 U.S. 941 (1963), Essex Universal Corp. v. Yates, 305 F. 2d 572 (CA2 1962), Perlman v. Feldman, 219 F. 2d 173 (CA2 1955).

5

"[S]hareholders in a close corporation are usually vitally interested in maintaining their proportionate control...." 1 O'Neil Close Corporation §3.39 (1971). At least since Perlman v. Feldman, supra, the academic dispute has not been over the existence of control, or its value, but rather over who is to benefit from the premium received upon its sale. See Leech, Transactions in Corporate Control, 104 U. Pa. L. Rev. 725 (1956); Hill, The Sale of Controlling Shares, 70 Harv. L. Rev. 986 (1957); Bayne, The Sale of Control Premium: The Disposition, 57 Cal. L. Rev. 615 (1969); Bayne, The Noninvestment Value of Control Stock, 45 Ind. Law J. 317 (1970).

6

See, e.g., the transactions described in Bayne, The Sale of Control Premium: The Disposition, 57 Cal. L. Rev. 615, 617 (1969).

7

See n. 3, supra.

8

This incompatibility was readily perceived by the Internal Revenue Service. Shortly after O'Malley was handed down, it promulgated Rev. Rul. 67-54 (1967) which concluded:

"Where a decedent transfers nonvoting stock in trust and holds for the remainder of his life voting stock giving him control over the dividend policy of the corporation, he has retained, for a period which did not in fact end before his death, the right to determine the income from the nonvoting stock. If he also retains control over the disposition of the nonvoting stock, whether as trustee, by restriction upon the trustee, or alone or in conjunction with another, he has in fact made a transfer whereby he has retained for his life the right to designate the persons who shall possess or enjoy the transferred property or the income therefrom. Since under section 20.2036-1 (b)(3) of the Estate Tax Regulations it is immaterial in what capacity a power was exercisable by the decedent, it is sufficient that the power was exercisable in the capacity of controlling stockholder. Under the facts of this case, therefore, the decedent has made a transfer with a reserved power within the meaning of section 2036 (a) of the Code."

9

This call for literalness strongly contrasts with the majority's §2036 (a)(2) analysis, see n. 3, supra.

10

The majority's argument ignores the fact that within a wide area of discretion Byrum had the "right" to allocate corporate income to purposes other than payment of dividends, and thus the "right" to shut off income to the trust's life tenants.

11

The intent of Congressmen and the care with which they measured the language which the majority thinks was carefully limited is suggested by the following:

"Mr. Hawley. Mr. Speaker, I ask unanimous consent for the present consideration of a joint resolution (H. J. Res. 529) relating to the revenue, reported from the Committee on Ways and Means. (The resolution, sect. 2036 (a)(1) and (2) substantially as they appear today, was read.)
"The Speaker. Is there objection?
"Mr. Schafer of Wisconsin. Reserving the right to object, I shall object unless the gentleman explains just what the bill is.
"Mr. Hawley. Mr. Speaker and gentlemen, the Supreme Court yesterday handed down a decision to the effect that if a person creates a trust of his property and provides that, during his lifetime, he shall enjoy the benefits of it, and when it is distributed after his death it goes to his heirs--the Supreme Court held that it goes to his heirs free of any estate tax . . .
"Mr. Schafer of Wisconsin. This is a bill to tax the rich man. I shall not object.
"Mr. Collins. I would like to have a little more explanation.
"Mr. Sabath. Reserving the right to object, all the resolution purports to do is to place a tax on these trusts that have been in vogue for the last few years for the purpose of evading the inheritance tax on the part of some of these rich estates?
"Mr. Hawley. It provides that hereafter no such method shall be used to evade the tax.
"Mr. Sabath. That is good legislation." 74 Cong. Rec. (71st Cong., 3d Sess., March 3, 1931, p. 7198).

12

In considering this and its companion case, Estate of Spiegel v. Commissioner, 335 U.S. 701 [37 AFTR 459] (1949), the Court invited argument on whether Northern Trust itself should be overruled. Journal of the Supreme Court, October Term, 1947, pp. 296-297. Though the Court held for the government without having to reach this issue I note that in the 23 years since Church and Spiegel an opinion of this Court has not once cited, much less relied upon, Northern Trust. Mr. Justice Reed, dissenting in Church and concurring in Spiegel, announced at the time that he thought these cases overruled Northern Trut.

13

The First Circuit again shifted its position on this question in Old Colony Trust Co. v. United States, 423 F. 2d 601 [25 AFTR 2d 70-1549] (1970), but this change is obviously irrelevant to the majority's argument as to the legitimacy of Byrum's reliance from 1958 to 1964.

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Tax Court & Board of Tax Appeals Reported Decisions

Estate of Wayne C. Bongard, et al. v. Commissioner, 124 TC 95, Code Sec(s) 2036.

ESTATE OF WAYNE C. BONGARD, DECEASED, JAMES A. BERNARDS, PERSONAL REPRESENTATIVE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:
[pg. 95]

Code Sec(s):	2036
Docket:	Dkt. No. 6141- 03.
Date Issued:	03/15/2005 .
Judge:	Opinion by Goeke, *J.*
Tax Year(s):	Date of death 11-16-98.
Disposition:	Decision for Taxpayers in part and for Commissioner in part.

HEADNOTE

1. Gross estate—transfers with retained life estate—exceptions—bona fide sales for adequate consideration-- intrafamily transactions. Gross estate didn't include stock in decedent's and family trust's closely owned corp. which he transferred to LLC within 3 years of death: transfer qualified for Code Sec. 2036(a) 's bona fide sale for adequate consideration exception. LLC was formed for legitimate and significant nontax business reason of positioning corp. for liquidity event; stock transfers thereto, although between related parties, reflected valid arm's length sale transaction whereby assets were pooled and parties received proportionate LLC interests properly credited to their respective capital accounts; and such consideration was adequate, particularly given nontax business reason for exchange. Also, fact that decedent didn't receive control premium reflecting his majority stock contribution wasn't dispositive because he maintained effective control post-transfer.

Reference(s): USTR Estate & Gift Taxes¶20,365.01(42). Code Sec. 2036

2. Gross estate—transfers with retained life estate—exceptions—bona fide sales for adequate consideration— intrafamily transactions—family limited partnerships—transfers within 3 years of death. Gross estate included units in LLC which decedent purportedly transferred to newly-formed FLP day after capitalizing LLC: transfer didn't qualify for Code Sec. 2036(a) 's bona fide sale exception where FLP never conducted any business and transfer was effected for no legitimate reason other than to recycle assets and provide preferential estate tax vehicle; and decedent retained life estate within meaning of Code Sec. 2036(a) by virtue of implied agreement giving him continued control or enjoyment of allegedly transferred units. Also, value of LLC units reflected in FLP interest which decedent subsequently transferred to wife, within 3 years of death, was also includible in gross estate by operation of above and Code Sec. 2035(a) .

Reference(s): USTR Estate & Gift Taxes ¶20,365.01(70); 20,355.01(3). Code Sec. 2036 ; Code Sec. 2035

3. Gross estate—valuation—alternate valuation date—discounts. Tax Court redetermined discounted, alternate valuation date value of LLC units includible in decedent's gross estate: value was based on parties' stipulations as to lack of control, lack of marketability and lack of voting rights.

Reference(s): USTR Estate & Gift Taxes ¶20,325.01(2). Code Sec. 2032 ; Code Sec. 2031

Syllabus

Official Tax Court Syllabus

In 1980, D incorporated Empak, Inc. In 1986, D established an irrevocable stock accumulation trust (ISA Trust) and funded it with some of his Empak stock. In the mid-1990s it was determined by Empak's board of directors and advisers that pooling all of D's family's Empak stock in a holding company, WCB Holdings, LLC. (WCB Holdings), would better position Empak for a corporate liquidity event, which was necessary to raise capital and remain competitive. On Dec. 28, 1996, D and ISA Trust capitalized WCB Holdings by transferring to WCB Holdings their respective shares of Empak stock, and in exchange received WCB Holdings class A and class B membership units. Each class of membership units was further divided into governance and financial units, the class A governance units being the only units with voting rights.

On Dec. 29, 1996, D and ISA Trust formed the Bongard Family Limited Partnership (BFLP). To capitalize BFLP, D transferred all of his WCB Holdings class B membership units to BFLP in exchange for a 99-percent limited partnership interest, and ISA Trust transferred a portion of its WCB Holdings class B membership units to BFLP in [pg. 96] exchange for a 1-percent general partnership interest. On Dec. 10, 1997, D made a gift of a 7.72-percent partnership interest to his wife. D made no other gifts of his BFLP interest before his death on Nov. 16, 1998.

The IRS issued a notice of deficiency to the estate on Feb. 4, 2003, which, among other things, returned to decedent's gross estate, under secs. 2035(a) and 2036(a) and (b), I.R.C., all of the Empak shares decedent had transferred to WCB Holdings.

The estate argues that sec. 2036(a), I.R.C., is not applicable to either D's transfer of Empak shares to WCB Holdings or D's transfer of his WCB Holdings class B membership units to BFLP because each transfer was a bona fide sale for adequate and full consideration. The estate argues, in the alternative, that even if the bona fide sale exception was not satisfied by each transfer, D did not retain a sec. 2036(a)(1) or (2), I.R.C., interest in the property he transferred in either transaction.

Held: D's transfer of his Empak stock to WCB Holdings satisfied the bona fide sale exception because D possessed a legitimate and significant nontax reason for the transfer.

Held, further, D's transfer of WCB Holdings class B membership units to BFLP did not satisfy the bona fide sale exception.

Held , further, an implied agreement existed whereby D retained a sec. 2036(a), I.R.C., [pg. 96] interest in the WCB Holdings class B membership units he transferred to BFLP.

Held , further, WCB Holdings class B membership units allocable to the 7.72- percent partnership interest in BFLP D gave to his wife are included in D's gross estate under sec. 2035(a), I.R.C.

Counsel

John W. Porter and Stephanie Loomis- Price, for petitioner.

Lillian D. Brigman and R. Scott Shieldes, for respondent.

GOEKE, *Judge*

Respondent determined a $52,878,785 Federal estate tax deficiency against the Estate of Wayne C. Bongard (the estate). After concessions and stipulations, two issues remain for decision: First, whether the shares of Empak, Inc. (Empak), decedent transferred to WCB Holdings, LLC. (WCB Holdings), are included in his gross estate pursuant to sections 2035(a) [1] and 2036(a) and (b); and second, whether the WCB Holdings membership units decedent transferred to the Bongard Family Limited Partnership (BFLP) are included in his gross estate under sections 2035(a) and 2036(a). The resolution of these issues depends on the applicability of section 2036(a) to decedent's respective transfers of Empak stock to WCB Holdings and of WCB Holdings membership units to BFLP.

FINDINGS OF FACT

Many of the facts have been stipulated. The stipulation of facts, stipulation of settled issues, and attached exhibits are incorporated herein by this reference.

Decedent resided in Minnesota on November 16, 1998, the date of his death. On December 9, 1998, the First Judicial District Court, Probate Court Division, Carver County, Minnesota, appointed James A. Bernards (Mr. Bernards) personal representative of decedent's estate. At the time the petition was filed, Mr. Bernards resided in Minnesota. On February 4, 2003, respondent issued a notice of deficiency to the estate with respect to its timely filed Form 706, United States Estate (and Generation- Skipping Transfer) Tax Return. [pg. 97]

I. *General Background and Time Line*

Decedent was a skilled and experienced businessman. In 1966, decedent was a founding employee of Fluoroware, Inc. (Fluoroware), a Minnesota corporation that produced packaging materials for the semiconductor, data storage, and microelectronic industries. In 1980, decedent left Fluoroware to start his own corporation, Empak.

On November 9, 1984, decedent married Cynthia Bongard. Decedent entered into this marriage with four children from a prior marriage: Beth Akerberg, Mark Bongard, Rhonda Notermann, and Lynn Zupan. Cynthia Bongard also entered the marriage with a child from a previous marriage, Terra Saxe. [2] Decedent and Cynthia Bongard never had any children together, nor did decedent adopt Terra Saxe.

On May 23, 1986, decedent formed the Wayne C. Bongard Irrevocable Stock Accumulation Trust (ISA Trust) for the benefit of his children and Terra Saxe, and funded it with shares of Empak stock. ISA Trust is described in further detail infra pp. 17-19.

On January 17, 1991, Empak incorporated Empak International, Inc. (Empak International), as a wholly owned subsidiary. Pursuant to a joint venture agreement, Empak sold an interest in Empak International to an unrelated foreign corporation. See infra p. 8 for greater details of this joint venture.

Between April 22, 1991, and December 30, 1994, ISA Trust made six distributions of shares of Empak stock to specific beneficiaries. After each distribution, Empak redeemed the shares from the distributee for cash. See infra pp. 18-19 for specific details of these distributions/redemptions.

On January 30, 1996, WCB Holdings, LLC. (WCB Holdings) was established, but was not capitalized until December 28, 1996. Before WCB Holdings was capitalized, two significant events occurred. First, on April 18, 1996, Empak had a stock split of 223 to 1, significantly increasing the number of shares decedent and ISA Trust owned. See infra pp. 10-11 and p. 19. for details regarding the stock split and its effect it on the Empak shareholders. Second, in February 1996, Empak incorporated Emplast, Inc. (Emplast), and capitalized [pg. 98] it with some of Empak's noncore assets. On July 31, 1996, Empak distributed its Emplast shares to decedent in exchange for some of his Empak shares, which were

canceled. This transaction and its effects are discussed further infra pp. 10-11 and p. 19.

On December 28, 1996, decedent and ISA Trust transferred their respective shares of Empak stock to WCB Holdings in exchange for WCB Holdings membership units, which were divided into class A governance, class A financial, class B governance, and class B financial units. For a greater discussion of this transaction, see infra pp. 11-14.

On December 29, 1996, decedent and ISA Trust created the Bongard Family Limited Partnership (BFLP). Decedent transferred all of his WCB Holdings class B membership units to BFLP in exchange for a 99-percent limited partnership interest, and ISA Trust transferred a portion of its WCB Holdings class B membership units to BFLP in exchange for a 1-percent general partnership interest. BFLP is discussed in further detail infra pp. 19-21.

On March 7, 1997, Empak International merged into Empak, which resulted in the foreign corporation's receiving an ownership interest in Empak and the cancellation of Empak's shares in Empak International. Facts regarding this transaction are set forth infra pp. 14-15.

On March 15, 1997, decedent transferred WCB Holdings class A membership units to three trusts that he had previously established. Each of these trusts was established to benefit different members of his family. See infra pp. 21-23 for further details regarding these trusts. On December 10, 1997, decedent gave Cynthia Bongard a 7.72-percent limited partnership interest in BFLP. That same day, Cynthia Bongard and decedent entered into a postmarital agreement. See infra pp. 23-24 for details of the postmarital agreement.

Decedent died unexpectedly on November 16, 1998, while on a business/hunting trip in Austria. Decedent was 58 years of age and appeared to be in good health before his death.

II. *Decedent's Business Interests*

A. *Empak*

On July 14, 1980, decedent founded Empak as a Minnesota corporation. Decedent was assisted by Mr. Bernards, who [pg. 99] was one of Fluoroware's outside accounting consultants, in incorporating Empak. Empak is an acronym for "electronic materials packaging". Empak engaged in the design, development, manufacture, and marketing of plastic products used in the semiconductor and data storage industries. Some of Empak's and Fluoroware's businesses directly competed with each other.

Decedent was Empak's sole shareholder upon incorporation. Empak had only one class of stock, common voting stock. When decedent funded the ISA Trust with shares of Empak stock in 1986, decedent's ownership percentage decreased to 85 percent. Decedent was also one of three directors on Empak's board of directors. In the mid-1980s, decedent became the sole member of Empak's board of directors and remained in that position until his death, except for a 28-day period from December 30, 1996, to January 24, 1997.

Empak grew into a successful business through decedent's leadership. Empak's growth was attributable to selling a greater number and variety of products, expanding its markets, reinvesting its earnings, and borrowing funds. Empak, however, never declared a dividend.

B. *Empak, Marubeni Corp., and Marubeni America Corp. Joint Venture*

In the 1980s, Empak, Marubeni Corp. (MC), and Marubeni America Corp. (MAC) engaged in a joint venture to produce plastic compact disk containers (a.k.a. jewel boxes). MC was a Japanese trading entity with over 700 subsidiaries and was listed on numerous international stock exchanges. MAC was

the U.S. sales and marketing subsidiary of MC. Basically, MC financed and provided materials for the joint venture and Empak manufactured the jewel boxes.

C. *Empak's Incorporation of Empak International*

On January 17, 1991, Empak incorporated Empak International, Inc., a wholly owned Minnesota subsidiary organized to distribute, sell, and manufacture a proprietary line of computer disk and semiconductor packaging products outside the United States and Canada. The formation of Empak International was a function of the joint venture agreement [pg. 100] between Empak and MC. Pursuant to Empak International's shareholder agreement, Empak sold 49 percent of Empak International's common stock to MC for $3,765,000 but remained the majority shareholder with a 51-percent interest. During 1992 and 1993, Mark Bongard was employed by Empak International as vice president of sales and marketing.

D. *Planning for Corporate Liquidity*

At a meeting in 1995, decedent, Robert Boyle (Mr. Boyle), Mr. Bernards, and Chuck Eitel (Mr. Eitel), then president of Empak, discussed various business plans for Empak to remain competitive in the market. Mr. Boyle began representing decedent's various business interests while he was an attorney at Larkin, Hoffman, Daly & Lindgren, Ltd. (Larkin Hoffman). Mr. Boyle left Larkin Hoffman in 1995 but continued his professional relationship with decedent. As part of these discussions, Mr. Boyle envisioned the necessary steps to position Empak for a corporate liquidity event, which the discussants agreed would provide Empak with the necessary capital to remain competitive. A corporate liquidity event included either a public or private offering of Empak stock. Mr. Boyle handwrote notes during this meeting. These contemporaneous handwritten notes indicate that a single holding company, to hold all the Empak stock owned by the Bongard family, was going to be established as part of this business plan. As explained hereinafter, the formation of BFLP was part of decedent's estate plan and not contemplated as a necessary step in positioning Empak for a corporate liquidity event. On December 22, 1995, Mr. Boyle provided decedent with a letter memorializing the steps associated with obtaining corporate liquidity. Many of these integrated steps were completed before decedent's death.

1. *Empak's Incorporation and Spinoff* [3] of Emplast

On February 21, 1996, Empak incorporated a wholly owned subsidiary, Emplast. Emplast was incorporated and capitalized with noncore assets of Empak to streamline Empak in preparation for a corporate liquidity event. The [pg. 101] noncore assets consisted of assets outside of Empak's semiconductor business. The net book value of these assets was $5,752,854, which represented 5 percent of Empak's net book value. Mark Bongard was appointed the chief executive officer of Emplast and remained in that position until decedent's death.

Empak had a stock split on April 18, 1996, which was approved by a vote of the outstanding Empak stockholders. Empak shareholders received 223 shares for each Empak share held, which increased decedent's number of shares to 5,686,500. The stock split also increased ISA Trust's number of shares. See infra p. 19. The day following Empak's stock split, decedent in his capacity as Empak's sole member on its board of directors adopted a resolution authorizing grants of incentive stock options and nonqualified stock options. It does not appear that any of these stock options were exercised before decedent's death.

On July 31, 1996, Empak distributed the stock of Emplast to decedent. In exchange for receiving 100 percent ownership of Emplast, 551,871 of decedent's shares in Empak were canceled. This decreased decedent's ownership interest in Empak to 5,134,629 shares, or 86.39 percent. Because some of decedent's shares were canceled and ISA Trust did not participate in the distribution, ISA Trust's ownership percentage in Empak increased to 13.61 percent. ISA Trust's percentage holding of Empak had decreased after 1986 due to the redemptions of some of the Empak stocks held by the trust.

2. *WCB Holdings*

In view of market conditions in 1996, Mr. Boyle determined that investors would be more likely to invest in Empak if the Bongard family members' ownership interests were placed in a holding company. As of December 1996, decedent and ISA Trust held all of the Empak stock. Decedent had established the ISA Trust on May 23, 1986, with the assistance of John Fullmer (Mr. Fullmer) and Mr. Boyle. When ISA Trust was established, Messrs. Fullmer and Boyle were both attorneys with Larkin Hoffman, but in 1996 only Mr. Fullmer was with Larkin Hoffman. In 1996, Mr. Boyle, who continued to represent decedent's business interests after leaving Larkin Hoffman, informed Mr. [pg. 102] Fullmer, decedent's estate planning attorney, that decedent's Empak stock was going to be transferred to a holding company as part of the overall plan to achieve corporate liquidity.

On January 30, 1996, Mr. Boyle, on behalf of decedent, organized WCB Holdings as a Minnesota limited liability company (WCB Holdings). Its articles of organization (articles), as amended, authorized the issuance of class A governance, class A financial, class B governance, and class B financial units. The class A governance units were the sole membership units with voting rights except as provided under State law. [4]

On December 28, 1996, decedent contributed his 5,134,629 shares of Empak stock to WCB Holdings. Decedent received in exchange 513,463 class A governance, 513,463 class A financial, 4,621,166 class B governance, and 4,621,166 class B financial membership units in WCB Holdings. This gave decedent an 86.39-percent ownership interest in each subclass of WCB Holdings membership units. ISA Trust also contributed its 808,598 shares of Empak stock to WCB Holdings and received 80,860 class Agovernance, 80,860 class A financial, 727,738 class B governance, and 727,738 class B financial units. This gave ISA Trust a 13.61-percent ownership interest in each subclass of WCB Holdings membership units. Decedent and ISA Trust received WCB Holdings class A governance, class A financial, class B governance, and class B financial membership units in proportion to the number of Empak shares each contributed. [5]

On December 28, 1996, Mark Bongard was elected chief manager, secretary, and treasurer of WCB Holdings. According to the Member Control Agreement, the chief manager is the person "duly elected or appointed pursuant to the terms of this Agreement to manage the business of the Company." Some of the chief manager's duties include general manage-[pg. 103] ment, presiding at meetings, overseeing that orders and resolutions are carried out, maintaining records and certifying proceedings, and signing and delivering WCB Holdings documents.

Limitations were placed on the chief manager's powers. For instance, the Member Control Agreement provided that the chief manager was not granted sole decisionmaking authority over the allocation of distributions. If a distribution were authorized, it would be allocated according to the number of class A financial and class B financial units owned. The chief manager was also charged with the decisionmaking for accounting matters, except if the members representing a majority of class A governance units disagreed. The members by a majority vote of the class A governance units could take any action the chief manager himself could take and could remove the chief manager. Lastly, the chief manager needed the approval of the members representing the majority of the class A governance units before he could issue additional membership units, lend, borrow, or commit WCB Holdings's funds in excess of $25,000, authorize capital expenditures in excess of $10,000, sell any of WCB Holdings's assets, including its Empak stock, worth over $10,000 in any 12- month period, or vote any securities, including its Empak stock, owned by WCB Holdings.

On December 30, 1996, 2 days after WCB Holdings was capitalized, a vote was held to increase the number of Empak directors to two. The WCB Holdings chief manager did not vote on this change, even though WCB Holdings was the sole shareholder of Empak stock. Rather, decedent and Mr. Boyle, as trustees for the ISA Trust, voted for this change.

3. *Empak International's Merger Into Empak*

On March 7, 1997, Empak International merged into Empak. As part of the merger, MC's stock in Empak International was canceled and MC received, among other things, 660,359 shares of Empak common stock and an option to purchase 58,667 additional shares of Empak common stock. Empak's stock in Empak International was canceled.

Pursuant to the merger, Empak assumed responsibility for the foreign distribution of Empak products with the exception of Japan. Empak appointed MAC as the exclusive [pg. 104] exporter of Empak products to Japan and MC as the exclusive distributor of Empak products in Japan. Empak's ownership was altered as a result of the merger of Empak International into Empak as follows:

Empak shareholder	Number of shares	Percentage of total
WCB Holdings	5,943,227	90%
MC	396,215	6
MAC	264,144	4
Total	6,603,586	100

E. *Consolidation of Empak and Fluoroware*

In the summer of 1998, Empak and Fluoroware began consolidation discussions. Decedent engaged in the discussions in his capacity as chairman of the board and chief executive officer of Empak. Before November 1998, decedent had sketched out potential organizational structures in the event the corporations consolidated, but Empak and Fluoroware did not agree to specific details regarding the consolidation before decedent's death. Following decedent's unexpected death on November 16, 1998, consolidation discussions were renewed.

On February 5, 1999, Mr. Bernards, who assisted in representing Empak in the discussions, recommended the approval of a consolidation between Empak and Fluoroware. On March 15, 1999, Empak and Fluoroware signed a letter of intent to consummate the general terms of the consolidation. Between April 13 and 14, 1999, Mr. Boyle, as corporate secretary of Empak, prepared and filed Federal Trade Commission (FTC) Form 4 (a.k.a. Hart- Scott-Rodino filing), with the FTC indicating the parties' intended consolidation. Mark Bongard, as chief manager of WCB Holdings, gave notice of a special meeting to its members to consider the proposed consolidation, which was approved by the members. On June 1, 1999, Empak and Fluoroware entered into a consolidation agreement which provided for the formation of a new corporation, Entegris, Inc. (Entegris). Pursuant to the new consolidation agreement, Empak shareholders received 10,250,789 Entegris shares, which represented a 40-percent ownership interest. [pg. 105]

On March 31, 2000, Entegris filed a registration statement with the Securities and Exchange Commission in anticipation of its initial public offering (IPO). On July 11, 2000, Entegris had a 2-for-1 stock split, resulting in WCB Holdings's owning 21,580,608 [6] shares of Entegris stock. Also on July 11, 2000, Entegris completed its IPO. WCB Holdings sold 1,925,000 shares of Entegris as part of the Entegris IPO.

III. *Decedent's Estate Planning*

Decedent sought counsel, considered advice, and worked on his estate planning from at least 1984. In 1984, decedent did not want either his children or Cynthia Bongard to directly own Empak stock. Decedent engaged Larkin Hoffman for estate and business planning purposes.

A. *ISA Trust*

On May 23, 1986, decedent established ISA Trust with the assistance of Larkin Hoffman. ISA Trust was

initially funded by decedent's transfer of 4,500 of Empak's 30,000 outstanding shares, which represented a 15-percent ownership interest in Empak. The beneficiaries of ISA Trust were decedent's four children and Terra Saxe. The initial trustees of ISA Trust were Mr. Bernards and Larry Welter, an employee of Empak. The trustees were granted the power to distribute the trust's income or principal to any beneficiary acquiring a home or establishing and maintaining a trade or business. On February 14, 1988, Mr. Bernards resigned as trustee of ISA Trust, leaving Mr. Welter as sole trustee.

ISA Trust made six distributions between April 22, 1991, and December 30, 1994. Each distribution was preceded by decedent's requesting the trustee or trustees to consider making the distribution. After each distribution, an entry was made in Empak's stock register recording ISA Trust's distribution of Empak shares to a particular beneficiary. Empak and the named distributee would enter into a stock redemption agreement at approximately the same time as the distribution. The stock redemption agreements provided for [pg. 106] Empak to redeem the distributed shares if the distributee was willing.

The first distribution occurred on April 22, 1991. ISA Trust distributed 150 shares of Empak stock to Mark Bongard, who then caused Empak to redeem the shares on May 1, 1991, for $40,000, which he used to purchase a home. The second distribution of 180 shares of Empak stock occurred on August 31, 1992. Beth Akerberg was the recipient of this distribution, which was shortly followed by a redemption of the shares by Empak in exchange for a 90- day note. On February 1, 1994, ISA Trust distributed 250 shares of Empak stock to Lynn Zupan. On the same day, Empak redeemed the 250 shares from Lynn Zupan. Empak paid a portion of the redemption proceeds directly to a third party who had performed home improvement work on Lynn Zupan's home. The fourth, fifth, and sixth distributions all occurred on December 30, 1994. Mark Bongard, Rhonda Notermann, and Beth Akerberg were the recipients of 85, 151, and 58 shares of Empak stock, respectively, all of which were apparently redeemed by Empak. Following these six distributions, ISA Trust held 3,626 shares of Empak stock which represented a 12.45-percent ownership interest.

On January 5, 1995, Mr. Welter appointed Mark Bongard and Mr. Boyle as cotrustees of ISA Trust; he then resigned as trustee. Mark Bongard and Mr. Boyle accepted their appointments on January 10 and 18, 1995, respectively. Mr. Boyle and Mark Bongard later reappointed Mr. Bernards as an additional ISA Trust trustee on October 1, 1997.

When Empak's stock was split 223 to 1 on April 18, 1996, ISA Trust's number of Empak shares increased to 808,598. When Empak distributed to decedent its Emplast stock on July 31, 1996, ISA Trust continued to hold 808,598 shares of Empak. ISA Trust's ownership percentage of Empak was 13.61 percent at that time.

B. *Bongard Family Limited Partnership*

On December 28, 1996, decedent signed a letter that was written by Mr. Fullmer and addressed to decedent's children. The letter expressed some reasons for forming WCB Holdings and BFLP. The letter explained that the entities provided, among other things, a method for giving assets to decedent's [pg. 107] family members without deterring them from working hard and becoming educated, protection of his estate from frivolous lawsuits and creditors, greater flexibility than trusts, a means to limit expenses if any lawsuits should arise, tutelage with respect to managing the family's assets, and tax benefits with respect to transfer taxes.

On December 29, 1996, decedent contributed all of his 4,621,166 WCB Holdings class B governance and 4,621,166 WCB Holdings class B financial units to BFLP in exchange for a 99-percent limited partnership interest in BFLP. ISA Trust contributed 46,678 WCB Holdings class B governance and 46,678 WCB Holdings class B financial units to BFLP and received a 1-percent general partnership interest in exchange. Mr. Boyle (as trustee of ISA Trust), decedent, and Mr. Fullmer (as decedent's estate planning counsel) negotiated the terms of the partnership, and explained the partnership to Mark Bongard (cotrustee of ISA Trust) before the partnership agreement was executed. Pursuant to the partnership agreement, either decedent, as limited partner, or ISA Trust, as general partner, could

propose amendments to the partnership. For a proposed amendment to be adopted, both the general partner, ISA Trust, and 60 percent of the limited partnership interests needed to vote in favor of the amendment. BFLP was validly created and existing under Minnesota law until decedent's death.

In the event BFLP liquidated, its assets were first to be allocated to satisfy its creditors, other than the general partner, limited partners, or assignees, second, to satisfy any liabilities owed to the interest holders, [7] and third, to satisfy any liabilities owed to the general partner. Any remaining assets were to be allocated among the general partner, limited partners, or assignees in accordance with their respective capital accounts.

C. *Additional Trusts Created by Decedent*

On December 28, 1996, decedent created the Wayne C. Bongard Children's Trust (CH Trust), and appointed Mark Bongard and Mr. Bernards as trustees. Decedent initially funded the CH Trust on March 15, 1997, with 77,262 class [pg. 108] A governance and 77,262 class A financial units in WCB Holdings.

On December 30, 1996, decedent created the Wayne C. Bongard Grandchildren's Trust (GC Trust). The trust agreement was drafted by Mr. Fullmer. Decedent appointed Del Jensen and Mr. Eitel, both of whom were employed by Empak, as trustees. Decedent funded GC Trust on March 15, 1997, by transferring 77,262 class A governance and 77,262 class A financial units in WCB Holdings. Decedent's children and issue were the named beneficiaries of GC Trust.

On December 30, 1996, decedent created the Cynthia F. Bongard Qualified Terminable Interest Property Trust (QTIP Trust). The QTIP Trust agreement was drafted by Mr. Fullmer. Gary Bongard (decedent's brother) and Gary Brown (decedent's friend) were appointed trustees of this trust. The named beneficiaries of QTIP Trust were Cynthia Bongard, decedent's children, and their issue. On March 15, 1997, QTIP Trust was funded by decedent with 71,319 class A governance and 71,319 class A financial units in WCB Holdings.

Decedent formed the Wayne C. Bongard Revocable Trust (Revocable Trust) on December 28, 1996. Decedent appointed himself trustee, Mr. Bernards successor trustee, and Mark Bongard second successor trustee. According to decedent's last will and testament dated December 28, 1996, all of his property was to go to the Revocable Trust, except his personal property was to go to Cynthia Bongard.

Decedent's funding of GC Trust, CH Trust, and QTIP Trust changed the ownership interests in WCB Holdings so that they were held as follows:

WCB Holdings member	Class A governance units/percent	Class A financial units/percent	Class B financial units/percent	Class B governance units/percent
Decedent	287,620/48.39	287,620/48.39	0/0	0/0
ISA Trust	80,860/13.61	80,860/13.61	681,060/12.73	681,060/12.73
BFLP	0/0	0/0	4,667,844/87.27	4,667,844/87.27
CH Trust	77,262/13	77,262/13	0/0	0/0
GC Trust	77,262/13	77,262/13	0/0	0/0
QTIP Trust	71,319/12	71,319/12	0/0	0/0
Total	594,323/100	594,323/100	5,348,904/100	5,348,904/100

Decedent reported the funding of CH Trust, GC Trust, and QTIP trust on a Federal gift tax return for 1997. The values reported on the gift tax return were consistent with a valu-[pg. 109] ation report prepared as of December 15, 1996, before WCB Holdings's formation.

D. *Decedent's Transfer of BFLP Interest to Cynthia Bongard*

On December 10, 1997, decedent made a gift representing a 7.72-percent ownership interest in BFLP to Cynthia Bongard. BFLP's ownership was then as follows:

BFLP partner	Partnership interest & type
ISA Trust	1%, general partner
Decedent	91.28%, limited partner /1/
Cynthia	7.72%, limited partner

/1/ Decedent owned this interest until his death.

Decedent did not report this gift on his gift tax return filed for taxable year 1997, as the marital gift tax exclusion was applicable. Cynthia Bongard and decedent entered into a postmarital agreement contemporaneously with the transfer. This agreement was "in full discharge, settlement, and satisfaction of all such rights and claims [either spouse may have possessed against the other], in the event of the termination of their marital relationship or after the death of the first of them to die".

E. *Purpose and Function of BFLP*

From its inception until decedent's death, BFLP did not perform any activities, never acted to diversify its assets, or make any distributions. The WCB Holdings membership units in BFLP were nonvoting, and decedent determined whether the Empak shares held by WCB Holdings would be redeemed. WCB Holdings did not redeem any of its class B membership units held by BFLP before decedent's death.

F. *1998 ISA Trust Distribution*

In early 1998, decedent suggested that ISA Trust make distributions to each of his children to see how maturely they would handle the funds. A series of transactions occurred in which Empak redeemed 52,924 of its outstanding shares from WCB Holdings, and WCB Holdings then redeemed 21,345 [pg. 110] of its class A and class B financial units from ISA Trust. This redemption generated $747,816.12. After covering tax liabilities of all WCB Holdings members, WCB Holdings and in turn ISA Trust distributed $400,000 in four equal shares to decedent's four children. The ownership interests in WCB Holdings were changed so that they were held as follows:

WCB Holdings member	Class A governance units/percentage	Class A financial units/percentage	Class B financial units/percentage	Class B governance units/percentage
Decedent	287,620/ 48.6	287,620/ 50.2	0/ 0	0/ 0
ISA Trust	80,860/ 13.4	59,515/ 10.39	681,060/ 12.73	659,715/ 12.38
BFLP	0/ 0	0/ 0	667,884/ 87.27	4,667,864/ 87.62
CH Trust	77,262/ 13	77,262/ 13.48	0/ 0	0/ 0
GC Trust	77,262/ 13	77,262/ 13.48	0/ 0	0/ 0
QTIP Trust	71,319/ 12	71,319/ 12.45	0/ 0	0/ 0
Total	594,323/100	572,978/100	5,348,944/100	5,327,579/100

IV. *The Estate of Wayne C. Bongard*

The estate filed a Federal estate tax return on February 15, 2000. For Federal estate tax purposes, the estate elected the alternate valuation date of May 16, 1999. On February 15, 2000, the estate completed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, which reported that the Federal estate tax owed was $17,004,363. The estate attached Schedule F, Other Miscellaneous Property Not Reportable Under Any Other Schedule, to its Form 706. Schedule F showed

the alternate values of decedent's WCB Holdings class A membership units and his 91.28-percent limited partnership interest in BFLP to be $4,193,000 and $41,329,838, respectively. On February 4, 2003, respondent issued to the estate a notice of deficiency, that determined a Federal estate tax deficiency of $52,878,785. In the notice of deficiency, respondent adjusted the values attached by the estate to many assets in decedent's gross estate. In addition, respondent determined that the 5,134,629 shares of Empak stock decedent transferred to WCB Holdings were includable in decedent's gross estate because decedent had retained sections 2035(a) and 2036(a) and/or (b) rights and interests in the transferred property. On the estate tax return, the estate reported values of the WCB Holdings class A units and BFLP interest held by decedent at his death totaling $45,523,338. Respondent in the notice of deficiency included in the gross estate a value [pg. 111] for decedent's Empak shares that had been transferred to WCB Holdings totaling $141,621,428. [8] This resulted in an adjustment increasing the gross estate by $96,098,120.

Prior to trial, respondent amended the answer to seek an increased deficiency based upon the parties' agreement that the starting price of Empak shares before any discounts was $32.24. Using this value, respondent's counsel estimated the revised adjustment to decedent's gross estate could be as high as $160 million.

OPINION

A Federal estate tax is imposed "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." Sec. 2001(a). The estate tax is imposed on the value of the taxable estate with specified adjustments made. Sec. 2001(b). A decedent's taxable estate is determined by the value of the decedent's gross estate less enumerated deductions. Sec. 2051. The value of a gross estate includes all of a decedent's property to the extent provided under sections 2033 through 2045. Sec. 2033. At issue here is whether certain property decedent transferred during his lifetime is included in his gross estate under sections 2035(a) and 2036(a) and (b).

I. *Burden of Proof*

The estate argues that under section 7491(a) the burden of proof has shifted to respondent. Conversely, respondent contends the burden has not shifted because the estate was not cooperative within the meaning of section 7491(a), and because the estate failed to introduce credible evidence necessary for the burden to shift. It is unnecessary for us to address the parties' disagreements and to determine whether the burden of proof has shifted because the outcome of this case is determined on the preponderance of the evidence and is unaffected by section 7491. See Blodgett v. Commissioner, 394 F.3d 1030, 1035 [95 AFTR 2d 2005-448] (8th Cir. 2005), affg. T.C. Memo. 2003-212 [TC Memo 2003-212]; Estate of Stone v. Commissioner, T.C. Memo. 2003-309 [TC Memo 2003-309]. [pg. 112]

II. *Sections 2035(a) and 2036(a)*

The purpose of section 2036 is to include in a deceased taxpayer's gross estate inter vivos transfers that were testamentary in nature. United States v. Estate of Grace, 395 U.S. 316 [23 AFTR 2d 69-1954] (1969). Section 2036(a) [9] generally provides that if a decedent makes an inter vivos transfer of property, other than a bona fide sale for adequate and full consideration, and retains certain enumerated rights or interests in the property which are not relinquished until death, the full value of the transferred property will be included in the decedent's gross estate. Section 2036(a) is applicable when three conditions are met: (1) the decedent made an inter vivos transfer of property; (2) the decedent's transfer was not a bona fide sale for adequate and full consideration; *and* (3) the decedent retained an interest or right enumerated in section 2036(a)(1) or (2) or (b) [10] in the transferred property which he did not relinquish before his death.

Additionally, pursuant to section 2035(a) a decedent's gross estate includes the value of any property in respect of which the decedent made a transfer or relinquished a power within 3 years of his death if the value of such property would have been included in the decedent's gross estate under section 2036

but for the decedent's transfer of an interest in the property or the decedent's relinquishment of a power with respect to the property.

This case focuses on each aspect of section 2036(a). The estate argues that decedent's transfer of Empak stock to WCB Holdings and decedent's transfer of WCB Holdings class B membership units to BFLP: (1) did not constitute "transfers" under , section 2036, (2) satisfied the bona fide sale exemp- [pg. 113] tion, and (3) did not include the retention of section 2036 interests.

A. *"Transfer" and Section 2036(a)*

The first question is whether decedent, in fact, made a lifetime transfer. See United States v. O'Malley, 383 U.S. 627, 631 [17 AFTR 2d 1393] (1966) (stating the purpose behind the predecessor to section 2036(a) was to tax all property that had been the "subject of an incomplete inter vivos transfer").

The term "transfer", as used in section 2036, is broadly defined. See Helvering v. Hallock, 309 U.S. 106 [23 AFTR 1054], n.7 (1940); Estate of Shafer v. Commissioner, 749 F.2d 1216, 1221-1222 [55 AFTR 2d 85-1531] (6th Cir. 1984), affg. 80 T.C. 1145 (1983); Guynn v. United States, 437 F.2d 1148, 1150 [27 AFTR 2d 71-1653] (4th Cir. 1971) (stating that section 2036 "describes a broad scheme of inclusion in the gross estate, not limited by the form of the transaction, but concerned with all inter vivos transfers where outright disposition of the property is delayed until the transferor's death"). The interpretation of the term "transfer" must reflect the purpose of section 2036(a), which is to include in a decedent's gross estate all property he transferred but retained an interest therein during his lifetime. See United States v. Estate of Grace, supra at 322; Ray v. United States, 762 F.2d 1361, 1362 [56 AFTR 2d 85-6496] (9th Cir. 1985) (citing United States v. Estate of Grace, supra at 320); Estate of Shafer v. Commissioner, supra (citing Foster v. United States, 303 U.S. 118, 120 [19 AFTR 1261] (1938)). Thus, the caselaw does not support a narrow definition of the term "transfer", but instead indicates a section 2036 analysis should begin by determining whether the decedent made an inter vivos voluntary act of transferring property. Estate of DiMarco v. Commissioner, 87 T.C. 653, 662-663 (1986). Any such act, including decedent's transfer of his Empak shares to WCB Holdings and decedent's transfer of his WCB Holdings class B financial and class B governance units, is included in a broad interpretation of the term "transfer".

B. *The Bona Fide Sale Exception*

As previously stated, Congress excepted from section 2036(a) any transfer made in a "bona fide sale for an adequate and full consideration" (the bona fide sale exception). Respondent argues that decedent's inter vivos transfers to [pg. 114] WCB Holdings and BFLP should not be allowed to deplete the gross estate because sections 2035(a) and 2036(a) and (b) are applicable. The estate urges us to respect the transfers, arguing each satisfied the bona fide sale exception. This exception has frequently been the grist of judicial interpretation.

In Estate of Harrison v. Commissioner, T.C. Memo. 1987-8 [¶87,008 PH Memo TC], we determined that a partnership agreement was not a substitute for a testamentary disposition since the decedent received "adequate consideration for his transfer to the partnership." On June 10, 1975, the decedent was in poor health and executed a power of attorney appointing his son as his attorney-in-fact. On August 1, 1979, the decedent's son, acting individually and under the power of attorney, organized a family limited partnership for purposes of consolidating and preserving the decedent's assets. Some of the assets the decedent contributed included oil and gas assets, which required active management. The decedent's 77.8-percent limited partnership interest and 1-percent general partnership interest were proportionate to the value of the property he transferred. The decedent's sons each received 10.6- percent general partnership interests. The decedent died on January 14, 1980. We held that the formation of the partnership was not a testamentary disposition for two reasons significant to this discussion. First, the decedent received adequate and full consideration for his transfer. Second, because the estate was able to show that the partnership was created for the business purpose of providing the necessary and proper management of the decedent's properties.

In Estate of Harper v. Commissioner, T.C. Memo. 2002-121 [TC Memo 2002- 121], the Court held the bona fide sale exception was not satisfied. On December 18, 1990, the decedent created a revocable trust. The trust instrument named the decedent the initial trustee. The decedent formed a limited partnership in which his two children received a combined 1-percent general partnership interest and the trust received a 99-percent limited partnership interest. The decedent never consulted with his children regarding how the partnership was going to be operated or structured.

As part of the analysis the Court stated that the applicability of the bona fide sale exception depends on two requirements: "(1) A bona fide sale, meaning an arm's- length transaction, and (2) adequate and full consideration." The [pg. 115] alleged nontax purpose for creating the partnership was to manage and invest the assets contributed. However, the facts revealed that no new investment strategies were employed by the partnership, nor did any of the assets constitute working assets as in Estate of Harrison v. Commissioner, supra. Moreover, the estate failed to identify the property, if any, the decedent's children transferred to him or the partnership in exchange for their partnership interests. See Estate of Reichardt v. Commissioner, 114 T.C. 144, 155 (2000) (holding that there was no adequate and full consideration where, among other things, the decedent's children transferred nothing to him or the partnership). A circuitous recycling of value occurred because the pooled assets were significantly composed of the same property contributed by the trust to the partnership.

In Estate of Thompson v. Commissioner, T.C. Memo. 2002-246 [TC Memo 2002- 246], affd. 382 F.3d 367 [94 AFTR 2d 2004-5764] (3d Cir. 2004), we again held the bona fide sale exception was not applicable. On January 16, 1969, the decedent established a revocable trust. The trust agreement was amended, and the trust was funded with securities and cash on March 17, 1993. The decedent received income from the securities held in the trust. In early 1993, the decedent's children and the decedent met with a financial adviser and an attorney who described for the decedent an estate plan that used family limited partnerships. The decedent agreed to form two limited partnerships to benefit his two children. Two new corporations were incorporated, each serving as general partner to one of the partnerships. The decedent received shares of stock that represented a 49-percent ownership interest in each newly formed corporation. Before forming the partnerships and corporations, the decedent and his two children agreed that he would be taken care of financially. Additionally, they wanted decedent to have access to money in each partnership in order to continue making gifts to his family. With respect to the adequate and full consideration prong, the substance of the transaction revealed that there was not a true pooling of assets. The income from some of the properties each partner contributed was allocated to that partner. The partnerships also failed to change the investment strategy of their principal assets—the stocks and bonds contributed by the decedent. The lack of nontax business reasons for the trans-[pg. 116] fer further supported the conclusion that the decedent did not receive adequate and full consideration within the meaning of section 2036(a). Finally, the Court determined that the partnership was conducted in a testamentary manner, rather than in a businesslike manner, because the decedent's money was used to finance the needs of individual family members including himself. On these findings, we held that the bona fide sale exception was not applicable.

In Estate of Strangi v. Commissioner, T.C. Memo. 2003-145 [TC Memo 2003- 145], the decedent executed a power of attorney in 1988 that named his son-in-law, Mr. Gulig, his attorney-in-fact. In 1993, the decedent's health began to deteriorate, and Mr. Gulig took over the decedent's personal affairs. On August 12, 1994, Mr. Gulig, as the decedent's attorney-in-fact, independently created the Strangi Family Limited Partnership (SFLP) and Stranco, Inc. (Stranco), the corporate general partner of SFLP. Mr. Gulig singlehandedly determined how the SFLP would be structured and operated. Mr. Gulig assigned 98 percent of the decedent's wealth to the SFLP in exchange for a 99-percent limited partnership interest. The assets contributed by the decedent included, among other things, his personal residence, securities, and insurance policies. The decedent and Mrs. Gulig (the decedent's daughter and Mr. Gulig's wife), purchased Stranco shares for cash. The decedent purchased a 47-percent interest in Stranco. Stranco contributed the cash to SFLP for a 1-percent general partnership interest. The Stranco shareholders acting in concert delegated its managing powers to Mr. Gulig. The decedent died on October 14, 1994.

We determined that the formation of the SFLP was not an arm's-length transaction because Mr. Gulig,

as the decedent's attorney-in-fact, established and operated SFLP without any meaningful negotiations, essentially standing on both sides of the transaction. Moreover, the Court determined that Mr. Gulig recycled the value of the decedent's assets through the partnership or corporate solution since the decedent contributed more than 99 percent of the total combined property in SFLP and Stranco and received an interest with a value derived "almost exclusively" from the assets he contributed rather than from a true pooling of assets. None of the contributed assets were found to be of the sort qualifying as a "functioning business enterprise" as discussed in Estate of [pg. 117] Harrison v. Commissioner, T.C. Memo. 1987-8 [¶87,008 PH Memo TC]. Accordingly, in Strangi we held that the bona fide sale exception was not satisfied.

Shortly thereafter, the Court in Estate of Stone v. Commissioner, T.C. Memo. 2003- 309 [TC Memo 2003-309], held that the bona fide sale exception in section 2036(a) was satisfied. In Estate of Stone, the decedent spouses (the Stones) had operated a successful closely held business for a number of years and created five family limited partnerships. We rejected the Commissioner's argument that the formation of each of the family limited partnerships was not "motivated primarily by legitimate business concerns". A reason for employing the limited partnership concept was to resolve the Stones' children's concerns. There were significant intrafamily disputes with regard to the Stones' assets which led to litigation.

The Court found that the future management of the Stones' assets by the children qualified as a legitimate business concern since they were going to succeed their parents in operating the business. The children actively managed the assets that were contributed to the partnership in which they had their respective interests. These facts supported a finding that each partnership had economic substance and was not merely a circuitous recycling of value. Additionally, the Stones were both in good health for most of the time the negotiations concerning the formation of the partnerships were taking place, and they retained sufficient assets outside of the partnerships to meet their personal needs. We also concluded that the terms of the transactions reflected arm's-length dealing. The Stones determined which assets would be contributed to the partnerships, and Mr. Stone's attorney drafted the partnership agreements, but the children each had counsel representing their individual interests.

The adequate and full consideration prong was also deemed satisfied. All partners in each partnership received interests proportionate to the fair market value of the assets they each transferred, and partnership legal formalities were respected. We rejected the Commissioner's argument that valuation discounts attached to the partnership interest the decedent received precluded the adequate and full consideration prong from being satisfied. We reasoned that the Commissioner's argument effectively read "out of section 2036(a) the exception that Congress expressly prescribed [pg. 118] when it enacted that statute". We found that the partnerships had economic substance as a joint venture for profit in which there was a genuine pooling of property and services.

This Court had another opportunity to consider the application of section 2036(a) and the bona fide sale exception in Estate of Hillgren v. Commissioner, T.C. Memo. 2004-46 [TC Memo 2004-46]. The decedent's estate argued that the creation of the limited partnership was motivated by a business purpose and premarital protection of the decedent's assets. The Court rejected the estate's contention that the partnership served as a means of premarital asset protection. On that point, the Court determined that because title to the properties remained in the decedent's name until after her death, and she was financially dependent on the distributions from the partnership, the transaction was not a bona fide sale, but rather was a paper transaction. The estate was unable to establish a credible nontax reason for engaging in the transaction, nor was it able to explain how the decedent's relationship to the properties allegedly transferred to the partnership was altered.

In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. See, e.g., Estate of Stone v. Commissioner, supra; Estate of Harrison v. Commissioner, supra. The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. See Estate of Harper v. Commissioner, T.C. Memo. 2002-121 [TC Memo 2002-121]; Estate of Harrison v. Commissioner,

supra. A significant purpose must be an actual motivation, not a theoretical justification.

By contrast, the bona fide sale exception is not applicable where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose. See Estate of Hillgren v. Commissioner, supra; Estate of Thompson v. Commissioner, supra; Estate of Harper v. Commissioner, supra; see also Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000). A list of factors that support such a finding includes the taxpayer standing on both sides of the transaction, Estate of Hillgren v. Commissioner, supra; [pg. 119] the taxpayer's financial dependence on distributions from the partnership, Estate of Thompson v. Commissioner, supra; Estate of Harper v. Commissioner, supra; the partners' commingling of partnership funds with their own, Estate of Harper v. Commissioner, supra, and the taxpayer's actual failure to transfer the property to the partnership, Estate of Hillgren v. Commissioner, supra.

The Court of Appeals for the Fifth Circuit recently decided a case in this area, Kimbell v. United States, 371 F.3d 257, 258 [93 AFTR 2d 2004-2400] (5th Cir. 2004). In Kimbell, the decedent transferred assets including $2.5 million in cash, an active oil and gas business, and royalties to a trust. The trust contributed the property to a family limited partnership and received a 99-percent pro rata partnership interest in return. The other partner was a limited liability company (the LLC) owned by the decedent, her son, and his wife. The LLC contributed $25,500 in exchange for a 1-percent general partnership interest. The oil and gas working assets constituted 11 percent of the partnership's assets. The decedent retained over $450,000 in assets for her personal expenses.

The court separated the bona fide sale exception into two prongs: (1) Whether the transaction qualifies as a bona fide sale; and (2) whether the decedent received adequate and full consideration. The court first examined the adequate and full consideration language and set forth an objective inquiry. Id. at 262. The court stated that the proper question in examining the adequate and full consideration prong was whether the sale depleted the gross estate. Id. (citing Wheeler v. United States, 116 F.3d 749, 759 [80 AFTR 2d 97-5075] (5th Cir. 1997)); see Estate of Frothingham v. Commissioner, 60 T.C. 211, 215-216 (1973).

The Court of Appeals disagreed with the District Court's determination that a sale between members of the same family cannot be a bona fide one. Kimbell v. United States, supra at 267. A transaction between family members is, however, subjected to heightened scrutiny to ensure that it is not a sham or disguised gift. Applying its test to the facts, the Court of Appeals held in Kimbell that the pro rata partnership interest the decedent received was adequate and full consideration. The court also found that the decedent's transfer met the bona fide sale exception because the partnership was in actual possession of the assets transferred, partner-[pg. 120] ship formalities were satisfied, she retained sufficient assets outside of the partnership to meet her personal needs, some of the assets contributed were active business assets, and she had nontax business reasons for creating the partnership. Id. The nontax business reasons included, among others, the protection of the taxpayer from personal liability with regard to the oil and gas properties contributed, the pooling of all of the decedent's assets to provide greater financial growth than splitting the assets up, and the establishment of a centralized management structure. Additionally, the court rejected the Commissioner's argument that the LLC's interest was de minimis since it found no principle in partnership law that required partners to own "a minimum percentage interest in the partnership for the entity to be legitimate". Id. at 268.

Recently, the Court of Appeals for the Third Circuit affirmed Estate of Thompson v. Commissioner, supra, in Estate of Thompson v. Commissioner, 382 F.3d 367 [94 AFTR 2d 2004-5764] (3d Cir. 2004). Focusing on the adequate and full consideration language, the court stated an inter vivos transfer in exchange for assets of a lesser value should trigger heightened scrutiny into the substance of the transaction. Id. at 381. The Third Circuit found that neither partnership engaged in transactions rising to the level of legitimate business operations that provided the decedent with a substantive nontax benefit. Id. at 379. This determination was supported by the partnerships' allocating income produced by certain assets to the contributing partner, and the testamentary nature of one of the partnership's lending practices. Even though the estate presented evidence that one of the partnerships engaged in a real estate investment, the testamentary nature of the transfer and the subsequent operation of the partnership outweighed any legitimizing effect of that investment. In addition, the Court of Appeals

found that the decedent contributed marketable securities to the partnerships, but the partnerships failed to sell or diversify them. Other than favorable estate tax treatment resulting from this change in form, the court was unable to identify a legitimate and significant nontax reason for the transfer. See id. at 380. The court therefore held that there was no adequate consideration within the meaning of section 2036(a). [pg. 121]

The Court of Appeals also concluded that the decedent's transfers to the family limited partnerships did not constitute bona fide sales within the meaning of section 2036(a). The Third Circuit noted that it is important to scrutinize the substance of an intrafamily transaction because "the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used." Id. at 382 (quoting Commissioner v. Culbertson, 337 U.S. 733 [37 AFTR 1391] (1949)).

C. *Decedent's Transfer of Empak Stock to WCB Holdings*

Respondent contends that decedent's transfer of Empak stock to WCB Holdings was not a bona fide sale for adequate and full consideration in money or money's worth. The estate's position is that decedent's transfer of Empak stock to WCB Holdings was a bona fide sale for adequate and full consideration. As stated above, a finding to that effect would preclude the application of section 2036; thus, the Empak stock decedent transferred to WCB Holdings would not be included his gross estate under section 2036(a). Moreover, if section 2036(a) does not apply to decedent's transfer, section 2035(a) cannot apply to the gifts he made of WCB Holdings class A governance units to CH Trust, GC Trust, and QTIP Trust. Essentially, the question is whether decedent's gross estate includes, via the application of section 2036(a), the Empak stock decedent transferred to WCB Holdings.

In order to answer this question, we must separate the true nontax reasons for the entity's formation from those that merely clothe transfer tax savings motives. Legitimate nontax purposes are often inextricably interwoven with testamentary objectives. See, e.g., Bommer Revocable Trust v. Commissioner, T.C. Memo. 1997- 380 [1997 RIA TC Memo ¶97,380].

In 1995, decedent, while in good health, met with his advisers, Messrs. Boyle, Bernards, and Eitel, to discuss how Empak could remain successful and competitive. These discussions determined that Empak needed to develop additional means for acquiring capital to remain successful and competitive. Mr. Bernards testified that for Empak to grow, "additional capital other than through bank debt and [pg. 122] through [reinvesting its] earnings" was needed. It was believed that positioning Empak for either a public or private offering (a corporate liquidity event) would accomplish this goal. Decedent and his advisers discussed how to facilitate a corporate liquidity event for Empak. Mr. Boyle drafted a memo and a checklist detailing the specific steps of the plan to position Empak for a corporate liquidity event.

Many of the steps in the checklist were completed. First, Empak formed Emplast, and Empak distributed its stock to decedent. Second, incentive stock options were established. Third, decedent and ISA Trust transferred their stock in Empak to WCB Holdings, and in exchange each received interests in WCB Holdings proportionate to the number of Empak shares they had contributed. Fourth, Empak International merged into Empak. Decedent was in good health until his sudden death in 1998; never was his health a reason to accelerate the completion of these steps.

The positioning and structuring of Empak to facilitate a corporate liquidity event was also beneficial for decedent and ISA Trust. ISA Trust held a single asset, Empak stock. The value of the shares held by both decedent and ISA Trust was maximized by positioning Empak to attract potential investors. Moreover, the potential market for the Empak shares was increased. These facts together support that positioning Empak for a corporate liquidity event was a legitimate and significant nontax reason that motivated the Empak shareholders to create WCB Holdings.

1. *Bona Fide Sale*

Respondent argues that the creation of WCB Holdings did not occur as the result of an arm's-length transaction, and consequently, was not a bona fide sale. In Estate of Harper v. Commissioner, T.C. Memo. 2002-121 [TC Memo 2002-121], relying partially on Estate of Goetchius v. Commissioner, 17 T.C. 495, 503 (1951), we determined that the bona fide sale exception in section 2036(a) is applicable only where there was an arm's-length transaction.

Respondent appears to assert that an arm's-length transaction cannot occur between related parties. An arm's-length transaction has been defined as "A transaction between two unrelated and unaffiliated parties", or alternatively, a trans-[pg. 123] action "between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises." Black's Law Dictionary 1535 (8th ed. 2004). A previous edition of Black's Law Dictionary stated that an arm's-length transaction was the standard for testing whether the resulting terms and conditions of a transaction were the same as if unrelated parties had engaged in the same transaction. See Black's Law Dictionary 100 (5th ed. 1979) (stating that "in testing whether $10,000 is an `arm's length' price [for the sale of property] it must be ascertained for how much the corporation could have sold the property to a disinterested third party in a bargained transaction"); see also Dauth v. Commissioner, 42 B.T.A. 1181, 1189 (1940) (stating "The test to determine whether a transaction is a bona fide transaction [for Federal income tax purposes] is described by the term `arm's length', or, in other words, Was the transaction carried out in the way that the ordinary parties to a business transaction would deal with each other?"). The bona fide sale exception has not been limited to transactions involving unrelated parties as respondent's argument implies. See Estate of Stone v. Commissioner, T.C. Memo. 2003-309 [TC Memo 2003-309].

It is axiomatic that intrafamily transactions are subjected to a higher level of scrutiny, but this heightened scrutiny is not tantamount to an absolute bar. In that connection, we have already concluded that decedent and ISA Trust had mutual legitimate and significant nontax reasons for forming WCB Holdings. In addition, both decedent and ISA Trust received interests in WCB Holdings proportionate to the number of shares transferred. We believe that had this transaction occurred between two unrelated parties the majority interest holder in Empak would have received similar powers to those the decedent received via WCB Holdings's member control agreement. An important purpose for creating WCB Holdings was to position Empak for a corporate liquidity event, and the record does not contain any credible evidence that unrelated parties would not have agreed to the same terms and conditions. Given these facts, we cannot hold that the terms of the transaction differed from those of two unrelated parties negotiating at arm's length.

Respondent's final argument is that the formation of WCB Holdings was not a bona fide sale because there was not a [pg. 124] true pooling of assets. WCB Holdings's purpose was to pool the Bongard family's Empak stock within a single entity, which decedent and ISA Trust satisfied through their respective contributions. WCB Holdings's creation was part of a much grander plan, to attract potential investors or to stimulate a corporate liquidity event to facilitate Empak's growth. Moreover, when WCB Holdings was capitalized, the members' capital accounts were properly credited and maintained, WCB Holdings's funds were not commingled with decedent's, and all distributions during decedent's life were pro rata. The amalgamation of these facts evinces that this transaction resulted in a true pooling of assets.

2. *Full and Adequate Consideration*

The factual circumstances of this case further establish that decedent and ISA Trust each received an interest in WCB Holdings that represented adequate and full consideration reducible to money value. See Estate of Stone v. Commissioner, T.C. Memo. 2003-309 [TC Memo 2003-309]; Estate of Higgins v. Commissioner, T.C. Memo. 1991-47 [¶91,047 PH Memo TC]; see also secs. 20.2036-1(a), 20.2043-1 (a), Estate Tax Regs. Decedent and ISA Trust received interests in WCB Holdings proportionate to the number of Empak shares each contributed. Although by itself this may not be sufficient evidence to meet the adequate and full consideration requirement, two additional facts do support such a finding. We have determined that the respective assets contributed by the members were properly credited to the respective capital accounts of each contributing member, and distributions from WCB Holdings required a negative adjustment in the distributee member's capital account. Most importantly, we have

found the presence of a legitimate and significant nontax business reason for engaging in this transaction.

Respondent nonetheless argues that decedent did not receive adequate and full consideration since decedent contributed 86.31 percent of Empak's outstanding stock without receiving a control premium for his contribution. Decedent did not need to receive a control premium because he retained effective control over Empak after he contributed his Empak stock to WCB Holdings. True, decedent was not the chief manager of WCB Holdings, but the 86.31- percent [pg. 125] interest in the class A governance units he received in the exchange provided him with the power to remove the WCB Holdings chief manager and appoint himself as chief manager, to take any action the chief manager himself could take, and to approve any significant action the chief manager could take, including selling more than $10,000 worth of any security in any 12-month period and the voting of any security held by WCB Holdings. See also Estate of Thompson v. Commissioner, 382 F.3d at 381 (agreeing that the dissipated value resulting from a transfer to a closely held entity does not automatically constitute inadequate consideration for section 2036(a) purposes, but such dissipation triggers heightened scrutiny into the substance of the transaction and whether there was a true business purpose).

3. *Conclusion*

We hold that decedent's transfer of Empak stock to WCB Holdings satisfies the bona fide sale exception of section 2036(a). Therefore, we need not determine whether decedent retained a section 2036(a) or (b) interest in the transferred property. This holding further precludes the application of section 2035 (a) to decedent's gifts of WCB Holdings class A membership units to CH Trust, GC Trust, and QTIP Trust as they were outright gifts, not gifts of retained section 2036(a) interests. See Kisling v. Commissioner, 32 F.3d 1222, 1225 [74 AFTR 2d 94-7463] (8th Cir. 1994), revg. T.C. Memo. 1993- 262 [1993 RIA TC Memo ¶93,262]; Estate of Jalkut v. Commissioner, 96 T.C. 675, 679 (1991); Estate of Frank v. Commissioner, T.C. Memo. 1995-132 [1995 RIA TC Memo ¶95,132].

D. *BFLP*

The estate argues that section 2036(a) is not applicable to decedent's transfer of WCB Holdings class B membership units to BFLP since that transfer was also a bona fide sale for adequate and full consideration. The estate contends that the creation of BFLP was motivated by nontax reasons. The BFLP agreement provides that BFLP was established to "acquire, own and sell from time to time stocks (including closely held stocks), bonds, options, mutual funds and other securities." At trial, Mr. Fullmer testified that BFLP was established to provide another layer of credit protection for decedent. Additionally, the estate asserts that BFLP facilitated [pg. 126] decedent's and Cynthia Bongard's postmarital agreement. Messrs. Bernards and Fullmer both also testified that BFLP was established, in part, to make gifts. On December 10, 1997, decedent made a gift of a 7.72-percent ownership interest in BFLP to Cynthia Bongard. This gift was the sole transfer of a BFLP partnership interest by decedent during his life. BFLP also never diversified its assets during decedent's life, never had an investment plan, and never functioned as a business enterprise or otherwise engaged in any meaningful economic activity.

Bona Fide Sale Exception

In determining whether the bona fide sale exception in section 2036(a) applies to an intrafamily transaction, the substance of the transaction is subject to a higher level of scrutiny. See Estate of Thompson v. Commissioner, supra at 383. Both parties set forth facts supporting their respective positions regarding decedent's transfer of WCB Holdings class B membership units to BFLP.

In support of its contention that decedent's transfer to BFLP satisfied the bona fide sale exception, the estate asserts that ISA Trust was adequately and independently represented in negotiating the terms of the BFLP transaction. Mr. Boyle explained to Mark Bongard, the other trustee of ISA Trust, the terms and reasons for engaging in the partnership. In addition, after BFLP was formed, partnership formalities

were complied with.

Conversely, respondent asserts that BFLP was "simply a paper transaction designed to facilitate the distribution of family wealth both before and after death while leaving decedent's lifetime control of Empak unimpaired." [11] In support of his position, respondent asserts that decedent's and ISA Trust's contributions to BFLP were not a true pooling of assets because decedent's relationship to the contributed assets remained the same before and after the contribution. Following decedent's contribution to BFLP and until his death, BFLP never engaged in any investment transactions or decisions. BFLP had neither an investment plan nor a diversification strategy. [pg. 127]

Estate tax savings did play an important role in motivating the transfer to BFLP. The record does not support that the nontax reasons for BFLP's existence were significant motivating factors. The formation of WCB Holdings eliminated direct stock ownership in Empak and allowed decedent to make gifts without diversifying the direct ownership of Empak. Messrs. Fullmer and Bernards testified that an impetus for forming BFLP was to continue decedent's gift giving. Decedent, in fact, made numerous gifts after the formation of BFLP, but not of his BFLP interest. All of the gifts decedent made were of WCB Holdings class A membership units, except for the 7.72-percent limited partnership interest he gave to Cynthia Bongard in 1997. At the time of BFLP's formation and at the time of his death, any additional gifts decedent had contemplated were speculative and indefinite at best. There was no immediate or definite plan for such gifts. Such intent is not sufficient to establish that the transfer of membership units to BFLP was motivated by a significant nontax reason.

Decedent and Cynthia Bongard entered into a postmarital agreement on December 10, 1997. For a postmarital agreement to be valid under Minnesota Statutes section 519.11 (West 1990 & Supp. 2004), in effect at the time the agreement was entered into, each spouse needed to have titled in that spouse's name property with a total net value exceeding $1,200,000. Attached to the postmarital agreement was Cynthia Bongard's financial statement, which included the value of her interest in BFLP and QTIP Trust. QTIP Trust was funded by decedent's giving it WCB Holdings class A membership units on March 15, 1997. Decedent's gift of a small portion of his BFLP interest to his wife does not establish that his prior transfer of all of his class B membership units to BFLP had a significant nontax motive. Decedent's gift of the 7.72-percent BFLP interest to Cynthia Bongard does not establish a significant nontax reason for decedent to transfer all 4,621,166 WCB Holdings class B membership units he owned to BFLP. The motive for the transfer of all of decedent's class B membership units to BFLP was not to fund the postmarital agreement. Rather, decedent used part of his BFLP interest to fund the postmarital agreement simply because that was where the assets rested when the agreement was completed. The vast majority of decedent's BFLP [pg. 128] interest was never transferred in the almost 2 years before his death.

The estate's credit protection argument is also unpersuasive because WCB Holdings served this function for decedent. In fact, decedent via letter stated that "by holding a majority of my assets in the limited liability company or the limited partnership, I will be providing a greater amount of protection for those assets from both creditors and lawsuits." Decedent contributed his Empak stock to WCB Holdings in exchange for WCB Holdings membership units, which he then contributed to BFLP in exchange for his limited partnership interest. Decedent's initial transfer of his Empak shares to WCB Holdings accorded him the credit protection he sought. Any additional benefit provided by BFLP was not significant to the transfer to BFLP because decedent's class A membership units, with their voting power, remained in WCB Holdings with only the protection provided by that entity.

Moreover, we find unpersuasive the estate's argument that decedent wanted to create BFLP because of the greater flexibility it would provide him as compared to the trusts he had previously created. Decedent in fact established three trusts within days of BFLP's creation. These trusts were funded months after BFLP was created with very large gifts. Clearly, decedent was not adverse to establishing trusts, nor is there evidence that would establish how a limited partnership interest in BFLP provided decedent with greater flexibility than he already possessed by holding WCB Holdings membership units outright.

Additionally, BFLP did not perform a management function for the assets it received. BFLP never

engaged in any businesslike transactions, either before or after decedent contributed his WCB Holdings class B membership units to BFLP. Until decedent's death, BFLP's only ownership interest was in WCB Holdings, and 99 percent of that interest was contributed by decedent. Similarly, BFLP never attempted to invest or diversify its assets. As a practical matter, decedent did not receive any benefit beyond transfer tax savings from placing his WCB Holdings class B membership units in BFLP. In Estate of Harper v. Commissioner, T.C. Memo. 2002-121 [TC Memo 2002-121], we found that the decedent only recycled the value of the property he transferred to the partnership. A recycling of value has occurred if "all decedent did was to change the [pg. 129] form in which he held his beneficial interest in the contributed property." Id. The partnership in Estate of Harper, like the partnership here, did not establish a different investment plan with respect to its assets. In this case, decedent recycled the value of his WCB Holdings class B membership units by contributing them to BFLP.

Under these facts, decedent's transfer of WCB Holdings class B membership units to BFLP did not satisfy the bona fide sale exception.

III. *Whether Decedent Retained a Section 2036(a) Interest in BFLP*

Our determination that the bona fide sale exception does not apply to decedent's transfer to BFLP does not end the inquiry. As pertinent here, section 2036(a) includes in a decedent's gross estate "all property to the extent of any interest therein" of which the decedent has made a transfer wherein he "has retained for his life" either "(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." Section 7701(a)(1) defines "person" to include "an individual, a trust, estate, partnership, association, company or corporation."

A. *Section 2036(a)*

"An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." Sec. 20.2036- 1(a), Estate Tax Regs. "The existence of formal legal structures which prevent de jure retention of benefits of the transferred property does not preclude an implicit retention of such benefits." Estate of Thompson v. Commissioner, 382 F.3d at 375; Estate of McNichol v. Commissioner, 265 F.2d 667, 671 [3 AFTR 2d 1838] (3d Cir. 1959). The existence of an implied agreement is a question of fact that can be inferred from the circumstances surrounding a transfer of property and the subsequent use of the transferred property. See Estate of Thompson v. Commissioner, supra at 376; Estate of Reichardt v. Commissioner, 114 T.C. 144, 151 (2000). [pg. 130]

The decedent did not need the membership interest in WCB Holdings class B shares to continue his lifestyle. However, decedent retained ownership of more than 91 percent of his BFLP interest and did not make gifts of such interest prior to his death. More importantly, decedent controlled whether BFLP could transform its sole asset, the class B WCB Holdings membership units, into a liquid asset. Decedent as CEO and sole member of Empak's board of directors determined when Empak redeemed its stock in each of the seven instances of redemptions prior to his death, including the last redemption of about $750,000 worth of Empak stock in 1998 after WCB Holdings was formed. None of the seven redemptions reduced the membership units owned by BFLP. In order for BFLP to be able to diversify or take any steps other than simply holding the class B membership units, decedent would have had to cause the membership units and the underlying Empak stock to be redeemed. He chose not to do this. By not redeeming the WCB membership units held by BFLP, decedent ensured that BFLP would not engage in asset management. Thereby, decedent exercised practical control over BFLP and limited its function to simply holding title to the class B membership units. Whether decedent caused the WCB membership units held by BFLP and the underlying Empak stock to be redeemed or not, his ability to decide whether that event would occur demonstrates the understanding of the parties involved that decedent retained the right to control the units transferred to BFLP.

The estate's argument that the general partner's fiduciary duties prevents a finding of an implied agreement is overcome by the lack of activity following BFLP's formation and BFLP's failure to perform any meaningful functions as an entity. [12] We conclude that decedent's transfer to BFLP for a 99-percent ownership interest in the partnership did not alter his con-[pg. 131] trol of the WCB Holdings class B membership units transferred to BFLP. See Estate of Thompson v. Commissioner, 382 F.3d at 376-377 (finding "nothing beyond formal title changed in decedent's relationship to his assets" where the practical effect on his relationship to the transferred assets during decedent's life was minimal).

B. *Conclusion*

Under the circumstances of this case, an implied agreement existed that allowed decedent to retain the enjoyment of the property held by BFLP. Therefore, under section 2036(a)(1), decedent's gross estate includes the value of the WCB Holdings class B membership units held by BFLP on decedent's death that is proportionate to decedent's 91.28-percent limited partnership interest. Given this finding, it is unnecessary to determine whether the terms of the BFLP agreement provided decedent explicit rights to control the property.

IV. *Section 2035(a) and Decedent's Gift to Cynthia Bongard*

As pertinent here, section 2035(a) provides that a decedent's gross estate includes the value of any property or interest therein if "(1) the decedent made a transfer *** [of an interest in such property] during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 *** if such transferred interest *** had been retained by the decedent on the date of his death". In this case, decedent transferred a 7.72-percent partnership interest in BFLP to Cynthia Bongard within 3 years of his death. The issue is whether the value of the partnership interest decedent gave to Cynthia Bongard would have been included in his gross estate had he retained it until his death.

As stated previously, decedent retained a section 2036(a)(1) interest in the WCB Holdings class B membership units he transferred to BFLP because we found the existence of an implied agreement between decedent and ISA Trust. Decedent's gift of a limited partnership interest to Cynthia Bongard decreased his ownership interest in BFLP. Because the partnership interest decedent gave to Cynthia Bongard [pg. 132] consisted of a portion of the property that triggered the application of section 2036 (a)(1) we find that section 2035(a) is applicable to decedent's transfer of the 7.72-percent limited partnership interest in BFLP. Thus, decedent's gross estate includes the value of the WCB Holdings class B membership units held by BFLP on decedent's death that is proportionate to the 7.72-percent limited partnership interest.

V. *Discounts Applicable to Decedent's Membership Units in WCB Holdings*

The relevant part of section 2031 provides that any property included in a decedent's gross estate is included at its fair market value. See also sec. 20.2031-1(b), Estate Tax Regs. The parties stipulated that on the alternate valuation date, May 16, 1999, Empak's stock per share value was $32.24. This was used as the starting point by the parties to determine the value of the decedent's interests in WCB Holdings and BFLP and was then decreased by stipulated discounts depending upon this Court's determinations regarding the application of section 2036.

We apply the discounts provided by the parties in their stipulation of settled issues with respect to the WCB Holdings membership units. If section 2036 was not applied to the transfers to WCB Holdings, the parties stipulated to a 13-percent lack of control discount and a 17.5-percent lack of marketability discount. We are left to apply the stipulation to the value of decedent's 287,620 WCB Holdings class A membership units and 4,621,166 WCB Holdings class B membership units.

The stipulation provides that the value of decedent's WCB Holdings class A membership units is equal to $32.24 less the stipulated discounts for lack of control and lack of marketability, multiplied by 287,620 (the total number of class A governance and financial membership units decedent owned on the alternate valuation date). As such, the value of decedent's WCB Holdings class A membership units was $6,655,527, as calculated below.

[{$32.24 - ($32.24 × .13)} - {($32.24 - ($32.24 × .13)) × .175}]= $23.14 × 287,620 = $6,655,527

We read the stipulation to further provide the WCB Holdings class B membership units an additional 5-percent lack-[pg. 133] of-voting-rights discount. Given the stipulation and our holdings herein, we find that the value of decedent's WCB Holdings class B membership units on the alternate valuation date was $101,573,229, [13] as calculated below.

[$23.14 - ($23.14 × .05)]= $21.98 × 4,621,166 = $101,573,229

To reflect the foregoing and give effect to the parties' stipulations,

Decision will be entered under Rule 155.

Reviewed by the Court.

GERBER, SWIFT, COLVIN, VASQUEZ, THORNTON, HAINES, WHERRY, KROUPA, AND HOLMES, *JJ.*, agree with this majority opinion.

GALE, *J.*, concurs in result only.

LARO, *J.*, concurring in result: I concur only because I am uncomfortable with the analysis used by the majority in arriving at its result. That analysis applies a new test that the majority has created to decide whether a transfer to a family limited partnership should be respected for Federal tax purposes. The majority applies its test in lieu of deeply ingrained caselaw that conditions satisfaction of the "bona fide sale for an adequate and full consideration in money or money's worth" exception of section 2036 (a) (adequate and full consideration exception) on the transferor's receipt of property equal in value to that of the property transferred by the transferor. In other words, under that caselaw, the adequate and full consideration exception may apply only where the transferor's receipt of consideration is of a sufficient value to prevent the transfer from depleting the transferor's gross estate.

The majority states its test as follows: "In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where [1] the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, [pg. 134] and [2] the transferors received partnership interests proportionate to the value of the property transferred." Majority op. p. 39. I disagree with both prongs of this test. I believe that a transferor satisfies the adequate and full consideration exception in the context of a transfer to a partnership only when: (1) The record establishes either that (i) in return for the transfer, the transferor received a partnership interest and any other consideration with an aggregate fair market value equal to the fair market value of the transferor's transferred property, or (ii) the transfer was an ordinary commercial transaction (in which case, the transferred property and the consideration received in return are considered to have the same fair market values), and (2) the transfer was made with a business purpose or, in other words, a "useful nontax purpose that is plausible in light of the taxpayer's [transferor's] conduct and useful in light of the taxpayer's economic situation and intentions." ACM Pship. v. Commissioner, T.C. Memo. 1997-115 [1997 RIA TC Memo ¶97,115], affd. in part and revd. in part on an issue not relevant herein 157 F.3d 231 [82 AFTR 2d 98-6682] (3d Cir. 1998); see also CMA Consol., Inc. v. Commissioner, T.C. Memo. 2005-16 [TC Memo 2005-16]; Salina Pship., L.P. v. Commissioner, T.C. Memo. 2000-352 [TC Memo 2000-352].

1. *Majority's Conclusion That Transferors Receive Partnership*

Interests Proportionate to the Value of the Property Transferred

Where the record establishes the existence of a legitimate and significant nontax reason for creating a family limited partnership, the majority concludes that the adequate and full consideration exception is met if the transferors received partnership interests proportionate to the value of the property transferred. I disagree with this conclusion. Section 2036(a) provides:

> SEC. 2036(a). General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (*except in case of a bona fide sale for an adequate and full consideration in money or money's worth*), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> > (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> [pg. 135]
>
> > (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. [Emphasis added.]

Firmly established caselaw holds that the emphasized text, the adequate and full consideration exception, is satisfied only when a transferor receives consideration in money or money's worth equal to the value of the property transferred by the transferor; i.e., consideration with a value sufficient to prevent the transfer from depleting the transferor's gross estate. E.g., Estate of Wheeler v. United States, 116 F.3d 749, 761 [80 AFTR 2d 97-5075] (5th Cir. 1997) ("unless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no `adequate and full consideration' for the purposes of either the estate or gift tax"); Estate of D'Ambrosio v. Commissioner, 101 F.3d 309, 312 [78 AFTR 2d 96-7347] (3d Cir. 1996) ("consideration should be measured against the value that would have been drawn into the gross estate absent the transfer"), revg. 105 T.C. 252 (1995); United States v. Past, 347 F.2d 7, 12 [15 AFTR 2d 1422] (9th Cir. 1965) ("The value of what the decedent received under the trust must be measured against the value of the property she transferred to the trust"); United States v. Allen, 293 F.2d 916, 917-918 [8 AFTR 2d 6055] (10th Cir. 1961) (consideration is "adequate and full" only if it equals or exceeds the value of the property that would otherwise be included in the gross estate absent the transfer); Estate of Frothingham v. Commissioner, 60 T.C. 211, 215-216 (1973) ("unless replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate, the property transferred in a testamentary transaction of the type described in the statute must be included in his gross estate"); see also Commissioner v. Wemyss, 324 U.S. 303, 307 [33 AFTR 584] (1945); Estate of Gregory v. Commissioner, 39 T.C. 1012 (1963). The adequacy of consideration for purposes of the adequate and full consideration exception is measured by the value of the property that would have otherwise been included in the transferor's gross estate had the transferor died immediately before the transfer. Estate of D'Ambrosio v. Commissioner, supra at 313. Because transfers of assets under facts similar to those here are typically motivated primarily (if not entirely) by testamentary concerns, section 2036(a) preserves the integrity of [pg. 136] the Federal estate tax system by preventing a depletion of an estate by testamentary- like inter vivos transfers for less than an adequate and full consideration. See United States v. Estate of Grace, 395 U.S. 316 [23 AFTR 2d 69-1954] (1969).

Whether the value of consideration received in the form of an interest in a partnership is "adequate and full" within the meaning of section 2036(a) is a valuation issue. For this purpose, I believe that the Court must determine the fair market value of the partnership interest as of the date of the transfer, applying the well-established valuation principles that take into account discounts and/or premiums inhering in that fair market value. [1] The value of the transferred property that would have been

included in the transferor's gross estate absent the transfer would have been determined under such a valuation approach. I believe it only natural to conclude that the same approach should apply to determine the value of the consideration that would have replaced the transferred property in the transferor's gross estate had the transferor died immediately after the transfer.

Moreover, the phrase "adequate and full consideration" has the same meaning in both gift and estate tax cases, Merrill v. Fahs, 324 U.S. 308, 309-311 [33 AFTR 587] (1945); Estate of Friedman v. Commissioner, 40 T.C. 714, 718-719 (1963), and this Court has previously applied such a valuation approach in a gift tax case, Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121 [1995 RIA TC Memo ¶95,121], arising under section 2512(b) from a transfer of property to a corporation upon its formation. [2] In Estate of Trenchard, the decedents (husband and wife), their daughter, and her three children (the six of whom are collectively referred to as the subscribers) each transferred property to a newly formed corporation in exchange for debt and stock; the [pg. 137] decedents' daughter and her three children were the only ones who received common stock. The Court determined that the fair market value of the property that each decedent transferred to the corporation exceeded the fair market value of the stock and debt that they each received in return. The Court determined the fair market value of that stock noting that a marketability discount inhered in it and that a premium for control also inhered in the fair market value of the decedent/husband's shares. Consistent with the test applied in this case by the majority, the executrix argued that the excess values were not gifts from each of the decedents to the common shareholders because the decedents' proportionate interests in all of the property transferred to the corporation did not exceed their interests in the total consideration that the subscribers had received in return. The Court disagreed. The Court held that the excess values were a gift from the decedents to the common shareholders in that the excess values accrued to the benefit of the common shareholders and increased the value of the interests received by them.

With but a passing reference to language in Estate of Stone v. Commissioner, T.C. Memo. 2003-309 [TC Memo 2003-309], the majority declines to address whether valuation discounts are taken into account for purposes of valuing the consideration received by the decedent from the Bongard Family Limited Partnership (BFLP). See majority op. pp. 37-38. Nor does the majority mention that this referenced language was recently rejected by a majority of a panel of the Court of Appeals for the Third Circuit in Estate of Thompson v. Commissioner, 382 F.3d 367, 386-387 [94 AFTR 2d 2004-5764] (3d Cir. 2004) (Greenberg, J., concurring and joined by Rosenn, J.), [3] affg. T.C. Memo. 2002-246 [TC Memo 2002-246]. This majority in [pg. 138] Thompson (Thompson majority) "reject[ed] Stone on the quoted point [the referenced language] as the Commissioner's position [that the valuation of partnership interests for purposes of section 2036(a) must take into account valuation discounts] in no way reads the [adequate and full consideration] exception out of section 2036(a) and the Tax Court does not explain why it does." Id. The Thompson majority went on to explain that the Commissioner merely "seeks to apply the exception precisely as written as his position should not be applied in ordinary commercial circumstances even though the decedent may be said to have enjoyed the property until his death." Id. at 387. The majority in this case does not address the Thompson majority's conclusion that valuation discounts may be taken into account for purposes of the adequate and full consideration exception. Nor does the majority in this case attempt to answer the Thompson majority's query as to why applying valuation discounts for such a purpose reads the adequate and full consideration exception out of section 2036(a).

I recognize that the Court of Appeals for the Fifth Circuit in Kimbell v. United States, 371 F.3d 257, 266 [93 AFTR 2d 2004-2400] (5th Cir. 2004), stated that valuation principles should not be equated with the test of "adequate and full consideration" because business or other financial considerations may enter into a transferor's decision to receive an interest in a limited partnership that may not be immediately sold for 100 cents on the dollar. While I do not disagree that these considerations may cause a transferor to accept such an interest in a partnership, the issue as I see it is whether the inability to realize the 100 cents is attributable to (1) an actual difference in value between the transferred and received properties or (2) the presence of one or more intangible assets the sales price of which is subject to dispute. Under the caselaw referenced above, the adequate and full consideration exception does not apply where a difference in value between transferred and received properties causes a depletion in the transferor's gross estate. Nor does Kimbell v. United States, [pg. 139] supra , hold otherwise. As the Thompson majority observed as to Kimbell:

> Kimbell does not take into account that to avoid the recapture provision of section 2036(a) the property transferred must be replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate *** on a money or money's worth basis. [Estate of Thompson v. Commissioner, supra at 387 n.24 (Greenberg, J., concurring and joined by Rosenn, J.); citations and quotation marks omitted.]

2. *Majority's Conclusion That the Record Establishes the Existence of a Legitimate and Significant Nontax Reason for Creating a Family Limited Partnership*

Where the transferors received family limited partnership interests proportionate to the value of property transferred to the partnership, the majority concludes that the adequate and full consideration exception is satisfied if there was a legitimate and significant nontax reason for creating the partnership. I disagree with this conclusion for three reasons.

First, I disagree with the use of the majority's "legitimate and significant nontax reason" test. See majority op. p. 39. I would apply the longstanding and well- known business purpose test of Gregory v. Helvering, 293 U.S. 465 [14 AFTR 1191] (1935). Indeed, the Court of Appeals for the Third Circuit used that business purpose test in Estate of Thompson v. Commissioner, supra at 383, when it stated:

> A "good faith" transfer to a family limited partnership must provide the transferor some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form. Even when all the "i's are dotted and t's are crossed," a transaction motivated solely by tax planning and with "no business or corporate purpose ... is nothing more than a contrivance." Gregory v. Helvering, 293 U.S. 465, 469 [14 AFTR 1191] (1935). ***

The Court of Appeals for the Eighth Circuit, the court to which an appeal of this case would most likely lie, also has regularly used a business purpose/economic substance test in Federal tax matters, e.g., IES Indus., Inc. v. United States, 253 F.3d 350 [87 AFTR 2d 2001-2492] (8th Cir. 2001); Bergman v. United States, 174 F.3d 928 [83 AFTR 2d 99-1882] (8th Cir. 1999), including matters dealing with estate and gift taxes, e.g., Estate of Schuler v. Commissioner, 282 F.3d 575 [89 AFTR 2d 2002-1300] (8th Cir. 2002), affg. T.C. Memo. 2000-392 [TC Memo 2000-392]; Sather v. Commissioner, 251 F.3d 1168 [87 AFTR 2d 2001-2423] (8th Cir. 2001), affg. [pg. 140] in part and revg. in part on the applicability of accuracy-related penalties T.C. Memo. 1999-309 [1999 RIA TC Memo ¶99,309].

Second, the words "legitimate" and "significant" are ambiguous and subject to various interpretations. For example, as I read the meaning of the adjective "legitimate" in Merriam-Webster's Collegiate Dictionary 665 (10th ed. 1999), I am unsure which of those meanings the majority intends to give to that word. The only possible meanings are: "2: being exactly as purposed: neither spurious nor false"; "3 a: accordant with law or with established legal forms and requirements"; and "4: conforming to recognized principles or accepted rules and standards". An uncertainty in the meaning of the words "legitimate" and "significant" may result in applications not intended by the majority.

Third, the majority requires only that the creation of the partnership be supported by a legitimate and significant nontax reason. Under the majority's analysis, therefore, the adequate and full consideration exception would seem to be satisfied as to all property transferred to a partnership as long as the record establishes the requisite legitimate and significant nontax reason and that the transferors received partnership interests proportionate to the value of the transferred property. Where, as here, the legitimacy of a partnership is not at issue, [4] I do not believe that the Court's analysis should rest solely on the transferor's reason for forming the partnership; the Court's analysis should also include an inquiry as to the business purpose for the transfers to the partnership. In fact, as I read the relevant text underlying the adequate and full consideration exception, that text speaks only to a "sale" of property and makes no specific statement as to the purchaser of that property.

MARVEL, *J.*, agrees with this concurring in result opinion. [pg. 141]

HALPERN, *J.*, concurring in part and dissenting in part. [1]

I. *Introduction*

I write separately to express my disagreement with the majority's interpretation of the bona fide sale exception found in section 2036(a). [2]

The majority states:

> In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes [1] the existence of a legitimate and significant nontax reason for creating the family limited partnership, and [2] the transferors received partnership interests proportionate to the value of the property transferred. [Majority op. p. 39]

I believe that the majority has strayed from the traditional interpretation of the bona fide sale exception by incorporating into the exception an inappropriate motive test ("a legitimate and significant nontax reason"), and by concluding that a partnership interest "proportionate" to the value of the property transferred constitutes adequate and full consideration in money or money's worth.

II. *Bona Fide Sale Exception*

A. *Introduction*

Section 2036 is entitled "Transfers with retained life estate", and subsection (a) thereof provides the following general rule:

> SEC. 2036(a). General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (*except in case of a bona fide sale for an adequate and full consideration in money or money's worth*), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> > (1) the possession or enjoyment of, or the right to the income from, the property, or

[pg. 142]

> > (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. [Emphasis added.]

Thus, even if a transferor of property retains lifetime possession, enjoyment, income, or control of the property, the value of the property will not show up in her gross estate if the transfer was a bona fide sale within the meaning of the underscored language (the bona fide sale exception).

With respect to at least that portion of the bona fide sale exception that requires " adequate and full consideration in money or money's worth" (for short, sometimes, full consideration), the identical language appears in section 2512(b), which provides that a gift occurs when property is transferred for insufficient consideration. [3] That language has the same meaning in the respective contexts of the gift

tax and the estate tax. Estate of Friedman v. Commissioner, 40 T.C. 714, 718-719 (1963) ("[I]f the transfer under scrutiny is considered as made for an adequate and full consideration for gift tax purposes, it likewise is to be considered for estate tax purposes."); see also Merrill v. Fahs, 324 U.S. 308, 311 [33 AFTR 587] (1945) (the gift and estate taxes are in pari materia and must be construed together). The gift-on-account-of-insufficient-consideration rule of section 2512(b) is construed in section 25.2512-8, Gift Tax Regs., which, in pertinent part, provides:

> SEC. 25.2512-8 Transfers for insufficient consideration.
>
> Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. ***

[pg. 143]

Under that regulation, transfers of property reached by the gift tax include transfers where (and to the extent) the value of the property transferred by the donor exceeds the value in money or money's worth (cash value) of the consideration given in exchange therefor. [4] A presumption of full consideration arises, however, in the case of a transfer of property made in the ordinary course of business; i.e., a transfer that is "bona fide, at arm's length, and free from any donative intent". Id. One consequence of satisfying the ordinary-course- of-business test is that the inquiry as to full consideration is avoided (and the actual fair market value of the consideration given for the transferred property is irrelevant).

B. *Approach of the Majority*

On pages 19-20 of its report, the majority makes the following finding:

> On December 28, 1996, decedent signed a letter that was written by Mr. Fullmer and addressed to decedent's children. The letter expressed some reasons for forming WCB Holdings and BFLP. The letter explained that the entities provided, among other things, a method for giving assets to decedent's family members without deterring them from working hard and becoming educated, protection of his estate from frivolous lawsuits and creditors, greater flexibility than trusts, a means to limit expenses if any lawsuits should arise, tutelage with respect to managing the family's assets, and tax benefits with respect to transfer taxes.

Mr. Fullmer was decedent's estate planning attorney, see majority op. p. 12, and among the reasons set forth by decedent for forming WCB Holdings, LLC (WCB Holdings) and the Bongard Family Limited Partnership (BFLP) are family gifts and the achievement of transfer tax benefits (read, "savings"). The transfer tax savings result from the loss in value (giving rise to a valuation discount) that petitioner claims accompanied decedent's sequential packaging of (1) his Empak, Inc. (Empak), stock in WCB Holdings and (2) his WCH Holdings Class B units in BFLP. The lost value, of course, was [pg. 144] not beyond reclamation: It would be restored if BFLP and WCB Holdings were unpacked, which seems likely once decedent's interests in the two entities passed through decedent's estate and the Empak shares became more liquid. The transfer tax savings that decedent admitted were his objective thus serve only to increase by the amount of those savings (less, of course, transaction costs, such as lawyer's fees) the size of decedent's estate passing into the hands of his heirs. The achievement of transfer tax savings evidences donative intent because such savings translate almost dollar for dollar into the enhancement of the net value that decedent could gratuitously transfer to family members. Consequently, the transfers to WCB Holdings and BFLP (together, the transfers) were not free of

donative intent. That being the case, the transfers were not, in the terms of section 25.2512-8, Gift Tax Regs., made in the ordinary course of business, and there is no presumption that either the WCB Holdings membership units received by decedent for his Empak shares or the 99-percent limited partnership interest in BFLP received by decedent for his WCB class B membership units constituted full consideration for those transfers. Id.

Therefore, to establish that the transfers were for full consideration, petitioner must, for each transfer, establish that the value of the property transferred by decedent did not exceed the cash value of the property received by him. Id. By the explicit terms of section 25.2512-8, Gift Tax Regs., the resulting inquiry is limited to an economic calculus, and there is no room for any inquiry as to the transferor's (decedent's) state of mind. Yet the majority makes his state of mind critical:

> Decedent *** received [an interest] in WCB Holdings proportionate to the number of Empak shares *** [he] contributed. Although by itself this may not be sufficient evidence to meet the adequate and full consideration requirement, two additional facts do support such a finding. We have determined that the respective assets contributed by the members were properly credited to the respective capital accounts of each contributing member, and distributions from WCB Holdings required a negative adjustment in the distributee member's capital account. *Most importantly, we have found the presence of a legitimate and significant nontax business reason for engaging in this transaction*. [Majority op. pp. 48-49; emphasis added.]

Certainly, decedent's state of mind (i.e., his intent) is important in determining whether the ordinary-course-of-business [pg. 145] exception applies (was the transfer "free of any donative intent"), but once it is determined that the transfer in question was not made in the ordinary course of business, intent is no longer relevant to the determination of whether the transfer was for full consideration.

I also disagree with the implication of the majority opinion that, in the context of a transfer to an entity (here, transfers to both a limited liability company and a family limited partnership), the full consideration requirement can be met by a showing that the transferor received an entity interest (e.g., a limited partnership interest) proportionate to the value of the property contributed to the entity. While an inquiry as to proportionality may have some bearing on whether the transfer was in the ordinary course of business, within the meaning of section 25.2512-8, Gift Tax Regs. (e.g., was at arm's length [5]), I fail to see how proportionality aids the inquiry as to whether the value of the property transferred exceeded the cash value of the consideration received in exchange. See id. Here, because of the presence of donative intent, the transfers cannot be considered in the ordinary course of business, as that term is used in section 25.2512-8, Gift Tax Regs., and proportionality is irrelevant.

Finally, as I read the majority's approach to the bona fide sale exception, the majority has added to the exception the requirement that the taxpayer show that the decedent's transfer to the entity was motivated "by a legitimate and significant nontax purpose." Majority op. p. 39. [6] If, indeed, that is the majority's approach, then even if an objective analysis indicates that the transferor received full consideration, the bona fide sale exception presumably would not be satisfied if a subjective analysis reveals that the transaction did not have a legitimate and significant nontax purpose. According to the majority, indicators of the lack of such purpose include (1) that the transferor stood on both sides of the transaction, (2) commingling of the transferor's and the transferee's funds, and (3) the failure of the transferor actu-[pg. 146] ally to make a transfer. Majority op. p. 39. Certainly, the "bona fide sale" portion of the bona fide sale exception would exclude transfers that were shams or based on illusory consideration. See, e.g., Wheeler v. United States, 116 F.3d 749, 764 [80 AFTR 2d 97-5075] (5th Cir. 1997). Beyond that, however, so long as an objective analysis demonstrates that, in exchange for the transferred property, the transferor received consideration with at least an equal cash value, no depletion of the transferor's wealth has occurred, and it is difficult to see any policy reason to bring back into the gross estate the value of the property transferred. As we reasoned in Estate of Frothingham v. Commissioner, 60 T.C. 211, 215-216 (1973) (emphasis added):

> [W]here the transferred property is replaced by other property of equal value received in

> exchange, there is no reason to impose an estate tax in respect of the transferred property, for it is reasonable to assume that the property acquired in exchange will find its way into the decedent's gross estate at his death unless consumed or otherwise disposed of in a nontestamentary transaction in much the same manner as would the transferred property itself had the transfer not taken place. ***
>
> In short, *unless* replaced by property of equal value that could be *exposed to inclusion* in the decedent's gross estate, the property transferred in a testamentary transaction of the type described in the statute must be included in his gross estate. ***

See also Kimbell v. United States, 371 F.3d 257, 262 [93 AFTR 2d 2004-2400] (5th Cir. 2004) (citing Wheeler v. United States, supra); Magnin v. Commissioner, 184 F.3d 1074, 1079 [84 AFTR 2d 99-5227] (9th Cir. 1999), revg. T.C. Memo. 1996-25 [1996 RIA TC Memo ¶96,025]; Estate of D'Ambrosio v. Commissioner, 101 F.3d 309, 312 [78 AFTR 2d 96-7347] (3d Cir. 1996), revg. and remanding 105 T.C. 252 (1995). [7][pg. 147]

C. *Conclusion*

I would approach the question of whether the value of property transferred by a decedent is included in the gross estate on account of section 2036 by, first, determining whether the decedent retained lifetime possession, enjoyment, income, or control of transferred property. Only after answering that question in the affirmative would I proceed to determine whether the bona fide sale exception applies to the transfer. In determining whether the bona fide sale exception applies, I would first determine whether the transfer was made in the ordinary course of business, as that term is used in section 25.2512-8, Gift Tax Regs. If not, I would determine whether the transfer was made for full value (i.e., whether the value of the transferred property at most equaled the cash value of the consideration received therefor). If not, then I would find that the value of the transferred property was included in the value of the gross estate pursuant to section 2036. Motive would only play the limited role I have outlined above (i.e., determining donative intent for purposes of the ordinary-course-of-business test).

III. *Gift on Formation*

The foregoing analysis suggests that, in forming a family-owned entity (e.g., a family limited partnership), one or more of the transfers to the entity might be deemed gifts, within the meaning of section 2512, because the transfers were for insufficient consideration, within the meaning of section 25.2512-8, Gift Tax Regs. I believe that a transfer to a family-owned entity may constitute a taxable gift, even if the size of the entity interest received by each transferor is deemed proportional to the value of the property contributed by that transferor. [8][pg. 148]

Consider the following hypothetical situation: [9]

> Father, son, and daughter (F, S, and D) join in the formation of a family limited partnership (FLP), father making the bulk of the total contribution and receiving a limited partnership interest, S and D making smaller contributions and receiving general and limited interests. Each transferor receives a percentage interest in profits, losses, and capital that is strictly proportionate to the value that each contributes (in relation to the total value contributed). Based on claims of lack of marketability, loss of control, and other value diminishing factors, each interest is accorded some loss of value (in comparison to the value of the property exchanged therefore). F's will and other testamentary-type documents are executed contemporaneously with the partnership agreement. They disclose that F's interest in FLP ultimately will pass to S, D, and their children.

Does any of the transferors make a gift on account of his or her contribution to the partnership for an interest of lesser value? Most likely, S and D do not. The reason is that, in pertinent part, section 25.2512-8, Gift Tax Regs., provides: "[A] sale, exchange, or other transfer of property made in the

ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." From S's and D's viewpoints, the transfers to FLP are made in the ordinary course of business, at least as that term is used in section 25.2512-8, Gift Tax Regs. See Rosenthal v. Commissioner, 205 F.2d 505, 509 [44 AFTR 90] (2d Cir. 1953) ("even a family transaction may for gift tax purposes be treated as one `in the ordinary course of business' as defined in *** [the predecessor to sec. 25.2512-8, Estate Tax Regs.] if each of the parenthetical criteria is fully met"), revg. and remanding 17 T.C. 1047 (1951). For S and D, the transfers are motivated strictly by self-interest and are free from donative intent. They have agreed to form a partnership that they believe will serve as a vehicle for the delivery of F's property to them and their children through a process whereby the transfer tax cost of the delivery will be substantially reduced through various valuation discounts. They agree to suffer a temporary loss of independ-[pg. 149] ence and control (and perhaps some loss of fair market value) in order to facilitate the reduction of transfer tax, the burden of which ultimately would fall on them. For them, the transfers are motivated by an acquisitive motive, not a donative motive. They make no gifts because they are deemed to have received full value under the ordinary-course-of-business test found in section 25.2512-8, Gift Tax Regs.

So long as it can be shown that F's contribution was not free of donative intent, the result is different for F. F's purpose (not necessarily his sole purpose, but an important one) is to pass his property to his family with a reduction in transfer tax cost that translates dollar for dollar into an enhancement of the net value that the family will receive. F cannot, therefore, pass the ordinary-course-of-business test in section 25.2512-8, Gift Tax Regs., and, because of the valuation discounts claimed, cannot show full consideration. F, therefore, has made gifts within the meaning of section 2512 and section 25.2512-8, Gift Tax Regs. The measure of the gifts is not the transfer tax reduction but is the inadequacy of the cash value of the limited partnership interest that F received in consideration for his contribution to FLP. See sec. 25.2512-8, Gift Tax Regs. It is precisely that debasement in value that F sought to achieve as his means of generating the transfer tax saving, and it is appropriate that that be the measure of his gift.

The fact that S, D, and their children may not realize the measure of F's gift (the difference between the inside and outside value of F's interest in FLP) until, by bequests, they receive his interest is not an impediment to concluding that F made a gift. Section 25.2511-2(a), Gift Tax Regs., provides:

> Sec. 25.2511-2 Cessation of donor's dominion and control.
>
> (a) The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

In Commissioner v. Wemyss, 324 U.S. 303, 307 [33 AFTR 584] (1945), the Supreme Court said: "The section taxing as gifts transfers that are not made for `adequate and full (money) consider-[pg. 150] ation' aims to reach those transfers which are withdrawn from the donor's estate." The value discounts obtained by F on the transfer to FLP withdrew from his estate amounts that will (and are intended to) reappear in the hands of his heirs. Taxation of those amounts under section 2512 is appropriate.

CHIECHI, *J.*, concurring in part [1] and dissenting in part: The majority opinion acknowledges that section 2036(a)(1) will not apply unless: (1) Decedent made a transfer; (2) such transfer was not a bona fide sale for an adequate and full consideration in money or money's worth; and (3) under such transfer decedent retained for his life the possession or enjoyment of, or the right to the income from, the property transferred. The majority opinion holds that decedent's transfer to the Bongard Family Limited Partnership (BFLP) of his WCB Holdings class B membership units was a transfer which was not a bona fide sale for an adequate and full consideration in money or money's worth and under which

decedent retained for his life the enjoyment of such units. [2] Consequently, according to the majority opinion, section 2036(a)(1) requires decedent's gross estate to include the value of such units owned on the date of decedent's death by BFLP that is proportionate to the 91.28-percent BFLP limited partnership interest owned on that date by decedent. [3] I dissent. [4] The majority opinion's holding that decedent's transfer [pg. 151] to BFLP of his WCB Holdings class B membership units is subject to section 2036(a)(1), which respondent does not even advocate, [5] is rejected by the statute and by United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72-5811] (1972), which the majority opinion does not even cite.

At the core of the majority opinion's holdings under section 2036(a)(1) are its conclusions (1) that "The record does not support that the nontax reasons for BFLP's existence were significant motivating factors", majority op. p. 53, and (2) that decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP.

I have serious reservations about the propriety of the majority opinion's conclusion that "The record does not support that the nontax reasons for BFLP's existence were significant motivating factors." Majority op. p. 53. However, for purposes of my dissent, I shall proceed on the assumption that that conclusion is proper. [6] Nonetheless, even if, as the majority opinion concludes, the record does not show that "the nontax reasons for BFLP's existence were significant motivating factors", majority op. p. 53, neither section 2036(a)(1) nor the caselaw under that section supports the majority opinion's inference that the absence of any significant nontax reason for the formation of BFLP, standing alone, establishes that decedent retained for his life the enjoyment of the WCB Holdings class B membership units that he transferred to BFLP within the meaning of section 2036(a)(1). [7][pg. 152]

I have serious disagreements with the majority opinion's conclusions that decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP. I shall discuss those disagreements below.

With the foregoing in mind, I shall now address the majority opinion's holding under section 2036(a)(1) that "an implied agreement existed that allowed decedent to retain the enjoyment of the property held by BFLP". Majority op. p. 59. In support of that holding, the majority opinion constructs the following rationale (majority opinion's rationale):

> The decedent did not need the membership interest in WCB Holdings class B shares to continue his lifestyle. However, decedent retained ownership of over 91 percent of his BFLP interest and did not make gifts of such interest prior to his death. More importantly, decedent controlled whether BFLP could transform its sole asset, the class B WCB Holdings membership units, into a liquid asset. Decedent as CEO and sole member of Empak's board of directors determined when Empak redeemed its stock in each of the seven instances of redemptions prior to his death, including the last redemption of about $750,000 worth of Empak stock in 1998 after WCB Holdings was formed. None of the seven redemptions reduced the membership units owned by BFLP. In order for BFLP to be able to diversify or take any steps other than simply holding the class B membership units, decedent would have had to cause the membership units and the underlying Empak stock to be redeemed. He chose not to do this. By not redeeming the WCB membership units held by BFLP, decedent insured that BFLP would not engage in asset management. Thereby, decedent exercised practical control over BFLP and limited its function to simply holding title to the class B membership units. Whether decedent caused the WCB membership units held by BFLP and the underlying Empak stock to be redeemed or not, his ability to decide if that event would occur demonstrates the understanding of the parties involved that decedent retained the right to control the units transferred to BFLP.
>
> The estate's argument that the general partner's fiduciary duties prevents a finding of an implied agreement is overcome by the lack of activity [pg. 153] following BFLP's formation

> and BFLP's failure to perform any meaningful functions as an entity. We conclude that decedent's transfer to BFLP for a 99-percent ownership interest in the partnership did not alter his control of the WCB Holdings class B membership units transferred to BFLP. See Estate of Thompson v. Commissioner, 382 F.3d 367, 376-377 [94 AFTR 2d 2004-5764] (finding "nothing beyond formal title changed in decedent's relationship to his assets" where the practical effect on his relationship to the transferred assets during decedent's life was minimal).

Majority op. pp. 57-59; fn. ref. omitted. The majority opinion's rationale is factually, logically, and legally flawed. [8]

The majority opinion's rationale is factually flawed for various reasons. One reason is that it concludes that decedent could have caused WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP. That conclusion is not supported by, and is contrary to, the following findings of fact of the majority opinion regarding the circumstances under which the chief manager of WCB Holdings (chief manager), who was decedent's son Mark Bongard, was required to obtain the approval of a majority of the WCB Holdings class A governance units before he could take certain actions on behalf of WCB Holdings:

> *the chief manager needed the approval of the members representing the majority of the class A governance units before he could* issue additional membership units, lend, borrow, or *commit WCB Holdings's funds in excess of $25,000*, authorize capital expenditures in excess of $10,000, *sell any of WCB Holdings's assets, including its Empak stock, worth over $10,000 in any twelve month period*, or vote any securities, including its Empak stock, owned by WCB Holdings.

Majority op. p. 14; emphasis added.

After decedent funded, by gift, on March 15, 1997, the Children's Trust, the Grandchildren's Trust, and the QTIP Trust, each with certain [pg. 154] class A governance units and certain class A financial units in WCB Holdings, decedent no longer owned a majority of the class A governance units in WCB Holdings, the only voting units in WCB Holdings. Thus, decedent could not have approved, and certainly could not have required, that the chief manager commit any of WCB Holdings's funds in excess of $25,000 for the purpose of redeeming the WCB Holdings class B membership interests owned by BFLP. In addition, decedent could not have approved, and certainly could not have required, that the chief manager sell to Empak, through a redemption by Empak, Empak stock owned by WCB Holdings worth over $10,000 in any 12-month period.

Another factual flaw in the majority opinion's rationale relates to the conclusion that decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings. That conclusion disregards not only the implications of the majority opinion's finding that decedent and ISA Trust transferred their respective shares of Empak stock to WCB Holdings in order to position Empak for a liquidity event [9] but also decedent's fiduciary duties as Empak's CEO and the sole member of its board of directors. Depleting Empak's assets by causing Empak to redeem the Empak stock owned by WCB Holdings in order to be able to diversify BFLP's assets through a redemption by WCB Holdings of the WCB Holdings class B membership units owned by BFLP would not have been consistent with the objective of positioning Empak for a liquidity event. Indeed, given that objective, it would have been, at best, bad business judgment on the part of decedent and a misconception by him of what was involved in positioning Empak for a liquidity event if he had decided to cause Empak to redeem the Empak stock owned by WCB Holdings in order to effect a diversification of BFLP's assets. Moreover, irrespective of the objective to position Empak for a liquidity event, any decision by decedent to deplete Empak's assets by causing Empak to redeem the Empak stock owned by WCB Holdings in order to effect such a diversification would have been, at worst, a breach by decedent of his fiduciary duties as Empak's CEO and the sole member of its board of directors. Any such decision by [pg. 155] decedent might have been actionable by the stockholders of Empak, which, as of March 7, 1997, were: (1) WCB Holdings, a 90-percent stockholder whose class A governance unitholders, other than decedent, [10] owned in the

aggregate on and after March 15, 1997, a majority of the voting class A governance membership units in WCB Holdings; (2) Marubeni Corp. (MC), a 6-percent stockholder and a Japanese trading entity which had more than 700 subsidiaries and whose stock was listed on various international stock exchanges; and (3) Marubeni America Corp., a 4-percent stockholder and the U.S. sales and marketing subsidiary of MC. Cf. United States v. Byrum, 408 U.S. at 137- 143. Thus, any ability of decedent to cause Empak to redeem the Empak stock owned by WCB Holdings was not unconstrained. Instead, any such ability was subject to the fiduciary duties imposed upon decedent as Empak's CEO and the sole member of its board of directors and to business and economic realities and variables over which he had little or no control and which he could ignore, but only at his peril. Cf. id.

The majority opinion's rationale contains other factual flaws. According to that rationale,

> decedent *controlled* whether BFLP could transform its sole asset, the class B WCB Holdings membership units, into a liquid asset. *** In order for BFLP to be able to diversify or take any steps other than simply holding the class B membership units, decedent would have had to cause the membership units and the underlying Empak stock to be redeemed. [[11]] He chose [pg. 156] not to do this. By not redeeming the WCB membership units held by BFLP, decedent insured that BFLP would not engage in asset management. Thereby, decedent exercised practical *control* over BFLP and limited its function to simply holding title to the class B membership units. Whether decedent caused the WCB membership units held by BFLP and the underlying Empak stock to be redeemed or not, his ability to decide if that event would occur demonstrates the understanding of the parties involved that decedent retained the right to *control* the units transferred to BFLP.
>
> *** decedent's transfer to BFLP for a 99-percent ownership interest in the partnership did not alter his *control* of the WCB Holdings class B membership units transferred to BFLP. ***

Majority op. pp. 57-59; emphasis added.

As is evident from the foregoing, the majority opinion establishes a "control" standard in applying section 2036(a)(1). However, the majority opinion never actually tells us what it means when it uses the terms "control" or "controlled" four times in the above-quoted excerpt. [12] Nonetheless, under any commonly accepted meaning of those terms, it is factually incorrect for the majority opinion to conclude that "decedent controlled whether BFLP could transform its *** class B WCB Holdings membership units *** into a liquid asset *** [,] exercised practical control over BFLP and *** retained the right to control the units transferred to BFLP" and that "decedent's transfer to BFLP *** did not alter his control of the WCB Holdings class B membership units transferred to BFLP." Majority op. pp. 57-58. After decedent and ISA Trust capitalized BFLP, which the majority opinion acknowledges was a validly created and existing partnership under Minnesota law, neither decedent nor ISA Trust had the same relationship to the respective WCB Holdings class B membership units that they transferred to BFLP. Decedent owned a limited partnership interest, and ISA Trust owned a general partnership interest, in BFLP. BFLP, in turn, owned such units transferred to it. Decedent, as a limited partner of BFLP, did not have, and did not exercise, control [pg. 157] over BFLP, its assets, its activities, or its general partner, ISA Trust.

In addition to the factual flaws in the majority opinion's rationale, that rationale is logically flawed. It is a non sequitur for the majority opinion to conclude that, because of decedent's alleged ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, "decedent controlled whether BFLP could transform its *** class B WCB Holdings membership units *** into a liquid asset *** [and] exercised practical control over BFLP". Majority op. pp. 57- 58. It also is a non sequitur for the majority opinion to conclude that any such alleged ability "demonstrates the understanding of the parties involved that decedent retained the right to control the units transferred to BFLP" and that his transfer to BFLP of his WCB Holdings class B membership units "did not alter his control" of such units. Majority op. pp. 58-59. The alleged ability of decedent to cause Empak to redeem the Empak stock owned by WCB Holdings

and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP does not logically lead to any of the foregoing conclusions. Nor does any such alleged ability logically lead to the majority opinion's holding that "an implied agreement existed that allowed decedent to retain the enjoyment of the property held by BFLP." Majority op. p. 59.

The majority opinion's rationale is also legally flawed. The language of section 2036(a)(1) [13] "plainly contemplates retention of an attribute of the property transferred—such as a right to income, use of the property itself, or a power of appointment with respect either to income or principal." United States v. Byrum, 408 U.S. at 149. Moreover, the term "enjoyment" used in section 2036(a)(1) is not a term or art; it "connote[s] substantial present economic benefit". Id. at 145. Decedent did not retain any attribute of the WCB Holdings class B membership units that he transferred to BFLP. Nor was decedent's alleged ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership [pg. 158] units owned by BFLP a substantial present economic benefit of such units. Any such alleged ability was not a present benefit at all; it was "a speculative and contingent benefit which may or may not *** [have been] realized." [14] Id. at 150. There simply are no circumstances surrounding decedent's transfer of his WCB Holdings class B membership units to BFLP and no subsequent use of such units by decedent from which an implied agreement may be inferred that decedent retained the enjoyment of such units. See Estate of Reichardt v. Commissioner, 114 T.C. 144, 151 (2000). Section 2036(a)(1) rejects the majority opinion's holding that decedent retained the enjoyment of the WCB Holdings class B membership units that he transferred to BFLP.

The legal flaws in the majority opinion's rationale are not limited to its disregard of section 2036(a)(1), which, as indicated above, the Supreme Court construed according to its plain language. See United States v. Byrum, supra at 145, 149. That rationale also ignores the principles under section 2036(a) that the Supreme Court established in Byrum and that this Court has applied in other cases. See, e.g., Estate of Cohen v. Commissioner, 79 T.C. 1015 (1982); Estate of Gilman v. Commissioner, 65 T.C. 296 (1975), affd. per curiam 547 F.2d 32 [39 AFTR 2d 77-1582] (2d Cir. 1976). In Byrum, the decedent Milliken C. Byrum (Mr. Byrum) transferred to an irrevocable trust that he created shares of stock in each of three closely held corporations. Prior to the transfer, Mr. Byrum owned at least 71 percent of the outstanding stock of each corporation. The beneficiaries of the trust that Mr. Byrum created were his children or, in the event of their death before termination of the trust, their surviving children. The trust instrument specified that there was to be a corporate trustee, and Mr. Byrum designated an independent corporation as sole trustee. The trust instrument vested in the trustee broad and detailed powers with respect to the control and management of the trust property. Such powers of the trustee were exercisable in the trustee's sole discretion, subject to the follow-[pg. 159] ing rights reserved by Mr. Byrum: (1) To vote the shares of unlisted stock held in the trust; (2) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; (3) to approve investments and reinvestments; and (4) to remove the trustee and to designate another corporate trustee to serve as successor trustee. United States v. Byrum, supra at 126- 127.

The Government's principal argument in Byrum was that, by retaining voting control over the corporations whose stock he transferred to the trust, which the Government maintained gave him, inter alia, control over the dividend policy of such corporations, Mr. Byrum retained the right under section 2036(a)(2) to designate the persons who were to enjoy the income from the transferred property. Id. at 131-132. The Government's alternative argument was that, by retaining voting control over the corporations whose stock he transferred to the trust, which gave him, inter alia, the power to determine whether and when such corporations would be liquidated or merged, Mr. Byrum retained under section 2036(a)(1) the enjoyment of the transferred property. Id. at 145.

The Supreme Court rejected the Government's principal argument under section 2036(a)(2) and its alternative argument under section 2036(a)(1), both of which were based on a "control" standard advanced by the Government. In rejecting the Government's arguments, the Supreme Court expressly rejected the use of a "control" standard as "the basis per se" in applying section 2036(a). The Supreme Court concluded:

> The "control" rationale, urged by the Government *** , would create a standard—not

specified in the statute— so vague and amorphous as to be impossible of ascertainment in many instances. ***

***

The Government uses the terms "control" and "controlling stockholder" as if they were words of art with a fixed and ascertainable meaning. In fact, the concept of "control" is a nebulous one. Although in this case Byrum possessed "voting control" of the three corporations (in view of his being able to vote more than 50% of the stock in each), the concept is too variable and imprecise to constitute the basis per se for imposing tax liability under § 2036(a). ***

Id. at 137 n.10 and 138 n.13. [pg. 160]

The majority opinion's reliance on a "control" standard in applying section 2036(a)(1) flies in the face of the Supreme Court's rejection of such a standard. [15] I.d. The "control" standard in the majority opinion's rationale, like the Government's "control" standard in Byrum, is "too variable and imprecise to constitute the basis per se", id. at 138 n.13, in applying section 2036(a)(1). [16]

Not only does the majority opinion's rationale fly in the face of the Supreme Court's rejection in United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72- 5811], of a "control" standard under section 2036(a), that rationale also flies in the face of other principles under section 2036(a) that the Supreme Court established in Byrum, including those set forth in the following excerpt from the Supreme Court's rejection of the Government's arguments in that case:

At the outset we observe that this Court has never held that trust property must be included in a settlor's gross estate solely because the settlor retained the power to manage trust assets. ***

***

*** The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power *** . Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

Byrum did retain the legal right to vote shares held by the trust and to veto investments and reinvestments. But the corporate trustee alone, not Byrum, had the right to pay out or withhold income and thereby to designate who among the beneficiaries enjoyed such income. Whatever power Byrum may have possessed with respect to the flow of income into the trust was derived not from an enforceable legal right specified in the trust instrument, but from the fact that he could elect a majority of the directors of the three corporations. The power to elect the directors conferred no legal right to command them to pay or not to pay dividends. A [pg. 161] majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. Moreover, the directors also have a fiduciary duty to promote the interests of the corporation. *** their [the corporate directors'] responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum's desires with respect thereto.

The Government seeks to equate the de facto position of a controlling stockholder with the legally enforceable "right" specified by the statute. Retention of corporate control (through the right to vote the shares) is said to be "tantamount to the power to accumulate income"

in the trust *** . The Government goes on to assert that "[t]hrough exercise of that retained power, [Byrum] could increase or decrease corporate dividends *** and thereby shift or defer the beneficial enjoyment of trust income." This approach seems to us not only to depart from the specific statutory language, but also to misconceive the realities of corporate life.

***

We conclude that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the "right" to designate who was to enjoy the income from trust property. His ability to affect, but not control, trust income, was a qualitatively different power from that of the settlor in [United States v.] O'Malley [383 U.S. 627 [17 AFTR 2d 1393] (1966)], who had a specific and enforceable right [set forth in the controlling trust instrument] to control the income paid to the beneficiaries. Even had Byrum managed to flood the trust with income, he had no way of compelling the trustee to pay it out rather than accumulate it. Nor could he prevent the trustee from making payments from other trust assets *** .

***

It is well settled that the terms "enjoy" and "enjoyment," as used in various estate tax statutes, "are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates." ***

***

*** The statutory language [of section 2036(a)(1)] plainly contemplates retention of an attribute of the property transferred—such as a right to income, use of the property itself, or a power of appointment with respect either to income or principal.

Even if Byrum had transferred a majority of the stock, but had retained voting control, he would not have retained "substantial present economic benefit," *** . The Government points to the retention of two "benefits." The first of these, the power to liquidate or merge, is not a *present* benefit; rather, it is a speculative and contingent benefit which may or may not be realized. ***

United States v. Byrum, 408 U.S. at 132- 133, 136-139, 143, 145, 149-150; fn. refs. omitted. [pg. 162]

The Supreme Court teaches us in United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72-5811] (1972), that section 2036(a)(1) (and section 2036(a)(2)) does not apply to a transfer by an individual to an irrevocable trust of shares of stock in certain corporations in which the transferor owned stock, [17] where such ownership gave the transferor the ability, inter alia, to liquidate or merge such corporations and where the powers of the independent trustee of such trust were subject to the following rights expressly reserved by the transferor: (1) To vote the shares of unlisted stock held in the trust; (2) to disapprove the sale or transfer of any trust assets, including the shares transferred to the trust; (3) to approve investments and reinvestments; and (4) to remove the trustee and to designate another corporate trustee to serve as successor trustee. Id. at 126-127.

A fortiori, under the principles that the Supreme Court established in United States v. Byrum, supra, even if in the instant case decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, any such ability does not demonstrate, and did not result in, decedent's retention of the enjoyment of the WCB Holdings class B membership units that he transferred to BFLP within the meaning of section 2036(a)(1). [18] In reaching a contrary holding, the majority [pg. 163] opinion loses

sight of, or chooses to disregard, the fact that any such ability is qualitatively different from the retention of the enjoyment (i.e., substantial present economic benefit, id. at 145) of the WCB Holdings class B units that he transferred to BFLP. See id. at 143, 145. In this connection, assuming arguendo the propriety of the majority opinion's conclusions that decedent had the ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, any such ability does not demonstrate, and did not result in, the retention by decedent of the right to compel BFLP or ISA Trust, the general partner of BFLP, to distribute such units to or on behalf of decedent or otherwise to permit decedent to have substantial present economic benefit of such units.

The majority opinion not only fails to apply section 2036(a)(1) and principles under section 2036(a) that the Supreme Count established in United States v. Byrum, supra, it also fails to apply principles established by Minnesota law regarding the fiduciary duties of the partners of partnerships and the trustees of trusts, which the majority opinion acknowledges exist. [19] This is evidenced by the following passage from the majority opinion's rationale:

> The estate's argument that the general partner's fiduciary duties prevents a finding of an implied agreement is overcome by the lack of activity [pg. 164] following BFLP's formation and BFLP's failure to perform any meaningful function as an entity. We conclude that decedent's transfer to BFLP for a 99-percent ownership interest in the partnership did not alter his control of the WCB Holdings class B membership units transferred to BFLP. ***

Majority op. pp. 58-59; fn. ref. omitted.

The majority opinion cites nothing in Minnesota law that supports the above- quoted conclusions. Irrespective of any " lack of activity" following BFLP's formation and any "failure [by BFLP] to perform any meaningful functions", majority op. pp. 58-59, ISA Trust, as the general partner of BFLP, owed fiduciary duties to decedent, and decedent, as a limited partner of BFLP, owed fiduciary duties to ISA Trust. Majority op. p. 59 note 12. ISA Trust, as the general partner of BFLP, and decedent, as a limited partner of BFLP, also owed fiduciary duties to BFLP. Margeson v. Margeson, 376 N.W.2d 269, 272 (Minn. Ct. App. 1985). In addition, the trustees of ISA trust owed fiduciary duties to the beneficiaries of that trust. Majority op. p. 59 note 12. The majority opinion points to nothing in Minnesota law that relieved decedent, ISA Trust, and its trustees of their respective fiduciary duties because of BFLP's "lack of activity" or "failure to perform any meaningful functions" during decedent's lifetime. Majority op. pp. 58-59. ISA Trust and decedent would be breaching their respective fiduciary duties to each other and to BFLP, and the trustees of ISA Trust would be breaching their fiduciary duties to the beneficiaries of that trust, if they were to allow decedent to retain, as the majority opinion concludes he did, "control over BFLP" and "control [over] the units transferred to BFLP", majority op. p. 58, and if, as the majority opinion also concludes, decedent's transfer to BFLP for a 99-percent ownership interest in that partnership "did not alter his control of *** [such] units", majority op. p. 59.

In conclusion, the majority opinion is wrong in holding, and section 2036(a)(1) and United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72-5811] (1972), reject the majority opinion's holdings, that "an implied agreement existed that allowed decedent to retain enjoyment of the property held by BFLP", majority op. p. 59, within the meaning of section 2036(a)(1) and that that section applies to decedent's transfer to BFLP of his WCB Holdings class B membership units. [pg. 165]

WELLS and FOLEY, *JJ.*, agree with this concurring in part and dissenting in part opinion.

1

Unless otherwise indicated, all section references are to the Internal Revenue Code, and all Rule references are to the Tax Court Rules of Practice and Procedure. Dollar amounts are generally rounded to the nearest dollar.

2

The parties stipulated that Terra is the correct spelling, but the Wayne C. Bongard Irrevocable Stock Accumulation Trust Agreement spells her name Tara.

3

The parties' stipulation terms this transaction as a "spinoff". However, it appears that the distribution was a splitoff.

4

Minn. Stat. Ann. sec. 322B.155 in effect in 1996 generally provided voting rights for any class of membership units, whether or not the articles of organization provided such units voting rights, only if the rights or interests attached to that class could be affected by a proposed change.

5

It appears the number of class A governance units and class A financial units issued to each member was determined by multiplying the number of Empak shares the respective shareholder contributed by 10 percent, rounded to the nearest share. The number of class B governance units and class B financial units issued to each member was then calculated by decreasing the number of Empak shares contributed by 10 percent of the number of Empak shares contributed, rounded to the nearest share.

6

It appears the Empak shareholders received an additional 539,515 shares of Entegris stock pursuant to the consolidation agreement on the first anniversary of the closing date (June 7, 1999).

7

Pursuant to the partnership agreement, an interest holder is a holder of an "interest". An "interest" is "an ownership interest in the Partnership [held] by a Limited Partner (or an assignee)".

8

This adjustment would include in the gross estate the value of the Empak shares previously held by decedent and transferred to WCB Holdings, including the Empak share value related to the WCB Holdings class B membership units that were transferred to BFLP.

9

SEC. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.

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

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

10

Sec. 2036(b) instructs that the retention of the right to vote shares of a controlled corporation that were transferred by a decedent is the retention of the enjoyment of the transferred property.

11

Respondent has not challenged whether BFLP is a partnership that should be recognized for tax purposes under sec. 761(a) or 7701(a)(2), so we do not reach that issue in this case.

12

Under Minnesota law, the relationship of partners is fiduciary in character, and each partner owes the other partners the highest degree of integrity, loyalty, and good faith. Prince v. Sonnesyn, 222 Minn. 528, 535 (1946); Margeson v. Margeson, 376 N.W.2d 269 (Minn. Ct. App. 1985). In a limited partnership, a general partner can be liable to the limited partners for breach of fiduciary duty. Minn. Stat. Ann. sec. 322A.33 (West 2004); see also Minn. Stat. Ann. sec. 323.20 (West 1995), repealed by Laws 1997, ch. 174, art. 12, sec. 68, effective Jan. 1, 2002, but replaced by Minn. Stat. Ann. secs. 323A.4-04 and 323A.4-05, effective Jan. 1, 1999 (West 2004). In addition, the ISA Trust trustees owed fiduciary duties to its beneficiaries. See Minn. Stat. Ann. sec. 501B.10 (West. Supp. 1990), repealed by Laws 1996, ch. 314, sec. 8, eff. Jan. 1, 1997, replaced by Minn. Stat. Ann. sec. 501B.151, effective Jan. 1, 1997 (West 2002 & Supp. 2004); Minn. Stat. Ann. sec. 501B.60 (West 1990).

13

We note that decedent's estate may be entitled to a deduction under sec. 2056 for his inter vivos gift of WCB Holdings class B membership units to Cynthia Bongard that was pulled back into his gross estate under sec. 2035(a).

1

The Court need not determine this fair market value, however, if the record establishes that the partnership interest was received in an ordinary commercial transaction. In that case, the values of the transferred and received properties would be considered to be equal. See sec. 25.2512-8, Gift Tax Regs. (transfers "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth"); see also Harper v. Commissioner, T.C. Memo. 2002-121 [TC Memo 2002-121].

2

As is true in sec. 2036(a), sec. 2512(b) refers to "value" and "adequate and full consideration in money or money's worth". Specifically, sec. 2512(b) provides:

SEC. 2512. VALUATION OF GIFTS.

***

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

3

I have found no law setting the precedential value of a concurring opinion that garners a second vote so as also to be a majority opinion of a Court of Appeals panel. Cf. Hunt v. Natl. Broadcasting Co., Inc., 872 F.2d 289, 296 (9th Cir. 1989) (recognizing the issue, but stating that it was unnecessary to decide there). To my mind, such a concurring opinion is entitled to the same respect as any other majority opinion of a panel. See Greene v. Massey, 706 F.2d 548, 550 (5th Cir. 1983) (in response to certification from the U.S. Court of Appeals for the Fifth Circuit, the Supreme Court of Florida answered that a concurring opinion by a Justice of that Court is the law of the case if joined by a majority of that Court's Justices); Detroit v. Mich. Pub. Utils. Commn., 286 N.W. 368, 379 (Mich. 1939) ("It is true that the views of Justice Fellows were expressed in a separate concurring opinion. Views, however, expressed in separate concurring opinions are the views of the court, when it appears that the majority of the court concurred in such separately expressed views"); Anderson v. Sutton, 293 S.W. 770, 773 (Mo. 1927)("Views expressed in a separate concurring opinion of an individual judge are not the views of the court, unless it appears that the majority of the court concurred in such separately expressed views"); see also State v. Dowe, 352 N.W.2d 660, 662 (Wis. 1984) ("In Outlaw [State v. Outlaw, 321 N.W.2d 145 (Wis. 1982)], the lead opinion represents the majority and is controlling on the issues of the state's burden and the existence of abuse of discretion by that circuit court. However, the concurring opinions represent the majority on the issue of the test to be applied and therefore control on this point").

4

The majority states that it is not deciding whether BFLP is a partnership that should be recognized for Federal tax purposes. Majority op. p. 52 n.11.

1

I concur with the majority insofar as it decides that the value of the shares of Empak, Inc., transferred by decedent to WCB Holdings, LLC (WCB Holdings), is not included in the value of the gross estate (although I do not agree with the reasoning the majority uses to reach that result). I disagree with the majority that the value of the WCB Holdings membership units transferred to the Bongard Family Limited Partnership is included in that value.

2

I have not joined Judge Laro's separate opinion because, in important particulars, I disagree with his stated views.

3

Sec. 2512(b) provides:

> SEC. 2512(b). Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

4

As we have recently said: "The meaning of the phrase `in money or money's worth', when it follows `adequate and full consideration', has been interpreted to confine the scope of `consideration' to money or its equivalent; i.e., to exclude a mere promise or agreement as consideration." Abeid v.

Commissioner, 122 T.C. 404, 409 n.7 (2004); see also sec. 25.2512-8, Gift Tax Regs. ("A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded [in determining adequate and full consideration], and the entire value of the property transferred constitutes the amount of the gift.").

5

I do not wish to suggest that proportionality (as discussed in the text) is determinative that a transaction is at arm's length. Unless a gift motive is conceded or some secret knowledge is presumed, I am not persuaded that a rational person dealing at arm's length would ever knowingly exchange assets worth $300 for an interest in an entity worth $200, with no right to control the entity or compel a distribution of her share of the entity's assets.

6

As I see it, the addition of that separate test is not necessary here, since petitioner has not otherwise shown that the transfers satisfy the bona fide sale exception.

7

Two commentators on the family limited partnership scene add the following with respect to meaning of the "bona fide sale" portion of the bona fide sale exception:

> Treas. reg. section 20.2036-1 indicates that the exception applies where there is "adequate and full consideration." It does not mention any requirement that the sale also be a bona fide one. It does, however, cross-reference Treas. reg. section 20.2043-1(a), which does appear to contemplate the need to satisfy two conditions for the exception to apply: that the sale be a bona fide one and that the consideration be adequate. Nonetheless, the latter regulation is not inconsistent with the traditional (Wheeler's [Wheeler v. United States, 116 F.3d 749, 764 [80 AFTR 2d 97-5075] (5th Cir. 1997)]) understanding of the exception. Its use of the phrase "bona fide" is obviously designed to do nothing more than make certain that the consideration was actually supplied and not an illusory one. Indeed, the last sentence of the provision confirms this reading. It provides that, if the value at the time of death of the transferred asset to be included under section 2036 (or similar section) exceeds the consideration received by the decedent, only the excess is included in the gross estate. The failure to require that the sale be a bona fide one to qualify for treatment under this last sentence makes it clear that it was intended to embrace the traditional understanding of the exception.

Gans & Blattmachr, "Strangi: A Critical Analysis and Planning Suggestions", 100 Tax Notes 1153, 1162, n.78 (Sept. 1, 2003).

8

Judge Ruwe suggests a gift-on-formation analysis in his dissenting opinion in Estate of Strangi v. Commissioner, 115 T.C. 478, 496 (Ruwe, J., dissenting), affd. in part and revd. in part 293 F.3d 279 [89 AFTR 2d 2002-2977] (5th Cir. 2002). The Estate of Strangi majority opinion, which I joined, rejects that possibility, at least on the facts presented, on the grounds that Mr. Strangi (the decedent) did not give up control of the assets he contributed to the family limited partnership (for a 99 percent limited partnership interest) and his contribution was allocated to his capital account: "Realistically, in this case, the disparity between the value of the assets in the hands of decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount applicable to the partnership interest. It does not reflect a taxable gift." Id. at 490. Similarly, in Estate of Jones v. Commissioner, 116 T.C. 121, 128 (2001), we said: "All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts."

9

The hypothetical and some of the following analysis are suggested by Professor Leo L. Schmolka; Schmolka, "FLPs and GRATs: What to do?", 86 Tax Notes 1473 (Special Supplement, Mar. 13, 2000).

1

I concur in the holdings of the majority opinion that decedent made a transfer to WCB Holdings of his Empak stock that was a bona fide sale for an adequate and full consideration in money or money's worth within the meaning of sec. 2036(a) and that consequently sec. 2036(a) does not apply with respect to that transfer. I also concur in the holdings of the majority opinion that, as a result of the foregoing holdings under sec. 2036(a), sec. 2035(a) does not apply with respect to decedent's respective gifts of certain class A membership units in WCB Holdings to the Wayne C. Bongard Children's Trust (Children's Trust), the Wayne C. Bongard Grandchildren's Trust (Grandchildren's Trust), and the Cynthia F. Bongard Qualified Terminal Interest Property Trust (QTIP Trust).

2

The majority opinion does not hold that decedent retained for his life the possession of, or the right to the income from, the WCB Holdings class B membership units that he transferred to BFLP. Thus, the focus herein is on whether decedent retained for his life the enjoyment of such units within the meaning of sec. 2036(a)(1).

3

Because the majority opinion holds that decedent's transfer to BFLP of his WCB Holdings class B membership units satisfies sec. 2036(a)(1), the majority opinion indicates that it need not address whether such transfer satisfies sec. 2036(a)(2), on which respondent relies. See infra note 5.

4

I also dissent from the majority opinion's holding that sec. 2035(a) requires decedent's gross estate to include the value as of the date of decedent's death of the WCB Holdings class B membership units owned on that date by BFLP that is proportionate to the 7.72-percent BFLP limited partnership interest owned on that date by his wife Cynthia Bongard, which she received from decedent as a gift on Dec. 10, 1997, less than a year before he died. That erroneous holding flows from the majority opinion's erroneous holding under sec. 2036(a)(1).

5

Respondent relies only on sec. 2036(a)(2), and not on sec. 2036(a)(1), with respect to decedent's transfer to BFLP of his WCB Holdings class B membership units. Respondent argues with respect to that transfer that, under the partnership agreement governing BFLP, decedent had the right, in conjunction with the Wayne C. Bongard Irrevocable Stock Accumulation Trust (ISA Trust), the general partner of BFLP, to liquidate BFLP and to amend that agreement. Consequently, according to respondent, decedent retained the right under sec. 2036(a)(2), either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property that he transferred to BFLP or the income therefrom, and sec. 2036(a)(2) requires decedent's gross estate to include the value of certain WCB Holdings class B membership units owned by BFLP on the date of decedent's death. See supra note 3.

6

Since I shall proceed herein on that assumption, I shall not address the majority opinion's holding

that decedent made a transfer to BFLP of his WCB Holdings class B membership units that was not a bona fide sale for an adequate and full consideration in money or money's worth within the meaning of sec. 2036(a).

7

The absence of a nontax reason for the creation of an entity, standing alone, might permit disregarding that entity for Federal tax purposes under, for example, a sham analysis. However, the majority opinion does not rely on a sham analysis, or any other analysis, that would result in disregarding BFLP for Federal tax purposes. See, e.g., secs. 761(a), 7701(a)(2); cf. Moline Props., Inc. v. Commissioner, 319 U.S. 436 [30 AFTR 1291] (1943). That is because, according to the majority opinion, "Respondent has not challenged whether BFLP is a partnership that should be recognized for tax purposes". Majority op. p. 52 note 11. As discussed supra note 5, respondent does not argue that sec. 2036(a)(1) applies to decedent's transfer to BFLP of his WCB Holdings class B membership units; respondent argues only that sec. 2036(a)(2) applies to that transfer. Nonetheless, the majority opinion applies sec. 2036(a)(1) in reaching its holdings with respect to the transfer at issue to BFLP. In reaching those holdings, not only does the majority opinion rely on a section of the Internal Revenue Code on which respondent does not rely, it constructs a rationale under that section which respondent does not advance and to which the Estate of Wayne C. Bongard (estate) did not have the opportunity to respond.

8

The majority opinion's reliance on Estate of Thompson v. Commissioner, 382 F.3d 367 [94 AFTR 2d 2004-5764] (3d Cir. 2004), affg. T.C. Memo. 2002-246 [TC Memo 2002-246], is misplaced, as is its reliance on certain other cases, principally Estate of Strangi v. Commissioner, T.C. Memo. 2003-145 [TC Memo 2003-145], and Estate of Harper v. Commissioner, T.C. Memo. 2002-121 [TC Memo 2002-121], in support of its holdings under sec. 2036(a)(1). Each of those cases found the existence of an agreement under which the decedent involved retained for life the possession or enjoyment of, or the right to the income from, the property that such decedent transferred within the meaning of sec. 2036 (a)(1). Each of those cases is materially distinguishable from, and is not controlling in, the instant case. For example, unlike cases cited by the majority opinion, decedent here did not transfer to BFLP assets needed to maintain his lifestyle; in the instant case, decedent had millions of dollars of assets that remained outside of BFLP (and outside of WCB Holdings) and that were more than adequate to maintain decedent's lifestyle during his lifetime. In addition, in the instant case, during decedent's lifetime there were no distributions to or on behalf of decedent from BFLP and no commingling of BFLP's assets with decedent's assets, as was done in cases on which the majority opinion relies.

9

That finding was critical to the majority opinion's holding that decedent's transfer to WCB Holdings of his Empak stock was a bona fide sale for an adequate and full consideration in money or money's worth within the meaning of sec. 2036(a).

10

On and after Mar. 15, 1997, the class A governance unitholders of WCB Holdings, other than decedent, were the ISA Trust, the Children's Trust, the Grandchildren's Trust, and the QTIP Trust.

11

In making that assertion, the majority opinion ignores that, upon the occurrence of a liquidity event with respect to Empak (Empak liquidity event), BFLP, like WCB Holdings, would be in a position to acquire liquid assets with which to engage in economic activity, such as diversifying investments. Until an Empak liquidity event occurred, WCB Holdings owned no assets other than the respective shares of Empak stock transferred to it by decedent and ISA Trust and thus owned no liquid assets with which to

engage in any economic activity. Similarly, until an Empak liquidity event occurred, BFLP, whose only asset was WCB Holdings class B membership units, had no liquid assets with which to engage in economic activity, such as diversifying its investments. The reason that during decedent's lifetime BFLP, like WCB Holdings, owned no liquid assets with which to engage in any economic activity is that decedent died unexpectedly on Nov. 16, 1998, before an Empak liquidity event occurred. However, an Empak liquidity event did occur about 19 months after decedent's death. Moreover, as the majority opinion acknowledges with respect to WCB Holdings, many of the steps necessary to position Empak for a liquidity event, and thus necessary to position both WCB Holdings and BFLP to acquire liquid assets as a result of such a liquidity event, were completed before decedent's death. Other such steps were completed after decedent died. Thus, in June 1999, Empak was consolidated with Fluoroware, which resulted in a combined company named Entegris, Inc. (Entegris), and Empak stockholders, including WCB Holdings which owned 90 percent of the outstanding Empak stock, received a 40-percent ownership interest in Entegris. In July 2000, Entegris stock split 2 for 1, and it completed an initial public offering of its stock. As part of that initial public offering, WCB Holdings sold 1,925,000 shares of the approximately 22,000,000 shares of Entegris stock that it owned. Thereafter, WCB Holdings distributed the proceeds of such sales on a pro rata basis to all of the owners of its membership units, including to BFLP.

12

It is not even clear whether in each of the four instances the majority opinion intends the same, or a different, meaning of the terms "control" or "controlled".

13

In order for sec. 2036(a)(1) to apply, decedent must have, inter alia, made a transfer of property under which he "retained for his life *** (1) the possession or enjoyment of, or the right to the income from, the property".

14

It is noteworthy that any speculative and contingent future benefit (i.e., diversification of BFLP's assets) that decedent might have received from his alleged ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP was substantially more tenuous than the contingent and speculative future benefits that Mr. Byrum might have received from his power to liquidate or merge the corporations involved in United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72-5811] (1972).

15

Under the majority opinion's "control" standard, because of decedent's alleged ability to cause Empak to redeem the Empak stock owned by WCB Holdings and to cause WCB Holdings to redeem the WCB Holdings class B membership units owned by BFLP, "decedent controlled whether BFLP could transform its *** class B WCB Holdings membership units *** into a liquid asset *** [,] exercised practical control over BFLP and *** retained the right to control the units transferred to BFLP", and his transfer to BFLP of his WCB Holdings class B membership units "did not alter his control" of such units. Majority op. pp. 57-59. Consequently, according to the majority opinion, "an implied agreement existed that allowed decedent to retain the enjoyment of the property held by BFLP." Majority op. p. 59.

16

As discussed above, we do not even know, because the majority opinion never tells us, what it intends by the terms "control" and "controlled" that appear in the majority opinion's rationale.

17

After the Supreme Court decided United States v. Byrum, 408 U.S. 125 [30 AFTR 2d 72-5811] (1972), Congress enacted sec. 2036(b), which is applicable to transfers made after June 22, 1976. Sec. 2036(b) expands the meaning of the phrase "retained *** enjoyment of" the transferred property for purposes of sec. 2036(a)(1). However, sec. 2036(b) is expressly limited to the retained right to vote shares of stock of a controlled corporation, as defined in sec. 2036(b)(2), and has no application to decedent's transfer to BFLP of his nonvoting WCB Holdings class B membership units. Thus, the effect of Byrum on the instant case is unchanged by the enactment of sec. 2036(b). See Rev. Rul. 81-15, 1981-1 C.B. 457, 458, where the Internal Revenue Service, in reliance on the legislative history of sec. 2036(b), acknowledged that "the effect of Byrum *** is not changed by the enactment of section 2036 (b)" in the case of a transfer of nonvoting stock.

18

Although there are factual differences between United States v. Byrum, supra, and the instant case, those differences have no significance for purposes of determining whether sec. 2036(a)(1) applies to decedent's transfer to BFLP of his WCB Holdings class B membership units. In fact, many of those differences strengthen the estate's position in the instant case. For example, in Byrum, Mr. Byrum expressly reserved the rights, inter alia, to disapprove the sale or transfer of any trust assets including the shares transferred to the trust, to approve investments and reinvestments of the trust, and to remove the trustee and designate another corporate trustee to serve as successor trustee. Id. at 127. In contrast, decedent in the instant case reserved no such rights, or any other rights, with respect to BFLP, BFLP's assets, or ISA Trust, BFLP's general partner.

Moreover, any suggestion that the principles announced by the Supreme Court in United States v. Byrum, supra, are limited to trusts, and do not apply to other types of entities such as limited partnerships like BFLP, is unfounded and disregards the respective fiduciary duties of the partners of a partnership to each other and to the partnership (discussed below). In fact, respondent has acknowledged in, inter alia, certain private letter rulings that those principles apply to limited partnerships. See, e.g., Priv. Ltr. Rul. 95-46-006 (Aug. 14, 1995); Priv. Ltr. Rul. 94-15-007 (Jan. 12, 1994); Priv. Ltr. Rul. 93-10-039 (Dec. 16, 1992). Although private letter rulings have no precedential effect, see sec. 6110(k)(3), they "are an instructive tool", Thom v. United States, 283 F.3d 939, 943 n.6 [89 AFTR 2d 2002-1384] (8th Cir. 2002), and "do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws", Hanover Bank v. Commissioner, 369 U.S. 672, 686 [9 AFTR 2d 1492] (1962); see also Wells Fargo & Co. & Subs. v. Commissioner, 224 F.3d 874, 886 [86 AFTR 2d 2000-5815] (8th Cir. 2000), affg. in part and revg. in part Norwest Corp. v. Commissioner, 112 T.C. 89 (1999).

19

The majority opinion acknowledges:

> Under Minnesota law, the relationship of partners is fiduciary in character, and each partner owes the other partners the highest degree of integrity, loyalty, and good faith. Prince v. Sonnesyn, 222 Minn. 528, 535 (1946); Margeson v. Margeson, 376 N.W.2d 269 (Minn. Ct. App. 1985). In a limited partnership, a general partner can be liable to the limited partners for breach of fiduciary duty. Minn. Stat. Ann. sec. 322A.33 (West 2004); see also Minn. Stat. Ann. sec. 323.20 (West 1995), repealed by Laws 1997, ch. 174, art. 12, sec. 68, effective Jan. 1, 2002, but replaced by Minn. Stat. Ann. secs. 323A.4-04 and 323A.4-05, effective Jan. 1, 1999 (West 2004). In addition, the ISA Trust trustees owed fiduciary duties to its beneficiaries. See Minn. Stat. Ann. sec. 501B.10 (West. Supp. 1990), repealed by Laws 1996, ch. 314, sec. 8, eff. Jan. 1, 1997, replaced by Minn. Stat. Ann. sec. 501B.151, effective Jan. 1, 1997 (West 2002 & Supp. 2004); Minn. Stat. Ann. sec. 501B.60 (West 1990).

Majority op. p. 59 note 12.

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American Federal Tax Reports

STRANGI v. COMM., Cite as 96 AFTR 2d 2005-5230, 08/08/2005 , Code Sec(s) 2036

Albert STRANGI, deceased, Rosalie Gulig, Independent Executrix, PETITIONER-APPELLANT v. COMMISSIONER of Internal Revenue, RESPONDENT-APPELLEE.

Case Information:

Code Sec (s):	2036
Court Name:	U.S. Court of Appeals, Fifth Circuit,
Docket No.:	No. 03- 60992,
Date Decided:	08/08/2005.
Prior History:	Tax Court, *Strangi, Albert Est, et al,* (2003) TC Memo 2003- 145, RIA TC Memo ¶2003-145 (opinion by Cohen, *J.*), on remand from (2002, CA5) 89 AFTR 2d 2002-2977, 293 F 3d 279, affirming in part, and reversing and remanding in part (2000) 115 TC 478, affirmed.
Tax Year(s):	Date of death 10-14-94.
Disposition:	Decision for Govt.

HEADNOTE

1. Gross estate—transfers with retained life estate—right to income, possession or enjoyment—family limited partnerships. Tax Court properly determined on remand that value of multimillion dollar assets and personal residence which decedent transferred to FLP few months before death were includible in gross estate under Code Sec. 2036(a)(1) : record clearly reflected implied agreement that decedent would retain assets' continued possession or enjoyment post-transfer. Notable facts included that numerous FLP distributions were used to pay funeral, estate's and decedent's personal expenses; asset transfers consisted of 98% of his wealth and left him without any meaning [pg. 2005-5231] ful liquid assets; and he continued to live in residence until death without paying any rent. Also, facts that rent was charged and later paid post-death weren't dispositive, particularly since rental deferral in itself provided significant economic benefit.

Reference(s): USTR Estate & Gift Taxes ¶20,365.01(45); 20,365.01(70). Code Sec. 2036

2. Gross estate—transfers with retained life estate—bona fide sales exception—family limited partnership. Tax Court properly determined on remand that estate wasn't entitled to Code Sec. 2036 (a) 's bona fide sales exception to inclusion in gross estate of decedent's retained interest in significant assets transferred to FLP few months before death: although adequate and full consideration was given in form of proportional partnership interest, transfer didn't qualify as bona fide sale in that there was no substantial non-tax business purpose for it. Taxpayer's various attempts to cast arrangement as designed to avoid potential/speculative litigation by decedent's former housekeeper, to avoid will contest, to save on executor fees by persuading executor to decline service, to establish joint investment vehicle, or to permit centralized active management of working assets, were all refuted by record evidence that none of those objectives were realistic or valid rationale for transfers.

Reference(s): USTR Estate & Gift Taxes ¶20,365.01(42). Code Sec. 2036

3. Refunds—time-barred claims—equitable recoupment—estate and income taxes. Tax Court properly determined in remand decision that estate wasn't entitled to amend petition to raise equitable recoupment claim for time-barred refund: taxpayer's position in another pending case, arguing that subject refund wasn't time- barred, was inconsistent with and fatal to equitable recoupment claim.

Reference(s): ¶ 65,145.01(30) USTR Estate & Gift Taxes ¶65,145.04(35). Code Sec. 6514 ; Code Sec. 6511 ; Code Sec. 7422

4. Gross estate—transfers with retained life estate—right to designate possession or enjoyment—valuation— restrictions—state law—substance vs. form—gift. These issues weren't discussed on appeal.

Reference(s): ¶ 79,007.15(15) ; ¶ 7045.12 USTR Estate & Gift Taxes ¶20,365.02(9); 20,315.18(10); 20,315.18(15); 27,035.01(20); 25,125.11(45). Code Sec. 704 ; Code Sec. 2036 ; Code Sec. 2703 ; Code Sec. 2511

OPINION

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT,

Appeal from a Decision of the United States Tax Court

Before REAVLEY, JOLLY, and PRADO, Circuit Judges.

Judge: E. GRADY JOLLY, Circuit Judge:

This case, which comes before us now for a second time, involves an assessment by the Commissioner of Internal Revenue of an estate tax deficiency against the Estate of Albert Strangi. Initially, the Tax Court held for the Estate. However, we remanded to the Tax Court, which reversed its prior holding and decided the case under I.R.C. § 2036(a). Section 2036(a) provides that transferred assets of which the decedent retained de facto possession or control prior to death are included in the taxable estate. The Tax Court held that Strangi retained enjoyment of the assets in question, and thus, that the transferred assets were properly included in the estate. The Estate now appeals that decision. We find no reversible error, and accordingly AFFIRM.

I

As failing health began to telegraph that the inevitable would occur, Albert Strangi transferred approximately ten million dollars worth of personal assets into a family limited partnership. Upon his death, Strangi's Estate filed an estate tax return based on the value of his interest in that partnership, as opposed to the actual value of the transferred assets. The Internal Revenue Service issued a notice of a deficiency of $2,545,826 in estate taxes. Strangi's Estate petitioned the Tax Court for a redetermination of the deficiency.

After protracted litigation, the Tax Court found that Strangi had retained an interest [pg. 2005-5232] in the transferred assets such that they were properly included in the taxable estate under I.R.C. § 2036 (a), and entered an order sustaining the deficiency. Our review of the Tax Court's decision requires an inquiry into the structure of the limited partnership established by Strangi and the extent to which he retained enjoyment of partnership assets. First, however, some account of antecedents is in order.

A

Albert Strangi died on October 14, 1994 in Waco, Texas. He was survived by four children from his first marriage: Jeanne, Rosalie, Albert Jr., and John (collectively, the "Strangi children"). Rosalie was married to Michael J. Gulig, a local attorney.

In 1965, after divorcing his first wife, Strangi married Delores Seymour. Seymour had two daughters, Angela and Lynda, from a prior marriage (collectively, the "Seymour children"). In 1987, Strangi and Seymour both executed wills, naming one another as primary beneficiaries and the Strangi and Seymour children as residual beneficiaries. That same year, Seymour began to suffer from a series of medical problems. As a result, Strangi and Seymour decided to move their residence from Florida to Waco, Texas. To facilitate the relocation, Strangi executed a general power of attorney naming Gulig as his attorney-in-fact.

In July 1990, Strangi executed a new will, naming the Strangi children as sole beneficiaries if Seymour predeceased him - -i.e., cutting out the Seymour children. The new will designated Strangi's daughter Rosalie and a bank, Ameritrust, as co-executors of the Estate. Seymour died in December 1990.

In 1993, Strangi began to experience health problems. He had surgery to remove a cancerous mass from his back, was diagnosed with a neurological disorder called supranuclear palsy, and had prostate surgery. At this point, Gulig took over management of Strangi's daily affairs.

Gulig testified that, on several occasions between 1990 and 1993, he discussed his concerns regarding Strangi's Estate with retired Texas probate Judge David Jackson, who was a personal friend. Gulig said that he felt "confident" that the Seymour children would either sue Strangi's Estate or contest the will. He also claimed to have been concerned about "horrendous executor fees" that he believed Ameritrust would charge. Further, Gulig said he worried about the possibility of a tort claim by Strangi's housekeeper for injuries she sustained in an accident while caring for Strangi. He testified that Judge Jackson advised him that his fears were "very valid" and that he "had to do something" to protect the Strangi Estate.

B

On August 11, 1994, Gulig attended a seminar provided by Fortress Financial Group, Inc., explaining the so-called "Fortress Plan". The Fortress Plan was billed as a means of using limited partnerships as a tool for (1) asset preservation, (2) estate planning, (3) income tax planning, and (4) charitable giving. Fortress marketed the plan as a means of, among other things, "lower[ing] the taxable value of your estate" by means of "well established court doctrines which recognize that the value of a limited partnership interest is worth less than the value of the assets owned by the limited partnership". In brief, the plan instructed parties to "sell" their assets in exchange for an interest in a newly-created limited partnership. Because a partnership interest is worth less for tax purposes than a proportional share of the partnership's assets -- due to lack of direct control and non-liquidity -- this "exchange" would reduce the taxable value of the estate.

The next day, Gulig, acting under power of attorney on behalf of Strangi: (1) prepared the Agreement of Limited Partnership of the Strangi Family Limited Partnership ("SFLP"); (2) prepared and filed the Articles of Incorporation of Stranco, Inc. ("Stranco"); (3) transferred 98% of [pg. 2005-5233] Strangi's assets [1] --valued at $9,932,967 -- to SFLP in exchange for a 99% limited partner interest; (4) transferred $49,350 of Strangi's assets to Stranco in exchange for 47% of Stranco's common stock; (5) facilitated the purchase of the remaining 53% of Stranco's common stock by the four Strangi children for $55,650; (6) issued a check from Stranco for a 1% general partner interest in SFLP.

The result of Gulig's efforts was a three- tiered entity, with SFLP -- and the roughly $10 million in assets Strangi had transferred into it -- at the top. The SFLP partnership agreement provided that Stranco, which owned a 1% general partnership interest in SFLP, had sole authority to conduct SFLP's business affairs. Strangi owned a 99% interest in SFLP, but was a limited partner, and thus had no formal control.

Stranco itself was a Texas corporation. Strangi owned 47% of Stranco's common stock; each of his four children owned a 13% share. Stranco's articles of incorporation named Strangi and the four Strangi children as the initial board of directors. On August 17, the five met to execute the corporate bylaws, a shareholder agreement, and an authorization to employ Gulig as manager of Stranco.

On August 18, Stranco made a corporate gift of 100 shares --a 1/4 of one percent stake -- to the McLennan Community College Foundation. Gulig later testified that he understood that the gift would improve the asset protection features of the Stranco/ SFLP structure. The implementation of the "Fortress Plan" was thus completed.

Following Strangi's death in October 1994, Gulig asked Texas Commerce Bank ("TCB", a successor in interest to Ameritrust) to decline to serve as executor of the Estate. To that end, Gulig claims to have issued a "threat that no distributions would be made from SFLP to pay executor fees". After receiving indemnification from the Strangi children, TCB agreed. Strangi's will was admitted to probate in April 1995 with Rosalie Gulig as the sole executor.

C

Both prior to and after Strangi's death, SFLP made various outlays, both monetary and in-kind, to meet his needs and expenses. In September and October of 1994, SFLP distributed $8,000 and $6,000, respectively, to Strangi. On both occasions, SFLP made proportional distributions -- $80.81 and $60.61, to be precise -- to its general partner, Stranco. The Commissioner suggests that these payments to Strangi were necessary because, after the transfer to SFLP, Strangi retained possession of only minimal liquid assets -- i.e., two bank accounts with funds totaling $762. The Estate responds by noting that Strangi received a monthly pension of $1,438 and Social Security payments of $1,559, and that he retained over $187,000 in "liquefiable" assets, which consisted largely of various brokerage accounts.

SFLP also distributed approximately $40,000 in 1994 to pay for funeral expenses, estate administration expenses, and various personal debts that Strangi had incurred. In 1995 and 1996, SFLP distributed approximately $65,000 to pay for Estate expenses and a specific bequest made by Strangi. Moreover, in 1995, SFLP distributed $3,187,800 to the Estate to pay federal and state inheritance taxes. The Estate notes that all of these disbursements were recorded on SFLP's books and accompanied by pro rata distributions to Stranco. The Estate further notes that it repaid SFLP for the $65,000 "advance" in January 1997.

In addition, prior to his death, Strangi continued to dwell in one of the two houses he had transferred to SFLP. The Estate notes that SFLP charged rent for the two months that Strangi remained in the house. Although the accrued rent was recorded in SFLP's books, it was not actually paid until January 1997, more than two years after Strangi's death. [pg. 2005-5234]

D

In December 1998, the Internal Revenue Service issued a notice of deficiency to the Estate, asserting that it owed $2,545,826 in federal estate tax or, in the alternative, $1,629,947 in federal gift tax. The deficiency was attributable to the IRS's determination that Strangi's interest in SFLP was $10,947,343 -- i.e., the actual value of the assets transferred -- rather than the $6,560,730 that the Estate reported. 2

The Estate petitioned the Tax Court for a redetermination of the deficiencies. In the Tax Court, the Commissioner of Internal Revenue contended, inter alia, that (1) SFLP should be disregarded because it lacked economic substance and business purpose; (2) the partnership agreement was a restriction on the sale or use of the underlying property that should be disregarded for valuation purposes; (3) the fair market value of Strangi's partnership interest was understated; and (4) if a discount was appropriate, Strangi had made a taxable gift on formation of SFLP to the extent the value of the

property transferred exceeded the value of his partnership interest.

Prior to trial, the Commissioner filed a motion for leave to amend his answer to include the alternative theory that, under I.R.C. § 2036(a), Strangi's taxable estate should include the full value of the assets he transferred to SFLP and Stranco. The Tax Court denied the motion. After a two- day trial, the court held for the Estate, rejecting all of the Commissioner's proffered reasons for inclusion of the assets. See Estate of Strangi v. Commissioner, 115 T.C. 478 (2000) ("Strangi I").

The Commissioner appealed, inter alia, the denial of the motion to amend his answer. This court affirmed in part and reversed in part, and remanded the case to the Tax Court with instructions that it either "set forth its reasons for ... denial of the Commissioner's motion for leave to amend" or "reverse its denial of the Commissioner's motion, permit the amendment, and consider the Commissioner's claim under § 2036". Estate of Strangi v. Commissioner, 293 F.3d 279, 282 [89 AFTR 2d 2002-2977] (5th Cir. 2002).

On remand, the Tax Court opted to permit the amendment. The parties submitted additional briefs on the § 2036(a) issue and the Tax Court entered its opinion in May 2003, finding in favor of the Commissioner, and upholding the initially-assessed estate tax deficiency. See Estate of Strangi v. Commissioner, T.C. Memo 2003-145 [TC Memo 2003-145] (2003) ("Strangi II"). The Estate now appeals the decision of the Tax Court.

II

[1] The Strangi Estate advances two primary arguments. Both hinge on the application of I.R.C. § 2036(a) to the facts at hand. Section 2036(a) provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death
>
> > ((1)) the possession or enjoyment of, or the right to the income from, the property, or
> > ((2)) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

First, the Estate contends that the Tax Court erred in holding that Strangi retained "possession or enjoyment" of the property he transferred to SFLP or the right to designate who would possess or enjoy it. If Strangi did not retain such an interest, § 2036(a) does not apply. Second, the Estate contends that, even if Strangi retained pos [pg. 2005-5235] session or enjoyment of the assets, the Tax Court erred in holding that the transfer did not fall within the "bona fide sale" exception to § 2036 (a).

A

The core of the Estate's argument on appeal is that the Tax Court erred in concluding that Strangi retained possession or enjoyment of the assets he transferred to SFLP. It follows, the Estate contends, that the Tax Court erred in holding that the assets were includible in the taxable estate under § 2036 (a).

Section 2036(a) is one of several provisions of the Internal Revenue Code intended to prevent parties from avoiding the estate tax by means of testamentary substitutes that permit a transferor to retain lifetime enjoyment of purportedly transferred property. See Estate of Lumpkin v. Commissioner, 474

F.2d 1092, 1097 [31 AFTR 2d 73-1381] (5th Cir. 1973). Specifically, § 2036(a) provides that property transferred by a decedent will be included in the taxable estate if, after the transfer, the decedent retains either (1) "possession or enjoyment" of the transferred property; or (2) "the right ... to designate the persons who shall possess or enjoy the property or the income therefrom".

A transferor retains "possession or enjoyment" of property, within the meaning of § 2036(a)(1), if he retains a "substantial present economic benefit" from the property, as opposed to "a speculative contingent benefit which may or may not be realized". United States v. Byrum, 408 U.S. 125, 145, 150 [30 AFTR 2d 72-5811] (1972). IRS regulations further require that there be an "express or implied" agreement "at the time of the transfer" that the transferor will retain possession or enjoyment of the property. 26 C.F.R. § 20.2036- 1(a).

In the case at bar, the benefits retained by Strangi --including, for example, periodic payments made prior to Strangi's death, the continued use of the transferred house, and the post-death payment of various debts and expenses -- were clearly "substantial" and "present", as opposed to "speculative" or "contingent". [3] As such, our inquiry under § 2036(a)(1) turns solely on whether there was an express or implied agreement that Strangi would retain de facto control and/or enjoyment of the transferred assets.

The Commissioner does not suggest that any express agreement existed. Thus, the precise question before us is whether the record supports the Tax Court's conclusion that Strangi and the other shareholders of Stranco -- that is, the Strangi children -- had an implicit agreement by which Strangi would retain the enjoyment of his property after the transfer to SFLP. [4]

The Tax Court's determination that an implied agreement existed is a finding of fact and is reviewed only for clear error. See Maxwell v. Commissioner, 3 F.3d 591, 594 [72 AFTR 2d 93-6733] (5th Cir. 1993). A factual finding is not clearly erroneous if it is plausible in light of the record read as a whole. See, e.g., United States v. Villanueva, 408 F.3d 193, 203 (5th Cir. 2005). As such, we will disturb the Tax Court's findings of fact only if we are "left with the definite and firm conviction that a mistake has been made". Otto Candles, L.L.C. v. Nippon Kaiji Kyokai Corp., 346 F.3d 530, 533 (5th Cir. 2003) (quoting Allison v. Roberts (In re Allison), 960 F.2d 481, 483 (5th Cir. 1992)).

The Tax Court, in its memorandum opinion, presented a litany of circumstantial evidence to support its conclusion. The Estate responds that each of the factors cited by the court is either factually erroneous or irrelevant. We consider each of the evidentiary factors in turn.

First, the Commissioner cites SFLP's various disbursements of funds to Strangi or his Estate. The Estate responds that only [pg. 2005-5236] two of the payments -- those made in September and October 1994, totaling $14,000 -- should be considered, because the remaining payments were made after Strangi's death, and thus "were not as a consequence of anything Mr. Strangi did".

The Estate's response misses the point. Certainly, part of the "possession or enjoyment" of one's assets is the assurance that they will be available to pay various debts and expenses upon one's death. [5] And that assurance is precisely what Strangi retained in this case. SFLP distributed over $100,000 from 1994 to 1996 to pay for funeral expenses, estate administration expenses, specific bequests and various personal debts that Strangi had incurred. These repeated distributions provide strong circumstantial evidence of an understanding between Strangi and his children that "partnership" assets would be used to meet Strangi's expenses. [6]

Second, the Tax Court found "highly probative" Strangi's "continued physical possession of his residence after its transfer to SFLP". The Estate responds by noting that SFLP charged Strangi rent on the home. As the Tax Court observed, although the rent charge was recorded in SFLP's books in 1994, the Estate made no actual payment until 1997. Even assuming that the belated rent payment was not a post hoc attempt to recast Strangi's use of the house, such a deferral, in itself, provides a substantial economic benefit. As such, the Tax Court did not err in considering Strangi's continued occupancy of his home as evidence of an implied agreement.

Third, both the Commissioner and the Tax Court point to Strangi's lack of liquid assets after the transfer to SFLP as evidence that some arrangement to meet his expenses must have been made. As noted supra, Strangi transferred over 98% of his wealth to SFLP and afterward retained only $762 in truly liquid assets. The Estate counters that Strangi had over $187,000 in "liquefiable" securities, which could have been sold to meet expenses for the remainder of Strangi's life -- that is, for the twelve to twenty-four months he was expected to live after August 1994. Even this limited assertion seems dubious, however, when, as the Tax Court noted, Strangi averaged nearly $17,000 in monthly expenses over the two months between the creation of SFLP and his death. See Strangi II, T.C. Memo 2003-145 [TC Memo 2003-145].

In sum, upon creation of SFLP, Strangi retained assets barely sufficient to meet his own living expenses for the low end of his life expectancy -- that is, for about one year -- assuming he was never required to pay rent, estate administration costs, outstanding personal debts, funeral expenses, or taxes. At the same time, Strangi began receiving substantial monthly payments out of SFLP's coffers. Given these circumstances, we cannot say that the Tax Court clearly erred in holding that Strangi and his children had some implicit understanding by which Strangi would continue to use his assets as needed, and therefore retain "possession or enjoyment" within the meaning of § 2036(a)(1). [7]

B

[2] The Estate next contends that, even if the assets transferred to SFLP do fall within the ambit of § 2036(a)(1), they should nonetheless be excluded from the taxable estate, based on the "bona fide sale" exception contained in § 2036(a). For the reasons set forth below, we disagree.

Section 2036(a) provides an exception for any transfer of property that is a "bona [pg. 2005-5237] fide sale for an adequate and full consideration in money or money's worth". The exception contains two discrete requirements: (1) a "bona fide sale", and (2) "adequate and full consideration". See Estate of Harper v. Commissioner, T.C. Memo 2002-121 [TC Memo 2002-121]. Both must be satisfied for the exception to apply.

1

We turn briefly to the "adequate and full consideration" requirement. This requirement is met only where any reduction in the estate's value is "joined with a transfer that augments the estate by a commensurate ... amount". Kimbell, 371 F.3d at 262 [93 AFTR 2d 2004-2400]. Where assets are transferred into a partnership in exchange for a proportional interest therein, the "adequate and full consideration" requirement will generally be satisfied, so long as the formalities of the partnership entity are respected. [8] The Commissioner concedes that such has been the case here. As such, the adequate and full consideration prong of the exception is satisfied and the sole question before us is whether the transfer was a "bona fide sale".

2

Thus, we turn our attention to the bona fide sale requirement. The term "bona fide", taken literally, means "in good faith" or "without fraud or deceit". See BLACK'S LAW DICTIONARY, 186 (8 th ed. 2004). As we have previously observed, use of a "bona fide" standard often requires the courts to assess both the subjective intent of a party and the objective results of his actions. See, e.g., United States v. Adams, 174 F.3d 571, 576–77 (5th Cir. 1999).

As we noted in Wheeler v. United States, however, Congress in 1976 removed a provision from the Internal Revenue Code that included within the taxable estate transfers "intended to take effect in possession or enjoyment" after the decedent's death. 116 F.3d 749, 765 [80 AFTR 2d 97-5075] (5th Cir. 1997). We observed that Congress's apparent purpose was to "eliminate factbound determinations hinging on subjective motive". Id. (quoting Estate of Elkins [*sic*, Ekins] v. Commissioner, 797 F.2d 481,

486 [58 AFTR 2d 86-6357] (7th Cir. 1986)). As such, since Wheeler, we have held that whether a transfer of assets is a bona fide sale under § 2036(a) is a purely objective inquiry. See Kimbell, 371 F.3d at 263–64.

We have yet to definitively state, however, precisely what this "objective" inquiry entails. Relying on language from Wheeler, the Estate contends that the "objective" bona fide sale inquiry requires only that the transfer be for adequate and full consideration. [9] The exception to § 2036(a), however, already expressly requires that transfers be for "adequate and full consideration". As such, the Estate's interpretation of the exception would render the term "bona fide" superfluous, and must therefore be rejected. [10]

We think that the proper approach was set forth in Kimbell, in which we held that a sale is bona fide if, as an objective matter, it serves a "substantial business [or] other non-tax" purpose. Id. at 267. As noted supra, Congress has foreclosed the possibility of determining the purpose of a given transaction based on findings as to the subjective motive of the transferor. In [pg. 2005-5238] stead, the proper inquiry is whether the transfer in question was objectively likely to serve a substantial non-tax purpose. [11] Thus, the finder of fact is charged with making an objective determination as to what, if any, non-tax business purposes the transfer was reasonably likely to serve at its inception. We review such a determination only for clear error. See Walker Intern. Holdings Ltd. v. Republic of Congo, 395 F.3d 229, 233 (5th Cir. 2004).

The Estate proffered five discrete non- tax rationales for Strangi's transfer of assets to SFLP. They are: (1) deterring potential tort litigation by Strangi's former housekeeper; (2) deterring a potential will contest by the Seymour children; (3) persuading a corporate executor to decline to serve; (4) creating a joint investment vehicle for the partners; and (5) permitting centralized, active management of working interests owned by Strangi. The Tax Court rejected each of the rationales as factually implausible. In reviewing for clear error, we ask only whether the Tax Court's findings are supported by evidence in the record as a whole, not whether we would necessarily reach the same conclusions.

First, the Estate contends that Strangi transferred his assets to SFLP partly out of concern that his former housekeeper, Stone, might bring a tort claim against the Estate for injuries sustained on the job. The Tax Court, however, heard admissions by Gulig that Strangi had paid all of the medical expenses stemming from Stone's injury and had continued to pay her salary during her absence from work.

Still, the Estate contends, had Stone sued, she might have recovered a substantial amount for her pain and suffering. Although this possibility cannot be ruled out entirely, the evidence before the Tax Court suggests otherwise. Gulig testified, for example, that Stone and Strangi were "very close" and admitted that he had never inquired as to whether there was any evidence that Strangi actually caused Stone's injury. Further, there is no evidence that Stone ever threatened to take any action. As such, the Tax Court did not clearly err in finding that the transfer of assets into SFLP did not operate to deter Stone from bringing a tort claim against the Estate.

Second, the Estate contends that SFLP served to deter a will contest by the Seymour children. The Tax Court concluded that "[t]he Seymour claims were stale when the partnership was formed, and they never materialized". Strangi I, 115 T.C. at 485. Further, although the Seymour children did retain counsel, Gulig admitted that prior to the creation of SFLP neither they nor their attorney ever contacted him in regard to Strangi's will, and that no claim was ever made against the Estate. Although reasonable minds might differ on this point, the Tax Court's factual conclusion -- i.e., that the Seymour children either would not or could not have mounted a successful challenge to the will -- is not clearly erroneous.

Third, the Estate argues that SFLP deterred TCB, the corporate co-executor of Strangi's will, from serving, thus saving the Estate a substantial amount in executor's fees. The Estate presented Gulig's testimony regarding a meeting with TCB and TCB's subsequent declination to serve. Nonetheless, the Tax Court was unpersuaded, noting that it was "skeptical of the estate's claims of business purposes

related to executor and attorney's fees". See id.

The Estate concedes that "the reason for which the corporate co-executor declined to serve[] is not reflected in the record". Thus, although a finder of fact might infer a causal relationship between the existence of SFLP and TCB's withdrawal, there is nothing clearly erroneous in the Tax Court's refusal to do so.

Fourth, the Estate contends that SFLP functioned as a joint investment vehicle for its partners. The Tax Court rejected this contention, noting that the contribution of the Strangi children, which totaled $55,650, was de minimis and thus properly [pg. 2005-5239] ignored for purposes of the bona fide sale requirement. The Tax Court further concluded that, even if the contributions of the children were properly considered, SFLP never made any investments or conducted any active business following its formation. See Strangi I, 115 T.C. at 486.

The Estate responds that ignoring a shareholder's contribution as de minimis runs contrary to Kimbell, in which we noted that there exists "no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for ... transfers to be bona fide". 371 F.3d at 268. It is certainly true that the de minimis contribution of a minority partner is not, in itself, sufficient grounds for finding that a transfer of assets to a partnership is not bona fide. However, where a partnership has made no actual investments, the existence of minimal minority contributions may well be insufficient to overcome an inference by the finder of fact that joint investment was objectively unlikely. Such appears to have been the case here. Thus, it was not clear error for the Tax Court to reject the Estate's "joint investment" rationale.

Finally, the Estate contends that SFLP permitted active management of Strangi's "working assets". As a preliminary matter, it is undisputed that the overwhelming majority of the assets transferred to SFLP did not require active management. Some seventy percent of the transfer, for example, was comprised of various brokerage accounts. As the Estate points out, however, this is not unlike the situation in Kimbell, where we reversed summary judgment for the Commissioner based in part on the transferor's contribution of $438,000 in working oil and gas properties, which comprised approximately 11% of the overall transfer. See id. at 267.

The Estate asserts that working assets -- including real property and interests in real estate partnerships -- comprise an approximately equal proportion of the transfer in this case, as in Kimbell. Assuming this to be an accurate characterization of Strangi's contribution, this analogy misses the point. In Kimbell, we reviewed cross motions for summary judgment on the "bona fide sale" issue. In reversing the Tax Court, we noted that the Commissioner "raised no issues of material fact in its motion for summary judgment and challenged none of the taxpayer's facts". Id. at 268–69. Among the unchallenged facts was the taxpayer's assertion that there had been significant active management of the transferred oil and gas properties. Id. at 267–68.

By contrast, this case comes to us after a full trial on the merits. The Tax Court heard uncontested evidence that "[n]o active business was conducted by SFLP following its formation". Strangi I, 115 T.C. at 486. In short, although Strangi may have transferred a substantial percentage of assets that might have been actively managed under SFLP, the Tax Court concluded, based on substantial evidence, that no such management ever took place. From this, the Tax Court fairly inferred that active management was objectively unlikely as of the date of SFLP's creation. As such, we cannot say that the Tax Court clearly erred in rejecting the Estate's "active management" rationale.

In sum, we hold that the Tax Court did not clearly err in finding that Strangi's transfer of assets to SFLP lacked a substantial non-tax purpose. Accordingly, the "bona fide sale" exception to § 2036(a) is not triggered, and the transferred assets are properly included within the taxable estate. We therefore affirm the estate tax deficiency assessed against the Estate.

C

[3] The Estate raises one final matter for our consideration. It contends that, even if the Tax Court did not err in holding the transferred assets includible under § 2036(a), it nonetheless abused its discretion in denying the Estate leave to amend its petition to include a computational offset, based on a time-barred income tax refund, under the doctrine of equitable recoupment. As such, the Estate requests that we remand the case to the Tax Court with instructions that it offset the assessed estate tax deficiency by $304,402 already paid in income taxes. [pg. 2005-5240]

The doctrine of equitable recoupment applies where the Commissioner brings a timely suit for payment of taxes owed and the taxpayer seeks to offset that amount by seeking a refund of an erroneously imposed tax, but the taxpayer's claim is time- barred. Equitable recoupment allows the taxpayer to raise the time barred refund claim "in order to reduce or eliminate the money owed on the [Commissioner's] timely claim". Estate of Branson v. Commissioner, 264 F.3d 904, 909 [88 AFTR 2d 2001-5726] (9th Cir. 2001).

The problem in this case, as the Tax Court points out, is that the Estate has adopted two inconsistent positions with respect to its equitable recoupment argument. To sustain a claim for equitable recoupment, the taxpayer must show, inter alia, that the refund sought is, in fact, time- barred. See Estate of Branson, 264 F.3d at 910 (citing Stone v. White, 301 U.S. 532, 538 [19 AFTR 503] (1937)). The Estate, however, currently has a separate action pending in the Western District of Texas, in which it contends that the disputed refund is not time-barred.

Given this inconsistency, the Tax Court held that the Estate failed to show that the refund was time-barred, and denied its motion to amend. On appeal, the Estate argues only that this result is inequitable. Unfortunately, in so doing, it neglects to address the controlling legal issue here -- i.e., whether the Tax Court erred in concluding that the refund was not time- barred, and thus not subject to equitable recoupment. In sum, because the Estate has failed to brief us on the underlying merits of the Tax Court's ruling, it has likewise failed to show that the Tax Court abused its discretion in denying the motion to amend.

III

For the foregoing reasons, the decision of the Tax Court is

AFFIRMED.

1

The assets that Strangi transferred to SFLP included, inter alia, (1) brokerage accounts at Smith Barney and Merrill-Lynch valued at $7.4 million; (2) an annuity valued at $276,000; (3) two life insurance policies valued at a total of $70,000; (4) two houses in Waco; (5) a condominium in Dallas; (6) a commercial warehouse in Dallas; and (7) several limited partnership interests, valued at approximately $400,000.

2

The basis for the discrepancy in this case -- and the primary rationale for the use of family limited partnerships generally -- is the IRS's practice of permitting discounts in the taxable value of an estate based on a lack of marketability or control of estate property. See 26 C.F.R. § 20.2031-1(b) ("The value of every item of property includible in a decedent's gross estate ... is its fair market value at the time of the decedent's death...").

3

See Byrum, 408 U.S. at 146–47 (A substantial present interest exists in "situations in which the owner of property divested himself of title but retained an income interest or, in the case of real

property, the lifetime use of the property".).

4

As the Tax Court explained, § 2036(a) includes within the taxable estate any asset that is not transferred "absolutely, unequivocally, irrevocably, and without possible reservations". Strangi II, T.C. Memo 2003-145 [TC Memo 2003-145] (quoting Commissioner v. Estate of Church, 335 U.S. 632, 645 [37 AFTR 480] (1945)). The controlling question for present purposes, then, is not whether Strangi actually kept any particular asset in his possession, but whether he received a general assurance that his assets would be available to meet his personal needs.

5

See 26 C.F.R. § 20.2036-1 ("The "use, possession ... or other enjoyment of the transferred property" is considered as having been retained by ... the decedent to the extent that the use, possession ... or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent ...."); see also Ray v. United States, 762 F.2d 1361, 1363 [56 AFTR 2d 85-6496] (9th Cir. 1985)(considering use of transferred assets to pay transferor's funeral expenses as supportive of finding that transferor retained possession or enjoyment under § 2036).

6

The Estate further contends that all of the above payments were "pro rata partnership distributions", meaning that Stranco received cash disbursements in proportion to its 1% general partner interest in SFLP. The Tax Court characterized these payments as "de minimis", insofar as they did not "in any substantial way operate to curb decedent's ability to benefit from SFLP property". Strangi II, T.C. Memo 2003-145 [TC Memo 2003-145]. In short, although the importance of the pro rata distributions to the "implied agreement" inquiry is perhaps debatable, there is nothing clearly erroneous about the decision to assign them minimal weight.

7

Because we hold that the transferred assets were properly included in the taxable estate under § 2036(a)(1), we do not reach the Commissioner's alternative contention that Strangi retained the "right ... to designate the persons who shall possess or enjoy the property", thus triggering inclusion under § 2036(a)(2).

8

As we observed in Kimbell, 371 F.3d at 266:

> The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

9

In support of its contention, the Estate cites Wheeler for the proposition that "[t]he only possible grounds for challenging the legitimacy of a transaction [under § 2036(a)] are whether the transferor actually parted with the [transferred property] and the transferee actually parted with the requisite

adequate and full consideration". 116 F.3d at 764. Our holding in Wheeler, however, was expressly limited to the narrow factual circumstances of an intra-family sale of a remainder interest in real property. See id. at 756. Although adequate consideration may suffice to show the absence of fraud or deceit where a real property interest is, in fact, transferred from one party to another, such is not the case where, as here, the purported transfer arguably deprives the transferor of literally nothing.

10

We recognize that the Estate's proposed interpretation of § 2036(a) would yield a more uniform and predictable rule than the one set forth in Kimbell and here. Although we acknowledge the importance of predictability in the law governing estates and estate planning, it cannot be had at the expense of the plain language of the statute.

11

Accord Merryman v. Commissioner, 873 F.2d 879, 881 [64 AFTR 2d 89-5009] (5th Cir. 1989) ("To determine whether economic substance is present, courts view the objective realities of the transaction or, in other words, whether what was actually done is what the parties to the transaction purported to do.").

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American Federal Tax Reports

U.S. v. GRACE et al., Cite as 23 AFTR 2d 69-1954 (395 US 316), 06/02/1969

U. S., PETITIONER v. Estate of Joseph P. GRACE, Deceased, et al., RESPONDENT.

Case Information:

Code Sec(s):	
Court Name:	U. S. Supreme Court,
Docket No.:	No. 574,
Date Decided:	06/02/1969
Prior History:	U. S. Court of Claims, No. 400-59, 21 AFTR 2d 1652 (393 F. 2d 939), reversed and remanded.
Tax Year(s):	Date of death, July 15, 1950.
Disposition:	Decision for Govt.
Cites:	23 AFTR 2d 69-1954, 395 US 316, 89 S Ct 1730, 23 L Ed 2d 332, 69-1 USTC P 12609.

HEADNOTE

1. ESTATE TAX—Transfers with retained life estate—retention of the right to income. When separate trusts were created by decedent and his wife for the benefit of each other for life, trust created by wife for decedent's benefit includible in his estate. Reciprocal trust doctrine applicable: finding that trusts were created in consideration for each other or to avoid estate taxes not required; only requirements are that trusts be interrelated and that they put settlors in approximately the same economic position as if they had retained a life estate in the trusts they created.

Reference(s): 1969 P-H Fed. ¶ 120,364(10); 147,202. [pg. 69-1955]

OPINION

On Writ of Certiorari to the United States Court of Claims.

Judge: Mr. JUSTICE MARSHALL delivered the opinion of the Court.

[1] This case involves the application of § 811 (c)(1)(B) of the Internal Revenue Code of 1939 to a so-

called "reciprocal trust" situation. [1] After Joseph P. Grace's death in 1950, the Commissioner of Internal Revenue determined that the value of a trust created by his wife was includible in his gross estate. A deficiency was assessed and paid, after denial of a claim for a refund, this refund suit was brought. The Court of Claims, with two judges dissenting, ruled that the value of the trust was not includible in decedent's estate under § 811(c)(1)(B) and entered judgment for respondent. Estate of Joseph P. Grace v. United States, 183 Ct. Cl. 745, 393 F. 2d 939 [21 AFTR 2d 1652] (1968). We granted certiorari because of an alleged conflict between the decisions below and certain decisions in the Courts of Appeals and because of the importance of the issue presented to the administration of the federal estate tax laws. 393 U. S. 975 (1968). We reverse.

I

Decedent was a very wealthy man at the time of his marriage to the late Janet Grace in 1908. Janet Grace had no wealth or property of her own, but between 1908 and 1931, decedent transferred to her a large amount of personal and real property, including the family's Long Island estate. Decedent retained effective control over the family's business affairs, including the property transferred to his wife. She took no interest and no part in business affairs and relied upon her husband's judgment. Whenever some formal action was required regarding property in her name, decedent would have the appropriate instrument prepared and she would execute it.

On December 15, 1931, decedent executed a trust instrument, hereinafter called the Joseph Grace trust. Named as trustees were decedent, his nephew, and a third party. The trustees were directed to pay the income of the trust to Janet Grace during her lifetime, and to pay to her any part of the principal which a majority of the trustees might deem advisable. Janet was given the power to designate, by will or deed, the manner in which the trust estate remaining at her death was to be distributed among decedent and their children. The trust properties included securities and real estate interests.

On December 30, 1931, Janet Grace executed a trust instrument, hereinafter called the Janet Grace trust, which was virtually identical to the Joseph Grace trust. The trust properties included the family estate and corporate securities, all of which had originally been transferred to her by decedent in preceding years.

The trust instruments were prepared by one of decedent's employees in accordance with a plan devised by decedent to create additional trusts before the advent of a new gift tax expected to be enacted the next year. Decedent selected the properties to be included in each trust. Janet Grace, acting in accordance with this plan, executed her trust instrument at decedent's request.

Janet Grace died in 1937. The Joseph Grace trust terminated at her death. Her estate's federal estate tax return disclosed the Janet Grace trust and reported it as a nontaxable transfer by Janet Grace. The Commissioner asserted that the Janet and Joseph Grace trusts were "reciprocal" and asserted a deficiency to the extent of mutual value. Compromises on unrelated issues resulted in 55% of the smaller of the two trusts, the Janet Grace trust, being included in her gross estate. [pg. 69-1956]

Joseph Grace died in 1950. The federal estate tax return disclosed both trusts. The Joseph Grace trust was reported as a nontaxable transfer and the Janet Grace trust was reported as a trust under which decedent held a limited power of appointment. Neither trust was included in decedent's gross estate.

The Commissioner determined that the Joseph and Janet Grace trusts were "reciprocal" and included the amount of the Janet Grace trust in decedent's gross estate. A deficiency in the amount of $363,500.97, plus interest, was assessed and paid.

II

Section 811(c)(1)(B) of the Internal Revenue Code of 1939 provided that certain transferred property

in which a decedent retained a life interest was to be included in his gross estate. The general purpose of the statute was to include in a decedent's gross estate transfers that are essentially testamentary — i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime. See Commissioner v. Estate of Church, 335 U.S. 632, 643-644 [37 AFTR 495] (1949).

The doctrine of reciprocal trusts was formulated in response to attempts to draft instruments which seemingly avoid the literal terms of § 811(c)(1)(B), while still leaving the decedent the lifetime enjoyment of his property. [2] The doctrine dates from Lehman v. Commissioner, 109 F.2d 99 [24 AFTR 198] (C.A. 2d Cir.), cert. denied, 310 U.S. 637 (1940). In Lehman, decedent and his brother owned equal shares in certain stocks and bonds. Each brother placed his interest in trust for the other's benefit for life, with remainder to the life tenant's issue. Each brother also gave the other the right to withdraw $150,000 of the principal. If the brothers had each reserved the right to withdraw $150,000 from the trust that each had created, the trusts would have been includible in their gross estates as interests of which each had made a transfer with a power to revoke. When one of the brothers died, his estate argued that neither trust was includible because the decedent did not have a power over a trust which he had created.

The Second Circuit disagreed. That court ruled that the effect of the transfers was the same as if the decedent had transferred his stock in trust for himself, remainder to his issue, and had reserved the right to withdraw $150,000. The court reasoned:

> "The fact that the trusts were reciprocated or 'crossed' is a trifle, quite lacking in practical or legal significance. ... The law searches out the reality and is not concerned with form." 109 F.2d, at 100.

The court ruled that the decisive point was that each brother caused the other to make a transfer by establishing his own trust.

The doctrine of reciprocal trusts has been applied numerous times since the Lehman decision. [3] It received congressional approval in § 6 of the Technical Changes Act of 1949, c. 720, 63 Stat. 893. [4] The present case is, however, this Court's first examination of the doctrine.

The Court of Claims was divided over the requirements for application of the doctrine to the situation of this case. Relying on some language in Lehman and certain other Courts of Appeals' decisions, [5] the majority held that the crucial factor was whether the decedent had established his trust as consideration for the establishment of the trust of which he was a beneficiary. The court ruled that decedent had not established his trust as a quid pro quo for the Janet Grace trust, and that Janet Grace had not established her trust in exchange [pg. 69-1957] for the Joseph Grace trust. Rather, the trusts were found to be part of an established pattern of family giving, with neither party desiring to obtain property from the other. Indeed, the court found that Janet Grace had created her trust because decedent requested that she do so. It therefore found the reciprocal trust doctrine inapplicable.

The court recognized that certain cases had established a slightly different test for reciprocity. [6] Those cases inferred consideration from the establishment of two similar trusts at about the same time. The court held that any inference of consideration was rebutted by the evidence in the case, particularly the lack of any evidence of an estate tax avoidance motive on the part of the Graces. In contrast, the dissent felt that the majority's approach placed entirely too much weight on subjective intent. Once it was established that the trusts were interrelated, the dissent felt that the subjective intent of the parties in establishing the trusts should become irrelevant. The relevant factor was whether the trusts created by the settlors placed each other in approximately the same objective economic position as they would have been in if each had created his own trust with himself, rather than the other, as life beneficiary.

We agree with the dissent that the approach of the Court of Claims majority places too much emphasis

on the subjective intent of the parties in creating the trusts and for that reason hinders proper application of the federal estate tax laws. It is true that there is language in Lehman and other cases that would seem to support the majority's approach. It is also true that the results in some of those cases arguably support the decision below. [7] Nevertheless, we think that these cases are not in accord with this Court's prior decisions interpreting related provisions of the federal estate tax laws.

Emphasis on the subjective intent of the parties in creating the trusts, particularly when those parties are members of the same family unit, creates substantial obstacles to the proper application of the federal estate tax laws. As this Court said in Estate of Spiegel v. Commissioner, 335 U.S. 701, 705-706 [37 AFTR 459] (1949):

> "Any requirement ... [of] a post-death attempt to probe the settlor's thought in regard to the transfer, would partially impair the effectiveness of ... [section 811(c)] as an instrument to frustrate estate tax evasions."

We agree that "the taxability of a trust corpus ... does not hinge on a settlor's motives, but depends upon the nature and operative effect of the trust transfer." Id., 335 U.S., at 705. See also Commissioner v. Estate of Church, supra.

We think these observations have particular weight when applied to the reciprocal trust situation. First, inquiries into subjective intent, especially in intrafamily transfers, are particularly perilous. The present case illustrates that it is, practically speaking, impossible to determine after the death of the parties what they had in mind in creating trusts over 30 years earlier. Second, there is a high probability that such a trust arrangement was indeed created for tax-avoidance purposes. And, even if there was no estate-tax-avoidance motive, the settlor in a very real and objective sense did retain an economic interest while purporting to give away his property. [8] Finally, it is unrealistic to assume that the settlors of the trusts, usually members of one family unit, will have created their trusts as a bargained-for exchange for the other trust. "Consideration," in the traditional legal sense, simply does not normally enter into such intrafamily transfers. [9]

For these reasons, we hold that application [pg. 69-1958] of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo for the other. Such a "consideration" requirement necessarily involves a difficult inquiry into the subjective intent of the settlors. Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries. [10]

Applying this test to the present case, we think it clear that the value of the Janet Grace trust fund must be included in decedent's estate for federal estate tax purposes. It is undisputed that the two trusts are interrelated. They are substantially identical in terms and were created at approximately the same time. Indeed, they were part of a single transaction designed and carried out by decedent. It is also clear that the transfers in trust left each party, to the extent of mutual value, in the same objective economic position as before. Indeed, it appears, as would be expected in transfers between husband and wife, that the effective position of each party vis-a-vis the property did not change at all. It is no answer that the transferred properties were different in character. For purposes of the estate tax, we think that economic value is the only workable criterion. Joseph Grace's estate remained undiminished to the extent of the value of his wife's trust and the value of his estate must accordingly be increased by the value of that trust.

The judgment of the Court of Claims is reversed and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Mr. Justice Stewart took no part in the consideration or decision of this case.

On Writ of Certiorari to the United States Court of Claims.

Judge: Mr. JUSTICE DOUGLAS, dissenting. The object of a reciprocal trust, as I understand it, is for each settlor to rid himself of all taxable power over the corpus by exchanging taxable powers with the other settlor. Yet Joseph P. Grace and his wife did not exchange taxable powers. Each retained a sufficient power over the corpus to require the inclusion of the corpus in his or her taxable estate. Each settler, as one of the three trustees, reserved the right to alter the trust by paying to the chief beneficiary "any amounts of the principal of the said trust, up to and including the whole thereof, which the said Trustees or a majority of them may at any time or from time-to-time in their sole discretion deem advisable." I have quoted from Janet Grace's trust. But an identical provision is in the trust of Joseph P. Grace. I would conclude from the existence of this reserved power * that the corpus of the Janet Grace trust was includable in her estate for purposes of the estate tax. Lober v. United States, 346 U. S. 335 [44 AFTR 467]. That is to say the use of a reciprocal trust device to aid the avoidance of an estate tax is simply not presented by this case. I would dismiss the petition as improvidently granted.

1

Section 811(c)(1)(B) provided that—

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property ...

"(c) ...

"(1) *General rule.* To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise—

"(B) under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (i) the possession or enjoyment of, or the right to the income from, the property, or (ii) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom ...."

Section 811(c)(1)(B) has been recodified as § 2036 of the Internal Revenue Code of 1954, 26 U. S. C. § 2036.

2

See Colgan & Molloy, Converse Trusts—The Rise and Fall of a Tax Avoidance Device, 3 Tax. L. Rev. 271 (1948).

3

See, e.g., Glaser v. United States, 306 F. 2d 57 [10 AFTR 2d 6224] (C.A. 7th Cir. 1962); Estate of Moreno v. Commissioner, 260 F. 2d 389 [2 AFTR 2d 6430] (C. A. 8th Cir. 1958); Hanauer's Estate v. Commissioner, 149 F. 2d 857 [33 AFTR 1474] (C. A. 2d Cir.), cert. denied, 326 U. S. 770 (1945); Cole's Estate v. Commissioner, 140 F. 2d 636 [32 AFTR 150] (C. A. 8th Cir. 1944).

4

See S. Rep. No. 831, 81st Cong., 1st Sess., 5-6 (1949); H. R. Rep. No. 920, 81st Cong., 1st Sess., 5 (1949).

5

See McLain v. Jarecki, 232 F. 2d 211 [49 AFTR 889] (C. A. 7th Cir. 1956); Newberry's Estate v. Commissioner, 201 F. 2d 874 [43 AFTR 244] (C. A. 3d Cir. 1953); In re Lueder's Estate, 164 F. 2d 128 [36 AFTR 233] (C. A. 3d Cir. 1947).

6

E. g., Orvis v. Higgins, 180 F. 2d 537 [39 AFTR 36] (C. A. 2d Cir.), cert. denied, 340 U. S. 810 (1950).

7

See cases cited in n. 5, supra.

8

For example, in the present case decedent ostensibly devised the trust plan to avoid an imminent federal gift tax. Instead of establishing trusts for the present benefit of his children, he chose an arrangement under which he and his wife retained present enjoyment of the property and under which the property would pass to their children without imposition of either estate or gift tax.

9

The present case is probably typical in this regard. Janet Grace created her trust because decedent requested that she do so; it was in no real sense a bargained-for quid pro quo for his trust. See also Hanauer's Estate v. Commissioner, supra, n. 3.

10

We do not mean to say that the existence of "consideration," in the traditional legal sense of a bargained-for exchange, can never be relevant. In certain cases, inquiries into the settlor's reasons for creating the trusts may be helpful in establishing the requisite link between the two trusts. We only hold that a finding of a bargained-for consideration is not necessary to establish reciprocity.

*

The relevant provision of the 1939 Internal Revenue Code (§ 811(d)(2)) is practically identical with the corresponding provision of the 1954 Code (26 U.S.C. § 2038(a)(2)). Each provides that a decedent's gross estate shall include property—

"To the extent of any interest therein of which the decedent has at any time made a transfer ... where the enjoyment therefore thereof was subject at the date of his death to any change through the exercise of a power ... by the decedent alone *or by the decedent in conjunction with any other person* ... to alter, amend, or revoke ...."

The provisions of the Joseph and Janet Grace trusts would seem to satisfy that test, for only two out of the three trustees were necessary to alter the trust. See Helvering v. City Bank Co., 296 U. S. 85 [16 AFTR 981].

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Estate Planning and Drafting Series 6th Edition

WEEK 4 READING AND DRAFTING

- Pennell Chapter 3
  Chapter 5, Parts B & C
- Code sections 2039, 2040, 2041, 2042, 2043, 2044, 2045, 2046, and corresponding Regulations
- ORC section 5808.14

Drafting

Client wants to establish an irrevocable trust for a grandchild. She plans to give $14,000 per year to the trust, and her husband plans to do the same. The contributions will be invested in marketable securities. The trust will end when the grandchild is 35. Client insists on serving as trustee, and she wants as much discretion as possible. You caution her about the dangers of § 2036 and § 2038, but she responds: "I'm sure you can find a way to make it work. I have friends in Palm Beach who do this all the time." Please prepare the provisions governing distribution of income and principal to grandchild, giving as much discretion to trustee as possible, while still avoiding application of § 2036 and § 2038.

Please E-mail or Fax your revised clauses to Mark, Bill, and Ken before 6:00 p.m., Saturday, February 6, 2016.

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