INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

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Index (UIL) No.: 6166.00-00, 6403.00-00, 2055.00-00, 2511.02-00, 414.00-00, 2053.09-00, 2032.00-00
CASE-MIS No.: TAM-142156-05 AUGUST 04, 2006

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year Involved:
Date of Conference:

Legend

Decedent =
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=
=
=
A =
B =
Trust =

Trust =

Trust =

Trust 2
Date 1 =

Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
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$X =
$Y =
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$AA =
$BB =
Corporation =
Co. 1 =
Co. 2 =

Co. 3 =
State =
Charity =
Cite 1 =

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Cite 3 =

Cite 4 =

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State Statute 1 =
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State Statute 5 =
State Statute 6 =
Company =
Footnote 2 =

Issue 1:

How should the $A payment made by the Estate in conjunction with the filing of the Form 4768 be applied in this case?

Issue 1: Conclusion:

If the Estate requests the Service to apply the remittance other than as originally designated to the outstanding GST and estate tax liabilities, the remittance can be treated as an undesignated voluntary payment. The Service has complete discretion to allocate undesignated payments against any matured tax liabilities (taxes for which the date for filing the return as expired) of the Estate at the time of the remittance. However, the Estate has no legal right to insist the Service reallocate the payment.

Decedent died testate on Date 1. On Date 2, the executor for Decedent's Estate ("the Estate") timely filed a Form 4768 (Application for Extension of Time to File a Return and/or Pay U.S. Estate and Generation-Skipping Transfer Taxes) requesting an extension until Date 3, for the filing of the Estate's Federal Estate Tax Return (Form 706). Along with the extension request, the Estate remitted $A, designating it as a payment of federal estate and generation skipping transfer (GST) taxes.

The estate tax return was timely filed on Date 3, reporting a total tax liability of approximately $B, and a balance due of $C after application of the $A remittance. On the estate tax return, the Estate elected to defer the maximum amount of estate tax eligible to defer under section 6166 of the Internal Revenue Code. On Date 4, the Estate amended its estate tax return to report a total tax liability of $D and a balance due of approximately $E, consisting of currently due GST tax in the amount of $F and deferred estate tax of approximately $G. The Estate did not make a claim for refund of the $A remittance at the time the amended estate tax return was filed. Also, on Date 3, the Estate filed original gift tax returns for Decedent for the years through , and amended gift tax returns for Decedent for the years through .

, on Date 5, the Estate filed amended gift tax returns for several years, and the outstanding reported gift tax liability was $H with interest thereon of $I, for a total of $J. The Estate paid $K of gift tax with respect to and . The Area Director released a tax lien upon the sale of property of the Estate and applied the proceeds to Decedent's outstanding gift tax liability. In addition, proceeds from the sales of various real estate properties were applied to Decedent's gift tax liability so that the current outstanding gift tax liability is approximately $L.

The first interest installment payment under section 6166 was due Date 6, and the Service Center sent the Estate a letter indicating that no amount was due as the $A payment had been applied towards the first installment. On Date 7, however, the Estate received a statement from the Service Center indicating that the Estate owed a combined $M for its first two interest installment payments under section 6166, and that the $A remittance had not been applied towards the interest installments due under section 6166.

Thus, the Estate currently owes the following amounts: approximately $L of gift tax, $N of GST tax, and $G of estate tax. The Estate requests that the Service first apply the $A remittance to all outstanding section 6166 interest installments with the remainder applied to Decedent's outstanding gift tax liability.

As a general rule, under sections 6075(a) and 6151(a), the estate tax return and payment of the estate tax liability of a decedent's estate is due within nine months of the decedent's death. Section 6166(a), as an exception to the above rule, provides that if the value of an interest in a closely held business included in determining the value of the gross estate of a decedent exceeds 35 percent of the adjusted gross estate, the executor of the estate may elect to pay part or all of the tax imposed by section 2001 (estate tax) in two or more (but not exceeding ten) equal installments. The first installment of tax must be paid on or before the date selected by the executor which is not more than 5 years after the date prescribed by section 6151(a) for payment of the tax. An executor electing to defer estate taxes under section 6166 must make annual payments of interest during the deferral period. In particular, interest must be paid annually during the 5-year period before the first installment of tax is due. Section 6166(f). When an estate fails to make payments of principal or interest, the Service may terminate the deferred payment election and force an acceleration of payment of the estate tax by issuing notice and demand. Section 6166(g)(3).

Section 6402(a) authorizes the Secretary of the Treasury to credit the amount of an overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and subject to certain limitations, refund any balance to such person. The regulations on Procedure and Administration provide that "refunds of overpayments may not be allowed or made after the expiration of the statutory period of limitation properly applicable, unless, before the expiration of such period, a claim therefore has been filed by the taxpayer." Section 301.6402-2(a)(1) of the Procedure and Administration Regulations. [1]

The Internal Revenue Code and Treasury regulations do not contain an all-inclusive definition of the term "overpayment." The United States Supreme Court, however, has defined the term as any payment in excess of that which is properly due. "Such an excess payment may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment." Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947). In United States v. Dalm, 494 U.S. 596, 609 n.6 (1990), the Supreme Court again addressed the meaning of the term "overpayment," stating that "[t]he common sense interpretation is that a tax is overpaid when a taxpayer pays more than is owed, for whatever reason or no reason at all." Although a taxpayer may overpay an installment of the tax, this is not an overpayment within the meaning of section

[1] In this case, the Estate has not filed a claim for refund, but rather requests the Service to apply the payment towards outstanding interest installments under section 6166(f), with the remainder to the outstanding gift tax liability.

6402. See Estate of Baumgardner v. Commissioner, 85 T.C. 455, 461 (1985), acq., 1986-2 C.B. 1 (stating that "an overpayment of an installment is not an 'overpayment of tax' until the entire amount of the tax has been paid;" citing Blair v. Birkenstock, 271 U.S. 348 (1926); Flora v. United States, 357 U.S. 63 (1958).

Rev. Proc. 84-58, 1984-2 C.B. 501, explains the procedure for treating remittances as deposits rather than as tax payments, in order to stop the running of interest on deficiencies.[2] A payment made with an extension request is considered a payment of tax. Dantzler v. U.S.,183 F.3d 1247, 1248 (11th Cir. 1999). See also, David v. United States, 964 F. Supp. 31 (D. Mass. 1997) (A remittance filed contemporaneously with a request for an extension is a payment, not a deposit, particularly when the remittance is not accompanied by any words of protest.) In addition, the Service has set forth its position on whether an overpayment can arise when an estate makes a payment along with a request for an extension of time to file an estate tax return. In this regard, the Service has ruled that an amount paid with a request for an extension of time to file is treated as a payment of tax, rather than a deposit. Rev. Rul. 81-189, 1981-2 C.B. 240 (citing Altantic Oil Producing Co. v. United States, 35 F. Supp. 766 (Ct. Cl. 1940)). Further, an overpayment of tax can exist only if the amount remitted with the request for an extension of time to file exceeds the final tax liability shown on Form 706. Id.

Section 7422 authorizes a taxpayer to institute a civil action for refund of overpaid taxes. As a general rule, a taxpayer can obtain judicial review under the refund method by instituting a suit for refund in a federal district court or the United States Claims Court, having first paid the full amount of the taxes that the Service has determined are due. Flora v. United States, 362 U.S. 145 (1960). Under this so called "full payment rule," it has generally been accepted by the courts that there can be no deviation from the requirement that full payment of the disputed tax be made. Thus, in order to gain access to the courts to file a refund claim, an estate previously had to pay the entire estate tax liability; payment of the section 6166 installments due prior to instituting the suit was insufficient to invoke jurisdiction. Rocovich v. United States, 933 F.2d 991 (Fed. Cir. 1991); Abruzzo v. United States, 24 Cl. Ct. 668 (1991).

The Internal Revenue Service Restructuring and Reform Act of 1998 enacted section 7422(j), thereby creating an exception to the "full payment rule." Pub. L. No. 105-206, § 3104. Section 7422(j) provides that the district courts of the United States and the United States Court of Federal Claims have jurisdiction to determine the correct amount of estate tax liability (including any refund of estate taxes), notwithstanding that the full amount of the estate tax liability has not been paid by reason of the election under section 6166. Section 7422(j) is effective for refund claims filed after July 22, 1998. The additional jurisdiction granted to the district courts and the Court of Federal Claims under section 7422(j) is invoked only when the lack of full payment is the sole reason why refund jurisdiction would have been denied under

[2] Rev. Proc. 84-58 was superseded by Rev. Proc. 2005-18, 2005-13, 2005-1 C.B. 759, which was issued in response to the enactment of section 6603 by the American Jobs Creation Act of 2004. Rev. Proc. 2005-18 provides guidance regarding the treatment of amounts held on deposit under Rev. Proc. 84-58 as amounts on deposit under section 6603.

prior law and does not change the fact that there must be an overpayment of the entire estate tax liability in order to obtain a refund. See Lewis v. Reynolds, 284 U.S. 281 (1932).

Section 6403 provides that, in the case of a tax payable in installments, if the taxpayer has paid as an installment of the tax more than the amount determined to be the correct amount of such installment, the overpayment shall be credited against the unpaid installments, if any. If the amount already paid, whether or not on the basis of installments, exceeds the amount determined to be the correct amount of the tax, the overpayment shall be credited or refunded as provided in section 6402. Section 6403 does not distinguish between installments that are currently due and those installments that are due at a later date. Moreover, the corresponding Treasury Regulations only provide that any overpayment will "be applied against any outstanding installment of such tax." Section 301.6403-1. Thus, section 6403 is applicable to all of the Estate's installments during the 14-year deferral period of section 6166. Consequently, section 6403 requires that the Service apply the amount paid in excess of the non-deferred portion to the interest payments in succeeding installments of interest (and principal for later years).[3]

The regulations under section 6166 provide the following example to illustrate the relationship between sections 6166 and 6403:

> Sixty percent of the value of [decedent] A's adjusted gross estate consisted of a . . . closely held business within the meaning of section 6166. A's executor, B, made a protective election under section 6166 when he filed A's estate tax return. B also applied for an extension of time under section 6161 to pay $15,000 of the $30,000 of estate tax shown due on the return. The requested extension was granted and was renewed at the end of 1 year . . . [A]fter examination of A's estate tax return, the value of the farm was found to constitute 67 percent of the adjusted gross estate. B entered into an agreement consenting to the values as established on examination and to a deficiency of $5,000. B then filed a final notice of election under section 6166, choosing a 5-year deferral followed by 10 annual installment payments and thereby terminated his extension under section 6161 because that amount of tax was then included under the section 6166 election. B could have extended payment of 67 percent of the total estate tax, or $23,450. $23,450 is eligible for installment payments under section 6166 and the section 6166 election is considered to be for that amount. B is considered to have prepaid $3,450 of tax since only $20,000 of tax remained unpaid. The $3,450 is attributed to the first installment of $2,345 and to $1,105 of the second installment which would have been payable under the section 6166 election.

Section 20.6166-1(i), Example (1)-(i), of the Procedure and Administration Regulations. Applying the prepayment in this manner is consistent with the general rule that when a taxpayer submits a partial payment of an assessed liability and does not provide instructions

[3] A decedent's estate is obligated to pay only interest during the first four years of the deferral period. Beginning on the date which is five years after the date prescribed for payment of the tax, the decedent's estate must make annual payments of principal and interest. See I.R.C. section 6166(a)(3), (f) (1), (2).

regarding its application, the Service will apply the payment to periods in the order of priority that the Service determines will serve its best interest. Rev. Proc. 2002-26, 2002-1 C.B. 746. If the amount applied is less than the liability for that period, it will be applied to tax, penalty, and interest in that order until the amount is absorbed. Id.

The relationship between sections 6166 and 6403 has been clarified by the Tax Court. In Estate of Bell v. Commissioner, 92 T.C. 714 (1989), aff'd, 928 F.2d 901 (9th Cir. 1991), the court stated that the crediting of overpayments made by a taxpayer that has elected to pay estate taxes in installments pursuant to section 6166 is governed by section 6403. The Tax Court held "pursuant to both the clear meaning of the language used in section 6403, and the regulations promulgated under section 6166, it is clear that section 6403 applies to the installment-method payments of estate taxes permitted by section 6166." Estate of Bell, 92 T.C. at 727.

The Tax Court in Estate of Bell, supra, found that section 6403 applies in a case where an estate has elected the benefits of section 6166 and has overpaid its installments, even though crediting any such overpayment may have the unintended effect of depriving the estate of the benefits of section 6166 treatment. In affirming the Tax Court, the Court of Appeals for the Ninth Circuit reiterated that the application of section 6403 to an overpayment in the context of an estate that has elected the benefits of section 6166 "is not clearly at odds with the purpose of section 6166." Estate of Bell, 928 F.2d at 904. Thus, the Ninth Circuit held that if a taxpayer, who has elected to defer estate tax liability under section 6166, overpays an installment of that tax, the amount of the overpayment will be credited against future installments rather than refunded to the taxpayer. Id. While both decisions in Estate of Bell, supra, were decided prior to the enactment of section 7422(j), nothing in section 7422(j) overrides the principal that section 6403 applies in the section 6166 context.

When a taxpayer makes a voluntary payment and designates the tax liability to which the payment should be applied, the Service must follow such designation. Hirsch v. United States, 396 F.Supp. 170, 172 (S.D.Ohio1975), 75-1 USTC ¶9348, 35 A.F.T.R.2d 75-1358. See also, Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir.1983) (citing O'Dell v. United States, 326 F.2d 451, 456 (10th Cir.1964)). The U.S. District Court , Eastern District New York has held that, "the right of a taxpayer to designate allocation of a payment is contractual in nature, the designation being viewed as a condition of payment. But the "contract" is complete when the payment is "accepted" by the Service. The taxpayer cannot unilaterally modify the terms of the payment." United States v. Lavi, 2004 WL 2482323, 6 (not reported in F.Supp. 2d). In fact, when a taxpayer designates a payment and the Service does not apply the payment as the taxpayer requested, the Service must correct the error when brought to the Service's attention. Buffalow v. United States, 109 F.3d 570, 574 (9th Cir. 1997). See Tull v. United States, 69 F.3d 394, 399 (9th Cir. 1995) (Court directed that error be corrected when Service has failed to correct designation error). If a taxpayer's designation, however, is untimely and not made with the payment, the Service is not bound by such designation. See Lavi at 6, (April 5, 1994 designation of payments made on December 30, 1986 held not effective); Schoen v. United States, 582 F. Supp. 47 (N.D. Ill.1984), vacated on

other grounds, 759 F.2d 614 (7th Cir.1985) (attempt to designate application of tax payment seven days after payment not timely); Hirsch, 396 F. Supp. at 172-3 (designation following payment by 1-2 months held ineffective).

Alternatively, if a taxpayer voluntarily remits a payment to the Service without designating the application of the funds, the Service has complete discretion to allocate the funds to any account of such taxpayer. In addition, the government is not estopped from then re-applying the funds to another account of a taxpayer once it allocates an undesignated payment to one account of such taxpayer, even after the Service notifies the taxpayer of the original designation in writing. Lavi at 6 (citing Muntwyler, 703 F.2d at 1032, Liddon v. United States, 488 F.2d 509, 513 (5th Cir.1971), cert. denied, 406 U.S. 918, 92 S.Ct. 1969, 32 L.Ed.2d 117 (1972)). See also Jinhong v. United States, 1994 WF 108062, 5 (Bankr. W.D. Wash). (not reported in B.R.) (Service not estopped from re-applying payments to a different liability of the taxpayer when the taxpayer does not designate the payment and the Service first agrees in writing to a specific allocation of the funds). The Service's policy is to designate payments to insure the maximum amount of assessed tax is collected, and courts have allowed reallocation of funds in light of new information or changed circumstances in situations where the taxpayer has made no showing of injury from the reallocation. Davis v. United States, 961 F.2d 867, 878-9 (9th Cir.1992). "Straitjacketing the IRS into its initial allocation decisions would be inconsistent with the goal of maximizing tax revenues." Id. at 879. The reallocation may take place during a later year, but may not be applied to unmatured debts of the taxpayer. Thomas v. United States, 98-2 U.S. Tax Cas. ¶50,622, 82 A.F.T.R.2d 5455 (C.D. Ill. 1998) (refusing to require the Service to reallocate taxpayer's undesignated voluntary payment as originally allocated by the Service despite language in IRM disallowing reallocation).

In the instant case, the $A remittance made with the Estate's Form 4768 extension request does not exceed the total estate tax liability. Applying the rationale of Jones, supra, there is no overpayment for which the Estate can obtain a refund because the Estate did not overpay its entire estate tax liability. While Estate of Bell, supra, indicates that section 6403 applies in the section 6166 context, section 6403 does not apply here because the remittance was made before the section 6166 installment election was made and, thus, was not paid as an installment of the tax.

Rather in the instant case, the Estate designated its remittance as a payment of estate and GST taxes, and the Service is bound by this designation. However, as noted above, the Service applied the overpayment to interest, as opposed to the estate and GST tax as the Estate requested. The Estate now requests that the Service apply the remittance as a payment of the outstanding GST taxes, section 6166 interest installment payments, and gift taxes. This request is essentially an attempt to redesignate the original remittance. A taxpayer may not, however, make a late designation of payments. The Service is bound to apply the funds as the taxpayer originally designated, and the Estate may require the Service to re-apply the funds as originally requested with its Form 4768. The Estate may also argue that the Service must use a portion of the remittance to satisfy the first interest installment since the taxpayer could be injured by the reallocation. The taxpayer's section

6166 election could be terminated if a portion of the $A payment is not applied to the Estate's first interest installment payment, as was initially indicated by the Service in writing. The Estate may not, however, require the Service by law to reapply its payment to suit its current needs.

If the Estate desires that the $A remittance be applied to other than GST and estate taxes, then the Estate would be requesting that the Service not follow the original designation. Thus, if the original designation is rescinded by the Estate, then the remittance would be considered an undesignated payment and the Service has complete discretion regarding how the funds are to be applied to the Estate's various accounts. If the remittance was made after the assessment, then the Service would be bound to apply it as a partial payment of tax, penalties, and interest in that order. However, since the tax and interest were not assessed at the time of the remittance, the Service has complete discretion to apply the remittance as a payment towards any tax and interest liabilities of the Estate outstanding or due and owing at the time the remittance was made.

Issue 2:

A. In determining the fair market value, under section 2031, of the Corporation shares included in the gross estate, should the shares Decedent owned outright be aggregated with the shares held by the Trust?

B. Assuming the Corporation shares included in the gross estate are aggregated and valued as a single controlling block for purposes of section 2031, then, in determining the deduction allowable for charitable transfers under section 2055(a), should the minority interest in Corporation passing to Charity be nonetheless valued separately as a minority interest?

Issue 2 conclusions:

A. In determining the fair market value, under section 2031, the shares Decedent owned outright and the shares held by the Trust are to be aggregated and considered a single block of shares.

B. In determining the deduction allowable for charitable transfers under section 2055(a), the minority number of Corporation shares passing to Charity are to be valued separately as a minority interest.

Facts:

Decedent, as settlor, created Trust on Date 8. The Trust provided for the distribution of income and principal during the Decedent's lifetime, as follows:

> Article Fifth: Distribution of Income and/or Principal During Lifetime of Settlor: During Settlor's lifetime, all of the net income shall be distributed to Settlor. The trustees,

> other than Settlor, may in their sole discretion distribute to the Settlor so much of the principal which they deem necessary to maintain in the station of life to which is now accustomed, or for emergencies arising in lifetime. Settlor shall have no vote as trustee in connection with this discretionary power of the trustees.

On Decedent's death, the remainder of the Trust was to be divided into equal shares per stirpes for Decedent's then living children and the living descendants of any deceased child of Decedent. However, under Article Third, Decedent reserved the power to dispose of the corpus, as follows:

> Article Third: Power to Re-allocate: Settlor [reserves] the sole right to re-allocate the disposition of the corpus upon death among children or any of descendants or [Charity].

Regarding the administration of the Trust, Article Thirteenth, provided as follows:

> Paragraph D: Power to Title Property in Straw Corporation, Etc.: The trustees may, in their sole discretion, cause the securities or other investments to be registered in their names as Trustees, in the name of their nominee, including any Straw Corporation now in existence or hereafter to be formed or in the individual name of a Trustee, or may take and keep them unregistered and may retain the same or any part thereof in such form that they will pass by delivery.
>
> Paragraph E: Power to Determine Income or Principal Items: The trustees shall determine, in their sole discretion, whether any payments received constitute income or principal, and whether any disbursements made shall be made from income or principal.
>
> Paragraph K: Power to Settle Differences of Opinion: During Settlor's life, if any difference of opinion shall at any time occur among the trustees as to any matter arising in the execution or exercise of any trust power or discretion under the trust, except as to the discretionary payment of principal to Settlor, then the Settlor's decision, as trustee, shall be binding upon the other trustees.

Decedent designated as one of three co-trustees, and continued to serve as a trustee until death. In addition, Decedent reserved the power to appoint additional trustees, and exercised this power during the Trust term.

Decedent funded the Trust with voting shares of Corporation, and these shares constituted the principal Trust asset during the term of the trust.[4] Corporation, a closely held Corporation, was a primary management and investment vehicle for Decedent. At Decedent's death, Decedent owned outright percent of Corporation's voting shares and percent of Corporation's nonvoting shares. Over the years,

[4] Decedent also transferred (directly and/or indirectly) parcels of real property to the Trust.

Corporation held substantial interests in companies: Cos. 1, 2 and 3. These companies, in turn, owned interests in other corporations.

On Decedent's death, the shares passed to Charity in accordance with Decedent's designation of Charity as the Trust remainderman. On the federal estate tax return filed for the Estate, the shares held by the Trust were valued separately from the shares held outright by Decedent. The reported fair market value of the shares held by the Trust reflected a minority discount and a discount for lack of marketability.

With the exception of limited periods during the Trust's existence, the Trust did not have a separate bank account nor were any formal Trust accountings prepared. Rather, all amounts received by the Trust were deposited into Corporation's and Decedent's bank accounts. For example, when Trust real property was condemned, the condemnation proceeds were deposited and held in Decedent's own bank account. Similarly, Trust operating expenses were paid from Corporation's and Decedent's bank accounts. Accounting for the Trust was maintained as follows: Decedent kept a ledger in which chronologically recorded all accruals and disbursements for entities held or controlled by . Trust receipts and disbursements were entered on this list, along with those of the other entities, as received or paid. To locate a specific Trust receivable or disbursement, one would go through the entire chronological list for all of the entities.

Law and Analysis

Issue 2A:

Section 2031(a) provides that the value of the gross estate shall be determined by including the value at the time of death of all property, real or personal, tangible or intangible wherever situated.

Section 20.2031-1(b) provides that the value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the alternate valuation date, and with the adjustments prescribed in that section. 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.

Section 2036(a)(1) provides for the inclusion in the gross estate of property transferred by the decedent during life pursuant to which the decedent retained the possession or enjoyment of, or the right to income from, the property. See also section 2036(b) providing generally that the retention of the right to vote transferred stock constitutes the retained enjoyment of the stock for purposes of section 2036(a)(1). Section 2038 provides for the inclusion in the gross estate of property transferred by the decedent during life pursuant to which the decedent retained the power to alter, amend, or revoke the transfer.

In Estate of Bonner v. United States, 84 F.3rd 196 (5th Cir. 1996), the Service argued that fractional interests in property held in a qualified terminable interest property (QTIP) trust, created by the Decedent's spouse and included in the Decedent's gross estate under section 2044, should be aggregated for valuation purposes with stock owned outright by the decedent. The court, however, concluded that aggregation should not apply. The court stated:

> The estate of each decedent should be required to pay taxes on those assets whose disposition that the decedent directs and controls, in spite of the labyrinth of federal tax fiction . . . [The decedent's spouse] controlled the disposition of her assets, first into the trust with a life interest for [her husband] and later to the objects of her largesse. The assets, although taxed as if they passed through [the decedent's] estate, in fact were controlled at every step by [decedent's spouse]. At the time of [decedent's] death, his estate did not have control over [decedent's spouse's] interests in the assets such that it could act as a hypothetical seller negotiating with willing buyers free of the handicaps associated with fractional undivided interests.

Estate of Bonner v. United States, 84 F.3d at 198-199. In Estate of Mellinger v. Commissioner, 112 T.C. 26, 37(1999), acq. 1999-2 C.B. xvi, the Tax Court reached a similar conclusion relying on Estate of Bonner, ("At no time did decedent possess, control, or have any power of disposition over the FOH shares in the QTIP trust.") See also, Estate of Nowell v. Commissioner, T.C. Memo. 1999-15.

In contrast, in Estate of Fontana v. Commissioner, 118 T.C. 318, 322 (2002), the Tax Court concluded that property held in a marital trust created by decedent's spouse that was subject to decedent's testamentary general power of appointment was to be aggregated with property owned outright by the decedent. The court distinguished its prior decision in Estate of Mellinger, on the basis that the decedent in Fontana possessed a testamentary general power of appointment over the trust such that it was the decedent, rather than the decedent's spouse (as was the case in Bonner and Mellinger), who controlled the ultimate disposition of the trust property, as well as the shares of stock he owned outright. Accordingly, aggregation was appropriate under those circumstances.

Rev. Rul. 79-7, 1979-1 C.B. 294, holds that stock included in the decedent's gross estate under the predecessor to section 2035(a) (requiring inclusion in the gross estate of property transferred within three years of death and in contemplation of death) is to be aggregated, for valuation purposes with stock owned outright by the decedent. The ruling reasons that section 2035, requiring inclusion of certain transfers made within three years of death, was intended to prevent the avoidance of the estate tax by taxing inter vivos gifts made as substitutes for testamentary transfers. Consequently, the value of property included in the decedent's gross estate under section 2035 should be treated, for estate

tax valuation purposes, in the same manner as if the transfer had not been made and the property had been owned by the decedent at the time of death. See, Humphrey's Estate v. Commissioner, 162 F. 2d 1(5th Cir. 1947); Igleheart v. Commissioner, 77 F.2d 704 (5th Cir. 1935).

Section 25.2511-2(b) of the Gift Tax Regulations provides that as to any property or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition whether for his own benefit or for the benefit of another, the gift is complete. However, if the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Further, if a donor transfers property in trust pursuant to which the trust income is to be paid to the donor, or accumulated in the trustee's discretion, and the donor retains a testamentary power to appoint the corpus, then no portion of the transfer is a completed gift.

In the instant case, the shares in Corporation Decedent owned outright should be aggregated with the shares held in the Trust in determining the fair market value of all Corporation shares included in the gross estate.

First, in view of the trust terms pursuant to which Decedent retained the right to receive trust income as well as the right to designate (among descendants and Charity) the beneficiary of the trust remainder, Decedent's transfers to the trust constituted wholly incomplete gifts. See section 25.2511-2(b) of the Gift Tax Regulations. In addition to this retained beneficial interest and dispositive power, Decedent as trustee retained until death significant additional control over the trust corpus. Thus, the trustee possessed broad powers to allocate receipts and disbursements between principal and income. Any such items allocated to income (such as sales proceeds) would be required under the trust to be distributed to Decedent. Further, trust assets could be registered in the name of an individual trustee. Significantly under Article Thirteenth, Paragraph K, these powers could be exercised unilaterally by Decedent. Thus, the beneficial interest in and control over the Corporation stock did not pass from Decedent until Decedent's death, at which time interests and control over the Trust terminated.

Further, in view of Decedent's retained interests and powers, the Trust corpus is includible in decedent's gross under sections 2036 and 2038. In Estate of Wylie v. Commissioner, 610 F. 2d 1282, 1290-1291 (5th Cir. 1980), the court summarized the purpose of section 2036, as follows:

> The purpose of this provision is to prevent circumvention of federal estate tax by use of inter vivos schemes which do not significantly alter lifetime beneficial enjoyment of property supposedly transferred by a decedent. See 74 Cong.Rec. 7078-79, 719899 (1931); H.R.Rep. No. 708, 72nd Cong., 1939-1 C.B. (Part 2) 457, 490-91; S.Rep. No. 665, 72nd Cong., 1939-1 C.B. (Part 2) 496, 532. The Supreme Court has recognized this purpose on several occasions. In United States v. O'Malley, 383 U.S. 627, 631, 86 S. Ct. 1123, 1126, 16 L. Ed. 2d 45 (1966), it was stated that the section shows the intent of Congress to subject "to tax all property which has been the subject of an incomplete Inter vivos transfer." In United States v. Estate of Grace, 395 U.S. 316, 320, 89 S. Ct. 1730, 1733, 23 L. Ed. 2d 332 (1969), the Court noted:

> 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 a control over the property transferred during his lifetime.

See also, Commissioner v. Estate of Church, 335 U.S. 632, 644 (1949).

As is the case with section 2035, sections 2036 and 2038 are intended to prevent estate tax avoidance by including in the gross estate essentially testamentary transfers. Accordingly, the rationale underlying Rev. Rul. 79-7, in the case of inter vivos transfers includible in the gross estate under section 2035, is equally applicable in the case of inter vivos transfers includible in the gross estate under section 2036 or section 2038.

In this regard, the situation presented in the instant case is clearly distinguishable from that presented in Estate of Bonner and Estate of Mellinger, where the decedent did not create the trust, nor control the disposition of the trust. In the instant case, it was Decedent alone who created the Trust, retained the beneficial enjoyment of the trust corpus, and retained the power, until death, to designate who would enjoy the Trust remainder. In fact, in Estate of Melllinger, the Tax court in concluding that aggregation was not appropriate with respect to property subject to inclusion under section 2044, contrasted property includible under sections 2035 and 2036. "Furthermore, at no time did decedent possess, control, or have any power of disposition over the FOH shares in the QTIP trust. Cf. secs. 2035, 2036, 2041 (requiring inclusion in the gross estate where a decedent had control over the assets at some time during her life.)" Estate of Mellinger, 112 T.C. at 36.

Further, as discussed above, Decedent retained significant administrative powers that could be exercised unilaterally by and that enabled to retain full access to the Trust's Corporation shares. These powers were explicitly reserved by Decedent when created the Trust, and the powers were spelled out in the Trust instrument. Decedent could legally enforce the exercise of retained powers, and a beneficiary had no legal grounds for complaint if Decedent did, in fact, exercise retained powers. United States v. O'Malley, 383 U.S. 627 (1966). In administering the Trust over a period, the receipts and disbursements relating to the Trust's Corporation shares were generally commingled with Corporation's and Decedent's own funds and treated as part of the larger enterprise rather than as those of the Trust. Indeed, the Trust was the subject of several rulings by Court of State involving a proceeding. That court specifically affirmed the determination that, in view of the terms of the Trust and the significant control exercised by the Decedent with respect to the Trust, the Trust corpus should be viewed as and taken into account as Decedent's property in determining net worth. Cite 1. [5]

[5] Footnote 2

Moreover, Decedent's creditors could reach own and the Trust's Corporation shares as a single block. Under State law, it is a matter of public policy that a settlor may not transfer property to a trust for own benefit and thereby exempt that property from creditors' claims. A spendthrift clause is void as to then existing or future creditors, and the creditors can reach the settlor's interests in the trust. Cite 2; Cite 3. Consequently, in this case, the Trust's Corporation shares were subject to acquisition (along with Decedent's own shares) by Decedent's creditors by reason (at the very least) of the Trust provisions under which Decedent retained the right to receive Trust income and distributions of corpus to maintain in station of life and for emergencies. The creditors could thus reach the Trust's Corporation shares as well as Decedent's own shares. See Rev. Rul. 76-103, 1976-1 C.B. 293; Rev. Rul. 77-378, 1977-2 C.B. 348.

Thus, to paraphrase the Fifth Circuit in Estate of Bonner, it was the Decedent who "at every step" held a beneficial interest in and controlled the Trust assets and directed the ultimate disposition of the Trust. Accordingly, the Trust's shares are to be aggregated with Decedent's shares held outright, and the fair market value of the shares is to be determined as a single block for purposes of section 2031. Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

Issue 2B:

Section 2055(a) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all charitable bequests, legacies, devises, or transfers.

In this case, as discussed above, in determining the value of the gross estate under section 2031, the shares held by the Trust and those held outright by Decedent are to be valued as a single controlling block of stock. However, where, as here, Decedent has transferred to the charity only a portion of the controlling block, the deduction under section 2055(a) must be limited to the value of what is actually received by the charity. Ahmanson Foundation v. United States, supra, at 772; Capital Blue Cross and Subsidiaries v. Commissioner, 122 T.C. 224 (2004); Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987); Estate of Proctor v. Commissioner, T.C. Memo. 1994-208.

Accordingly, for purposes of section 2055(a), the amount of the deduction allowable with respect to the Trust's Corporation shares that passed to Charity is determined based on the value of the minority interest that passed to Charity from the Trust.

Issue #3:

A. Are Co. 1 and the other entities in which the decedent had an interest a "controlled group" within the meaning of section 414(b)?

B. Assuming: (i) Co. 1 and the other entities are a "controlled group," and (ii) Co. 1 is liable for an underfunded pension plan contribution of $AA, then for

purposes of section 2031, in determining the fair market value of the other entities of the controlled group, to what extent, if any, is Co. 1's $AA liability taken into account?

C. For purposes of section 2031, in determining the fair market value of Co. 1, to what extent, if any, are potential environmental clean-up costs taken into account?

Issue 3 conclusions:

A. Co. 1 and the other entities are a "controlled group" within the meaning of section 414(b).

B. In determining the value of Co. 1 and the controlled group under section 2031(a), the amount of the liability is to be discounted to reflect the fact that the liability may not be payable for an extended period of time.

C. The extent to which the clean-up costs are taken into account under section 2031(a) is dependent on the facts presented as of the valuation date including: (i) the extent to which the clean-up problem was known; (ii) whether it was foreseeable that Co. 1 would be required to pay the clean-up cost, and, if so, when Co. 1 would be required to pay the costs; and (iii) whether Co. 1 would be entitled to receive federal or state funding incentives to allay the cost.

Issue 3A: Controlled group status: Law and Analysis

Under section 412 an employer sponsoring certain qualified plans is required to make contributions to meet the minimum funding standard. Section 412(c)(11)(B) provides that where an employer is a member of a controlled group, each member of the group is joint and severally liable for contributions required under section 412 and for any installments required under section 412(m). Under section 414(b), the rules of section 1563(a) apply in determining whether an employer is a member of a controlled group.

Section 1563(a)(2) provides that a set of corporations is a brother-sister controlled group of corporations: (1) if there are 5 or fewer persons who own at least 80 percent of the voting power or 80 percent of the value of each corporation; and (2) if the same 5 or fewer persons own at least 50 percent of the voting power or 50 percent of the value of each corporation taking such stock ownership of each person into account only to the extent it is identical with respect to each such corporation.

Section 1563(d) provides that for purposes of section 1563(a)(2) (i.e., for brother-sister controlled groups) stock owned by a person means stock owned directly by the person and stock owned indirectly by application of section 1563(e).

Section 1563(e)(3)(A) provides that stock owned by a trust shall be considered as owned by any beneficiary who has an actuarial interest of 5 percent or more in such stock, to the extent of such actuarial interest. For this purpose, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary and the maximum use of such stock to satisfy his rights as a beneficiary.

Section 1563(e)(6) provides that if an individual owns at least a 50 percent share of the voting power of a corporation, he is considered to own the shares which are owned by his or her children.

Sections 4971(a), (b) and (f) impose excise taxes in respect of accumulated funding deficiencies for qualified plans. Section 4971(e)(2) provides that when a plan sponsor is a member of a controlled group, each member of such group is joint and severally responsible for such additional tax.

Analysis of Voting Control of Corporation for Controlled Groups

For purposes of identifying a controlled group, an interest of at least 80 percent of the corporation is sufficient to provide a definite conclusion. Here, Decedent held outright percent of the Corporation voting stock, and under section 1563(e)(6), is considered to own those Corporation shares owned by children (i.e., Trust owned percent of the voting shares). In addition, the Trust owned percent of the voting shares, and Decedent's interest in the Trust exceeds the value of the Trust's voting shares of Corporation. Accordingly, Decedent's interest in Corporation's voting shares was, at a minimum, equivalent to an amount which establishes 80 percent control.

Analysis of Controlled Group Status

In this case, Decedent directly and indirectly owned percent of Co. 1, percent of the voting power of the various other corporations, and owned at least 80 percent of the voting shares of Corporation. Therefore, all of the corporations constitute a controlled group of corporations with Co. 1 within the meaning of section 414(b) and section 1563(a)(2). Under section 1563(b)(1), all of these corporations are component members of the controlled group.

All of the corporations, together with Corporation and Co. 1, are joint and severally liable for the contributions required under section 412 and the installments required under section 412(m), and for the tax imposed by sections 4971(a), (b), and (f) with respect to the qualified plan of any of the members of the controlled group.

Decedent owned either , or of, a number of other entities, including limited partnerships and limited liability companies. Some of these entities may, under state law, be so structured as to qualify for treatment as a corporation, and thus fall under the provisions of section 414(b) as components of the controlled group of corporations. In addition, some of these entities may qualify as a trade or business under

common control as defined under section 414(c). Such entities may be entities under common control with Co. 1, Corporation, and the other corporations.

PBGC Termination Liability

In addition to liabilities for contributions under section 412, entities under common control are also joint and severally liable for termination liabilities for a member of the controlled group under section 4061 of ERISA. Section 4001.3 of the regulations under Title IV of ERISA provides that persons are under common control if they are members of a controlled group of corporations under section 414(b) or if they are two or more trades and businesses under common control under section 414(c). Since we have found the other corporations, and Corporation, and Co. 1 to be a controlled group of corporations under section 414(b), these corporations would also be joint and severally liable for termination liabilities under section 4062 of ERISA.

Issue 3B: Pension Liability

Facts:

On the date of death and the alternate valuation date, Co. 1 was subject to a pension liability of approximately $AA. The pension liability consisted of unfunded vested benefit liabilities. There were no unpaid minimum funding contributions or PBGC premiums due on either the date of death or alternate valuation date. The liability was contingent on the termination of the Co. 1 pension plans.

creditors of Co. 1 filed an involuntary bankruptcy petition against Co. 1 under Chapter 11 of the Bankruptcy Code. Co. 1 continued to operate the business as a debtor-in-possession until Year 3, when the Bankruptcy Court confirmed the debtor's plan of reorganization and the company emerged from Chapter 11. The reorganization plan involved the sale of Co. 1 to the highest bidder. The highest bid came from Company, a company owned by Decedent. In Year 3, a settlement agreement was executed with PBGC which provides as follows:

> [Decedent], [Company], and [Corporation] hereby acknowledge that if the Stock Purchase Agreement is consummated and the Plan of Reorganization is confirmed, [Company] and [Corporation] will become a part of a Controlled Group with Reorganized [Co. 1] for all purposes under ERISA, and that they will remain a part of such Controlled group for as long as [Company], [Corporation] and Reorganized [Co. 1] are under Common Control.

Co. 1 filed a voluntary petition for bankruptcy under Chapter 11 on Date 9, after Decedent's death. At approximately the same time, the PBGC perfected liens. In order to obtain the release of PBGC's liens so that the Estate could continue its business operations, and to protect against termination of the pension plans, the Estate, through of the controlled group entities, made contributions to the

Co. 1 pension plans. Because Co. 1 will not in the near future be able to meet the ongoing minimum funding contributions required to be made to Co. 1's pension plans, the controlled group entities continue to bear joint and several liability for Co. 1's current and future pension liabilities.

Law and Analysis:

In Estate of Jelke v. Commissioner, T.C. Memo. 2005-131, the court considered the extent to which a potential capital gain tax liability (that would be incurred only when the corporate assets were sold) was to be taken into account in determining the fair market value of an interest in a closely held corporation. The court determined that the net asset value of the corporation should be reduced to reflect the liability that would necessarily be incurred when the corporate assets were sold. The Commissioner's expert calculated the appropriate reduction based on projections of when the tax liability would likely be incurred. The court agreed with this approach, and held that, because the tax liabilities are incurred when the property is sold, the liabilities must be indexed or discounted to account for the time value of money. See also, Estate of Dunn v. Commissioner, T.C. Memo 2000-12, rev'd, 301 F.3d 339 (5th Cir. 2002); Estate of Jameson v. Commissioner, T.C. Memo 1999-43, rev'd, 267 F. 3rd 366 (5th Cir. 2001). In Estate of Dunn, the Fifth Circuit concluded on this point that under an asset-based valuation methodology, the net asset valuation should be reduced for the built-in gains tax liability on a dollar-for-dollar basis and the probability of liquidation was to be considered in assigning relative weights to the asset-based and income-based valuation approaches.

In this case, Co. 1 and the corporate members of the control group may be required to pay the $AA pension liability at some time in the future. Therefore, this potential liability should be taken into account for valuation purposes. However, a dollar-for-dollar reduction for the $AA pension liability would not be appropriate if the payment will not be due until some time in the future. Accordingly, if, as of the valuation date, the facts indicated that the liability would not be due and payable for an extended period of time, the $AA liability must be indexed or discounted to account for the time value of money. See also, Okerlund v. United States, 365 F.3d 1044 (Fed. Cir. 2004) (underlying valuation projections are made using facts known on the valuation date, but post-death events may demonstrate the reasonableness of those projections).

Issue 3C: Co. 1's environmental clean-up liability

Facts:

At Decedent's death and on the alternate valuation date, Co. 1 had a potential environmental clean-up liability of approximately $BB. Co. 1 did not have insurance coverage for environmental liabilities. The environmental liabilities consist of estimated expenses related to a particular site. Two aspects of the liability would come into effect if the underground water filtration and purification system that is in place to reduce the level of hazardous materials were to be shut down. As long as the system is

operating, EPA requirements are satisfied. The other aspects of the liability are not necessarily related to operation of the underground water filtration and purification system. However, all of the clean-up liabilities would have to be incurred if the system were to be shut down.

Law and Analysis:

In Estate of Necastro v. Commissioner, T.C. Memo. 1994-352, the court considered the extent to which potential environmental clean up costs for solid waste were to be taken into account in determining the value of the decedent's property. In applying the "willing buyer-willing seller" test of section 20.2031-1(b), the court stated:

> In our view, the question is whether, on [the decedent's date of death], a reasonable buyer would have discovered solid waste on the property and, if solid waste were discovered, whether a buyer would have discounted the value of the property because of it.

The court responded to the petitioner's argument that the potential expense should be taken into account as follows:

> [W]e cannot determine whether the contamination occurred before or after the valuation date. Second, there was ongoing use of the property after decedent's death, including addition of fill, and no major environmental problems were reported . . . Finally, petitioner has not proven that a buyer [on the decedent's date of death] would have perceived the solid waste as an environmental problem that would have caused a reduction in the value of the . . . property due to remediation costs or the property's diminished value due to decreased marketability.

In this case, the environmental clean up costs may have to be incurred at some future time. However, Co. 1 continued its operations at the site, and, on the valuation date, it was not clear when, if ever, the costs would have to be paid. Thus, from the standpoint of the hypothetical "willing buyer" of section 20.2031-1(b), whether the "willing buyer" would take the clean-up costs into account depends on such factual determinations, made as of the valuation date, as: (i) the extent to which the environmental problem was known, (ii) whether and when Co. 1 would be required to pay the clean-up cost, and (iii) whether Co. 1 would receive federal or state funding incentives to allay the cost. See, for example, Rev. Rul. 66-234, 1966-2 C. B. 436.

Issue 4:

> To the extent received, under the Settlement Agreement, more than the fair market value of interest in Corporation, and assuming the excess amount is attributable to waiver of rights to Decedent's estate and other such rights:
>
> (i) Is a deduction allowable under section 2053(a) for the excess amount?

(ii) To the extent the excess amount represents Corporation property that was distributed to after the decedent's death, how should the excess amount be taken into account in determining, under section 2031, the fair market value of Corporation and the decedent's interest therein?

Issue 4: Conclusions:

The properties received by under the Settlement Agreement, that were held by Corporation at the time of Decedent's death, were equitably owned by and, thus, are not taken into account in determining the value of Corporation under section 2031 or in determining the amount of claims against the estate under section 2053(a).

Issue 4: Facts

Over a period of years, beginning in Year 1, several trusts were established for the benefit of (referred to collectively as Trust), by Decedent or or another family member. In addition, a series of trusts were established for the benefit of (referred to collectively as Trust), by the same individuals. Decedent transferred percent of the voting stock in Corporation to Trust and percent of the voting stock in Corporation to Trust. Under the terms of these trusts, the trust property (including the shares of Corporation) was to be distributed to the respective beneficiary ( ) when attained age . Although attained age , the Corporation shares remained in the respective trusts.

In Year 2, instituted a civil action against Decedent and Corporation. complaint alleged that Decedent, individually, and Decedent and Corporation had breached their contracts with for services rendered by . At the same time, instituted an action alleging that Decedent had mismanaged Corporation and the trusts for benefit that held Corporation stock. An agreement settling both actions was finalized before Decedent's death.

The agreement provided that interest in Corporation, held by through Trust, was to be redeemed. was to select assets with an aggregate gross fair market value of $O.[6] after the selection process was complete, Corporation was to convey a deed to each asset selected by along with $P in cash (representing a percentage of Corporation's cash and prepaids). However, if there were outstanding tax and mortgage liabilities for a property selected by , the property would be held in escrow and transferred to when paid the those liabilities. In addition, was to

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release and renounce: (i) all right or interest in any trust of which Decedent was settlor or beneficiary; and (ii) any right to contest Decedent's will.

In accordance with the property selection process, chose Corporation-owned properties with a specified fair market value of $Q. received cash for the difference between that amount and $O. In addition, $R of debt owed to Corporation was cancelled. The properties chosen by were held by Corporation under the escrow arrangement to ensure compliance with the agreement's tax and mortgage payment requirements. During the escrow period, all of the income attributable to the properties was credited to , and all of the expenses or debits were allocated to . All of the properties were held by Corporation pursuant to the escrow agreement at Decedent's death. properties were transferred to after Decedent's death. The other properties continued to be held by Corporation and were transferred at a later time.

Law and Analysis

Section 2053(a) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate amounts for claims against the estate.

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year by any individual. Section 2511 provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.0-1(b) provides that the gift tax is a tax imposed upon the transfer of property to individuals. It is not applicable to transfers by corporations or persons other than individuals. However, section 25.2511-1(h)(1) provides that the transfer of property (that is not made for an adequate consideration in money or money's worth) by a corporation to an individual is a gift to the individual from the stockholders of the corporation. If the individual is a stockholder, the transfer is a gift to the individual from the other stockholders but only to the extent it exceeds the individual's own interest in such amount as a shareholder.

Section 2512(a) provides that 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.

Under section 25.2512-8, 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. 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, and the entire value of the property transferred constitutes the amount of the gift. Similarly, a relinquishment or promised relinquishment of dower or curtesy, or of a

statutory estate created in lieu of dower or curtesy shall not be considered to any extent a consideration "in money or money's worth."

In this case, the agreement provided for to relinquish shares of Corporation in exchange for a specified amount to be funded with the properties of choice, cash, and cancellation of indebtedness. If any tax or mortgage expenses were outstanding with respect to a property, the property was to be held in escrow until paid those expenses. complied with the agreement: selected properties; paid some of the related expenses; and relinquished shares. When Decedent died later, Corporation still held the properties in escrow, but income and expenses of the properties were allocated to .

In these circumstances, under State law, received and held equitable title to the properties from the inception (i.e., no later than when chose the properties and relinquished shares). Corporation held the bare legal title only to secure payment of the outstanding expenses related to the properties. In contrast, held enforceable rights of ownership. Cite 1; Cite 2; Cite 3. Thus, dominion and control had passed from Corporation to before Decedent's death. The escrow arrangement did not delay the effective transfer date to a time after Decedent's death, and the value of the properties is neither taken into account in determining the value of Corporation under section 2031, nor in determining the amount of claims against the estate under section 2053(a). See Estate of Davenport v. Commissioner, 184 F.3d 1176 (10th Cir. 1999); Richardson v. Commissioner, T.C. Memo. 1984-595.

On the other hand, to the extent the transfers were made for less than adequate consideration in money or moneys worth, the transaction presents gift tax ramifications. A gift for federal gift tax purposes encompasses sales and other exchanges of property in which the value of the property transferred is more than the value of the consideration received therefor. The existence or nonexistence of donative intent is irrelevant. However, the federal gift tax does not attach to a transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent). Rather, a transfer made in the ordinary course of business is considered as made for an adequate and full consideration in money or money's worth. Section 25.2512-8.

The courts look to certain factors in ascertaining whether a transfer is made in the ordinary course of business or, instead, is a gift under section 25.2512-8. For example, where the basic premise for the transaction is to pass the family fortune on to others, "it is impossible to conceive of this as even approaching a transaction in the ordinary course of business." Robinette v. Helvering, 318 U.S. 184, 188 (1943). See Kincaid v. United States, 682 F.2d 1220, 1225, 1226 (5th Cir. 1982), ("No [businessperson] would have entered into this transaction. . . there was no business purpose . . . for [her] to accept less value in return than she gave up.")

In Estate of Maggos v. Commissioner, T.C. Memo. 2000-129, the decedent redeemed her stock in a closely-held corporation in exchange for a note. The estate argued, inter alia, that the redemption constituted an arm's length transaction under section 25.2512-8, and to the extent the fair market value of the redeemed stock exceeded the redemption price, the transaction constituted a bad bargain and not a gift. The court, however, determined that the redemption lacked the indicia of an arm's length transaction and therefore constituted a gift to the extent the value of the stock exceeded the redemption price. See also, Fehrs v. United States, 620 F.2d 255, 259-260 (Ct.Cl. 1980) (redemption of corporate stock constituted a gift to the extent the value of the redeemed stock exceeded the value of annuities received in exchange).

Further, a relinquishment of inheritance rights is not regarded as a consideration in money or money's worth. Section 25.2512-8. See also, Estate of Huntington v. Commissioner, 100 T.C. 313, 316 (1993), aff'd, 6 F.3d 462 (1st Cir. 1994) (applying this principle in the context of a deduction under section 2053 requiring a liability contracted bona fide and for adequate consideration in money or money's worth). To the extent a transfer is made in exchange for a relinquishment of inheritance rights or as a substitute for an inheritance, the transfer is subject to the gift tax. Rev. Rul. 68-379, 1968-2 C.B. 414.

In the transaction in this case, asserted claims against Decedent for breach of contract and for mismanagement of Corporation and Trust. asserted claims against Corporation for breach of contract. The settlement provided for Corporation to pay assets and cash to . In exchange, transferred shares to Corporation and relinquished all rights to Decedent's estate or any trust property controlled by Decedent. In the present case, based on the facts as submitted, it appears that the parties (and Decedent) were dealing at arm's length in resolving the dispute. This fact would distinguish the redemption at issue in this case from Estate of Maggos and Fehrs, where the courts found the transactions did not satisfy the requirements of section 25.2512-8. Nonetheless, relinquishment of inheritance rights, even if bargained for, would not constitute a consideration in money or money's worth for gift tax purposes. Accordingly, any part of the settlement amount paid to attributable to relinquishment of those rights is subject to the gift tax.

For gift tax purposes, a gift made by a Corporation is an indirect gift from the shareholders to the extent of their proportionate interests. Section 25.2511-1(h), Example 1. See also, Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982). It follows in the present case that, to the extent the redemption constitutes a gift for gift tax purposes, Decedent is regarded as making a gift based on proportionate interest in Corporation.

Issue 5:

A. For purposes of section 2031, in determining the fair market value of Corporation and Decedent's interest therein as of the alternate valuation date under section 2032(a), to what extent, if any, is the $S amount required to be paid under the post-death Settlement Agreement with taken into account?

B. To the extent that, under the post-death Settlement Agreement, received more than the fair market value of interest in Corporation, how is such excess amount treated for estate tax purposes?

Issue 5: Conclusion

That portion of the $S amount payable under the Settlement Agreement determined to be payable in settlement of will contest is not taken into account in determining the fair market value of Corporation and the Decedent's interest therein as of the alternate valuation date.

Issue 5: Facts

Decedent executed a will on Date 10 ("the 1st will") bequeathing all of Corporation voting shares and $W to a trust for benefit. Under the will, was to receive each year the greater of $X or the trust net income, and, in the trustees' discretion, $Y of principal. On death, the remaining trust property was to pass to Charity. Decedent also bequeathed to all of personal effects and a residence (Residence.) Decedent bequeathed percent of interest in certain real property to . The Estate residue was to pass to Charity. The executors and trustees were to be , A, and . At the same time, Decedent designated as the recipient of the Trust property (Discussed in Issue 2, above) remaining at death.[7]

Decedent executed another will on Date 11, approximately years after Date 10 ("the 2nd will") revoking the 1st will. Under this will, was designated as the Estate's personal representative and was to receive Decedent's personal property and the balance of the estate (other than a pecuniary bequest for the benefit of a friend of Decedent). Decedent also revoked previous designation of as the remainder beneficiary of Trust and designated Charity as the new beneficiary.[8]

After Decedent death on Date 1, presented the 2nd will for Probate and obtained letters of administration. filed a petition contesting probate of the 2nd will, requesting the appointment of and A as personal representatives, and alleging that Decedent lacked testamentary capacity, and that exercised undue influence over Decedent in execution of the 2nd will. also filed a civil complaint alleging, inter alia, that diverted Corporation assets and misused Corporation funds, etc. Subsequently, within of Decedent's death, a settlement agreement (Settlement Agreement) was entered into and executed a

[7] If the 1st will and designation were effective, would hold of Corporation's voting shares and percent of the non-voting shares. Charity would hold percent of the non-voting shares.

[8] If the 2nd will and designation were effective, would hold percent of Corporation's voting shares and percent of the non-voting shares. Charity would hold percent of the voting shares and percent of the non-voting shares. would hold the remaining voting shares and non-voting shares.

in which released the Estate, , and Corporation from any and all rights and claims may have had in any capacity.

The Settlement Agreement states that it is intended to resolve law suit against Corporation, probate action and all other claims that were or could have been raised by . In full settlement of all claims, causes of actions, etc., had or could have asserted against Corporation, Corporation agreed to redeem stock in Corporation for a total payment of $S. A portion of the $S payment is to be satisfied by cancellation of debt to Corporation. The balance, $T, is to be satisfied by the transfer to of a residence (owned by Corporation), and a lump sum cash payment. The balance is to be paid over a period of pursuant to a specific schedule. In addition to the $S payment, the Settlement Agreement provided that the Estate was to pay $U, a amount in relation to the total amount paid to under the Settlement Agreement, in settlement of all claims could have asserted against the Estate and (i.e., the probate action).

The Settlement Agreement provided that could elect to receive all or a part of the $T balance due in real estate assets owned by Corporation or the Estate (i.e., Decedent's own property), as listed on a schedule. In fact, elected to receive the entire $T in cash. The Estate and unconditionally guaranteed Corporation's obligation for the payments, and the Estate and waived all rights to contribution or reimbursement from Corporation. The Estate's and obligations could not to be impaired by Corporation's bankruptcy, etc. None of Corporation's or the Estate's real property could be transferred or encumbered in any manner without prior consent. As collateral to secure payment, Corporation granted to a security interest in all of Corporation's assets, and the Estate granted to a security interest in all assets the Estate owned directly or indirectly. The Estate could not make any distributions to beneficiaries (other than specific bequests), until the liability was satisfied.

The Estate and are responsible for any judgment or settlement of claims brought by (in contesting the 2nd will). To the extent the judgment or settlement exceeded $V, was to pay the excess up to an additional $V.

On the Form 706 filed by the Estate, the elected the alternate valuation date under section 2032(a) for determining the fair market value of the Estate's assets.

Law and analysis:

Section 2032(a) provides that the value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows: (1) in the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death, such property shall be valued as of the date of distribution, sale, exchange, or other disposition; (2) in the case of property not distributed, sold, exchanged, or

otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.

Under section 20.2032-1(c)(1), a distribution, sale, exchange, or other disposition includes all possible ways by which property ceases to form part of the gross estate. Section 20.2032-1(c)(2) provides that, if a binding contract for the sale, exchange, or other disposition of property is entered into, property is considered as sold, exchanged, or otherwise disposed of on the effective date of the contract.

In the instant case the Estate's representatives agree that the $S paid to under the Settlement Agreement exceeds the fair market value of minority interest in Corporation by $Z. They assert, however, that the transaction was a redemption of Corporation shares, and the excess amount represents a premium paid to a dissident shareholder. They assert that, in the business judgment of the corporate directors, it was necessary to pay the excess amount to avoid future litigation and controversy for Corporation. Further, will contest claims were frivolous and therefore only the $U amount is properly allocable to settlement of will contest. Thus, the representatives contend that: (i) the date for determining the fair market value of Corporation is the date 6 months after Decedent's death; and (ii) in determining the value, Corporation's assets are to be reduced by the $T paid under the agreement as it was an expense incurred in a corporate redemption during the 6-month period following Decedent's death. (Of course, the portion of the Corporation included in the gross estate is increased to reflect the redemption of shares.)

It is well recognized that the IRS is not bound by the parties' allocation of the proceeds of a lawsuit that is set out in a settlement agreement resolving the controversy. Rather, the allocation may be driven by tax considerations and may not reflect the true value of the various claims that are settled or resolved. Thus, notwithstanding the terms of the settlement, the proceeds may be reallocated, based on the facts and circumstances, to properly reflect the correct amount attributable to the various claims presented. Francisco v. United States, 267 F.3d 303, 322 (3d Cir. 2001); Delaney v. Commissioner, 99 F.3d 20 (1st Cir. 1996); Robinson v. Commissioner, 102 T.C. 116, 127 (1994), aff'd 70 F.3d 34, 38 (5th Cir. 1995); Alexander v. Internal Revenue Service, 72 F.3d 938 (1st Cir. 1995); Stocks v. Commissioner, 98 T.C. 1 (1992). Factors to be considered in determining the validity of the allocation include: the intent of the payor; the details surrounding the litigation in the underlying proceeding; the allegations contained in the payee's complaint; and the arguments made in the underlying proceeding by each party. Robinson v. Commissioner, 102 T.C. at 127-128. See also, Estate of Glover v. Commissioner, T.C. Memo. 2002-186.

In this case, under the settlement agreement, a portion of the total amount paid was designated as paid in settlement of probate claim. However, the total amount paid under the Settlement Agreement exceeded the value of Corporate stock. To the extent this excess amount is properly characterized as paid in satisfaction of claims to Decedent's estate under the 1st will, the payment constitutes a distribution to an estate beneficiary that should be included in the value of the

Corporation stock for estate tax purposes under section 20.2032-1(c)(1).

The amount properly allocable to probate claims contesting the validity of the 2nd will is a question of fact. However, in making this determination we believe the following factors should be taken into account.

1. Under State law, relating to will contests, there is a presumption of undue influence when a substantial beneficiary under the contested will occupied a confidential relationship with the testator and was active in procuring the will. Cite 6; Cite 7. Under guidelines established by the State Supreme Court, factors that establish this presumption include: (1) the presence of the beneficiary at the execution of the will; (2) the presence of the beneficiary at those times when the testator expressed a desire to make a will; (3) the beneficiary recommends an attorney to draw the will; (4) the beneficiary has knowledge of the will's contents before execution; (5) the beneficiary gives instructions on preparing the will; (6) the beneficiary secures the witnesses to the will; and (7) the beneficiary retains possession of the will. Cite 8.

2. Approximately after Decedent's death, the State legislature enacted legislation requiring that, in cases involving claims of undue influence where the presumption is established, the beneficiary-proponent of the will (in this case,) must effectively prove the nonexistence of undue influence. State Statute 1. The statute established a higher standard of proof for will proponents. Cite 9.

3. In the between Decedent's death and the execution of the agreement, attorneys had issued and were preparing to issue: (i) subpoenas to depose the witnesses to the 2nd will and the notary who attested to the signatures; (ii) subpoenas demanding production of the widest possible range of documents and other materials; and (iii) notice to depose . These facts indicate that was prepared to vigorously pursue the Probate claims.

4. received almost a much as did in a "redemption" of identical stock interest (Issue 4), even though had claimed additional amounts for breach of contract and mismanagement of trust. transaction was also characterized as a redemption of shares. Thus, it would appear the amount paid to reflected factors in addition to the redemption of stock.

5. Under the 1st will and remainder designation with respect to Trust, was entitled to a significant portion of Decedent's estate, and under the 2nd will,

was entitled to no portion of the estate. This significant discrepancy raises the question as to whether would relinquish claim to take under the 1st will in exchange for the $U payment.

6. Under the Settlement Agreement, the Estate agreed to guarantee Corporation's obligations. This significant undertaking indicates the Estate had a substantial interest in resolving the dispute.

As noted above, the representatives argue that the corporate directors paid a premium to in order to avoid future litigation and controversy with respect to the Corporation. They argue that the decision comes within the purview of the business judgment rule, which creates a presumption that corporate directors making business decisions act in good faith, on an informed basis, and in the honest belief that their actions are in the corporation's best interest. 3A William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations (perm. ed., rev. 2002) § 1036. Therefore, it is unlikely that the decision could be successfully questioned.

However, it is questionable whether the rule has any relevance to the estate tax question at issue here, regarding the true nature of the excess payment to . That is, if the excess payment was made for business reasons relating to corporate operations, the rule would apply in testing the propriety of the payment. But the rule provides no guidance regarding the question presented here, that is, whether the payment was made in settlement of inheritance rights in the first instance, or for business reasons relating to the Corporation. Even if the rule was relevant to the inquiry presented here, there are many exceptions to application of the rule. Maldonado v. Flynn, 413 A.2d 1251 (Del.Ch. 1980) (the rule does not protect illegal or ultra vires decisions by the directors); Orman v. Cullman, No. Civ. A. 18039 (Del. Ch. March 1, 2002) (The rule does not apply when a majority of the directors had a financial interest in the transaction or were dominated or controlled by a materially interested director); Orloff v. Shulman, No. Civ. A. 852-N (Del. Ch. Nov. 23, 2005); In re LNR Property Corp. Shareholders Litigation, No. C.A. 674-N (Del. Ch. Dec. 14, 2005) (The rule does not apply where the directors wasted corporate assets, or where directors stood on both sides of the transaction or they expected to derive personal financial benefit from the transaction, and it was not equally shared by all the stockholders.) [9] In the instant case, , a director of the Corporation, was the principal heir under the 2nd will and stood to gain significantly, if the 2nd will, rather than the 1st will, was admitted to probate. In view of these exceptions, it is questionable whether the rule would apply in this case.

Issue 6:

Are the attorney and other fees incurred by and that were paid from Trust 2 assets deductible for estate tax purposes under section 2053?

Issue 6: Conclusions

[9] While it is not clear who the directors were at the time of this transaction, indicated that shortly before Decedent's death, the directors were: , Decedent, B, and .

Attorney's fees and expenses incurred by the beneficiaries can be deducted under section 2053(a) to the extent the expenses satisfy the requirements of section 2053(a)(2) and the applicable regulations. The Estate must substantiate the expenses as to purpose, nature, reasonableness, etc. in order to establish that the expenses meet the requirements of section 2053(a)(2).

Issue 6: Facts

Decedent created Trust 2 during life and reserved the right to designate, at death, the person or persons (from among children, grandchildren, and Charity) to receive the remaining principal. In Year 3, designated as the remainderman. In Year 4, designated as the remainderman. contested the validity of the designation change. Subsequently and entered into a settlement under which Trust 2 was to be divided equally between them. At the time of Decedent's death, Trust 2 held real estate properties.

and incurred attorney fees and related expenses in connection with resolving disputes with the trustees, the sale of the trust's real property, trust accountings, and valuation of trust assets and liabilities. In addition, incurred fees in providing assistance in the preparation of the estate tax return. The probate court approved the payment of these expenses from Trust 2. On the estate tax return, the Estate claimed a deduction under section 2053(a) for these fees and related expenses incurred by

and .

Law and Analysis

Section 2053(a)(2) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for administration expenses as are allowable by the laws of the jurisdiction under which the estate is being administered.

Section 20.2053-3(a) provides that the amount deductible from a decedent's gross estate as "administration expenses" are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate, that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such as only attend the settlement of an estate and the transfer of the property of the estate to the individual beneficiaries. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, may not be taken as deductions.

Section 20.2053-3(c)(3) provides that attorney's fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate.

In general, in order to be deductible under section 2053, administration expenses, such as attorney's fees, must be allowable under local law, and in addition, must satisfy the federal standards contained in the regulations. Estate of Grant v. Commissioner, 294 F.3d 352 (2d Cir. 2002); Estate of Millikin v. Commissioner, 125 F. 3rd 339, 342-343 (6th Cir. 1997); Marcus v. DeWitt, 704 F.2d 1227, 1229-30 (11th Cir. 1983). Accordingly, an attorney's fee that does satisfy the requirements of the regulations is not deductible as an administration expense even if it is approved by a local court as an expense payable or reimbursable by the estate.

Rev. Rul. 74-509, 1974-2 C.B. 302 considers a situation where the decedent's will contained an ambiguity regarding the amount passing to two testamentary trusts created under the terms the decedent's will. In the course of the probate proceeding to resolve the ambiguity, the beneficiaries of the respective trusts incurred attorney's fees and guardian ad litem fees that the local court approved for payment by the estate. The question presented was to what extent are these fees, incurred by the beneficiaries incident to determining the proper amount passing to the trusts, deductible under section 2053(a)(2).

Rev. Rul. 74-509 provides that in order to be deductible: (1) the fees must be reasonable in amount with respect to the services performed; (2) the fees must be allowable as an administration expense under the local law; and (3) the services performed for which the fees were incurred must be appropriate or necessary to the settlement of the estate generally, or, in particular, to the collection of assets, payment of debts, or distribution of the estate's property to the persons legally entitled thereto. Regarding the third requirement, the revenue ruling states that attorney's fees are deductible if incurred in serving significant purposes in the collection, conservation or effectuation of the just distribution of the estate assets. On the other hand, fees are not deductible if the services are not helpful generally to the settlement of the estate, but are instead only remotely related to the administration of the estate and are performed primarily in the interests of a particular person.

Based on these criteria, the revenue ruling concludes that the fees at issue were necessary to the settlement of the estate because the fees were incurred for services essential to the proper determination of the amount transferred from the decedent to the respective trusts. See also, Pitner v. United States, 388 F.2d 651,660 (5th Cir. 1967) (allowing a deduction for fees incurred by beneficiaries in a will contest proceeding). Thus, fees may be deductible if the services rendered were essential to the administration of the estate irrespective of whether the beneficiaries may have personally benefited from the services. Estate of Reilly v. Commissioner, 76 T.C. 369 (1981).

Under applicable State law, the costs of selling property in order to pay taxes and make distribution and costs incurred in the care and collection of property are allowable estate and trust administration expenses. State Statutes 2-6.

In this case, Trust 2 is includible in Decedent's gross estate. In accordance with Rev. Rul. 74-509, the expenses incurred by the Trust 2 beneficiaries are deductible to the extent the expenses are necessary to the administration of the estate. Thus, for example, in accordance with Rev. Rul. 74-509, expenses incurred by the Trust 2 beneficiaries in resolving the amount passing to each respective beneficiary on Decedent's death would ordinarily be deductible. See also, Pitner v. United States, cited above. However, the extent to which the particular expenses incurred by the Trust 2 beneficiaries; e.g., attorney's fees incurred in the sale of real property, trust accountings, valuation, etc. satisfy the requirements of the regulations and applicable case law is dependent on the facts and circumstances presented with respect to the particular expense. See e.g., Marcus v. DeWitt, 704 F.2d 1227 (11th Cir. 1983), allowing the deduction of expenses incurred in the sale of the decedent's residence under section 2053. See also, Estate of Glover v. Commissioner, T.C. Memo. 2002-186, allowing a deduction for compensation paid to a beneficiary for services provided to the estate that benefited the estate as well as fees paid to the beneficiary's attorney. Compare LeFever v. Commissioner, T.C. Memo. 1995-321, aff'd, 100 F.3d 778, 792 (10th Cir. 1996), disallowing a deduction for attorney fees incurred by a qualified heir challenging the imposition of the additional estate tax under section 2032A, on the grounds that the additional estate tax is a personal liability of the qualified heirs and litigation contesting imposition of the tax was commenced for the personal benefit of the heir and was not related to the administration of the estate.

- END-

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.