2018 Delaware Tax Institute

Recent Developments in Transfer Taxes

Drafting Family Entity Agreements In the Wake of *Powell*

By: Jocelyn M. Borowsky*

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Recent Transfer Tax Cases

By: Tiffany Nicholson and Eric Hague

*With special thanks to Angela Santos, Esq. who materially participated in the preparation of this outline.
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I. Drafting Family Entity Agreements In The Wake of *Powell*

A common estate planning technique is for a settlor to transfer a limited partnership or limited liability company ("LLC") interest to an irrevocable trust with the hope that by the time of the settlor's death, the interest will appreciate in value without being included in the settlor's estate. The settlor often will want to retain control over the entity after the interest in it is transferred. If the settlor retains managerial powers over the partnership or LLC, this raises a question as to whether such powers constitute a retained interest under section 2036 of the Internal Revenue Code of 1986, as amended ("IRC" or the "Code").

Code section 2036(a) provides that a settlor has a retained interest in property transferred by gift where the settlor retains at death "possession or enjoyment of or the right to income from" the property[1] or "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."[2]

In the 1972 landmark case, *United States v. Byrum,*[3] the U.S. Supreme Court held that Code section 2036(a)(2) did not apply notwithstanding the settlor's retained voting control over corporate stock transferred in trust. Code section 2036(b)(1) was enacted in response to *Byrum*, and expressly provides that where the settlor transfers shares of a controlled corporation by gift and retains the right to vote directly or indirectly, the settlor has a retained interest in the stock.[4] The Code does not contain a similar express provision with respect to the right to vote as a partner of a partnership or manager of an LLC. Because section 2036(b)(1) applies expressly to corporate stock, it was assumed that the legal analysis of Code section 2036(a)(2) set forth in *Byrum* continued to apply to other entities, such as family partnerships and LLCs. However, the Tax Court recently distinguished *Byrum* in *Powell*, a case involving the retention of a family LLC.

The following discussion summarizes *Byrum, Powell* and certain other cases where the settlor retains managerial powers over a pass through entity held in trust, and in particular, the applicability, or lack thereof, of IRC § 2036.

Byrum:

In *Byrum,* the Supreme Court held that Code § 2036(a)(2) did not apply when a decedent, who owned a controlling interest in each of three different corporations, transferred shares of stock in each corporation to an irrevocable trust for the benefit of his children and simultaneously retained the right to vote the transferred shares and veto sales of the shares.[5]

In *Byrum*, the patriarch of a family created an irrevocable trust for the benefit of his issue and transferred the shares of three closely held corporations into the trust. The grantor gave a

[1] IRC § 2036(a)(1).

[2] IRC § 2036(a)(2).

[3] 408 U.S. 125 (1972).

[4] IRC § 2036(b)(1).

[5] *Id*.

corporate trustee the power to manage and control the assets, subject to certain rights that the grantor retained. The grantor kept the powers: (1) to vote the closely held shares of stock; (2) to veto the transfer of trust assets; (3) to approve investments and reinvestments; and (4) to change the corporate trustee. The grantor retained no right to the income or personal enjoyment of the trust assets.

The Service argued that the grantor retained the power to designate enjoyment of the stock because he retained the right to vote the majority of the closely held corporations' stock. According to the Service, this allowed the grantor to de facto decide the dividend policy of the company and, consequently, when and if the transferees would receive income. The Supreme Court rejected this argument, stating that section 2036(a)(2) "connotes an ascertainable and legally enforceable power" such as an express power under the terms of a trust; whereas the power retained by the settlor over the stock held in trust was the power to use his majority position and influence over the corporate directors to regulate dividends paid to the trust.[6] The settlor was not a trustee and did not have the right to pay out or withhold income from the trust. The court characterized such a right as neither ascertainable nor legally enforceable, and therefore not a retained right under section 2036.[7] Whatever indirect power a shareholder had would be constrained by the fiduciary duties owed by both the directors and any majority shareholder.[8] Such power would be further limited by the economic pressures of running a small operating business.[9]

In response to the Court's interpretation of section 2036(a) in *Byrum*, Congress overturned *Byrum* when it enacted section 2036(b) as part of the Tax Reform Act of 1976. Section 2036(b) states that the decedent's retained power to vote stock causes inclusion in the decedent's gross estate.

The *Byrum* case has evolved to stand for the general proposition that a decedent's managerial authority, in connection with a family limited partnership, does not trigger section 2036(a)(2) if the decedent's authority was constrained by one or more fiduciary duties.[10] However, more recent decisions have limited its application.

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[6] *Id.*, 408 U.S. at 136.

[7] *Id.*, 408 U.S. at 136-137.

[8] *Id.*, 408 U.S. at 138.

[9] *Id.*, 408 U.S. at 139-140.

[10] E.g. IRS Tech. Adv. Mem. 01-31-006 (Aug. 2, 1991) (citing *Byrum* and concluding that partnership interests contributed to trust were not includable in settlor-decedent's estate because of fiduciary duty owned by settlor-general partner to other partners); *see also*, Ronni G. Davidowitz and Jonathan C. Byer, *United States v. Byrum: Too Good To Be True?*, 42 ACTEC LJ No. 1, Spring 2016 at 97, 98.

Estate of Strangi:

In *Estate of Strangi*,[11] the Tax Court chipped away at *Byrum's* fiduciary duty limitation on the application of section 2036(a)(2), stating that *Byrum* does not require blind application of its holding to scenarios where enforcement of fiduciary duties appears theoretical in nature rather than realistic, as they appeared in *Byrum*.[12] In *Strangi*, the decedent's son-in-law, acting as decedent's agent under a durable power of attorney, formed and funded a family limited partnership with liquid assets comprising approximately 98% of the decedent's wealth in exchange for a 99% limited partner interest, and capitalized the corporate general partner in exchange for 47% of common stock. At the time of the decedent's death (two months after funding the entities), the decedent owned a 99% limited partner interest, and 47% of a corporation that owned the 1% general partner interest. The decedent's children owned 52% of the corporate general partner, and the remaining 1% was owned by a charity.

Under these facts, the Tax Court held that the decedent retained enjoyment of the partnership's assets, and thus, the partnership's assets were includable in the decedent's gross estate under section 2036(a)(2).[13] Under the terms of the partnership agreement and the corporate general partner's bylaws, the decedent, acting with the other partners, could distribute profits or dissolve the partnership. Further, the court found that constraints on powers found in *Byrum* were not present in *Strangi*. In *Byrum*, the shares were held in trust. Only the trustee, a bank, held the power to distribute any dividends received from the companies. In contrast, the decedent in *Strangi* directly owned the partnership interest.[14] Any profits distribution would flow directly to the decedent. The subject company in *Byrum* was an operating business whose financial fortunes would impact any dividend distribution decision. No similar outside influence would constrain a distribution decision in *Strangi*.[15] Finally, the *Strangi* court distinguished the extent to which fiduciary duties held by the majority shareholder and directors in *Byrum* would constrain the decedent's ability to control the enjoyment of the property or income therefrom. The *Strangi* court observed that before the son-in-law assumed his duties to the partnership, he had owed a duty to the decedent personally as the decedent's attorney-in-fact, and concluded that in exercising his duties to the partnership, the son-in-law would not "disregard his preexisting obligation to the decedent."[16] Because the decedent owned 99% of the partnership, any fiduciary duties that limited the decedent's authority, acting through his son-in-law, to manage the partnership were duties that the decedent owed "essentially to himself."[17]

In concluding that the decedent was not subject to *Byrum*-like fiduciary duties, the Tax Court commented that "[i]ntrafamily fiduciary duties within an investment vehicle simply are not

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[11] T.C. Memo 2003-145, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005).

[12] *Id.*, T.C. Memo 2003-145 at *17.

[13] *Id.* T.C. Memo 2003-145 at *15.

[14] *Id.*, T.C. Memo 2003-145 at *16.

[15] *Id.*

[16] *Id.*, T.C. Memo 2003-145 at *17.

[17] *Id.*, T.C. Memo 2003-145 at *18.

equivalent in nature to the obligations created by the [*U.S. vs. Byrum*]...scenario."[18] Although it affirmed the result on appeal, the Fifth Circuit Court did not address the Tax Court's analysis of section 2036(a)(2). As a result, some commentators consider the foregoing Tax Court analysis of section 2036(a)(2) in *Strangi* to be dicta.[19]

Estate of Mirowski:

Conversely, serving as the general manager of an LLC was not found to trigger section 2036(a)(2) in *Estate of Mirowski v. Commissioner*.[20] Here, the decedent formed a single member LLC and transferred a significant portion of her wealth to the LLC. Then the decedent transferred a 16% interest in the LLC to each of her three daughters' respective trusts, retaining a 52% interest in the LLC for herself, as well as the position of general manager of the LLC.

The court set out a 3-part 2036 analysis:[21]

1. Was there a transfer of property by the decedent?

2. If there was a transfer of property by the decedent, was the transfer a bona fide sale for adequate and full consideration in money or money's worth (the "bona fide sale exception")?

3. If there was a transfer of property by the decedent that was not a bona fide sale for adequate and full consideration in money or money's worth, (a) did the decedent retain possession or enjoyment or, or the right to the income from, the property transferred within the meaning of Section 2036(a)(1), or (b) did the decedent retain, either alone or in conjunction with any person, the right to designate the persons who shall possess or enjoy the property transferred or the income therefrom within the meaning of Section 2036(a)(2)?

The decedent's estate prevailed in its position that the decedent's transfer of property to the LLC met the "bona fide sale exception."[22] Therefore, the analysis as to whether the decedent retained a taxable power over the LLC was inapplicable to the decedent's retained 52% interest in the LLC.[23]

A separate analysis applied to the 16% interests that the decedent gave to trusts for her daughters. The decedent's estate acknowledged that the decedent's gifts of 16% interests in the LLC to each daughters' respective trust were transfers of property under section 2036(a). Further,

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[18] *Id.*

[19] *See* Steve R. Akers, Esq., *In Plurality Opinion, Tax Court Holds that FLP Assets are Included in Estate Under §2036(a)(2): Possibility of Double Inclusion Remains Uncertain*, 42 EGTJ Issue No. 04 (July 13, 2017), at 156-157.

[20] T.C. Memo 2008-74 LEXIS 75.

[21] *Id.*, T.C. Memo 2008-74 at *54-55.

[22] *Id.,* T.C. Memo 2008-74 at *73.

[23] *Id.*

the decedent's estate acknowledged that the gifts were not bona fide sales for adequate and full consideration in money or money's worth under section 2036(a).

The estate argued that there was no express or implied agreement that the decedent retained any interest in the 16% LLC interests transferred to the trusts for the benefit of the decedent's daughters. The Service countered that both an express and implied agreement existed because the decedent was designated the General Manager and had the sole and exclusive authority to manage the affairs of the LLC, including the timing and amounts of distributions from the LLC, and the decedent could not be removed or replaced because the decedent retained a majority 52% interest in the LLC.[24]

The court found that even though the LLC in question granted the decedent as General Manager full discretionary control over the Company, this broad discretion was limited by other detailed, legally enforceable provisions of the operating agreement which specified requirements for distributions, dissolution, and other key events, and such discretion, power and authority as General Manager were subject to state law that imposed on the decedent as General Manager fiduciary duties to the others members of the LLC, namely, her daughters' trusts.[25]

The cash flow provisions were of critical importance to the court's holding in that the operating agreement required distributions to be made at a specific time and in proportion to ownership interests. The court found that the operating agreement afforded the decedent no discretion as to cash flow distributions.[26] The Service argued that since the decedent had the discretion to hold back an amount for reserves, she could have manipulated the cash flow.[27] The court rejected this argument for lack of evidence and because the manager was subject to fiduciary duties under state law.[28]

The Service argued under Code section 2036(a)(1) and section 2036(a)(2) that the decedent had the right in conjunction with others (her daughters' trusts as members of the LLC) to designate the persons who shall possess or enjoy the proceeds of the transferred property. The Service pointed to the operating agreement which gave all members the unanimous right to sell property and purportedly gave the manager the right to determine the timing and distribution of the sale proceeds. The court disagreed with the Service's reading of the operating agreement.[29] The court read the operating agreement to require that proceeds would be distributed immediately after a

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[24] *Id.*, T.C. Memo 2008-74 at *78.

[25] *Id.*, T.C. Memo 2008-74 at *80-81.

[26] *Id.*, T.C. Memo 2008-74 at *86.

[27] *Id.*, T.C. Memo 2008-74 at *86, n. 62.

[28] *Id.*, T.C. Memo 2008-74 at *83-86.

[29] *Id.*, at *85.

capital transaction and would be distributed in proportion to membership interests.[30] The manager would have fiduciary duties to limit her discretion.

Therefore, while the General Manager had the power to make distributions, their amount and timing were dictated by the operating agreement, rather than subject to the decedent's discretion. Accordingly, the Tax Court held that section 2036(a)(1) and 2036(a)(2) did not apply because the operating agreement, rather than the General Manager, controlled when distributions would be made.[31]

Estate of Powell:

In the 2017 case of *Estate of Powell v. Commissioner*,[32] the Tax Court applied section 2036(a)(2) in the context of a decedent who owned (or was deemed to own) a 99% limited partner interest, but not a general partner interest, in a family limited partnership controlled by her sons.

On August 6, 2008, Jeffrey Powell ("Jeffrey"), Nancy Powell's son, formed NHP Enterprises LP ("NHP") as a general partner. Two days later, acting as Mrs. Powell's agent under her durable power of attorney, Jeffrey funded NHP with approximately $10,000,000 of marketable securities and cash from Mrs. Powell's revocable trust. At the time NHP was funded, Mrs. Powell may not have had capacity. One week after NHP was funded, Mrs. Powell passed away.

As a result of NHP's funding, Mrs. Powell received a 99% limited partner interest. Both Jeffrey and his brother received a general partner interest, each funded with an unsecured promissory note. In addition, on the same day that NHP was funded, Jeffrey transferred Mrs. Powell's limited partner interest to a charitable lead annuity trust (the "CLAT"). Jeffrey made this transfer as Mrs. Powell's agent under her power of attorney.

Under the terms of the limited partnership agreement, Jeffrey, as general partner, could unilaterally determine the amount and timing of partnership distributions. NHP could be dissolved with the written consent of all partners, including the consent of the limited partner.

Estate of Powell was reviewed by the Tax Court, with seventeen judges participating in the decision. The primary opinion, however, is only a plurality opinion joined by eight of the seventeen judges. Seven judges instead partnered in a concurring opinion, and two judges agreed with the plurality in result only.[33]

The plurality opinion held that Mrs. Powell's right to act in conjunction with the other partners to dissolve NHP was a right "to designate the persons who shall possess or enjoy" the cash and securities, "or the income therefrom," transferred to NHP within the meaning of section

[30] *Id.,* at *86.

[31] *Id.* at 81.

[32] 148 T.C. No. 18, 2017 U.S. Tax Ct. LEXIS 19 (T.C. May 18, 2017).

[33] The concurring opinion agreed with the plurality's section 2036(a)(2) analysis. As a result, fifteen of the seventeen judges in *Estate of Powell* explicitly agreed that section 2036(a)(2) applied. Two other judges agreed with the result.

2036(a)(2).[34] Thus, the value of the assets transferred to NHP was includable in her gross estate under either section 2036(a)(2) or section 2035(a), depending upon the validity of her gift to the CLAT. It is notable that the estate did not deny that had Mrs. Powell retained the 99% partnership interest at her death, the value of the cash and securities transferred to the partnership would have been included in the value of her gross estate under Code section 2036(a)(2).[35]

To reach this holding, the plurality opinion compared *Estate of Powell* to *Strangi*. The plurality noted that, in both cases the decedent could act with other family members to dissolve the partnership.[36] In both cases, a partnership dissolution would likely cause the majority of the assets contributed to the partnership to be distributed back to the taxpayer. The court remarked that this factor alone was sufficient to invoke estate inclusion under Code § 2036(a)(2).[37] The court went on to observe a second significant factor favoring estate inclusion that was present in both cases, namely, the power over partnership distributions. In *Strangi*, the decedent's son-in-law had power to determine the amount and timing of partnership distributions under a management agreement with the corporate general partner. The same son-in-law held a power of attorney for the decedent, who owned a 99% limited partner interest in the family limited partnership. In both cases the courts impute to the decedent the power held by the general partner because the general partner could act on behalf of the decedent under a power of attorney.[38]

Furthermore, the plurality opinion distinguished *Byrum* on the same grounds that the Tax Court distinguished *Byrum* in *Strangi*. In distinguishing *Byrum*, the plurality noted that, while Jeffrey had fiduciary duties as NHP's general partner, he also owed duties to Mrs. Powell as an agent under her power of attorney. Moreover, the plurality noted that nothing suggested that Jeffrey would have "exercised his responsibility as general partner of NHP in ways that would have prejudiced [Mrs. Powell's] interests."[39] It also remarked that, because the decedent owned a 99% limited partner interest in the partnership, "whatever fiduciary duties limited [Jeffrey's] discretion in determining partnership distributions were duties that he owed almost exclusively to decedent herself." Moreover, the court found that NHP "conducted no meaningful business operations or was anything other than an investment vehicle for decedent and her sons."[40] The foregoing factors led the court to conclude, as it did in *Strangi,* that such powers were tantamount to the decedent having direct control over partnership distributions, and that any fiduciary duties that Jeffrey owed as a general partner were illusory.[41]

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[34] *Powell*, 2017 U.S. Tax Ct. LEXIS 19 at *12.

[35] *Id.*

[36] *Id.*, 2017 U.S. Tax Ct. LEXIS 19 at *15.

[37] *Id.*, 2017 U.S. Tax Ct. LEXIS 19 at *16.

[38] *Id.*, 2017 U.S. Tax Ct. LEXIS 19 at *16-17.

[39] *Id.*, 2017 U.S. Tax Ct. LEXIS 19 at *19.

[40] *Id.*

[41] *Id.*, 2017 U.S. Tax Ct. LEXIS 19 at *19-20.

Analysis:

What do these cases mean for purposes of preparing a family entity's operating agreement or a trust agreement? Can the settlor ever retain a managerial interest in a family entity?

A comparison of the foregoing cases is instructive on this point.

In *Byrum*, the decedent gave shares of stock in trust and retained the power to vote the shares but did not retain any other benefit as a beneficiary of the trust or as a trustee. The decedent did retain shares in his own name following the gift in trust.

In *Mirowski*, the decedent gave away family LLC interests to three separate trusts, one for each of her daughters, but retained a majority interest in the LLC at death and, significantly, retained managerial control over the LLC.

In both *Strangi* and *Powell*, the decedent did not give (or was deemed to have not given away) the decedent's interest in the family entity. In each case the decedent retained a 99% interest in the entity at death.

In *Powell* and *Strangi* the decedent, through a family member's exercise of a durable power of attorney, funded the family entity shortly before the decedent died in exchange for a 99% interest in the entity. The same family member held managerial power over the family entity while also retaining control over the decedent's 99% interest through exercise of the durable power of attorney. Neither of these entities had an independent business purpose, nor did they have any significant unrelated minor owners.

Mirowski is more similar to *Byrum* in that the decedent funded trusts with a portion of her interest but died owning a majority interest in the LLC. The *Byrum* entity was a small operating business. The *Mirowski* entity held patents that it actively managed.

In all of the cases, the Service analyzed the decedent's power over distributions, both distributions of profits in the ordinary course of business and upon a sale of assets not in the ordinary course of business.

The Service's argument in *Mirowski* that the decedent retained an interest over the trusts focused on the power that she purportedly retained over the amount and timing of distributions from the LLC in her capacity as manager of the LLC or as majority member.[42] Finding that the operating agreement restricted the decedent's power to make distributions by requiring annual distributions of cash flow and distributions to follow any capital transaction, the *Mirowski* court held that the decedent did not retain a power under Code section 2036(a)(1) or (a)(2).

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[42] The Service lost its argument that she retained an interest in the LLC interest that she held personally at death under the *bona fide* sale exception to Code § 2036. *Mirowski*, T.C. Memo 2008-74 at *73.

In *Powell* and *Strangi*, both courts focused on the ability of the decedent, with the consent of all partners, to dissolve the partnership. Because the decedent owned a 99% partnership interest at death, any dissolution of the partnership would necessitate the return of almost all of the partnership assets to the decedent. Given the control held by a single person over the entity in both cases, the courts refused to give weight to the estate's argument that the manager would be bound by any fiduciary duties.

For planning purposes, some obvious points are to avoid deathbed planning, and not to give a single person control over the entire entity through use of a durable power of attorney over the majority ownership interest and managerial powers. It is also helpful for the decedent not to retain any ownership interest in the entity upon death.

With directed trusts, it is often the case that the client wishes to retain a power over the trust as an investment adviser. Similarly, the client typically prefers to remain manager of the family entity. To avoid the argument that the client has retained an interest over the timing and amount of distributions from the entity, the operating agreement should restrict the client's ability to determine cash flow distributions, distributions upon sale of assets and dissolution of the company. Any amendments to the entity operating agreement, as well as the power to remove and replace the manager, should also be held by persons other than the client. The operating agreement in *Mirowski* required that cash flow distributions be made within 75 days after the close of the calendar year. The manager had the ability to determine the amount of reserves held by the company, but the court found that the manager would not be able to manipulate the reserves to her benefit since she had fiduciary duties. An operating agreement should clearly recite that any holdback of reserves is subject to fiduciary duties. To avoid the appearance that the client, in conjunction with others, may engineer a dissolution or capital transaction, other members should hold such power, if possible. With respect to a directed trust of which the client wishes to be investment adviser, the trustee (or other fiduciary) should hold the power to vote as a member or partner of an interest held in trust, rather than the client.

In conclusion, a settlor may retain some managerial control over a family entity intended to be excluded from the gross estate but should deflect control over voting, cash flow distributions, dissolution of the company or sale of assets to others in order to avoid the appearance of having control over company distributions.

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II. Recent Transfer Tax Cases

A. *U.S. v. Paulson*, 122 AFTR 2d 2018-5808 (S.D. Cal. September 7, 2018)

In *Paulson*, a complex estate tax collection suit filed by the United States, the U.S. District Court of the Southern District of California (the "District Court") considered various motions for summary judgment.

Allen E. Paulson (the "Decedent") died on July 19, 2000. The Decedent was survived by his third wife, Madeleine Pickens ("Madeleine"), his three sons, Richard Paulson ("Richard"), James Paulson ("James"), and John Michael Paulson ("Michael"), and a granddaughter Crystal Christensen ("Crystal"). During his lifetime, the Decedent established the Allen E. Paulson Living Trust (the "Living Trust"). At the time of the Decedent's death, all of his assets were held by the Living Trust except for some shares in a casino corporation. Michael served as the executor of the Estate of Allen E. Paulson (the "Estate) and as a co-trustee of the Living Trust.

In 2001, the IRS received the Estate's Form 706 (*United States Estate (and Generation-Skipping Transfer) Tax Return*). Later that year, the IRS selected the Estate's tax return for examination. While under review, several disputes arose between the Paulson family and other beneficiaries of the Living Trust. As a result, the parties reached a first settlement agreement (the "2003 Settlement").

In 2005, the IRS issued a notice of deficiency in the estate tax reported on the return, the Estate challenged, and the Tax Court agreed with the IRS that the Estate was required to pay additional estate taxes.

In 2009, the California Probate Court (the "Probate Court") removed Michael as trustee of the Living Trust for misconduct. Vikki Paulson, the Decedent's former daughter-in-law, and James were appointed as co-trustees in Michael's place.

In 2010, in response to one or more missed estate tax installment payments, the IRS issued a notice that the extended payment time granted under section 6166 of the Internal Revenue Code of 1986, as amended (the "Code") no longer applied to the Estate's tax obligations. The Estate challenged the IRS's position and the Tax Court sustained the order.

Thereafter, James was removed as co-trustee of the Living Trust by the Probate Court for breach of court orders. Vikki remained as the sole trustee of Living Trust until Crystal was appointed as a co-trustee.

Between 2007 and 2013, there were further disputes between the Paulson family and other beneficiaries of the Living Trust. The parties settled their disputes by a second settlement agreement (the "2013 Settlement"). As part of the 2013 Settlement, Michael attempted to resign as executor of the Estate.

In July 2015, the Estate had an unpaid estate tax liability of over $10 million. Later that year, the United States of America (the "Plaintiff") filed a complaint against Michael, James, Madeleine, and Vikki (collectively, the "Defendants"). Subsequently, each of the parties filed

various motions to dismiss and cross-claims. Thereafter, the following motions for summary judgment were brought before the District Court.

1. Plaintiff's Motion for Summary Judgment Against Michael and Michael's Cross Motion for Summary Judgment

Plaintiff brought its summary judgment motion on three points: (1) Michael is a statutory executor liable to Plaintiff in his representative capacity; (2) Michael is personally liable to Plaintiff under section 6324(a)(2) of the Code; and (3) Michael was not discharged of his personal liability for the estate tax due to his capacity as trustee of the Living Trust. Michael opposed Plaintiff's position and filed a motion for summary judgment against Plaintiff on the same issues.

Plaintiff's first point was that Michael was a statutory executor liable to Plaintiff in his representative capacity. Plaintiff argued that it was undisputed that Michael was the court appointed executor before his purported resignation. However, because there was no executor appointed by the Probate Court after his resignation via the 2013 Settlement, Michael was still the statutory executor. In opposition, Michael argued that he resigned as the executor through the 2013 Settlement. In its analysis, the District Court found significant Michael's inability to prove that he completed the requisite procedural steps set forth in the Probate Code to resign as an executor. Michael did not establish that he settled the Estate's accounts and the record presented no order from the Probate Court discharging Michael of his duty as statutory executor. Without evidence of proper withdrawal, the District Court determined that Michael was the statutory executor. Therefore, the District Court granted Plaintiff's summary judgment motion on this issue and denied Michael's cross motion on the issue.

Plaintiff's second point was that Michael was personally liable to Plaintiff under section 6324(a)(2) of the Code. section 6324(a)(2) of the Code provides:

> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, or trustee . . . or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under section 2034 to 2042 inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax.

Thus for liability to attach, the property must be part of the gross estate pursuant to sections 2034 through 2042 of the Code. Plaintiff argued that because Michael, as trustee of the Living Trust, took possession of the trust assets upon the Decedent's death, he held property of the Estate at the time of the Decedent's death and was personally liable for any unpaid estate tax. Michael did not refute Plaintiff's argument but instead argued that the transfer of property in a living trust from a decedent to a successor trustee does not fall within section 2038 of the Code. Instead, Michael argued that the trust assets should have been included in the gross estate under section 2033 of the Code. section 2038 of the Code provides:

> The value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer … by trust or otherwise, where the enjoyment 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, revoke, or terminate, or

> where any such power is relinquished during the three year period ending on the date of the decedent's death.

In comparison, section 2033 of the Code provides that the value of the gross estate shall include "the value of all property to the extent of the interest therein of the decedent at the time of his death." Ultimately, the District Court found no genuine dispute of material fact that the trust assets were properly included as part of the gross estate under section 2038 of the Code. The District Court stated that a revocable living trust allows a settlor to retain an unlimited right to revoke any conveyance to trust, thereby giving the settlor the power to regain absolute ownership of the trust property. The District Court stated that "[t]his power to "revoke" a trust is the essence of section 2038 [of the Code]." In sum, the District Court found that the Decedent's ability to amend, revoke, or terminate the Living Trust as trustor triggered section 2038 of the Code.

In further opposition, Michael argued that even if the trust property was included in the gross estate pursuant to section 6324(a)(2) of the Code, it would be unjust and inequitable to hold him personally liable for estate taxes beyond the period that he was trustee of the Living Trust. The District Court found this argument meritless because nothing in section 6324 states that liability under such section depends on factors related to equity. Accordingly, as trust assets were properly included under section 2038 of the Code and Michael was in actual possession of the Decedent's property at the time of the Decedent's death, Plaintiff's motion for summary judgment on its second issue was granted and Michael's cross motion for summary judgment was denied.

Plaintiff's third point was that Michael was not discharged of his personal liability for the estate tax due to his capacity as trustee of the Living Trust. Plaintiff contended that although Michael was discharged from personal liability arising out of his position as executor, he was not discharged from personal liability arising out of his role as trustee of the Living Trust pursuant to section 2204 of the Code. In opposition, Michael argued that he followed all of the required procedures to be discharged as both executor of the estate and trustee of the trust.

> section 2204 of the Code states:
> (b) Fiduciary other than executor. – If a fiduciary other than the executor makes written application to the Secretary for determination of the amount of any estate tax for which the fiduciary may be personally liable, and for discharge from personal liability therefor, the Secretary upon the discharge of the executor from personal liability under subsection (a), or upon the discharge of the expiration of 6 months after the making of such application by the fiduciary, if later, shall notify the fiduciary (1) of the amount of such tax for which it has been determined the fiduciary is liable, or (2) that it has been determined that the fiduciary is not liable for any such tax. Such application shall be accompanied by a copy of the instrument, if any, under which such fiduciary is acting, a description of the property held by the fiduciary, and such other information for purposes of carrying out the provisions of this section as the Secretary may require by regulations….

The letter that Michael argued demonstrated his proper resignation under section 2204 of the Code was titled "Request for discharge of fiduciaries from personal liability," and was signed by

Michael as "J. Michael Paulson, Co-Executor of the Will of Allen E. Paulson, Deceased." The District Court stated that the letter on its face did not demonstrate that Michael followed proper procedures. Significantly, the District Court stated that the letter was ambiguous, as it did not specify that Michael was seeking discharge as the executor, trustee or both and instead only requested a "discharge of fiduciaries." Consequently, the District Court found that there were still genuine issues of material fact as to whether Michael successfully requested discharge as the trustee of the Living Trust and denied both Plaintiff's motion for summary judgment and Michael's cross-motion for summary judgment.

2. Madeleine's Summary Judgment Motion Against Plaintiff

Madeleine brought her summary judgment motion on three points: (1) she was not a statutory executor; (2) she was indemnified under the 2003 Settlement; and (3) she was not liable for the estate tax under section 6324(a)(2) of the Code as the trustee of a separate trust for her benefit which received the Decedent's former property following the 2003 Settlement.

As to the first point, the District Court restated that there were no genuine issues of material fact regarding Michael's status as the statutory executor and thus, both Madeleine's and Plaintiff's motion for summary judgment were denied as moot.

On the second point, Madeleine argued that she was not liable for estate tax under the 2003 Settlement because the agreement clearly and unambiguously provided that she was limited to the estate tax that was attributable to the property distributed to her and payable as a result of any distribution made to her. Plaintiff conceded this point. Consequently, the District Court granted Madeleine's motion for summary judgment on this matter and denied Plaintiff's cross-motion for summary judgment.

With respect to the third point, Madeleine contended that as she did not receive the property at issue until nearly three years after the Decedent's death, she was not liable for estate tax under section 6324(a)(2) of the Code. In response, Plaintiff asserted that Madeleine was liable as a trustee under such section because the statute provides for liability for assets held on the date of death and assets that are received later. Section 6324(a)(2) states in pertinent part that an individual is personally liable for taxes if they "receive[], or ha[ve], on the date of the decedent's death, property included in the gross estate." Thus, the issue before the District Court was whether the phrase "who receives, or has on the date of the decedent's death" required an individual to receive property on the date of the decedent's death, or if the comma in the phrase signified that an individual could receive the property at any time to be liable for taxes. Quoting *United States v. Johnson*, the District Court stated:

> Because section 6324(a)(2) may be interpreted in multiple ways, it is ambiguous and must be interpreted in favor of the Heirs. The court concludes that in order for a person to be a transferee under section 6324(a)(2), the person must have or receive property from the gross estate immediately upon the date of the decedent's death rather than at some point thereafter.

112 AFTR 2d 2013-5474. The District Court found the holding in *Johnson* persuasive. Accordingly, as Madeleine received property nearly three years after the Decedent's death, she was not liable as a trustee under section 6324(a)(2) of the Code. Thus, the District Court granted

Madeleine's summary judgment motion and denied Plaintiff's cross-motion for summary judgment.

3. Plaintiff's Motion for Summary Judgment Against James

Plaintiff argued that James was liable to it under section 6324(a)(2) of the Code as a "trustee" who received assets that were included in the gross estate under section 2038 of the Code. Similar to the analysis of Plaintiff's previous section 6324(a)(2) claim against Madeleine, the District Court found that because James did not hold possession of all of the assets of the Living Trust in his capacity as trustee until nine years after the Decedent's death, James was not liable and the Plaintiff's motion for summary judgment was denied.

4. Michael's Motion for Summary Judgment Against Madeleine

Michael argued that pursuant to the 2003 Settlement, Madeleine released any rights to the Estate and the Living Trust. Specifically, Michael pointed to language in the 2003 Settlement providing that Madeleine acknowledged and confirmed that the distribution of assets to her under the terms of the 2003 Settlement constituted full and complete satisfaction of any and all rights she had to the distribution of assets under the Living Trust or in the Estate. Thus, as the 2003 Settlement extinguished any interest Madeleine had in the Trust and Estate, Michael did not owe her any fiduciary duties. Madeleine contended that she agreed to such language in consideration for Michael's obligation to distribute the property to her free and clear of all debts. Thus, if Michael breached his promise to distribute the property in such manner, her release had no consideration and no effect.

The District Court noted that to successfully claim a breach of fiduciary duty, the claimant must establish (1) the existence of a fiduciary relationship giving rise to a fiduciary duty, (2) breach of that duty, and (3) damage proximately caused by the breach. The District Court found that Madeleine failed to satisfy her burden in demonstrating genuine issues of material fact that Michael breached his fiduciary duty to her. The District Court agreed with Michael that the language of the 2003 Settlement extinguished any fiduciary relationship between Michael and Madeleine. Additionally, the District Court found Madeleine's breach of fiduciary duty claim to be time-barred pursuant to the Probate Code. Thus, the District Court granted Michael's motion for summary judgment on this issue.

5. Michael's Motion for Summary Judgment Against Co-Trustees

Michael argued that in the event the District Court entered judgment against the Estate and determined that he was the statutory executor of the Estate, he would be liable for the estate tax due to the extent of the Decedent's property that he possessed. However, pursuant to the 2013 Settlement, Michael asserted that Vikki and Crystal (together, the "Co-Trustees") agreed to indemnify him from his estate tax liability. In opposition, the Co-Trustees asserted that summary judgment on Michael's indemnity claim would be premature and that he was not entitled to indemnity. The relevant language from the 2013 Settlement provided:

> Except for the matters for which liability is assigned to or indemnity is to be provided by Michael under this Agreement and any claim arising in whole or in

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> part from Michael's own legally determined wrongful actions or wrongful conduct, from and after the Settlement Date, the Co-Trustees shall indemnify, defend (including the payment of reasonable attorney's fees) and hold Michael harmless from, against, or with respect to any and all claims filed, made, asserted, brought, or prosecuted by the IRS, solely arising from this settlement and the terms of this Agreement….

The District Court found that Michael failed to demonstrate the absence of a genuine issue of material fact in regards to his claim for indemnification against the Co-Trustees. First, the District Court noted that the 2013 Settlement required that Michael be held harmless with regards to all claims "solely arising from [the] settlement." Michael broadly argued that in the event that he was determined to be the statutory executor, he would be liable for the estate tax to the extent of the Decedent's property in his possession. However, the District Court did not find Michael's broad conclusion to establish that his status as executor and the claims against him exclusively arose from the 2013 Settlement nor that the claims stemmed from conduct "from and after the Settlement date" as was required by the 2013 Settlement. Instead, Michael argued that his liability was "traceable to the 2013 Settlement" which the District Court found inadequate. In addition, the District Court noted that the indemnity section of the 2013 Settlement explicitly delineated that claims arising from Michael's own "legally determined wrongful actions or wrongful conduct" would not be indemnified. The District Court highlighted that in 2009 Michael was removed by the Probate Court as a trustee for "wrongful" conduct. Thus, the District Court found that because Michael was determined by the Probate Court to have misused funds, he could not then seek indemnity when his actions may have left the Living Trust in the position of being unable to pay its federal estate tax obligation. Accordingly, Michael's summary judgment motion on his claim of indemnification against the Co-Trustees was denied.

6. <u>Plaintiff's Motion for Summary Judgment Against Co-Trustees</u>

Plaintiff argued that the Co-Trustees were liable to Plaintiff in their representative capacity as statutory executors. Additionally, Plaintiff contended that the Co-Trustees were liable under California Probate Code section 19001, the express terms of the Living Trust, and that Plaintiff was entitled to enforce its tax liens against any obligation the Living Trust owed to the Estate for estate taxes. The Co-Trustees opposed Plaintiff's motion on all counts.

With respect to Co-Trustees' liability as statutory executors, the District Court restated its finding that there was no genuine issue of material fact that Michael was the statutory executor and denied Plaintiff's motion as moot.

The District Court next addressed the Co-Trustees' liability under California Probate Code section 19001. Section 19001 of the California Probate Code provides:

> (a) Upon the death of a settlor, the property of the deceased settlor that was subject to the power of revocation at the time of the settlor's death is subject to the claims of creditors of the deceased settlor's estate and to the expenses of administration of the estate to the extent that the deceased settlor's estate is inadequate to satisfy those claims and expenses.

> (b) The deceased settlor, by appropriate direction in the trust instrument, may direct the priority of sources of payment of debts among subtrusts or other gifts established by the trust at the deceased settlor's death….

Plaintiff contended that the Co-Trustees were liable for the unpaid estate tax pursuant to section 19001 as taxes are expenses of administration of the estate. In opposition, the Co-Trustees argued that section 19001 does not provide a mechanism to collect federal estate taxes from the Living Trust, does not provide a remedy against trust assets for "debts" of a probate estate generally, and does not create a remedy of any kind.

The District Court found that there was no genuine issue of material fact as to Plaintiff's claims under section 19001. Significantly, the District Court reasoned that the Co-Trustees disregarded the implied legislative intent of the statute, which was to prioritize government collection of taxes above administration expenses and creditor claims. Accordingly, the District Court granted Plaintiff's motion on this issue.

Next, Plaintiff contended that the Co-Trustees were liable to Plaintiff for the unpaid estate tax under the express terms of the Living Trust. In opposition, the Co-Trustees argued that Plaintiff was not a third-party beneficiary to the Living Trust and thus Plaintiff was not entitled to enforce the express terms of the Living Trust for its benefit. The District Court's reasoning distinguished a trust from a contract. Ultimately, the District Court found significant Plaintiff's failure to demonstrate how the Living Trust was a contract and how Plaintiff was a third-party beneficiary to the supposed contract at issue.

The final issue addressed by the District Court was the enforcement of the tax liens. Plaintiff asserted that to the extent that the Living Trust was obligated to make payments to the Estate so that it could then pay the estate taxes, rather than having made a direct payment to Plaintiff, it had federal tax liens against all property and rights to property of the Estate under Code sections 6321 – 6333. In opposition, the Co-Trustees argued that the tax lien provided no recourse to the assets of the Living Trust. Specifically, Co-Trustees contended that as California Probate Code section 19001 did not create any interest in the Living Trust to pay for the Estate's taxes and the Living Trust did not create an obligation for the Living Trust to pay for the estate taxes, Plaintiff could not enforce its tax liens. Ultimately, the District Court found that the Co-Trustees arguments in opposition failed to demonstrate genuine issues of material fact over Plaintiff's right to enforce its liens when an amount of estate taxes was determined. The District Court noted this in light of the fact that the Order actually concluded that California Probate Code section 19001 did create an interest in the Living Trust for the Estate's taxes. Accordingly, the section 6321 lien that the Government had against the "property" of the Estate did extend to assets of the Living Trust pursuant to section 7403 of the Code. Thus, Plaintiff's motion was granted.

B. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018)

In *Cahill*, the Tax Court considered motion for partial summary judgment filed by an estate that IRC §§ 2036(a)(2), 2038(a) and 2703(a) were inapplicable to the valuation of a decedent's interest in certain split-dollar life insurance agreements for estate tax purposes.

In 2010, the decedent established an irrevocable trust, the primary beneficiaries of which were the decedent's son and his issue. The decedent entered into a series of split-dollar life insurance agreements via his revocable trust whereby the trust advanced $10 million to the irrevocable trust to enable the irrevocable trust to purchase life insurance policies on the lives of the son and the son's wife. The revocable trust financed the $10 million premium with a five-year term loan from a trust company. The total death benefit under the policies was $79.8 million.

The terms of the SDAs provided that in exchange for the revocable trust's funding of the $10 million premiums for the irrevocable trust's benefit, the revocable trust received the right to terminate the SDAs upon mutual agreement with the trustee of the irrevocable trust. Upon termination, the irrevocable had the option to retain the policy, in which case it would then pay to the revocable trust the greater of (i) total premiums paid or (ii) the cash surrender value of the underlying policy. If the irrevocable trust declined its option, the policy would be transferred to the trust company that financed the $10 million loan in full or partial satisfaction of the revocable trust's debt.

Additionally, the SDAs provided that upon the death of the insured, the revocable trust would receive the greatest of (i) the remaining loan balance, (ii) total premiums paid, or, (iii) the cash surrender value of the underlying policy. The irrevocable trust in turn would receive any excess of the death benefits beyond what it paid to the revocable trust.

The decedent died in 2011. On his federal estate tax return, his estate claimed that the aggregate value of the decedent's rights under the SDAs had a value of $183,700. The estate argued that because the decedent's right to terminate the SDAs was conditioned upon the mutual consent of the irrevocable trust, and because it would never make economic sense for the irrevocable trust to consent to termination, that these termination rights were essentially worthless. On that basis, the estate valued its interests under the SDAs based on the son's and his wife's life expectancies, with the amount payable to the revocable trust upon their deaths under the SDAs discounted to present value.

The IRS issued a deficiency notice adjusting the value of the decedent's interest in the SDAs to $9,611,624, or the cash surrender value of the policies as of date of death. The IRS argued that this approach was warranted under alternative theories applying §§ 2036(a)(2), 2038(a) and 2703(a).

Before the Tax Court, the estate sought partial summary judgment on the basis that these three sections did not apply to the valuation of the decedent's interests in the SDAs for estate tax purposes. The Court the denied estate's requests for partial summary judgment in full.

Sections 2036 and 2038

In general, § 2036 includes property in a decedent's gross estate if (i) the decedent made an inter vivos transfer of property, (ii), the decedent's transfer was not a bona fide sale for adequate and full consideration, and (iii) the decedent kept certain interests or rights in the transferred property which the decedent still held at date of death, i.e., possession of, or the right to receive income from, the transferred property, or the right, "either alone or in conjunction with

any person," to designate the persons who shall possess or enjoy the property or income from the property.

In general, § 2038 includes transferred property in a decedent's gross estate if (i) the decedent made an inter vivos transfer of property, (ii) decedent's transfer was not a bona fide sale for adequate and full consideration, and (iii) the decedent kept certain interests or rights in the transferred property which the decedent still held at date of death, i.e., a power, exercisable by the decedent alone or "in conjunction with any other person," to alter, amend, revoke, or terminate the transferee's enjoyment of the transferred property.

The estate argued that §§ 2036 and 2038 were inapplicable because the decedent's retained rights under the SDA's were insufficient to justify application of those sections, namely because the decedent's right to terminate the SDAs could only be exercised upon mutual agreement with the irrevocable trust. The Court rejected this argument on the basis that §§ 2036 and 2038 contemplate retained rights exercisable "in conjunction with any other person."

The Court went on to argue the applicability of §§ 2036 and 2038 on the basis that the revocable trust's transfers to the SDAs were evidently not for full and adequate consideration as the value, per the estate, of what the decedent received in the SDA transaction was "not even close" to the $10 million expended by his revocable trust. The Court therefore denied the estate's motions for partial summary judgment as to the applicability of §§ 2036 and 2038.

<u>Section 2703(a)</u>

Section 2703(a) provides that the value of property for estate tax purposes shall be determined without regard to (i) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (ii) any restriction on the right to sell or use such property.

The IRS argued that, as an alternative to §§ 2036 and 2038, the fact that the revocable trust's termination rights as to the SDA's were conditioned upon the consent of the irrevocable trust should be disregarded under § 2703(a) for purposes of valuing the decedent's rights under the SDA for estate tax purposes. The estate argued, without citing authority, that § 2703 was limited in its application to certain types of transactions, such as buy-sell agreements, and the section was never intended by Congress to be applied to split-dollar insurance agreements.

The Court rejected the estate's arguments that § 2703 was categorically inapplicable to split-dollar insurance agreements and found that § 2703(a) was applicable because (i) per the estate's own valuation of its interests in the SDAs, the SDA transaction represented an exchange for less than fair market value and (ii) the SDAs contained restrictions on the parties' ability to unilaterally terminate the agreements. The Court therefore denied the estate's motion for partial summary judgment as to the applicability of §§ 2703(a).

<u>Additional Arguments by the Estate</u>

In its motions, the estate also argued that the difference between its $183,700 valuation of the decedent's interest in the SDAs for estate tax purposes and the $10 million it contributed would be accounted for in the form of gift tax to be later paid, as the cost of the current life

insurance under the SDAs would continue to be attributable to the revocable trust and would be valued under § 1.61-22 of the income tax regulations, which applies in the context of gift tax valuations. The estate argued that by increasing the valuation of the decedent's interests in the SDAs for estate tax purposes, future gift tax liability associated with the continuing cost of the current life insurance would represent a "double counting." The Court rejected this argument on the basis that even if the estate's theory regarding future gift tax liability as to the revocable trust were accurate, such gifts would be attributable to the beneficiaries of the trust, rather than the decedent, so no double counting of the decedent's interests in the SDAs for gift and estate tax purposes would occur.

Lastly, the estate argued that the valuation of the decedent's interests in the SDAs should be conducted under Reg. § 1.61-22, which applies the economic benefit regime to split-dollar agreements for gift tax purposes. The estate contended that to not apply this rule in the estate tax context would result in an inconsistency. The Court rejected this argument on the basis that Reg. § 1.61-22 is definitionally not a rule as to estate tax, and found no inconsistency between the gift tax valuation approach under the rule and the valuation of the decedent's interest in the SDAs for estate tax purposes as proposed by the IRS.

C. *Estate of Morrissette v. Commissioner*, Order, No. 4415-14 (U.S. Tax Ct., June 18, 2018)

Three days after its decision in *Cahill*, the Tax Court decided another motion for partial summary judgment on the issue of whether § 2703(a) was applicable for estate tax valuation purposes to certain split-dollar arrangements with similar termination restrictions.

In *Morrissette*, the decedent entered into split-dollar arrangements via her revocable trust with three irrevocable trusts established for the benefit of each of her sons and their issue whereby the revocable trust advanced approximately $30 million to the irrevocable trusts to be used to prepay premiums of universal life policies on the lives of each son's brothers. The SDAs provided that upon the death of the insured, the revocable trust was to receive the greater of (i) the cash surrender value of the relevant life insurance policy, and (ii) the aggregate premium payments on the policy.

The terms of the SDAs provided that the arrangements could be terminated upon mutual agreement of the revocable trust and the respective irrevocable trust. Upon such termination, the revocable trust would receive the greater of (i) the total amount of the premiums paid or (ii) the cash surrender value of the policy.

The decedent died after the revocable trust entered into the SDAs. In litigation before the Tax Court with the IRS regarding how to value the decedent's interest in the SDAs for estate tax purposes, the decedent's estate moved for partial summary judgment that § 2703(a) was inapplicable to the valuation of such interests.

In support of its position, the estate argued that the decedent's only interests in the SDAs were in the death benefits, which rights were not subject to any restrictions as defined in § 2703(a)(2), and therefore § 2703(a) was inapplicable.

The Court disagreed, siding with the IRS' position that the decedent's interests in the SDAs included her termination rights. The Court cited *Cahill* for the proposition that termination restrictions of the kind present in the *Morrissette* SDAs where the parties could mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements were restrictions for purposes of § 2703(a)(2). The Court therefore denied the estate's motion for partial summary judgment.

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