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I. Introduction

The sale to an Intentionally Defective Irrevocable Trust ("IDIT") in exchange for the IDIT's promissory note has been a popular estate

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planning strategy since the mid-1990s.[1] A more recent variant of the standard sale to an IDIT technique is the sale to what can be called a Beneficiary Intentionally Defective Irrevocable Trust ("BIDIT") in exchange for the BIDIT's promissory note.

In the standard sale to an IDIT, the seller establishes the trust. The trust instrument has no provisions which would cause assets which the seller transfers to the IDIT to be included in the seller's Federal gross estate. This is not the case with a BIDIT. A BIDIT is established by a grantor other than the seller. The seller is granted interests and powers which would typically cause assets which the seller transfers to the BIDIT to be included in the seller's estate. It appears that the sale to an IDIT technique "works" and is actually recognized as effective by the Internal Revenue Service ("IRS"). With a sale to a BIDIT, that same conclusion presently cannot be reached with the same level of confidence. This article examines the two techniques and seeks to justify the conclusion that the sale to a BIDIT should also be a successful estate planning strategy.

II. Structure of Standard Sale to IDIT Transaction

The standard sale to an IDIT technique involves a grantor establishing an IDIT and selling assets to the IDIT in exchange for the IDIT's promissory note. The IRS has asserted in litigation that IRC Sec. 7872 applies to a promissory note given in a sale transaction and that if, pursuant to IRC Sec. 7872(f), a promissory note bears interest at the applicable Federal rate under IRC Sec. 1274, it has a gift tax value equal to its face amount. This position has been accepted by the Tax Court.[2] The sale to an IDIT is a mechanism by which equity can be converted into debt without income tax consequences.[3]

Both the sale to an IDIT and the sale to a BIDIT strategies make use of the grantor trust income tax rules of IRC Secs. 671 *et seq.* to avoid any capital gain on the sale. An IDIT is a trust which is established by the party who effects the sale. With an IDIT, grantor trust status is created by intentionally violating one or more grantor trust income tax rules which do not cause the IDIT to be included in the seller's Federal

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1 *See*, *e.g.*, Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3, *1, *2 (1996); Michael D. Mulligan, *Fifteen Years of Sales to IDITs – Where Are We Now?*, 35 ACTEC L.J. 227, 227, 231-32 (2009).

2 Frazee v. Comm'r, 98 T.C. 554, 589 (1992); Estate of True v. Comm'r, T.C. Memo. 2001-167, 82 T.C.M. (CCH) 27, 130-31 (2001), *aff'd on other grounds,* Estate of True v. Comm'r, 390 F.3d 1210, 1247 (10th Cir. 2004).

3 For an article advocating abolition of the grantor trust rules to foreclose this kind of planning, see Daniel L. Ricks, *I Dig It, but Congress Shouldn't Let Me: Closing the IDGT Loophole*, 36 ACTEC L.J. 641, 660 (2010).

gross estate. It is fairly easy to achieve this result. The grantor trust income tax rules have greater reach than the estate tax rules.[4]

The position of the IRS is that an IDIT does not exist for Federal income tax purposes.[5] All income of an IDIT, including capital gain, is taxed directly to its grantor. The grantor's sale of appreciated property to an IDIT causes no recognition of gain. Interest on a promissory note paid by an IDIT to its grantor is not taxed to the grantor or deductible by the IDIT. For income tax purposes, such interest is ignored. An IDIT has the option to use the social security number of its grantor as its tax identification number.[6]

The estate tax statutes to be avoided are IRC Secs. 2036(a), 2037 and 2038(a)(1). These statutes deal with transfers with respect to which the transferor has retained interests or powers. Although an IDIT contains no express provisions which would cause inclusion in the grantor's estate under any of these statues, a concern is that the IRS might treat the promissory note as a retained interest causing assets sold to the IDIT to be included in the seller's gross estate under IRC Sec. 2036(a)(1).

If a sale to an IDIT in exchange for a promissory note produces estate tax inclusion under IRC Sec. 2036(a)(1), it also likely produces gift tax consequences under IRC Sec. 2702. Those consequences could be severe, since the applicability of IRC Sec. 2702 is likely to cause the promissory note to be assigned a value of zero.[7] A zero value results in the full value of assets transferred to the IDIT in the sale being treated as a gift, with no reduction in value produced by the promissory note.

Under authority of the decision of the United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith,*[8] it appears that application of IRC Secs. 2036(a)(1) and 2702 can be avoided if assets are available to satisfy the IDIT's promissory note in addition to those assets sold to the IDIT in the sale transaction. The other assets afford a cushion of equity to support the note. In conversations with IRS personnel in the process of obtaining Ltr. Rul. 9535026, Byrle Abbin was informed that other assets equal to or exceeding 10% of the payments due under the promissory note should be a sufficient cushion.[9]

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[4] For an examination of grantor trust rules which might be utilized without causing estate tax inclusion, see Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note – An End Run Around Chapter 14?*, 32 U. Miami Heckerling Inst. on Est. Plan. ch. 15, ¶ 1504 (1998).

[5] Rev. Rul. 85-13, 1985-1 C.B.184.

[6] Treas. Reg. §§ 1.671-4(b)(2)(i)(A), 301.6109-1(a)(2)(i)(B), (a)(2)(ii).

[7] I.R.C. § 2702(2).

[8] 356 U.S. 274, 280-81 (1958).

[9] Byrle M. Abbin, *[S]He Loves Me, [S]He Loves Me Not - Responding to Succession Planning Needs Through a Three Dimensional Analysis of Considerations to be Ap-*

One method of creating the cushion is for the seller to gift assets to the IDIT having a value equal to or greater than 10% of the promissory note. A donor serving as trustee with the power to make distributions to a number of beneficiaries does not keep a gift by the donor to the IDIT from being incomplete so long as the trustee's power to make distributions to beneficiaries is limited by a fixed or ascertainable standard.[10] If limited by a fixed and ascertainable standard, the grantor's power as trustee to allocate distributions among beneficiaries does not cause the gift to be included in the grantor's estate under IRC Sec. 2036(a)(2) or 2038(a)(1).[11]

It also appears possible to avoid a gift by the seller through use of a guarantee by one or more beneficiaries of the IDIT. The guarantee could be in the amount of cushion which is determined to be appropriate, e.g. 10% of the indebtedness. Any guarantor must have sufficient assets to make good on the guarantee.[12] There is authority for the proposition that a guarantee does not constitute a gift unless and until the beneficiary makes payment on the guarantee.[13] The risk of a guarantee being treated as a gift might be reduced by paying the guarantor a reasonable fee for the guarantee.

III. Beneficial Results Produced by Sale to an IDIT

A grantor retained annuity trust, or GRAT, produces an estate tax savings if the total return (net income plus appreciation) on the assets transferred to the GRAT exceeds the applicable I.R.C. Sec. 7520 rate used to compute the value of the retained interest. Similarly, a sale to an IDIT produces an estate tax savings if the assets sold to the IDIT generate a total return in excess of the interest on the IDIT's promissory note.

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plied in Selecting From the Cafeteria of Techniques, 31 U. Miami Heckerling Inst. on Est. Plan. ch. 13, ¶ 1300.1(O) (1997); Mulligan, *supra* note 4, ¶ 1505.2.

10 Treas. Reg. § 25.2511-2(c).

11 Estate of Budd v. Comm'r, 49 T.C. 468, 476 (1968); Estate of Pardee v. Comm'r, 49 T.C. 140, 149-50 (1967) *acq.*, 1973-2 C.B. 3; United States v. Powell, 307 F.2d 821, 828-29 (10th Cir. 1962); Estate of Kasch v. Comm'r, 30 T.C. 102, 109 (1958), *acq.*, 1958-2 C.B. 6; Jennings v. Smith, 161 F.2d 74, 79 (2d Cir. 1947); Rev. Rul. 73-143, 1973-1 C.B. 407.

12 In Letter Ruling 9515039, the IRS held that a guarantee was sufficient to avoid application of IRC Sec. 2036(a)(1) under the tests of *Fidelity-Philadelphia Trust Co.* so long as the beneficiary had sufficient assets to pay on the guarantee if required to do so. PLR 9515039 (Apr. 14, 1995); *see supra* note 8 and accompanying text.

13 Richard B. Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, 26 U. Miami Heckerling Inst. on Est. Plan. ch. 1, ¶ 119.4(A)(2) (1992); Jerald David August, *Planning Around Contingent Liabilities*, 26 U. Miami Heckerling Inst. on Est. Plan. ch. 18, ¶ 1802.3 (1992); Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. Tax'n 152, 154, 156 (2000).

Such excess is retained in the IDIT and excluded from the seller's estate. This result is easier to achieve with an IDIT than with a trust which is separately taxed on its income. An IDIT's income is not reduced by taxes.

Since an IDIT is excluded from the estate of its grantor, the grantor's payment of taxes on an IDIT's income could be viewed as an indirect gift to the beneficiaries of the IDIT. In Rev. Rul. 2004-64,[14] however, the IRS ruled that such payment is not subject to gift tax.

The results produced by the sale technique can be particularly striking with the sale of an interest in an entity upon which income tax is not imposed at the entity level, e.g., a partnership, limited liability company or S corporation. The seller of such an interest continues to be taxed on the entity's income attributable to that interest. A partnership, limited liability company or S corporation frequently makes distributions to its owners to assist them in paying tax on its income. After the sale of an interest in such an entity to an IDIT, it is the IDIT which receives that distribution, not the seller. To move funds to the seller, the IDIT can make payment on its promissory note. Such payment reduces the balance due on the promissory note and, consequently, the value of the seller's estate. If the entity generates a significant amount of taxable income, that reduction can be substantial. The reduction in the value of the seller's estate can be the most favorable result produced by a sale to an IDIT.

A sale to an IDIT can also produce favorable generation-skipping tax results. These favorable results can be illustrated by an example. A grantor may make a gift of $5,000.00 in cash to an IDIT, and then sell assets having a fair market value of $50 million to the IDIT in exchange for the IDIT's $50 million promissory note. The grantor/seller need only allocate $5,000.00 in GST exemption to the IDIT for the IDIT to have an inclusion ratio of zero. With that allocation, all of the excess return excluded from the grantor/seller's estate for Federal estate tax purposes is also insulated from generation-skipping tax. The significant point is that this insulation is achieved without allocation of any additional GST exemption.

IV. Gift Tax Return Reporting Sale to an IDIT

An IDIT is designed so that its assets are not includable in the grantor's estate. Consequently, any gratuitous transfer that a grantor makes to an IDIT constitutes a completed gift for Federal gift tax purposes. With a sale to an IDIT, it is possible for the grantor/seller to file a gift tax return reporting the sale transaction. The return can take the posi-

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14 Rev. Rul. 2004-64, 2004-2 C.B. 7.

tion that the sale is not a gift because the value of the assets sold to the IDIT does not exceed the value of the IDIT's promissory note. If the return adequately discloses the transaction, the IRS is foreclosed from challenging that position to assess a gift tax once the three-year statute of limitations has elapsed.[15] A timely filed gift tax return also establishes the value of a transfer for purposes of allocating GST exemption.[16]

In addition, it is a good idea for a beneficiary guaranteeing any payment under the IDIT's promissory note to file a gift tax return taking the position that the guarantee does not constitute a gift. As noted in the discussion at note 13, *supra*, there is authority for the proposition that a guarantee itself is not a gift for Federal gift tax purposes until such time, if any, as the guarantor makes payment on the gift. If a return adequately discloses a guarantee and takes the position that the guarantee does not constitute a gift, that position would appear to be a legal conclusion binding upon the IRS after the gift tax statute of limitations has expired.[17]

As noted above, the possibility exists that the IRS might assert that a promissory note received in a sale to an IDIT constitutes a retained interest causing inclusion under IRC Sec. 2036(a)(1). There is an exception to inclusion under IRC Secs. 2036(a), 2037 and 2038(a) provided by identical language contained within parentheses in all three of these statutes. Under this parenthetical exception, the statutes do not apply to any transfer constituting "a bona fide sale for an adequate and full consideration in money or money's worth." Satisfying the parenthetical exception makes any of the three statutes inapplicable even if there is a retained interest or power which would otherwise cause inclusion. A question arises as to whether the passage of the three-year statute of limitations on a gift tax return adequately disclosing a sale transaction has any impact on the availability of the parenthetical exception to avoid possible inclusion under IRC Sec. 2036(a)(1).

The parenthetical exception has two requirements. There must be (i) a bona fide sale, and (ii) adequate and full consideration. In the case of a sale to an IDIT for a promissory note, the "bona fide sale" requirement would seem easily satisfied so long as the formalities with respect to the sale are observed. A true sale to a party different from the seller has, in fact, taken place. Passage of the statute of limitations on a gift tax return adequately disclosing a sale to an IDIT which reports a gift of zero should establish "adequate and full consideration" under the parenthetical exception.

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15 I.R.C. §§ 2001(f), 2504(c), 6501(a), (c)(9).

16 *Id.* § 2642(b)(1).

17 Treas. Reg. §§ 20.2001-1(b), 25.2504-2(b).

IRC Sec. 2001(f) provides that if the time has expired under IRC Sec. 6501 within which a gift tax may be assessed "the value thereof shall, for purposes of computing the tax under this chapter, be the value as finally determined for purposes of chapter 12." This language does not indicate that there is any exception to the rule that gift tax value is determinative for estate tax purposes. On the contrary, the statute appears to create a rule that applies with respect to any aspect of the process involved in computing estate tax. The question of whether adequate and full consideration was received for a transfer which might be included in the gross estate under IRC Sec. 2036(a) or 2038(a)(1) is a part of that process. The preamble to the Final Regulations on adequate disclosure contains the statement that the Final Regulations "preclude adjustments with respect to all issues related to a gift once the gift tax statute of limitations expires with respect to that gift."[18]

A number of commentators have concluded that IRC Sec. 2001(f) does not operate to establish adequate and full consideration under the parenthetical exception,[19] primarily under authority of Treas. Reg. Sec. 20.2001-1(b).[20] That Regulation states that gift tax value is conclusive for purposes of determining adjusted taxable gifts. The commentators construe Treas. Reg. Sec. 20.2001-1(b) as applying solely for purposes of determining adjusted taxable gifts.[21] They also express the view that determining the correct amount of adjusted taxable gifts is a different issue than determining whether IRC Secs. 2036(a) and 2038(a) apply to a transfer.[22]

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18 T.D. 8845, 1999-51 I.R.B. 683, https://www.irs.gov/pub/irs-regs/td8845.pdf.

19 See U.S. Tr., Bank of Am. Priv. Wealth Mgmt., *The Beneficiary Grantor Trust*, PRAC. DRAFTING, July 2011, at 10471, 10486-87; Austin W. Bramwell, *Considerations and Consequences of Disclosing Non-Gift Transfers*, 116 J. TAX'N 19, 27-28 (2012); William R. Culp, Jr. et al., *The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust*, 44 ACTEC L.J. 63, 119-20 (2019).

20 Treas. Reg. Sec. 20.2001-1(b) provides as follows:

> *Adjusted taxable gifts and Section 2701(d) taxable events occurring after August 5, 1997.* For purposes of determining the amount of adjusted taxable gifts as defined in Section 2001(b), if, under Section 6501, the time has expired within which a gift tax may be assessed under Chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) with respect to a gift made after August 5, 1997, or with respect to an increase in taxable gifts required under Section 2701(d) and § 25.2701-4 of this chapter, then the amount of the taxable gift will be the amount as finally determined for gift tax purposes under Chapter 12 of the Internal Revenue Code and the amount of the taxable gift may not thereafter be adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

21 S*ee* U.S. Tr., Bank of Am. Priv. Wealth Mgmt., *supra* note 19, at 10486.

22 *See id.*; Bramwell, *supra* note 19, at 11; Culp et al., *supra* note 19, at 119-20.

Although Treas. Reg. Sec. 20.2001-1(b) can be read to imply that its rule applies only to the determination of adjusted taxable gifts, it does not expressly state such to be the case. It is possible that Treas. Reg. Sec. 20.2001-1(b) is intended to be an expression of how the rule applies to the determination of adjusted taxable gifts without addressing how the expiration of the gift tax statute of limitations applies to other issues, e.g., the determination of whether adequate and full consideration was received for purposes of the parenthetical exception.

On the other hand, it may be an intention of the Regulation to restrict its application solely to the determination of adjusted taxable gifts. If so, this intent would seem to be more restrictive than the rule established by the language of IRC Sec. 2001(f), the applicable statute. In the event of a conflict between the Regulation and the statute, the statute prevails.

If the foregoing analysis is correct, adequate disclosure of a sale to an IDIT which has language in the governing instrument making a gift complete for gift tax purposes will start the gift tax statute of limitations to run. Once that statute has run, a conclusion in the return that consideration received in the sale was sufficient to avoid any gift should also be conclusive on the question of adequate and full consideration under the parenthetical exception. Such a conclusion is consistent with the Fifth Circuit's decision in *Wheeler v. United States*, discussed in Part VII, *infra*, that full and adequate consideration for gift tax purposes constitutes and establishes full and adequate consideration for estate tax purposes.

V. Indications That IRS Recognizes Sale to IDIT Technique

There are no reported cases involving the sale to an IDIT technique. The IRS has not officially pronounced upon the technique in a manner that can be relied upon by taxpayers. There are indications, however, that the IRS recognizes the effectiveness of the sale to an IDIT technique.

Karmazin v. Commissioner[23] was a case filed in the Tax Court involving an asserted gift tax deficiency arising out of a sale to IDIT transaction. In *Karmazin,* the taxpayer sold limited partnership interests to two IDITs in exchange for the IDITs' promissory notes. The notes bore interest at the applicable Federal rate. The taxpayer made gifts of limited partnership interests affording a 10% cushion. The sale documents provided for the sale of limited partnership interests having a value equal to a fixed dollar amount, which amount equaled the face amount

[23] No. 2127-03 (T.C. Oct. 15, 2003) (stipulated decision).

of the promissory note given by the IDITs in the sale transactions. A discount of 42% was claimed on the gift tax return reporting the sales.

The gift tax examiner determined that IRC Sec. 2702 applied to the sales transactions and assigned a zero value to the IDITs' promissory notes.[24] The gift tax examiner also disallowed any discount for the limited partnerships.[25]

The case was settled on terms very favorable to the taxpayer. In the settlement, it was agreed that IRC Sec. 2702 did not apply.[26] The sale was recognized, and it was agreed that the promissory notes had gift tax values equal to their face amounts. The discount produced by the limited partnership was agreed to be 37%, rather than the 42% claimed. Thus, the deficiency originally asserted by the gift tax examiner was reduced by 95%. These settlement terms were so favorable to the taxpayer that one commentary concluded that the IRS "was not serious" about its IRC Sec. 2702 contentions.[27]

Estate of Marian Woelbing v. Commissioner[28] and *Estate of Donald Woelbing v. Commissioner*[29] were two companion cases filed in the Tax Court which involve facts similar to those in *Karmazin*. In the *Woelbing* cases, the IRS asserted the applicability of IRC Sec. 2702 to a sale of non-voting stock of a closely held corporation by Mrs. Woelbing to an IDIT in exchange for the IDIT's promissory note.[30] The Woelbings were husband and wife. They both consented under IRC Sec. 2513 to treat any gift in the sale as having been made one-half by each of them. The IRS also asserted that the assets sold to the IDIT by Mr. Woelbing should be included in his Federal gross estate under IRC Secs. 2036(a) and 2038(a).[31]

As with *Karmazin*, the *Woelbing* cases were settled on terms very favorable to the taxpayer. From the stipulated decisions entered in both cases in March of 2016, it is clear that the IRS abandoned its IRC Secs. 2036(a), 2038(a) and 2702 arguments.[32]

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24 *Id.*

25 *Id.*

26 *Id.*

27 Richard B. Covey & Dan T. Hastings, *Recent (2003) Developments in Transfer and Income Taxation of Trusts and Estates*, 38 U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 1, ¶ 129 (2004).

28 No. 30260-13, 2015 U.S. Tax Ct. LEXIS 13 (Jan. 26, 2015).

29 No. 30261-13, 2015 U.S. Tax Ct. LEXIS 12 (Jan. 23, 2015).

30 *Ron Aucutt on* Woebling [sic]*: Parties Settle Closely Watched Tax Court Cases Involving Defined Value Clauses*, EST. PLAN. EMAIL NEWSL. - ARCHIVE MESSAGE #2419 (Leimberg Info. Servs., Inc.), May 24, 2016.

31 *Id.*

32 *See id.*

The IRS has recognized the sale to IDIT technique in two private letter rulings.[33] The author's office has been involved in more than fifty estate or gift tax audits in which individuals had engaged in a sale to an IDIT transaction. In none of those audits was the basic structure of the sale challenged. None of the examining agents in those audits asserted that either IRC Sec. 2036(a)(1) or 2702 was applicable. Generally, the only issue in the audits was the value of the assets sold to the IDIT. In cases in which beneficiaries had guaranteed an IDIT's promissory note, agents inquired as to whether the guarantors had sufficient financial wherewithal to make good on their guarantees. The author's experience is that the IRS recognizes the sale to IDIT technique. This is true even in cases in which the seller is acting as sole trustee of the IDIT. *Karmazin* and the *Woelbing* cases do not appear to indicate an official IRS position that sales to IDITs are to be challenged.

VI. Sale to a BIDIT

The trust instrument establishing a BIDIT differs substantially from a trust instrument establishing an IDIT.

A. Description of a BIDIT

With a BIDIT, a party might establish a trust for the benefit of an individual beneficiary and the beneficiary's descendants. The beneficiary will be the seller in the sales transaction. The governing instrument might name the individual beneficiary as trustee, and authorize the trustee to make distributions of income and principal of the BIDIT to the beneficiary and the beneficiary's descendants living from time to time for health, support, maintenance or education. The trust instrument could also prohibit the trustee from making any distribution which satisfies any legal obligation of the trustee, including the obligation to support a descendant. The trust might continue for the beneficiary's lifetime. The beneficiary might be granted a testamentary power to appoint any assets of the trust at death to any appointee of the beneficiary's selection, other than the beneficiary, the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.

Because the beneficiary as trustee is precluded from using assets of the BIDIT to satisfy claims of the beneficiary's creditors and because the trustee's power to make distributions to himself or herself is limited

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[33] PLR 9436006 (Sept. 9, 1994); PLR 9535026 (Sept. 1, 1995). However, see PLR 9251004 which involved the right to receive annual payments on a promissory note received from a trust in exchange for the transfer of stock in a transaction described as a "sales/gift." The IRS held that the right to receive annual payments on the note constituted a retained right to receive trust income, causing the transferred stock to be included in the transferor's estate. PLR 9251004, *1, *7, *10 (Dec. 18, 1992).

by an ascertainable standard related to health, support, maintenance or education, the powers which the beneficiary possesses as trustee during his or her lifetime do not constitute a general power of appointment.[34] Although the testamentary power of appointment is broad, because permissible appointees exclude the beneficiary, the beneficiary's creditors, the beneficiary's estate, or the creditors of the beneficiary's estate, the testamentary power does not constitute a general power of appointment.[35] Thus, any assets of the trust which cannot be traced, directly or indirectly, to a transfer by the beneficiary are not included in the beneficiary's Federal gross estate.

The grantor might gift up to $5,000 to the BIDIT and grant the individual beneficiary a power to withdraw that contribution which, if not exercised, lapses after a period of time, e.g., 30 days. So long as the grantor is not taxed under any of the grantor trust rules subpart E,[36] such power causes the beneficiary to be treated as the owner of the trust. While the power is outstanding, the beneficiary is treated as the owner under IRC Sec. 678(a)(1). After the power has lapsed, the beneficiary is treated as the owner under IRC Sec. 678(a)(2). Because the lapse does not exceed the $5,000 or 5% limits of IRC Sec. 2014(e), the lapse of the power of withdrawal is not considered to be a gift by the beneficiary. In addition, because the $5,000 or 5% limits of IRC Sec. 2041(b)(2) are not exceeded, the lapse of the power to withdraw is not considered a release causing the lapsed amount to be included in the beneficiary's estate by virtue of the beneficiary's retained interests and powers with respect to the lapsed amount.

At this point, the situation with respect to the BIDIT is the same with respect to the beneficiary as with an IDIT and its grantor. The BIDIT is recognized to exist for Federal estate tax purposes. The grantor's $5,000 contribution is excluded from the beneficiary's Federal gross estate. For income tax purposes, the BIDIT is not recognized to exist separate and apart from the beneficiary.[37] As with an IDIT and its grantor, the beneficiary can sell appreciated assets to the BIDIT without recognizing gain. The beneficiary is taxed individually on all income generated by the BIDIT's assets. The beneficiary's payment of tax on such income is not considered to be a gift by the beneficiary to the BIDIT.[38]

With an IDIT, the 10% cushion can be created by the grantor/seller making a gift of additional assets to the IDIT. This option is not availa-

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34 Treas. Reg. § 20.2041-1(c)(1)(b), (c)(2).
35 *Id.* § 20.2041-1(c)(1)(b).
36 I.R.C. § 678(b).
37 Rev. Rul. 85-13, 1985-1 C.B. 184.
38 Rev. Rul. 2004-64, 2004-2 C.B. 7.

ble with the BIDIT described above, because the interests and powers possessed by the beneficiary/seller which the beneficiary/seller gifts to the IDIT would cause inclusion under IRC Secs. 2036(a) and 2038(a). One method of dealing with this problem is to add a provision in the governing instrument which precludes the beneficiary from having any interest or power with respect to any assets which the beneficiary transfers to the BIDIT for less than an adequate and full consideration. Such a provision would cause any gift by the beneficiary to be a completed gift for Federal gift tax purposes. The gifted assets would, however, be available to satisfy the promissory note to the beneficiary in the same way that gifted assets are available to satisfy a promissory note given on the sale of assets to an IDIT. If this method is utilized, care must be taken not to commingle any assets gifted by the beneficiary, together with any income from such assets, with other assets of the BIDIT.

Another method of providing a cushion for the promissory note is for beneficiaries of the BIDIT other than the beneficiary/seller to guarantee at least 10% of the amounts payable under the promissory note. All of the discussion in Parts II and IV, *supra*, with respect to guarantees by beneficiaries of an IDIT is applicable to guarantees by beneficiaries of a BIDIT.

B. The BDOT and SGT

There are two other types of trusts that have been suggested as alternatives to the BIDIT. One such other type of trust has been called a "Beneficiary Deemed Owner Trust" or "BDOT."[39] The other has been called a "Spousal Grantor Trust" or "SGT."[40]

The BDOT is a trust with respect to which a beneficiary is treated as owner under IRC Sec. 678. The BDOT grants the beneficiary the continuing right to withdraw annually all of the net taxable income of the BDOT, i.e., dividends, interest and taxable income allocated to principal, such as capital gain. The power can be satisfied out of the entire income or corpus of the trust. The beneficiary's withdrawal power lapses in each year to the extent it is not exercised.

The reference in IRC Sec. 678(a)(1) to "income" is to taxable income, not accounting income. Because the beneficiary's withdrawal power extends to the taxable income of the entire trust, the effect of the withdrawal power is to make the BDOT a wholly grantor trust. All of its income, both accounting income and capital gain income, is taxed to the beneficiary. It is contemplated that the beneficiary will withdraw annu-

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[39] S. Stacy Eastland, *Best Estate Planning Techniques Under TCJA–Part 4: BDOT*, 45 Est. Plan. 19 (2018).

[40] Culp et.al., *supra* note 19, at 63.

ally any taxable income in excess of the $5,000 or 5% limits of IRC Secs. 2041(b)(2) and 2514(e). The 5% limit is 5% of the value of the entire trust. Any lapsed amounts remain in the BDOT excluded from the beneficiary's Federal gross estate.

A stated advantage of the BDOT over the BIDIT is that the grantor can make a substantial gift to the trust, all of which is treated as owned by the beneficiary for income tax purposes under IRC Sec. 678(a)(1). With a BIDIT, the initial gift does not exceed $5,000. The greater initial funding possible with the BDOT means that there is equity in the trust to support any note given by the BDOT in purchasing assets from the beneficiary, giving the sale more of the attributes of an arm's length transaction than exists with a BIDIT which is funded only with a maximum of $5,000. The equity also satisfies the test enunciated by the United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith* that assets in addition to those purchased be available to satisfy the trust's promissory note.[41]

An SGT is similar to an IDIT. One spouse establishes the SGT of which the other spouse is a beneficiary and which is a grantor trust treated as owned by the spouse establishing the SGT (and who is not a beneficiary of the SGT). The beneficiary spouse who is not treated as the owner of the trust under the grantor trust rules sells assets to the SGT in exchange for its promissory note. Gain on the sale of appreciated assets is avoided not because the SGT is treated as owned by the selling spouse under the grantor trust income tax rules, but rather by application of IRC Sec. 1041. That statute provides that no gain or loss is recognized on a transfer of property to, or in trust for the benefit of, the transferor's spouse. IRC Sec. 1041 applies because the assets which the beneficiary spouse sells to the SGT are treated as sold to the grantor spouse by virtue of the SGT's grantor trust status. IRC Sec. 1041 does not apply to interest on the SGT's promissory note, and such interest is taxable to the selling spouse. If the SGT has investment income, it may be entitled to an offsetting deduction for the interest paid.[42]

VII. The Parenthetical Exception - The *Wheeler* Case

An IDIT contains no express provisions in the governing instrument which cause assets in the IDIT to be included in the grantor/seller's estate for Federal estate tax purposes. The exact opposite is the case with a BIDIT. The provisions of the BIDIT cause any assets which the beneficiary gifts to the BIDIT to be included in the beneficiary's estate. The theory upon which the sale to BIDIT transaction rests is that

41 *See* text accompanying note 8, *supra*.
42 I.R.C. § 163(d).

the beneficiary's sale of assets to the BIDIT falls within the parenthetical exception rendering the retained interests and powers irrelevant. This result is achieved only if the beneficiary's transfer of assets to the BIDIT constitutes a bona fide sale for an adequate and full consideration.

The purpose of the parenthetical exception is to ensure that the estate is replenished for the value by which it may have been reduced because of the transfer.[43] Because the estate and gift tax rules for valuing transferred assets permit discounting, adequate and full consideration is deemed to have been received so long as the consideration received for a transferred interest is at least equal to the estate and gift tax value (after any discounts) of the assets transferred. That the value is sufficient to avoid a gift on the sale should also mean that adequate and full consideration has been received for purposes of the parenthetical exception.

This point is illustrated by the Fifth Circuit's decision in *Wheeler v. United States*,[44] which is a leading case involving the parenthetical exception. In *Wheeler*, the decedent sold a remainder interest in a farm to his two adopted sons several years before his death. The decedent reserved a life estate in the farm. The actuarial tables at Treas. Reg. Sec. 25.2512-5(A) were used to determine the purchase price, which the sons paid for the remainder interest by their promissory note. Applying IRC Sec. 2043(a), the IRS determined that the decedent's gross estate should include the date of death value of the farm, less the amount of the sons' promissory note. The District Court accepted the IRS's argument, finding under authority of a number of prior cases[45] that to be applicable, adequate and full consideration per the parenthetical exception required that the value received by the decedent must be equal to the value of the underlying property and not the actuarial value of the remainder interest.

Following the Third Circuit's decision in *D'Ambrosio v. Commissioner*,[46] the Fifth Circuit held that the value of the remainder interest constituted adequate and full consideration under the parenthetical exception. The Fifth Circuit stated that the decedent received adequate and full consideration for gift tax purposes, and thus should also be considered to have received adequate and full consideration for purposes of

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[43] Comm'r v. Wemyss, 324 U.S. 303, 306 (1945); Merrill v. Fahs, 324 U.S. 308, 312 (1945).

[44] Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997).

[45] Gradow v. United States, 897 F.2d 516, 518 (Fed. Cir. 1990); Pittman v. United States, 878 F. Supp. 833, 835 (E.D.N.C. 1994).

[46] 101 F.3d 309, 310 (3rd Cir. 1996), *cert. denied,* 520 U.S. 1230 (1997).

the parenthetical exception. The Fifth Circuit's opinion contains the following:

> To the extent the "bona fide" qualifier in section 2036(a) has any independent meaning beyond requiring that neither transfers nor the adequate and full consideration for them be illusory or sham, it might be construed as permitting legitimate, negotiated commercial transfers of split-interests that would not otherwise qualify as adequate consideration using the actuarial table values set forth in the Treasury Regulations to qualify under the exception. Such a result comports with the same construction the term is given in the gift tax regulations. The gift tax regulations prevent an "ironclad" operation of the gift tax statute from transforming every bad bargain into a gift by the losing party. [Citations omitted.] Accordingly, the term "bona fide" preceding "sale" in section 2036 is not, as the government seems to suggest, an additional wicket reserved exclusively for intrafamily transfers that otherwise meet the Treasury Regulations' valuation criteria. The government implicitly asserts that the term "bona fide" in section 2036(a) permits the IRS to declare that the same remainder interest, sold for precisely the same (actuarial) amount but to different purchasers, would constitute adequate and full consideration for a third party but not for a family member. This construction asks too much of these two small words. In addition to arguing that "adequate and full consideration" means different things for gift tax purposes than it does for estate tax purposes, the government would also have us give "bona fide" not only a different construction depending on whether we are applying the gift or estate tax statute, but also different meanings depending upon the identity of the purchaser in a section 2036(a) transaction. We do not believe that Congress intended, nor do we believe the language of the statute supports, such a construction.[47]
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> ***
>
> Here the sons parted with real money in the form of a fully secured, conventional real estate lien note on which each had entire personal liability; the purchase price of the remainder interest was the uncontested fair market value of the ranch discounted by the actuarial factor set forth in the government's own regulations; Melton received not only the principal

[47] *Wheeler*, 116 F.3d at 763-64.

> amount due under the note, but also interest income generated by the note prior to its assignment to The Melton Company; no payments were missed, the note was never in danger of default, and it was *in fact* paid off in full, principal and interest, by January 1988, more than three years before Melton's death; although there were no negotiations concerning the purchase price, it is patent that, at the time of the transfer, a third party would have been ill-advised to pay more than its actuarial value; . . . This was a bona fide sale.[48]

Under the Fifth Circuit's opinion in *Wheeler*, the bona fide sale requirement of the parenthetical exception is satisfied if consideration for a transfer is, in fact, received by the transferor. When the consideration actually received by the transferor is adequate and full, both requirements of the parenthetical exception are satisfied and IRC Sec. 2036(a) is not applicable. Additionally, under *Wheeler*, adequate and full consideration for gift tax purposes is also adequate and full consideration for estate tax purposes.[49]

VIII. Gift Tax Return Reporting a Sale to a BIDIT

The discussion in Part IV, *supra*, suggests that a sale to an IDIT might be disclosed on a gift tax return which reports no gift because the value of the promissory note is at least equal to the value of assets purchased. If the return adequately discloses the sale, the IRS cannot assess a gift tax on the sale once the three-year statute of limitations has elapsed. Further, as observed in that discussion, the return should also establish the existence of adequate and full consideration for purposes of the parenthetical exception. It would be beneficial if the same result could be achieved by filing a gift tax return adequately disclosing a sale to a BIDIT.

A beneficiary's retained interests and powers over assets which the beneficiary transfers to the BIDIT described in Part VI.A, *supra*, causes any gift by the beneficiary to be incomplete.[50] Reporting an incomplete gift does not start the limitations to run.[51] Without dealing with the incompleteness issue, it does not appear possible to achieve finality by adequately disclosing a sale to a BIDIT on a gift tax return.

It has been suggested that the incomplete gift issue can be avoided by reporting the sale to a BIDIT as a "non-gift completed transfer"

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48 *Id.* at 770.
49 *See also* Kimbell v. United States, 371 F.3d 257, 261-62 (5th Cir. 2004).
50 Treas. Reg. § 25.2511-2(c).
51 Treas. Reg. § 301.6501(c)-1(f)(5).

under Treas. Reg. Sec. 301.6501(c)-(1)(f)(5).[52] That Regulation provides that if a transfer adequately disclosed on a gift tax return is reported as a completed gift, the statute of limitations for assessing gift tax on the transfer will run, even if the transfer is later determined to be an incomplete gift. Treas. Reg. Sec. 301.6501(c)-(1)(f)(5) also states that "once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included." The suggestion is that if the sale to a BIDIT is reported as a completed gift on a gift tax return, the quoted language precludes the IRS from including the assets sold to the BIDIT in the seller's Federal gross estate.

Read closely, the quoted language of the Regulation does not support this suggestion. That language states only that interests and powers which cause a transfer to be incomplete are disregarded. Ignoring only those interests or powers which prevent a transfer from being complete does not necessarily preclude that transfer from being included in the transferor's estate. For example, if a transferor's interest in the income from assets which a transferor has transferred to a BIDIT is sufficient to permit the transferor's creditors to reach that income to satisfy claims against the transferor, those assets are includable in the transferor's gross estate under IRC Sec. 2036(a).[53] Ignoring interests and powers which make the transfer incomplete does not change this result.

There is another method of dealing with the incomplete gift issue, which is likely to be more successful than the non-gift completed transfer approach. That other method is to include language in the governing instrument suggested in Part VI.A, *supra*, which provides that a beneficiary is not to have any beneficial interest in or any testamentary power of appointment over any assets which the beneficiary transfers to the BIDIT for less than a full and adequate consideration. Such a provision would cause any gift by a beneficiary to be a completed gift for Federal gift tax purposes. A gift tax return adequately disclosing a sale to a BIDIT containing such a provision which takes the position that the sale did not constitute a gift because the value of the assets sold did not exceed the value of the BIDIT's promissory note should preclude the IRS from challenging that position once the statute of limitations has run. Further, for the reasons stated in Part IV, *supra*, the gift tax return should also conclusively establish the existence of adequate and full consideration for purposes of the parenthetical exception.

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52 Jerome M. Hesch et al., *A Gift from Above: Estate Planning on a Higher Plane*, 150 Tr. & Est., Nov. 2011, at 17, 26-27.

53 Treas. Reg. § 20.2036-1(a).

IX. Limited Partnership Cases - Substantial Non-Tax Purpose Required for a Bona Fide Sale

Recently, there have been a substantial number of reported cases involving the parenthetical exception. Most of these cases involved the question of whether or not valuation discounts were available for interests in a limited partnership or limited liability company included in a decedent's Federal gross estate. In many of these cases, an individual transferred marketable securities or other liquid assets into a limited partnership or an LLC in exchange for limited partnership interests or non-voting membership interests in the LLC. It is asserted that the Federal estate tax value of such interests is less than the value of the assets transferred into the entity, i.e., that the value of the individual's Federal gross estate is reduced below what it would have been had the transfer not taken place. The IRS asserts that the assets which the individual contributed into the entity are included in the gross estate under IRC Sec. 2036(a) or 2038(a), or both, because of interests or powers retained or possessed at death. Essentially, the IRS's position is that the existence of the entity is ignored. The individual's estate typically argues that even if interests or powers exist, inclusion is avoided by virtue of the parenthetical exception. Specifically, the estate argues that the transfer of assets into the entity in exchange for interests in the entity constituted a bona fide sale for adequate and full consideration.[54]

The cases have uniformly held that the receipt of partnership interests proportionate to a partner's contribution to a partnership constitutes adequate and full consideration.[55] The applicability of the parenthetical exception thus depends upon whether the transfer of assets into the limited partnership constitutes a bona fide sale. The cases involving this issue require a substantial non-tax reason or purpose justifying the formation of a limited partnership as a pre-requisite for finding the existence of a bona fide sale.

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[54] Most of the decided cases involve limited partnerships rather than LLCs. *See infra* note 55. For convenience, this article frequently refers to limited partnerships without mentioning LLCs. The considerations involved in applying IRC Secs. 2036(a) and 2038(a) to limited partnership interests and non-voting interests in an LLC are the same. Treas. Reg. §§ 2036(a), 2038(a).

[55] Estate of Harper v. Comm'r, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, 1648 (2002); Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004); Estate of Thompson v. Comm'r, 382 F.3d 367, 386 (3d Cir. 2004); Estate of Bigelow v. Comm'r, 503 F.3d 955, 968 (9th Cir. 2010).

A. *Strangi* and Its Progeny

Estate of Strangi v. Commissioner[56] is an early case in which the IRS asserted that IRC Sec. 2036(a) applied to cause assets transferred into a limited partnership to be included in the transferor's gross estate. In *Strangi*, the decedent, through his attorney-in-fact, transferred assets to a limited partnership interest in exchange for a 99% limited partnership interest. Seventy-five percent of the transferred assets constituted cash and marketable securities. The decedent was in ill health at the time the partnership was formed and died just over two months later.

In a regular opinion written by Judge Cohen,[57] the Tax Court rejected the IRS's contention that the existence of the limited partnership should be ignored for lack of economic substance or a business purpose. The Tax Court's opinion expressed skepticism regarding the existence of non-tax motives for the partnership. Nevertheless, noting that formalities were followed and that the limited partnership changed the relationship between the decedent, his heirs and actual and potential creditors, the Tax Court held that the limited partnership had sufficient substance to be recognized for Federal estate tax purposes.[58]

The Tax Court in *Strangi* rejected a number of other arguments by the IRS, including the argument that the underlying assets of the partnership should be included in the decedent's gross estate under IRC Sec. 2036(a).[59] The IRS first asserted the applicability of that statute in a motion filed in the Tax Court fifty-two days prior to trial. In filing that motion, the IRS reversed the position it had previously taken in a number of private letter rulings. In these rulings, the IRS held IRC Sec. 2036(a)(2) did not apply to a general partner's power to control distributions from a limited partnership because of the fiduciary duty a general partner owes the other partners.[60] The Tax Court denied the IRS's motion to amend because it considered the motion untimely.[61]

On appeal, the Fifth Circuit affirmed all of the Tax Court's holdings other than its conclusion regarding IRC Sec. 2036(a). It remanded the case with directions to the Tax Court to consider the IRS's 2036(a) claim.[62]

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56 115 T.C. 478 (2000), *aff'd in part and rev'd in part*, Gulig v. Comm'r, 293 F.3d 279 (5th Cir. 2002), *on remand* Estate of Strangi v. Comm'r, T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005).

57 *Strangi*, 115 T.C. at 490-91.

58 *Id.* at 486-87.

59 *Id.* at 492-93.

60 *See e.g.*, PLR 9546006 (Nov. 17, 1995); PLR 9415007 (Apr. 15, 1994); PLR 9310039 (Mar. 12, 1993); PLR 9332006 (Aug. 13, 1993); TAM 9131006 (Aug. 2, 1991); TAM 8611004 (Nov. 15, 1985).

61 *Strangi*, 115 T.C. at 486.

62 Gulig v. Comm'r, 293 F.3d 279, 282 (5th Cir. 2002).

Back in the Tax Court, one argument made by the estate was that the parenthetical exception rendered IRC Sec. 2036(a) inapplicable. The Tax Court rejected this argument in a memorandum opinion by Judge Cohen,[63] who was also the author of the Tax Court's 2000 regular opinion in *Strangi*.

The Estate proffered five different non-tax reasons for the decedent's transfer of assets into the limited partnership. These reasons were (i) deterring potential tort litigation by the decedent's former housekeeper; (ii) deterring a potential will contest suit; (iii) persuading a corporate executor to decline to serve; (iv) creating a joint investment vehicle; and (v) permitting centralized, active management of working interests.[64] Judge Cohen rejected each of these rationales as a sufficient non-tax purpose justifying the formation of the partnership.

The Fifth Circuit affirmed this determination upon finding that it was not clearly erroneous.[65] According to the Fifth Circuit, the bona fide sale requirement of the parenthetical exception could be satisfied only by a demonstration that the "transfer in question was objectively likely to serve a substantial non-tax purpose."[66]

After its success in *Strangi*, the IRS has used IRC Sec. 2036(a) as the only basis upon which it challenges valuation discounts for limited partnership interests included in a decedent's Federal gross estate. In cases after *Strangi*, courts have generally replicated the methodology adopted by Judge Cohen in her 2003 memorandum opinion. After finding that there is a retained interest or power sufficient to cause inclusion under IRC Sec. 2036(a), the courts consider whether inclusion is avoided by virtue of the parenthetical exception. In determining whether the parenthetical exception applies to avoid IRC Sec. 2036(a), courts have considered whether there is a sufficient non-tax purpose justifying a limited partnership's existence. If no substantial non-tax reason for the limited partnership is found to exist, the courts find that the assets contributed by a decedent into a limited partnership are included in the decedent's gross estate as though owned by the decedent.[67] Para-

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63 Estate of Strangi v. Comm'r, T.C. Memo. 2003-145, *43-45, 85 T.C.M. (CCH) 1331 (2003).

64 Estate of Strangi v. Comm'r, 417 F.3d 468, 480 (5th Cir. 2005).

65 *Id.*

66 *Id.* at 479.

67 Steve R. Akers lists 36 cases involving limited partnerships or limited liability companies. Steve R. Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, Bessemer Trust 83-85 (Apr. 2019), https://www.bessemertrust.com/sites/default/files/2019-04/Heckerling%20Musings%202019_04_17_19.pdf. Fourteen of those cases held that IRC Sec. 2036(a) was not applicable by virtue of the parenthetical exception. *Id*. at 83-84. Twenty-two cases held for inclusion under IRC Sec. 2036(a). Further, Akers categorizes 2 of the 22 cases as partial wins for the estates. *Id*. at 84-85.

doxically, searching for a substantial non-tax purpose as a test for inclusion under IRC Sec. 2036(a) involves the same analysis in which Judge Cohen declined to engage while rejecting the IRS's business purpose and economic substance argument in her first *Strangi* opinion.

B. The *Powell* Case and IRC Sec. 2043(a)

The courts uniformly followed the methodology outlined in the preceding paragraph until the Tax Court's decision in *Estate of Powell v. Commissioner*.[68] In a plurality decision joined in by eight of the seventeen judges participating in the case (with two judges concurring in result), the Tax Court held that assets contributed to a limited partnership were includable in the decedent's Federal gross estate.[69]

In *Powell*, the decedent's son, acting under a durable power of attorney, contributed assets of the decedent into a limited partnership in exchange for a 99% limited partnership interest.[70] After the limited partnership was formed, the decedent's son, again acting under the durable power, transferred the 99% limited partnership interests into a charitable lead trust.[71] The validity of the transfer to the charitable lead trust was in doubt because the durable power of attorney only authorized annual exclusion gifts to the decedent's issue.[72] The decedent died seven days after the limited partnership interests were transferred to the charitable lead trust.[73] In granting the IRS's motion for summary judgment, the judges joining in the plurality opinion held that the transfer of the decedent's assets to the limited partnership was subject to a retained right to designate under IRC Sec. 2036(a)(2).[74] The Tax Court plurality held IRC Sec. 2036(a)(2) applied because the decedent, in conjunction with all of the other partners, could dissolve the partnership.[75] The plurality further held that IRC Sec. 2036(a)(2) was not avoided by the transfer to the charitable lead trust even if it was assumed that such transfer was valid.[76] Because the transfer occurred within three years of the decedent's death, IRC Sec. 2035 caused IRC Sec. 2036(a)(2) to continue to apply even though the decedent no longer held the limited partnership interests at death.[77]

68 148 T.C. 392 (2017).
69 *Id.* at 419.
70 *Id.* at 394.
71 *Id.* at 395.
72 *Id.*
73 *Id.* at 394.
74 *Id.* at 404.
75 *Id.* at 401-02.
76 *Id.* at 407-08.
77 *Id.* at 394.

The Tax Court's analysis of the application of IRC Sec. 2036(a)(2) in *Powell* might be questioned. A limited partner has no power to participate in the management or distributions from the partnership. It is the first case in which any court has applied IRC Sec. 2036(a)(2) to hold for inclusion when the decedent did not hold a general partnership interest.[78] It would seem that if the Tax Court's analysis is in *Powell* is correct, the taxpayer should never have won a single limited partnership estate tax case. Any partnership can be dissolved by agreement of all of its partners. Treas. Reg. Sec. 20.2038-1(a)(2) provides that IRC Sec. 2038(a) does not apply if a decedent's power could be exercised only with the consent of the parties having an interest (vested or contingent) in the transferred property. Although there is no similar provision in the Regulations under IRC Sec. 2036(a)(2), there is no reason why the rule established by Treas. Reg. Sec. 20.2038-1(a)(2) should not also apply to that statute.

After finding for inclusion under IRC Sec. 2036(a)(2), the plurality opinion in *Powell* then engaged in an extended discussion on the interaction of IRC Sec. 2036(a)(2) with IRC Sec. 2043(a). The latter statute applies when consideration is received for a transfer, but the consideration is not adequate and full. According to the plurality opinion, the amount included in the estate under IRC Secs. 2036(a) and 2043(a) in limited partnership cases is the date of death value of the assets transferred to the limited partnership, reduced by the value of limited partnership interests received in exchange for such transfer, the received interests being valued as of the date of the transfer.[79] Further, according to the plurality, the limited partnership interests held by the decedent at death is separately included in the estate under IRC Sec. 2033 at its date of death value.[80] The effect of this interaction among IRC Secs. 2036(a), 2043(a) and 2033 is to include in the estate the excess of the date of death value of the transferred assets (reduced by the date of transfer value of the limited partnership interests received) over the date of death value of the limited partnership interests received.

In *Powell*, the parties stipulated that the value of the assets transferred to the limited partnership was also their value as of date of death. Because of that stipulation, the net value actually included in *Powell* was the amount of the discount produced by the limited partnership. In footnote 7 of its opinion, the plurality notes that its view of the interaction of IRC Secs. 2036(a), 2043(a) and 2033 produces the possibility of double inclusion if the value of the transferred assets increases between

78 *Id.* at 422.
79 *Id.* at 414-15.
80 *Id.* at 420.

date of transfer and date of death.[81] This is because the appreciation in the value of the transferred assets is included under IRC Secs. 2036(a) and 2043(a) and is also included in determining the date of death value of the limited partnership interests included in the gross estate under IRC Sec. 2033.

The seven judges joining in the concurring opinion in *Powell* rejected the plurality's analysis of IRC Secs. 2036(a), 2043(a) and 2033, noting that the issue had not been argued or briefed by either party.[82] The concurring opinion notes that all prior cases applying IRC Sec. 2036(a) to limited partnerships ignored the existence of the limited partnership.[83] According to the concurring opinion, limited partnership interests held at death should be regarded as having no distinct value, being an "alter ego" of the assets transferred to the limited partnership in exchange for such interests.[84]

C. Substantial Non-Tax Purpose Test Should Be Limited to Limited Partnership Cases

A recent article[85] analyzes *Powell* in the context of examining the propriety generally of using IRC Sec. 2036(a) as the basis for deciding whether a limited partnership interest is to be recognized as effective to produce valuation discounts. The article contrasts how courts have applied the parenthetical exception's bona fide sale test in limited partnership cases as compared to how they apply it in non-partnership cases. Citing *Wheeler*,[86] the article observes that in conventional analysis, even if a sale were tax driven, the parenthetical exception applied to avoid double inclusion when the decedent received a substitute asset equal in value to the asset transferred. The article criticizes the courts' rejection of what it describes as a "more appropriate methodology for closing down" tax driven limited partnerships, i.e., that limited partnerships formed for the sole purpose of avoiding the estate tax should be disregarded.[87]

In addition to finding fault with the courts' indifference to *Wheeler* and rejection of the "more appropriate methodology," the article points to a number of unfavorable consequences resulting from the use of IRC Sec. 2036(a) in limited partnership cases. One problem is the possibility

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81 *Id.* at 408 n.7.
82 *Id.* at 420-21.
83 *Id.* at 421-23.
84 *Id.* at 423.
85 Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (2017).
86 *Id.* at 271-72, 272 n.84.
87 *Id.* at 269-70.

of double taxation referred to in footnote 7 of the plurality's opinion in *Powell*.[88] The article also points out that under the tests which have been developed in the jurisprudence under IRC Sec. 2036(a), a partnership formed without any non-tax justification will in some instances nevertheless be recognized.[89] For example, a partnership whose sole purpose is to avoid estate taxes will not be ignored under IRC Sec. 2036(a)(1) if no distributions are made from the partnership and if the decedent retains sufficient assets outside of the partnership upon which to live. In such a case, there is no evidence of a retained income interest causing IRC Sec. 2036(a)(1) to apply. The article observes that "having chosen section 2036, the courts are left with the complications such as those that surfaced in *Powell*."[90]

In *Estate of Trombetta v. Commissioner*,[91] the Tax Court appears to have recognized issues created by the courts' use of the substantial non-tax reason test to decide limited partnership cases. The decedent in *Trombetta* transferred assets to a trust in exchange for an annuity payable for a term of months. The estate argued against inclusion of the GRAT in the decedent's estate under IRC Sec. 2036(a)(1) on the grounds that the parenthetical exception applied. According to the estate, the decedent established the trust for an assured income stream and to avoid managing the properties she transferred to the trust. The estate argued that these purposes for establishing the trust constituted legitimate and significant non-tax reasons making the parenthetical exception applicable. The Tax Court found that the significant non-tax reason test should be limited in application to limited partnership cases:

> Although a number of other cases have applied the "legitimate and significant nontax reasons" standard to determine whether a bona fide sale exception was satisfied, all of the cases applied the standard in the context of a transfer to a family limited partnership. [Citations omitted.] Decedent transferred the Tierra Plaza and Black Walnut Square properties to a grantor trust, not a family limited partnership. Decedent's transfers are not comparable to a transfer to a family limited partnership, particularly given that no other individual received a present interest in the annuity trust. We are not persuaded and are unable to find that decedent's transfers to the annuity trust are sufficiently similar to a transfer to a family

88 *Powell*, 148 T.C. at 408 n.7.

89 Gans & Blattmachr, *supra* note 85, at 278.

90 *Id.* at 275.

91 T.C. Memo. 2013-234, 106 T.C.M. (CCH) 416 (2013).

limited partnership to apply the "legitimate and significant nontax reasons" standard.[92]

Given the conceptual difficulties that have arisen in applying IRC Sec. 2036(a) and the non-tax purpose test in limited partnership cases, it would be understandable if the courts were to reconsider that application. With the number of decisions that have been based upon IRC Sec. 2036(a), such a development seems unlikely. At the very least, however, the courts should limit the use of the non-tax purpose test to limited partnership cases and not extend it to a case involving the applicability of the parenthetical exception to a sale to a BIDIT.

X. Seller on Both Sides of the Transaction

There are cases in which the courts have expressed as a justification for applying IRC Sec. 2036(a) the assertion that a decedent "stood on both sides of the transaction." A number of those cases involve limited partnerships.[93] In these cases, the courts have made the observation that a decedent has stood on both sides of the transaction in holding that the exchange of assets for interests in a limited partnership or other entity did not constitute a bona fide sale. In the cases in which this observation is made, the decedent or someone acting on the decedent's behalf was the controlling voice as to the structure of the limited partnership and the rights and responsibilities of the various partners, and there was little or no evidence of engagement by the other partners in the formation of the limited partnership.

A. Receipt of Adequate and Full Consideration Establishes a Bona Fide Sale

The statement has also been made in cases which did not involve limited partnerships. *Estate of Trombetta v. Commissioner*[94] involved a transfer of assets to a trust in exchange for an annuity payable over a specified term. The trust instrument provided that the annuity was to qualify under IRC Sec. 2702, which deals with retained interests. The court held that the annuity constituted a retained interest causing the assets transferred to the trust to be included in the decedent's estate under IRC Sec. 2036(a)(1). Among the grounds given by the court for

92 *Id.* at 422.

93 *See, e.g.*, Estate of Bongard v. Comm'r, 124 T.C. 95 (2005); Estate of Erickson v. Comm'r, T.C. Memo. 2007-107, 93 T.C.M. (CCH) 1175 (2007); Estate of Turner v. Comm'r, T.C. Memo. 2011-209, 102 T.C.M. (CCH) 214 (2011); Estate of Liljestrand v. Comm'r, T.C. Memo. 2011-259, 102 T.C.M. (CCH) 440 (2011); Estate of Strangi v. Comm'r, T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331, *aff'd* Estate of Strangi v. Comm'r 417 F. 3d 468 (5th Cir. 2005).

94 *See supra* note 91.

this holding was that the decedent stood on both sides of the transaction:

> [The decedent's attorney] and decedent determined how the entire estate plan would be structured and operated and what property would be contributed to which vehicle. Decedent, as the sole beneficiary and the sole transferor, formed the transaction, fully funded the annuity trust, and essentially stood on both sides of the transaction.[95]

In another article, the authors identified in note 85, *supra*, analyze the decision in *Trombetta*.[96] One point the article discusses is the Tax Court's suggestion that a lack of meaningful negotiation (i.e., being on both sides of the transaction) renders the parenthetical exception unavailable. The article comments that the *Trombetta* court's discussion of the decedent being on both sides of the transaction was not necessary to its decision, because the value of the annuity was exceeded by the value of the assets which the decedent transferred to the trust.[97] That excess value was reported on a gift tax return. Irrespective of whether the transaction constituted a bona fide sale, the requirements of the parenthetical exception were not satisfied because the decedent had not received adequate and full consideration.[98]

The article also notes that the above quote from the *Trombetta* opinion can be construed as requiring an arm's length transaction for a sale to be bona fide under the parenthetical exception.[99] The article states that an arm's length negotiation should not be required if a decedent has received adequate and full consideration in a sale.[100] Echoing the view of the parenthetical exception expressed by the court in *Wheeler*, the article observes that it makes no sense as a policy matter to require inclusion under IRC Sec. 2036(a) if in fact full consideration was received.[101]

B. Fiduciary Responsibilities

A trustee has fiduciary responsibilities which should be and have been recognized as distinguishing an individual acting in his or her individual capacity. The decision in *Goodman v. Commissioner*[102] illustrates

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95 *Id.* at 421.

96 Mitchell M. Gans & Johnathan G. Blattmachr, *Private Annuities and Installment Sales:* Trombetta *and Section 2036*, 120 J. TAX'N 227, 229-31 (2014).

97 *Id.* at 228.

98 *Id.* at 227.

99 *Id.*

100 *Id.*

101 *Id.* at 231-32.

102 74 T.C. 684 (1980).

this point. *Goodman* was decided after the Fifth Circuit affirmed the Tax Court's decision in *Rushing v. Commissioner*.[103] In *Rushing* the taxpayer sold corporate stock to an irrevocable trust in exchange for the trust's installment note after the corporation had adopted a plan of liquidation. The IRS asserted that the taxpayer was not entitled to installment treatment and should be taxed immediately on the sale.[104] The Fifth Circuit rejected the IRS's argument, holding that the taxpayer was entitled to installment treatment. In the course of its opinion, the Fifth Circuit emphasized that the trust had an autonomous corporate trustee which was independent of the taxpayer.[105]

In *Goodman*, the taxpayers sold apartments to trusts the day before the trusts sold the apartments to an unrelated party. The taxpayers in *Goodman* were the trustees of the trusts. The Tax Court rejected the IRS's argument that the taxpayers were not entitled to installment treatment.[106] The court distinguished other cases in which taxpayers had entered into transactions with themselves as trustees, noting that the taxpayers' status as trustees was not the reason for the decisions in those cases against the taxpayers:

> Considering our holdings in a number of other cases, we conclude that the fact that a seller of property is the trustee of the trusts to which the property is sold, standing alone, does not cause the same to lack substance or bona fides, or the seller to constructively receive the income from the sale received by the trusts. The crucial factor is whether the trustee was acting solely as trustee and in the best interests of the trusts in making the purchase and sale of the property.
>
> In our view, under the facts here present, [the taxpayers] did not have control over the proceeds of the sale or control over making the sale to Cathedral except in their capacity as trustees, which was a capacity distinct and apart from their capacity as individual sellers of the property.[107]

Although the beneficiary/seller of a BIDIT continues to possess substantial interests and powers with respect to any assets which he or she sells to the BIDIT, the beneficiary/seller no longer has absolute control over those assets. Under the terms of the BIDIT, the beneficiary/seller as trustee is limited to distributions for health, support, mainte-

103 441 F.2d 593, 598 (5th Cir. 1971), *aff'g* Rushing v. Comm'r., 52 T.C. 888 (1969).

104 *Rushing*, 441 F.2d at 595-97.

105 *Id*. at 598.

106 *See Goodman,* 74 T.C. at 684.

107 *Id.* at 708-09. The decision in *Rushing* and its progeny led to the enactment of IRC Sec. 452(e), which disallows installment treatment in sales to a related party if the buyer disposes of the purchased property within two years. *See Rushing*, 441 F.2d at 597.

nance or education. As trustee, the beneficiary/seller has fiduciary duties to the other beneficiaries of the BIDIT. In states with statutes similar to Section 813 of the Uniform Trust Code, the beneficiary/seller, as trustee, is required to notify qualified beneficiaries of the BIDIT's existence, the identity of the settlor, the right to request a copy of the trust instrument and the right to receive annual reports.[108] The trustee is also obligated to send annual reports to the permissible distributees who do not waive the right to receive them and to other beneficiaries of the BIDIT who request them.[109] The duty to notify and provide annual reports cannot be overridden by the trust instrument.[110]

There is a distinction between full control that exists with outright ownership and a beneficiary/seller's interests and powers under a BIDIT. Those differences caused the Tax Court to reach the conclusions it did in *Goodman* in spite of the Fifth Circuit's emphasis in *Rushing* on the existence of an independent corporate trustee. As in *Goodman*, what should ultimately count is that the fiduciary duties which the law imposes upon a trustee should be sufficient to overcome an assertion that the seller in a BIDIT transaction is on both sides of the transaction.

C. Standing on Both Sides of Transaction Not Sufficient as the Sole Ground for Finding No Bona Fide Sale

While *Trombetta* and a number of the other cases cited in note 93, *supra,* refer to the grantor of a trust being on both sides of the transaction, that fact was just one of a number of justifications that the courts used in reaching a result adverse to the taxpayer. In no case has being on both sides of the transaction been the only ground upon which no bona fide sale has been found to exist. In *Estate of Stone v. Commissioner*[111] and *Estate of Purdue v. Commissioner*,[112] the courts found that the decedents were on both sides of the transaction, but that the parenthetical exception nevertheless applied to avoid inclusion under IRC Sec. 2036(a). In *Stone* and *Purdue*, the courts found that the parenthetical exception applied because of the existence of substantial non-tax reasons for the formation of the entities in those cases.

In *Estate of Thompson v. Commissioner*,[113] the Third Circuit held that the assets which a decedent had transferred into a limited partnership were includable in the decedent's estate under IRC Sec. 2036(a)(1). While discussing the parenthetical exception, the court's opinion ad-

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108 Unif. Tr. Code § 813(b)(3) (Unif. L. Comm'n amended 2010).
109 *Id.* § 813(c)-(d).
110 *Id.* § 105(b)(8)-(9).
111 T.C. Memo. 2012-48, 103 T.C.M. (CCH) 1237 (2012).
112 T.C. Memo. 2015-249, 110 T.C.M. (CCH) 627 (2015).
113 382 F.3d 367, 381-82 (3d. Cir. 2004).

dressed the IRS's contention that the decedent in that case stood on both sides of the transaction:

> The Commissioner argues that there was no "bona fide sale" in this case because decedent "stood on both sides of the transaction" as transferor and a limited partner of the family partnerships. The Commissioner's position is supported by several cases which have concluded that a "bona fide sale" requires an arm's length bargain. *See, e.g.*, *Bank of New York v. United States*, 526 F.2d 1012, 1016 (3d Cir. 1975) ("[T]he value of the claim settled by the estate may not be deducted if the agreement on which the claim was based was not bargained at arm's length.); *Harper*, 83 T.C.M. at 1653 (denying the § 2036 exception, in part, where there was no "arm's length bargaining because decedent "stood on both sides of the transaction"); *Strangi*, 85 T.C.M. at 1343 (finding no bona fide sale where "decedent essentially stood on both sides of the transaction"). As a practical matter, an "arm's length" transaction provides good evidence of a "bona fide sale," especially with intrafamily transactions . . . .
>
> That said, however, neither the Internal Revenue Code nor the governing Treasury Regulations define "bona fide sale" to include an "arm's length transaction." Treasury Regulation 20.2036-1(a) defines "bona fide sale for an adequate and full consideration" as a transfer made "in good faith" and for a price that is "adequate and full equivalent reducible to a money value." 26 C.F.R. § 20.2036-1(a) (referring to 26 C.F.R. § 20.2043-1(a)). Based in part on an interpretation of this regulation, the Court of Appeals for the Fifth Circuit concluded a "bona fide sale" only requires "a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange." *See Kimbell*, 371 F.3d at 265. The court reasoned:
>
> [J]ust because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide. A transaction that is a bona fide sale between strangers must also be bona fide between members of the same family. In addition, the absence of negotiations between family members over price or terms is not a compelling factor in the determination . . . particularly when the exchange value is set by objective factors.

> *Id*. at 263 (discussing *Wheeler*, 116 F.3d 749) (internal citations omitted).
>
> We similarly believe a "bona fide sale" does not necessarily require an "arm's length transaction" between the transferor and an unrelated third-party. Of course, evidence of an "arm's length transaction" or "bargained-for exchange" is highly probative to the § 2036 inquiry. But we see no statutory basis for adopting an interpretation of "bona fide sale" that would automatically defeat the § 2036 exception for all intrafamily transfers. *Wheeler*, 116 F.3d at 655 ("Unless and until the Congress declares that intrafamily transfers are to be treated differently . . . we must rely on the objective criteria set forth in the statute and Treasury Regulations to determine whether a sale comes within the ambit of the exception to section 2036(a).").[114]

The Third Circuit's analysis in *Thompson* of what constitutes a bona fide sale corresponds with the Fifth Circuit's analysis in *Wheeler*. That analysis rejects both sides of the transaction as a basis for finding no bona fide sale as long as there is an actual exchange in which consideration is received by the seller.[115] The BIDIT should be viewed as having sufficient characteristics that distinguish it from the seller, so that an exchange between distinct parties has taken place. A bona fide sale occurs even though the seller might superficially be said to be on both sides of the transaction.

There are a number of factors which make a sale to either an IDIT or a BIDIT appealing as a planning technique to reduce Federal estate taxes. As noted in Part III, *supra*, because of the grantor trust income tax status of both the IDIT and the BIDIT, no gain is recognized on the sale of appreciated assets to either type of trust. In addition, as noted above, the seller's continued payment of income taxes on assets sold to either an IDIT or a BIDIT without gift tax consequences causes a reduction of the seller's Federal gross estate. The ability to use strategies to discount the gift tax value of what is sold (and, consequently, the value of the seller's estate) is another appealing factor. These factors which make the sale to either an IDIT or a BIDIT attractive as a planning technique should have no bearing on the determination of whether a sale to either an IDIT or a BIDIT constitutes a bona fide sale for an adequate and full consideration. The question should not be whether or not there is a reason why a seller would want to engage in a sale to a

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114 *Id.*

115 *See id.* at 381-82.

BIDIT, but, under *Thompson* and *Wheeler*, rather whether a sale involves a true exchange of assets for a consideration.

As noted in Part I, *supra*, the IRS appears to recognize the sale to an IDIT technique even when the seller is trustee of the IDIT. A seller on both sides of the transaction does not invalidate a sale to an IDIT.[116] It should likewise not be a sufficient basis standing alone to invalidate a sale to a BIDIT.

XI. Conclusion

The essential structure of a sale to a BIDIT is the same as that of a sale to an IDIT, i.e., a seller exchanges assets for a promissory note. Both transactions satisfy the tests enunciated by the Fifth Circuit in *Wheeler* for establishing the existence of a bona fide sale for an adequate and full consideration, i.e., both involve an actual exchange of assets for consideration. It appears that the IRS recognizes the validity of the sale to an IDIT strategy. That is true even when the seller is also the trustee of the IDIT and thus could be viewed as being on both sides of the transaction.

The presence or absence of a substantial non-tax reason or justification for a sale to a BIDIT should be irrelevant. A gift tax return adequately disclosing the sale and reporting no gift should establish adequate and full consideration for purposes of the parenthetical exception once the three-year statute of limitations has expired. The fact that the seller might be viewed as standing on both sides of the transaction under the language of some of the cases should not preclude the transaction from being recognized as a bona fide sale between separate and distinct parties.

A sale to a BIDIT should work as well as a sale to an IDIT.

[116] *See id.* at 367.