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Subject: **General Estate and Gift Tax Developments: January 2011**

1. **Residence In Which Decedent Lived on Date of Her Death Is Includible in Gross Estate Under IRC § 2036 Despite Prior Transfer**

Prior AALU Washington Reports: *10-110*

Major References: ***Estate of Van v. Commissioner, TC Memo 2011-22 (January 27, 2011)***

2. **Federal Appeals Court Rejects Application of Step Transaction Doctrine to Taxpayers' Gifts of LLC Interests to Children**

Major References: ***Linton v. U.S. __ F.3d __ No. 09-35681 (9th Cir. January 21, 2011)***

Prior AALU Washington Reports: *10-88; 09-99; 02-67; 02-48; 00-110*

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This Washington Report summarizes a few of the more important cases and rulings in the estate and gift tax areas which were decided or reported by the courts and the Internal Revenue Service in January of 2011, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

Cases

1. _Estate of Van v. Commissioner_, _TC Memo 2011-22 (January 27, 2011)_

In Estate of Van v. Commissioner, Decedent Adelina Van lived in a house, got title to the house, and then tried to give the house away when she began to think about her own death. She did not actually move out of the house before she died, and the Tax Court held that, since she had retained the beneficial enjoyment of the property during her lifetime, it was includible in her gross estate under section 2036 of the Internal Revenue Code ("Transfers With Retained Life Estate").

In 1962, Adelina Cheng Van emigrated to the United States from China as a divorced 41-year-old mother of four. She eventually settled in San Mateo, California, with three of her children—Norma, Robert, and Michael. From 1965 to 1973 the Vans lived in a house that they had scraped money together to buy in Foster City. But then Van started courting a man named Marcel Periat, who in June 1973 bought a house for her on Capistrano Way in San Mateo, very close to his own home. Periat incurred all the costs himself and kept title to the property in his own name. Van moved into the Capistrano house and began living there expense free.

In 1988, Van's daughter and son-in-law, Norma Van Hu and James Hu ("the Hus") asked Van to see if Periat would sell the Capistrano house to them. Periat instead negotiated a "Mutual Agreement and Release" with Van. The Agreement required him to sell the Capistrano house to Van for $250,000, with $170,000 as a down payment and a secured promissory note to him for the remaining $80,000. Van, however, did not use her own money. The Hus were the source of her funds, both of the down payment and of the payments on the note.

Although Van took title to the house in 1989, within hours of recording the deed Van recorded a grant deed conveying title to the house to herself and two of her grandchildren—the Hus' daughters Virginia and Arleen, as joint tenants. Without telling her daughter and son-in-law, Van then had Virginia and Arleen reconvey sole title back to her in 1994. Then in August 1997 Van created the Adelina Cheng Van Revocable Trust and deeded the Capistrano house to herself as trustee in December 1997. Two years later, she transferred title to the house from herself as trustee to her daughter Norma and three granddaughters: Virginia, Arleen, and Christina Hu. All of these transfers were without consideration.

Van died on May 1, 2000. Her estate's federal estate tax return disclosed the existence of the Capistrano house but did not list the house as an asset of the estate. The Commissioner sent the estate a notice of deficiency that included the Capistrano house as a taxable asset of Van's estate, claiming that Van retained possession or enjoyment of the Capistrano house until she died, "even after title to it began ducking and weaving throughout her extended family."

The estate contested the inclusion, arguing that it was really the Hus who owned the house. They purportedly gave the money to Van under what they claim was an agreement that they were to be the legal purchasers of the house even though Van would take title to placate Periat. The estate argued that the Hus' past dealings with Van, in which she served as their agent for real-estate purchases, supported this characterization.

Burden of Proof

In a move that the Tax Court itself described as "uncommon," it determined that the Commissioner in this case bore the burden of proof for the following reasons:

"The estate clearly flagged the issue in its return: It listed the Capistrano house and its fair market value on "Schedule A— Real Estate" and then deducted the value, explicitly noting the estate's belief that Van had no ownership interest in the house as the Hus had provided the purchase money and title had passed to Norma Hu and her three daughters before Van's death. The estate also went out of its way to cooperate with the IRS—it allowed the IRS to interview the Hus in its counsel's office; provided the IRS with all the relevant documents . . . and even translated Van's letters into English for the IRS."

Decision

Despite the shift in the burden of proof, the Court decided the case in favor of the Commissioner, on the basis of Internal Revenue Code section 2036, which "includes in a decedent's gross estate the value of all property that a decedent gives away but which she keeps in her possession or in which she continues to enjoy an interest until her death."

The estate argued that, under California law, Van never had an interest in the Capistrano house because Norma Hu and her husband were the real owners. Van purportedly had taken title only as their agent. To back up this claim, the estate pointed to other real-estate transactions where Van served as the Hus' agent. The Court found this argument unconvincing because, in this case, unlike others in which Van actually took title as the Hus' agent, "Van took legal title to the Capistrano house in her own name and actually lived there."

In fact, noted the Court, California law actually presumes that "[t]he owner of the legal title to property is . . . the owner of the full beneficial title. This presumption may be rebutted only by clear and convincing proof . . ." which was clearly lacking in this case.

Nor did the Court agree with the estate's fallback position that a resulting trust was established under state law when the Hus supplied the money for the purchase. "This concept of a resulting trust", noted the Court, "does exist in California law." However, even if such a doctrine exists, in this case there was clear evidence " . . . that Van not only 'intended to take the beneficial interest' in the Capistrano home, she actually did take a beneficial interest—after all, she was living there until she died." In addition, in this case, the relationship of Van to the Hus - *i.e.,* that of parent and child - "is a circumstance which prima facie establishes the presumption of an advancement and thereby rebuts the presumption of a resulting trust."

Having found that Van had a beneficial interest in the house, the Court's next task was to determine if her divestment of title to the house acted to remove the value from her estate. It found that the divestment of title was irrelevant because Van's relationship to the property did not change in that she retained the possession and enjoyment of the property until her death, without the payment of rent or other charge.

The Court therefore concluded that the house should be included in Van's gross estate for federal estate tax purposes.

The ***Van*** case may be contrasted with the decision of the 2nd Circuit in ***Estate of Stewart v. Commissioner,*** (see our Bulletin No. 10-110) in which the appellate court, reversing the Tax Court, held that there was no implied agreement to retain the benefit of 100 percent of the use of certain real property that the decedent owned jointly with her son.

2. *Linton v. U.S.* __ *F.3d* __ *No. 09-35681 (9th Cir. January 21, 2011)*

.In Linton v. U.S., the Ninth Circuit Court of Appeals reversed a grant of summary judgment in favor of the government on the issue of whether gifts of LLC interests were made after the contribution of assets to the LLC, and whether, in any case, the steps of the

transaction ought to be collapsed and viewed as a single, integrated transaction under the "step transaction" doctrine.

The gift tax under Section 2511 of the Code applies whether the gift is direct or indirect. Section 25.2511-1(h)(1) of the Treasury Regulations illustrates a transfer of property by a shareholder to the corporation for less than adequate consideration. The regulation concludes that, generally, such a transfer represents an indirect gift by the shareholder to the other individual shareholders to the extent of their proportionate interests in the donee-corporation. Similarly, under ***Shepherd v. Commissioner***, 115 T.C. 376, 389 (2000), affd. 283 F.3d 1258 (11th Cir. 2002) *rehearing, en banc, den.* 2002 U.S. App. LEXIS 14147 (2002) (*see* our Bulletins Nos. 00-110 and 02-67), if a partner transfers property to a partnership for less than adequate consideration, the transfer generally may be treated, depending on the facts and circumstances surrounding the transfer, as an indirect gift by the transferor to the other partners. *See also* TAM 200212006, discussed in our *Bulletin No.* 02-48.

In our Bulletin Nos. 09-99 and 10-88, we further described the cases of ***Heckerman v. U.S.*** and ***Pierre v. Commissioner,*** both of which applied the "step transaction" doctrine to collapse a series of steps resulting in the transfer, by gift, of LLC interests to the transferors' children into a single transaction.

Now, in ***Linton v. Commissioner***, __ F.3d __ No. 09-35681 (9th Cir. January 21, 2011), the Ninth Circuit Court of Appeals appears to have cast some doubt on the reflexive application of the step transaction doctrine to such transfers in all cases. In that case, the Ninth Circuit held that the district court [(638 F.Supp.2d 1277 (W.D.Wash.2009)] erred in granting summary judgment in favor of the IRS on Taxpayers' claim for a refund of 2003 federal gift taxes; where Taxpayers contended that they gifted interests in a limited liability company ("LLC") and the IRS contended that Taxpayers made an indirect gift of cash, securities and real property, because material facts remained in question as to the sequence of the transactions.

At issue was the order of the transactions. If Taxpayers first contributed cash, securities and real property to the LLC and then, after a lapse of time, transferred the LLC interests to trusts for Taxpayers' children, as Taxpayers contended, the gifts would ordinarily be characterized as gifts of LLC interests, and the value of those LLC interests for gift tax purposes might be properly discounted for lack of lack of marketability and/or minority interests. However, if the contributions to the LLC occurred after the transfer of LLC interests to the children's trusts, the gifts would ordinarily be characterized as indirect gifts of the contributed assets and would not be discountable for purposes of the gift tax.

The district court, in granting the IRS's motion for summary judgment, found that the contributions of cash, securities and real property were made to the LLC either simultaneously with or after the gifts of the LLC interests to the children's trusts, thereby constituting indirect gifts to the trusts of pro rata shares of the assets conveyed to the LLC. The district court further determined, in the alternative, that even if Taxpayers established that the cash, securities and real property were contributed to the LLC prior to the gifts of the LLC interests to the children's trusts, Taxpayers made indirect gifts of the transferred assets to their children's trusts under the step transaction doctrine.

The Ninth Circuit, applying Washington state law, found significant ambiguity as to the date on which the gifts of LLC interest were complete because, while all of the documents were signed on January 22, 2003, the documents regarding the gifts of the LLC interests were not dated on January 22, 2003. Additionally, the Ninth Circuit noted that "[t]he mere preparation of a donative document does not effect a present transfer necessary to perfect a gift. Such a writing becomes effective when the donor manifests the intention that the document is to be operative to make a present transfer." Generally, the writing will be deemed effective "when the donor puts the document beyond retrieval" by delivering the document to the donee.

Based on the foregoing, the Ninth Circuit stated that the current record suggested two possibilities. Either: (i) that the trustee's (and, therefore, for legal purposes, the donee's), leaving the meeting on January 22, 2003 with copies of the undated gift documents was a sufficient objective manifestation that the gift documents were intended to be effective immediately; or (ii) the Taxpayers appointed their attorney to be their agent with the power to make the gift documents effective at some later date, that later date occurring whenever the agent dated the gift documents and made some objective manifestation that the gift was effective (such as by sending a copy of the signed documents to the trustee) in March or April of 2003. The Ninth Circuit held that, because the record was subject to contrary inferences as to operative date of the gift, the IRS was not entitled to summary judgment on this pivotal point. Accordingly, the Ninth Circuit remanded the case to the district court for such proceedings as it deems necessary to resolve this question.

The Ninth Circuit then addressed the district court's determination that, even if the sequence of events was as Taxpayers contended, the gifts would still be characterized as indirect gifts of cash, securities and real property to the children's trusts pursuant to the step transaction doctrine. Under that doctrine, the IRS will collapse "formally distinct steps in an integrated transaction" in order to assess taxes based on a "realistic view of the entire transaction." The step transaction doctrine treats multiple transactions as part of a single integrated transaction for tax purposes if the elements of at least one of three tests are satisfied.

The first of the tests, the "end result test," queries whether a series of steps were undertaken to reach a particular result, and, if so, treats the steps as a single transaction. Accordingly, under this test, a court must ask "whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way." The Ninth Circuit concluded that, under this test even if the transactions could somehow be merged, Taxpayers would still prevail, because the end result would be that their gifts of LLC interests would be taxed as they contended.

The second test, the "interdependence test" examines "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." The Ninth Circuit concluded that transferring assets into the LLC was an ordinary and objectively reasonable business activity that made sense with or without any subsequent gift. Accordingly, the Ninth Circuit concluded that the facts did not meet the requirements of the interdependence test.

Finally, the "binding commitment" test asks whether, at the time the first step of a transaction was entered, there was a binding commitment to take the later steps. This test only applies to transactions spanning several years. Since Taxpayers' transactions took place over the course of no more than a few months, and arguably a few weeks, the Ninth Circuit found that the binding commitment test was inapplicable.

Consequently, the Ninth Circuit reversed the district court's grant of summary judgment in favor of the IRS. The Ninth Circuit concluded that issues of material fact existed as to the sequence of transactions by which the gifts were made, and, therefore, remanded the case to the district court for a determination of when the four elements of a gift under Washington state law were simultaneously present, and, in particular, to determine when Taxpayers first objectively manifested their intent to make the gifts effective.

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