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Subject: **General Estate and Gift Tax Developments: April 2010**

1. **IRS Further Extends Interim Guidance on Investment Advisory Fees and Other Trust Fees Subject to 2 Percent Floor**

Major References: [Notice 2010-32, 2010-16 I.R.B. 594](#)

Prior AALU Washington Reports: 08-115; 08-43; 08-10; 07-90; 06-151; 06-124; 05-93

2. **Appellate Court Affirms Tax Court's Valuation of Gifted FLP Interests**

Major References: [Holman v. Commissioner, F.3d , No. 08-3774 \(8th Cir. April 7, 2010\)](#)

Prior AALU Washington Reports: 08-45

MDRT Information Retrieval Index Nos.: 2500.00; 7400.021; 7400.022; 7400.024

**SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO
THE CONCLUSION OF THIS WASHINGTON REPORT.**

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 April of 2010, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

IRS Notices

1. *Notice 2010-32, 2010-16 I.R.B. 594*

IRS Notice 2010-32 extends to taxable years that begin before January 1, 2010 the interim guidance provided in Notices 2008-116 and 2008-32 (see our Bulletins No. 08-115 and 08-43) on the treatment of “bundled” investment advisory costs and other costs that are subject to the so-called “2-percent floor” and are incurred by a nongrantor trust or an estate.

On January 16, 2008, the U.S. Supreme Court issued its decision in *Knight v. Commissioner*, 552 U.S. 181, 128 S. Ct. 782 (2008) (see our Bulletin No. 08-10), holding that costs paid to an investment advisor by a nongrantor trust or estate generally are subject to the 2-percent floor for miscellaneous itemized deductions. Under the *Knight* decision, the appropriate test is whether trust-related administrative expenses constitute expenses subject to the 2-percent floor is whether such expenses are “commonly incurred by individual taxpayers.” (Emphasis supplied.) The Supreme Court states that Section 67 of the Revenue Code (the statutory “floor” source) “excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur.” Investment advisory expenses are not among such “uncommon” expenses, in that “[i]t is not uncommon or unusual for individuals to hire an investment adviser.”

Because final regulations to be issued in accordance with the *Knight* decision could not be published before the due date of 2007 income tax returns, the Treasury Department and the Revenue Service provided interim guidance that specifically addresses the treatment of a bundled fiduciary fee in taxable years beginning before January 1, 2008. Under Notice 2008-32, for each pre-2008 taxable year, taxpayers could deduct the full amount of “bundled” fiduciary fees – i.e., fees that are integrated as part of one commission or fee paid to the trustee or executor - without regard to the 2-percent floor. Notice 2008-116 extended the interim guidance of Notice 2008-32 to taxable years that begin before January 1, 2009, thus removing this issue as a problem for the filing of 2008 tax returns.

Notice 2010-32 further extends the interim guidance of the prior Notices to provide that taxpayers may deduct the full amount of “bundled” fiduciary fees without regard to the 2-percent floor for all tax years beginning before January 1, 2010. Payments by the fiduciary to third parties for expenses subject to the 2-percent floor “are readily identifiable and must be treated separately from the otherwise Bundled Fiduciary Fee.”

Final regulations, when they are issued, may contain one or more safe harbors for the allocation of fees and expenses between those costs that are subject to the 2-percent floor and those that are not. Any safe harbors in the final regulations for determining that allocation presumably will be available for taxpayers to use for taxable years beginning on or after January 1, 2010. (Proposed Regulations, which incorporate a slightly different test for full deductibility than the Supreme Court enunciated, were published in the Federal Register on July 26, 2007, but were never finalized. See our Bulletin No. 07-90.)

We anticipate that the *Knight* opinion will be reflected in the long overdue final regulations.

Cases

2. ***Holman v. Commissioner*, ___ F.3d ___, No. 08-3774 (8th Cir. April 7, 2010)**

In Holman v. Commissioner, the Federal Court of Appeals for the 8th Circuit affirmed the decision of the Tax Court (see our Bulletin No. 08-45) holding that a

couple's transfer of publicly-traded stock to a newly created family limited partnership, followed (within a week) by gifts of limited partnership interests to children, was not an indirect gift of the stock. However, restrictions on transfer in the partnership agreement were ignored for purposes of section 2703 of the Internal Revenue Code. The Court nevertheless determined discounts for lack of marketability and control.

Taxpayer Thomas Holman, Jr. (Husband), was employed by Dell Computer Corp. (Dell) from October 1988 through November 2001. While employed by Dell, Husband received substantial stock options, some of which he had exercised. Husband and Taxpayer Kim Holman (Wife) purchased additional shares of Dell stock.

Beginning in 1996, when they lived in Texas, and continuing through early 1999, Taxpayers made annual gifts of Dell stock to three custodial accounts under the Texas Uniform Transfer to Minors Act (Texas UTMA), one for each of their (eventually) four daughters.

On November 2, 1999, Taxpayers executed the agreement of the Holman Limited Partnership, a Minnesota limited partnership. Taxpayers were both general and limited partners. Beginning in 1999, Taxpayers transferred Dell stock of substantial value to a newly formed family limited partnership and then - starting on November 9, 1999 - made gifts of limited partnership units in the Partnership (LP units) to a custodian for one of their children and in trust for the benefit of all of their children. Taxpayers made a large gift in 1999 and smaller gifts in 2000 and 2001 (collectively, the gifts; individually, the 1999, 2000, or 2001 gift, respectively). In valuing the gifts for Federal gift tax purposes, they applied substantial discounts of 49.25% for minority interest status and lack of marketability.

The IRS, on audit, argued the following:

1. With respect to the 1999 gift, that the gift should be treated as an indirect gift of Dell shares and not as a direct gift of LP units (essentially a “gift on formation” argument);
2. For all of the post-1999 gifts treated as gifts of LP units, that the restrictions contained in the Partnership agreement on a limited partner’s right to transfer her interests in the Partnership should be disregarded pursuant to section 2703(a)(2); and
3. That the Taxpayers’ claimed discounts should be substantially reduced.

The Tax Court rejected the Revenue Service’s “gift on formation” argument (despite the closeness in time of the gifts to the partnership’s formation), and held that the gifts were gifts of limited partnership interests. The Tax Court also held that the Commissioner correctly applied I.R.C. section 2703 and properly disregarded the partnership agreement's transfer restrictions. Finally, the Tax Court applied smaller lack-of-marketability and minority-interest discounts than claimed by the donors. The Tax Court accepted lack-of-marketability discounts of 12.5% for each tax year and minority-interest discounts of 4.63–14.34%, all as asserted by the Commissioner's expert.

All of these rulings by the Tax Court were upheld on appeal by the Eight Circuit, which focused most of its discussion on the section 2703 argument.

In pertinent part, section 2703(a) provides that, for purposes of the gift tax, the value of any property transferred by gift is determined without regard to any right or restriction relating to the property. In *Holman*, the Partnership agreement contained restrictions on the right of a limited partner in the partnership to sell or assign her partnership interest.

Section 2703(b) provides that section 2703(a) does not apply to disregard a restriction if the restriction meets each of the following three requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

The Tax Court had found that the restrictions in the Holman Partnership failed at least the first and second of the foregoing requirements, and therefore that the restrictions should be disregarded in determining the values of the Partnership units transferred. It also implied, in so many words, that, with respect to the third requirement ("arm's length transaction") no rational person would have entered into this arrangement with the Holmans on terms that prohibited the transfer of their interests in almost all circumstances.

The Eighth Circuit court emphasized that the Taxpayers could not satisfy the "bona fide business arrangement" test where there was, in effect, no business. All that the Holman Partnership did in this case was to hold publicly traded stock. The transfer restrictions were "personal and testamentary in nature."

Although both the trial and appellate courts had determined to disregard the restrictions in the Partnership agreement, they permitted a discount for lack of marketability (12.5%), as well as for minority interest (14.34% to 4.63%). Both the government's and the Taxpayers' experts applied minority interest discounts in valuing the gifts by reference to the prices of shares of publicly traded, closed-end investment funds, which typically trade at a discount relative to their share of fund net asset value (NAV). Since, by definition, such shares enjoy a high degree of marketability, those discounts must be attributable, at least to some extent, to a minority shareholder's lack of control over the investment fund.

The *Holman* case illustrates that discounts can still be obtained for gift tax purposes even for family limited partnership interests in which the assets of the partnership consist solely of publicly traded stock. However, the Service's success with its Section 2703 issue probably means that it will continue to advance that argument, and that such discounts may be substantially reduced.

Any AALU member who wishes to obtain a copy of any of the items discussed in this Washington Report may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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