DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
January 21, 1999

OFFICE OF
CHIEF COUNSEL

CC:DOM:FS:P&SI
TL-N-6725-98
UILC: 704.00-00; 2036.01-00;2036.08-02; 2036.23-00; 2056.07-03; 2207A.02-00; 2511.01-00; 2512.00-00; 2519.00-00; 6324.01-00; 6324.02-00; 6901.02-00; 6902.01-00

Number: **199916025**
Release Date: 4/23/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

ATTN:

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

W =
H =
S =
W Trust =
H Trust =
Descendants' Trust =

X Partners =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

Year 5	=
$x1	=
State A	=
State A Code	=
Case A	=
Case B	=

ISSUES:

1. Whether H's disposition of his interest in the W Trust is subject to gift tax.

2. Whether the agreements in Year 3 and Year 4 between S and H resulted in a gift from H to S.

3. Whether the agreement in Year 4 between S and H resulted in estate tax consequences.

4. Whether H made an indirect gift that benefitted the Descendants' Trust when in his capacity as general partner, he failed to require reimbursement of losses before he resigned as general partner, resulting in the depletion of his capital accounts to the benefit of the capital accounts of the Descendants' Trust.

5. Whether the Service may assert transferee liability for the transfers made pursuant to the Year 4 settlement agreement that are subject to estate and gift taxes.

CONCLUSIONS:

1. H's inter vivos disposition of his qualifying income interest for life in the marital portion of the W Trust is a transfer of all interests in such property other than the qualifying income interest. Thus, under Internal Revenue Code § 2519, H is treated as gifting the remainder of the marital portion of the W Trust in Year 4.

2. Based upon the facts presented, the Year 3 agreement was not respected by H and S and was superceded by the Year 4 agreement. In the Year 4 agreement, H transferred significant value to S when he transferred his

qualifying income interest for life in the marital portion of the W Trust, relinquished certain rights in the H Trust, and relinquished his rights in X Partners to resolve the litigation. However, based on the facts presented, it appears that the Year 4 agreement was made in the ordinary course of business between S and H, and therefore, was not a taxable gift.

3. Pursuant to the Year 4 agreement, H retained a monthly annuity for life in the H Trust. Accordingly, we conclude that pursuant to section 2036, H's gross estate includes the amount of the H Trust corpus needed to generate the monthly annuity and the taxes paid thereon. In addition, since H retained a life estate in certain real and personal property, the date of death values of these properties are also includible in H's gross estate under section 2036.

4. Based upon the facts provided, we conclude that H did not make an indirect gift by failing to require reimbursement of losses before he resigned as general partner. Pursuant to the applicable regulations, there was no triggering event requiring restoration of the capital accounts.

5. The transferee may be held liable for the estate tax under section 6324(a)(2) and for the gift tax under the doctrine of transferee liability in equity. However, further factual development is required. There may be no transferee liability to the extent either party has made the transfers for full and adequate consideration. Section 6901(c) allows the Service one year beyond the expiration of the period of limitations for assessment against the transferor to assess such transferee liabilities.

FACTS:

W and H were married and had one son, S. In Year 1, W and H formed X Partners pursuant to the laws of State A. X Partners has two classes of limited partners: special limited partners and regular limited partners. The partnership agreement provides that H and W are special limited partners and the Descendants' Trust (with S as trustee), H, and W are regular limited partners.

The partnership agreement was amended in Year 2 to allocate the partnership losses to W and H. The amendment provided that losses allocable to each partner would be charged against his portion of the partner's earnings retained in business and any partner's negative balance would be collectible by the partnership as any other obligation owed to the partnership with interest at a reasonable rate to be determined by the general partners.

In Year 3, W and H created irrevocable trusts containing essentially the same terms called the W Trust and H Trust. W and H transferred their interests in X Partners to their respective trusts. W and H were co-trustees of both trusts, and when W died, S became co-trustee of both trusts with H. Under the terms of the trusts, the trustee was authorized to distribute net income and principal to the grantor and the grantor's spouse for their medical, dental, hospital and nursing expenses and for their support and maintenance in their accustomed manner of living. S was the primary beneficiary of the remainder interest of both trusts following the death of H and W, but H and W retained the right to revoke the beneficiary designations.

W died in Year 3. On the estate tax return filed by the estate, the executor of W's estate elected to treat the marital trust portion of the W Trust (which was included in W's gross estate) as qualified terminable interest property under section 2056 (b)(7), and her estate claimed a marital deduction for the value of the marital trust. The return reported that no estate tax was due.

Shortly after W's death, H desired to remarry against the wishes of S. To resolve the disputes over the family's assets, S and H entered into a formal agreement in Year 3. The terms of the agreement required that all income from assets in the W and H Trusts continue to be used to support H in his accustomed manner of living, "pursuant to the discretionary authority granted..." in the trust instruments. The Year 3 agreement also provided that payments from X Partners from the trusts that exceeded a combination of the distributions of net income to H and the net income distributions from the marital trust portion of the W Trust would reduce a contingent liability of S to pay the surviving spouse named in H's will a certain amount. This contingency never occurred. The agreement also provided that upon the sale before H's death of certain property held by X Partners, an amount equal to the selling price would be distributable to S. Although the property was sold, H never distributed an amount equal to the selling price to S. The agreement also provided that certain life insurance proceeds be returned to H.

The day after the agreement was signed, H remarried. S hired an attorney as trustee of the Descendants' Trust and sued H for amongst other things, that as general partner he failed to require reimbursement of partnership losses by the general partner. H counterclaimed and argued that S had cut off the payments that H was entitled to from the H Trust and had failed to return the insurance proceeds as provided for under the Year 3 agreement.

S and H entered into an agreement in Year 4 to resolve the litigation. H agreed to resign as general partner of the partnership and as trustee of the W and H Trusts. S remained the trustee of the trusts and agreed to dissolve the partnership and distribute partnership assets to the partners in accordance with their capital accounts. The documents indicate that this distribution has not been made. Real property and two motor vehicles owned by the partnership were transferred to H for life. S and H also agreed that H will be paid $x1 per month for life plus the taxes due on the annuity from the principal of the H Trust. If the H Trust is depleted, payment would come from the income, and if necessary from the principal of the marital portion of the W Trust. With the exception of this monthly annuity, H relinquished all of his legal rights to payments from the H Trust and the marital portion of the W Trust. Further, H relinquished his right to change the beneficiary designation on the H Trust when he relinquished his legal rights to that trust.

H died in Year 5.

LAW AND ANALYSIS

Issue 1 - Whether H's disposition of his interest in the marital portion of the W Trust is subject to gift tax.

Law

Section 2044 (a) provides, in part, that the value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life. Section 2044(b) provides that section 2044 applies to any property if: (1) a deduction was allowed with respect to the transfer of such property to the decedent (A) under section 2056 by reason of subsection (b)(7) thereof, or (B) under section 2523 by reason of subsection (f) thereof, and (2) section 2519 (relating to dispositions of certain life estates) did not apply with respect to a disposition by the decedent of part or all of such property.

Section 2056(a) generally provides that for purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(7) provides that in the case of qualified terminable interest property-(i) for purposes of section 2056(a), such property shall be treated as passing to the surviving spouse, and (ii) for purposes of section 2056(a)(1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse. Section 2056(b)(7)(B)(i) defines the term "qualified terminable interest property" as property (I) which passes from the decedent; (II) in which the surviving spouse has a qualifying income interest for life; and (III) which an election under this paragraph applies. Under section 2056(b)(7)(B)(ii), the surviving spouse has a qualifying income interest for life if: (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and, (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Section 2207A(b) provides that if for any calendar year tax is paid under chapter 12 with respect to any person by reason of property treated as transferred by such person under section 2519, such person shall be entitled to recover from the person receiving the property the amount by which: (1) the total tax for such year under chapter 12, exceeds (2) the total tax which would have been payable under such chapter for such year if the value of such property had not been taken into account for purposes of chapter 12.

Section 2511 generally provides that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Section 2519 generally provides that for purposes of chapters 11 and 12, any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest.

Section 2519(b) provides that section 2519 applies to any property if a deduction was allowed with respect to the transfer of such property to the donor: (1) under section 2056 by reason of subsection (b)(7) thereof, or (2) under section 2523 by reason of subsection (f) thereof.

Treas. Reg. § 2512-8 provides in pertinent part that a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent), will be considered as made for an adequate and full consideration in money or money's worth.

Treas. Reg. § 25.2519-1(a) provides, in part, that if a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) or section 2523(f) for the transfer creating the qualifying income interest, the donee spouse is treated for purposes of chapters 11 and 12 of subtitle B of the Internal Revenue Code as transferring all interests in property other than the qualifying income interest.

Analysis

Under section 2056(b)(7) property that passes from a decedent to the surviving spouse, in which the surviving spouse has a qualifying income interest for life, qualifies for the marital deduction if the executor elects to treat the property as qualified terminable interest property (QTIP). The consequence of the QTIP election is that the property remaining at the surviving spouse's death must be included in the surviving spouse's gross estate under section 2044 unless the surviving spouse made a transfer of the interest under section 2519. The inter vivos relinquishment of a qualifying income interest may invoke two sections; section 2519 imposes a gift tax on the remainder interest and section 2511 imposes a gift tax on the qualifying income interest.

The executor of W's estate made an election under section 2056(b)(7) for the marital trust portion of the W Trust and claimed a marital deduction on W's federal estate tax return for the value of the marital trust. H had the benefit of a qualifying income interest for life and received the benefit of deferred estate taxation. As part of the settlement between S and H in Year 4, H made a disposition of his qualifying income interest for life when he relinquished all legal rights to payments from the marital portion of the W Trust but for the contingency should the assets in the H Trust become depleted. The agreement provided that H will be paid $x1 per month for life from the principal of the H Trust. If the H Trust corpus depleted, only then would payment come from the income, and if necessary from the principal of the marital portion of the W Trust. H specifically relinquished all of his legal rights to payments from either trusts, with the exception of this annuity arrangement.

The term "disposition," as used in section 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981) that states:

> The bill provides that property subject to a [QTIP election] will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse's death.

The estate tax marital deduction provisions are intended to provide a special tax benefit that allows property to pass to the surviving spouse without the decedent's estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. See Rev. Rul.

98-8, 1998-6 I.R.B. 24. It is necessary under the estate and gift tax laws to tax the transfer of the remainder interest because the predeceased spouse's estate received a marital deduction for the terminable interest property, and after the inter vivos transfer of the qualifying income interest, the remainder will no longer be included in the surviving spouse's estate under section 2044. We conclude that in Year 4, H gave up his right to receive the qualifying income interest for life in the marital portion of the W Trust. The amount of the gift under section 2519 is the value of the trust corpus less the value of the qualifying income interest. The amount of the gift is further reduced by the gift tax liability if the donee reimburses the estate for the gift taxes attributable to the transfer under 2519. See Section 2207A.

Furthermore, pursuant to section 2511, H may have gifted the qualifying income interest when he relinquished his rights to that interest. Section 2512(b) provides that where propery is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year. However, if the transfer of property was made in the context of an agreement that is determined to be bona fide, at arm's length, and free from donative intent, the transfer will be deemed to be made for an adequate and full consideration in money or money's worth. See Treas. Reg. § 25.2512-8. Although the inter vivos disposition of the qualifying income interest under section 2511 may be characterized as a transfer of property made in the ordinary course of business under Treas. Reg. § 25.2512-8, that does not affect the application of section 2519.

The facts and documents provided indicate that there was animosity between H and S. Litigation was pending, pleadings were filed, temporary restraining orders were obtained, and negotiations ensued. Based on the facts presented, it appears that the transfers were free from donative intent, and the transfers may have been at arm's length and bona fide due to the acrimonious relationship. Without further factual development, we do not believe H made a gift of the qualifying income interest under section 2511 and express no opinion whether the terms of the marital trust satisfied the requirements of section 2056(b)(7)(B).

Issue 2 - Whether the agreements in Year 3 and Year 4 between S and H resulted in a gift from H to S.

Law

Section 2501(a) imposes a tax on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2511 provides, in part, that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that where propery is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Treas. Reg. § 25.2512-8 provides in pertinent part that a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent), will be considered as made for an adequate and full consideration in money or money's worth.

Transactions within a family group are subject to special scrutiny. When considering an intra-family transaction, particularly between a parent and a child, the presumption is that the transaction is a gift rather than a bona fide business transfer. See Harwood v. Commissioner, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986); Bergeron v. Commissioner, T.C. Memo. 1986-587. For example, in Estate of Huntington v. Commissioner, 16 F.3d 462, 466 (1st Cir. 1994), aff'g 100 T.C. 313 (1993), the court stated:

> transactions among family members are subject to particular scrutiny, even when they apparently are supported by monetary consideration, because that is the context in which a testator is most likely to be making a bequest rather than repaying a real contractual obligation.

Analysis

The determination of whether a transaction between family members is in reality a gift, subject to gift tax, is a factual issue to be determined on the facts of each case.

The facts and documents presented indicate that although H and S attempted to settle their disagreements in Year 3, neither party adhered to the terms of the settlement. Because the Year 4 agreement appears to have settled most, if not all, of the property disputes, we believe that any attempted settlement in Year 3 was superceded by the Year 4 settlement. Accordingly, we do not believe the Year 3 agreement was a contingent gift completed in Year 4.

The Year 4 settlement and the attendant transfers appear testamentary in nature. S transferred nothing to H but received essentially all of H's assets, including control of X Partners. H agreed to resign as general partner of the partnership and as trustee of the W and H Trusts. S remained the trustee of the trusts and agreed to dissolve the partnership and distribute partnership assets to the partners in accordance with their capital accounts. The facts indicate that S has not dissolved the partnership and distributed its assets. H was to be paid $x1 per month for life from the principal of the H Trust and was given a life estate in certain real and personal property held by X Partners. With the exception of the monthly annuity, H relinquished all of his legal rights to payments from the W and H Trusts. Further, H relinquished his right to change the beneficiary designation on the H Trust.

However, the relationship between S and H appears to have been acrimonious. Litigation was pending, pleadings were filed, temporary restraining orders were obtained, and negotiations ensued. Pursuant to Treas. Reg. § 25.2512-8, a sale, exchange, or other transfer of property that is bona fide, at arm's length and free from donative intent will be considered as made for an adequate and full consideration in money or money's worth. Based on the facts presented, it appears that the transfers were free from donative intent, and the transfers may have been at arm's length and bona fide due to the acrimonious relationship. Accordingly, without further factual development, we do not believe that the settlement agreement in Year 4 resulted in a gift under section 2511.

Issue 3 - Whether the settlement agreement in Year 4 between S and H resulted in estate tax consequences.

Law

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in a case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death - (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Treas. Reg. § 20.2036-1 provides in pertinent part that if the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in the gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence.

Analysis

In Year 3, H created the H Trust and retained an interest under section 2036(a)(1). H enjoyed, or had the right to the income from, the property. Under the terms of the H Trust, the trustees, H and W, were authorized to distribute net income and principal to H and W for their medical, dental, hospital and nursing expenses and for their support and maintenance in their accustomed manner of living. See Treas. Reg. § 25.2511-2(b).

Section 2036 generally provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has retained for his life the possession or enjoyment of, or the right to the income from, the property. Pursuant to the terms of the settlement in Year 4, H rearranged his affairs but continued to retain a section 2036(a)(1) string to the H Trust. H retained a lifetime annuity in the amount of $x1 net per month from the principal of the H Trust plus payment of the taxes. H had a section 2036(a)(1) interest before the settlement, and pursuant to the terms of the settlement, retained a section 2036(a)(1) interest in the H Trust. Accordingly, we conclude that the corpus needed to produce the $x1 net per month and the taxes paid thereon is includible in H's estate pursuant to section 2036(a)(1). See Treas. Reg. § 20.2036-1; Rev. Rul. 82-105, 1982-1 C.B. 133.

Further, under section 2036 (a)(1), the date of death values of the personal and real property in which H retained a life estate are also includible in his gross estate. In Year 1, H and W created X Partners with their own funds and set up the trusts to hold their partnership interests. Prior to the Year 4 agreement, H was general partner and special limited partner. When S and H entered into the agreement to resolve the litigation, H agreed to resign as general partner of the partnership and as trustee of the W and H Trusts. However, H retained life estates in two motor vehicles and real property owned by the partnership, the values of which are includible in his gross estate under section 2036.

Issue 4 - Whether H made an indirect gift that benefitted the Descendants' Trust when in his capacity as general partner, he failed to require reimbursement of losses before he resigned as general partner, resulting in the depletion of his capital accounts to the benefit of the capital accounts of the Descendants' Trust.

Law

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Treas. Reg. § 1.704-1 provides, in general, that the economic effect test requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement.

Treas. Reg. § 1.704-1(b)(2)(ii) provides, in pertinent part, that in order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden. Based on these principles, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides – (1) for the determination and maintenance of the partners' capital accounts in accordance with the rules of (b)(2)(iv) of this section, (2) upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs, and (3) if such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs, he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year, which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances.

Treas. Reg. § 1.704-1(b)(2)(iv) provides that the economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(i) of this section, an allocation of income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

Treas. Reg. § 1.704-1(b)(2)(iv)(l) generally provides that upon the transfer of all or part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner.

Analysis

The rules governing partnership capital accounts are set forth in the regulations under section 704(b). The section 704(b) capital accounts are designed to track the economic effect of the allocation of partnership items to a partner. Under the regulations, each partner has one capital account that reflects the value of the partner's contributions to the partnership and is increased by the partner's share of income and is reduced by the partner's share of partnership deductions and by distributions to the partner. See Treas. Reg. § 1.704-1(b)(2)(iv) for the rules governing the proper maintenance of capital accounts. To insure that tax allocations (items of income, gain, loss, or deduction) have economic effect, the partners must agree to liquidate based on positive capital accounts and to require that partners with a negative capital account restore this negative account upon liquidation. See Treas. Reg. § 1.704-1(b)(2)(ii). The time for the restoration of a negative capital account is when the partnership is being liquidated or the partner's interest in the partnership is being liquidated. See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) and (3).

The partnership agreement was amended in Year 2 to allocate the partnership losses to H and W. In Year 4, in settlement of litigation between H and S, H resigned as general partner and as trustee of the H and the W Trusts. This transfer may have been a sale or exchange or a gift, but in either case, it was not the time that a partner is required to restore his/her deficit capital account. Under the section 704(b) regulations the transferee inherits the capital account of the transferor. See Treas. Reg. § 1.704-1(b)(2)(iv)(l).

Accordingly, based on the information provided to us, H had no obligation under section 704(b) to restore his negative capital account (if he had one) on the transfer of his interest in the partnership in Year 4. We express no opinion regarding whether the allocation of losses to the general partners satisfied the requirements for substantial economic effect under the section 704(b) regulations.

Issue 5 - Whether the Service may assert transferee liability for the transfers made pursuant to the settlement agreement that were subject to estate and gift taxes.

Law

Section 6324(a)(2) provides that where property is included in the gross estate of a decedent pursuant to sections 2034 through 2042, the transferee of the property automatically becomes liable for any unpaid estate tax to the extent of the date-of-death value of the property received.

Section 6901(a)(1) provides that the liability of a transferee of property of a decedent, in the case of a tax imposed by chapter 11 (relating to estate taxes) or of a donor in the case of a tax imposed by chapter 12 (relating to gift taxes), shall be assessed, paid and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred.

Section 6902(a) and Tax Court Rule 142(a) provide that in proceedings before the Tax Court, the burden of proof shall be upon the Secretary to show that a petitioner is liable as a transferee of property of a taxpayer, but not to show that the taxpayer was liable for the tax. In other words, the Service must prove each and every element of a prima facie case.

Section 6901(c) allows the Service one year beyond the expiration of the period of limitations for assessment against the transferor to assess such transferee liability.

Analysis

The analysis provided herein concludes that both gift and estate taxes are due from H's estate. Under section 2519, gift tax is due on the remainder of the marital portion of the W Trust based upon H's inter vivos transfer of his lifetime qualified income interest in the marital portion of the W Trust. Under section 2036, estate tax is due on the amount of the corpus needed to support the lifetime annuity retained from the H Trust and the date of death value of the real and personal property that H retained for his life.

Section 6901(a) allows the government to assess a liability against a transferee in the same manner as the tax would be assessed against the transferor/taxpayer. Section 6901(h) provides that a transferee may be a donee, heir, legatee, devisee, distributee, and with respect to estate taxes, any person who is personally liable for the tax. Treas. Reg. § 301.6901-1(b); See Baptiste v. Commissioner, 100 T.C. 252 (1993), aff'd in part and rev'd in part, 29 F.3d 433 (8^{th} Cir. 1994), cert. denied, 513 U.S. 1190 (1995). However, section 6901(a) does not actually create transferee liability; it merely provides an alternative procedure for collecting the unpaid taxes of the transferor. The substantive liability of the transferee for unpaid estate liability must be determined under federal law. Section 6324(a)(2).

Transferee Liability for Estate Taxes

Based on the available facts, in this case, to resolve litigation between H and S in Year 4, real property and two vehicles owned by X Partners were given to H for life. S and H also agreed that H was to be paid $x1 per month plus taxes for life from the principal of the H trust. As noted above, it has been determined that the corpus needed to produce the $x1 net per month and the taxes paid thereon and the date of death values of the personal and real property are includible in the gross estate of H pursuant to section 2036. Section 6324(a)(2) specifically provides that where property is included in the gross estate of a decedent pursuant to sections 2034 through 2042, the transferee of the property automatically becomes liable for any unpaid estate tax to the extent of the date of death value of the property received. Section 6324(a)(2).[1] This section allows the United States to assert transferee liability against persons receiving property that is transferred outside the probate proceeding. Magill v. Commissioner, T.C. Memo. 1982-148, aff'd sub nom, Berliant v. Commissioner, 729 F.2d 496 (7th Cir. 1984) cert. denied sub nom., Kraft v. Commissioner, 469 U.S. 852 (1986); Groetzinger v. Commissioner, 69 T.C. 309 (1977). Thus, a person who receives nonprobate assets that were included in the gross estate of a decedent is a transferee, and may be subject to transferee liability under section 6901 without regard to whether he would be treated as a transferee under state law. Schuster v. Commissioner, 312 F.2d 311, 314-316 (9th Cir. 1962), aff'g 32 T.C. 998 (1959) and rev'g on another issue, 32 T.C. 1017 (1959); Groetzinger, supra, 69 T.C. at 316-317; and Bergman v. Commissioner, 66 T.C. 887, 892 (1976).

As possessors of property includible in the gross estate of H, the partnership and the H Trust are transferees within the meaning of section 6324(a). S, as trustee, is personally liable for the unpaid estate taxes of the H estate. Where a trustee who, as in this case, is in possession of property includible in the decedent's gross estate at the date of death, the trustee is personally liable as a transferee. First Western Bank & Trust v. Commissioner, 32 T.C. 1017 (1959), modified on other grounds sub nom. Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962).

---

[1] Section 6324(a)(2) provides in part:

(a) Liens for Estate Tax. - . . .

. . .

> (2) Liability of Transferees and Others. - If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee, . . . surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or a release of a power of appointment or beneficiary, who receives, or has on the date of decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, shall be liable for such tax. . . .

Eggleston v. Commissioner, T.C. Memo. 1985-327 (transferee's receipt of property includible in the decedent's estate under sections 2034-2042 made her liable as trustee); Commissioner v. Kuckenberg, 309 F.2d 202, 207 (9th Cir. 1962), cert. denied, 373 U.S. 909 (1963)(Government not required to proceed against the partnership entity; individual partners were liable as transferees since they owned and controlled the partnership.) Accordingly, the Service may assert transferee liability against S, since he is the trustee of the H trust, and the partners of the partnership. However, to the extent that the transfers were made for full and adequate consideration, no transferee liability would exist. See Scott v. Commissioner, 70 T.C. 71, 81 (1978). Section 6901(c) allows the Service one year beyond the expiration of the period of limitations for assessment against the transferor to assess such transferee liability.

Transferee Liability for Gift Taxes

As noted above, under section 2519, H's inter vivos disposition of the qualifying income interest in the marital portion of the W Trust results in a gift tax imposed upon the remainder of the marital portion of the W Trust. Transferee liability may also be established either at law or in equity. Estate of Stein v. Commissioner, 37 T.C. 945 (1962), subsequent proceedings, 40 T.C. 275 (1963). Transferee liability at law arises when 1) the transferor transfers property; 2) at the time of the transfer and at the time the transferee liability is asserted, the transferor is liable for the tax; and 3) a valid contract exists between the transferor and the transferee, and under the contract, the transferee agrees to assume the liability of the transferor, or the transferee liability is imposed under an applicable state or federal statute. Southern Pacific Co. v. Commissioner, 84 T.C. 375 (1985), later proceeding, 90 T.C. 771 (1988). A review of the available facts reveals that there is no contractual agreement to assume the unpaid transfer tax liabilities of H. Section 6324(b) provides for a special gift tax lien that attaches to any and all gifts made during a filing period and continues for ten years from the date the gifts are made, unless the gift tax is paid in full or sooner becomes unenforceable by the lapse of time. See CCDM 34(722)(9). Based upon the available facts, it appears that any potential gifts by H occurred in Year 4. Thus, it appears that the government's special gift tax lien under section 6324(b) lapsed. Section 6324(b) cannot be used to establish transferee liability at law.

To establish transferee liability in equity, the Service must generally prove the following: 1) the transferee received property from the transferor; 2) the property was transferred to the transferee without consideration or for less than adequate consideration; 3) the transfer was made during or after the period the gift tax liabilities had accrued; 4) the transferor was insolvent to or because of the transfer of property to the transferee[2]; 5) all reasonable efforts to collect from the estate of the transferor were made and that further collection efforts would be futile; and 6) the value of the property transferred. Hagaman v. Commissioner, 100 T.C. 180 (1993).

The existence and extent of transferee liability in equity is determined by the applicable state law. Commissioner v. Stern, 357 U.S. 39 (1958). In this case, the transfers of property were made in State A; therefore, it is necessary to look to the law of State A to determine transferee liability. Under State A law, transferee liability at the time of the transaction is governed by State A Code.

In this case, the Service initially would have to establish that the transferee received property from the transferor. Further factual development is required before we can opine on this element of transferee liability.

The second element that must be proven is whether the transfers were made for "consideration deemed valuable in law." This requires a valuation not only of the property transferred, but also of the legal rights given up in exchange for the property. As this transfer has been deemed a gift, it appears that inadequate consideration was given for the transfer. However, further factual development is required before we can opine on this element of transferee liability.

The third element of transferee liability concerns the accrual of the transferor's gift tax liability at the time of the transfer. Thus, to the extent there is an unpaid gift tax liability, transferee would be liable for the deficiencies in the decedent's gift tax for gifts made during Year 4. See Estate of Mandels v. Commissioner, 64 T.C. 61, 74 (1975).

The fourth element that is generally required to establish transferee liability is to show insolvency of the transferor at the time of the transfer or insolvency resulting from the transfer. In this case, under State A's law, it is necessary to prove insolvency. Case A (Debtor is insolvent when he has insufficient assets to pay his debts). In order to prove insolvency, both the value of the debtor's assets and the amount of his liabilities must be established. Case B. There is insufficient evidence for a determination as to whether H was insolvent at the time of the transfer or rendered insolvent by the transfer.

Before the Service can recover from the transferee, it must exhaust all remedies against the transferor for the unpaid gift tax liabilities. This requirement is met when it is apparent that proceeding against the transferor would be futile. It is our understanding that H's estate does not have assets to pay the tax, making

---

[2]. This may or may not be required under state law. See Hagaman v. Commissioner, 100 T.C. 180 (1993).

collection futile. However, this fact must be verified before initiating a transferee liability case.

Finally, the Service must establish the value of the transferred property. Bartmer v. Automatic Self-Service Laundry, Inc. v. Commissioner, 35 T.C. 317 (1960), acq. 1961-2 C.B. 4. In this regard, the Service would have the burden of establishing the item transferred and its value. Bartmer 35 T.C. at 325; Milliken v. Commissioner, T.C. Memo. 1959-210, 18 TCM (CCH) 995, 1019 (1959), aff'd, 298 F.2d 830 (4th Cir. 1962). The facts provided to us do not specifically address this issue. We are unable to recommend that transferee liability for the gift tax be asserted at this time because further factual development is necessary.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

There are several viable theories in this case. We recommend pursuing the imposition of gift tax on the remainder of the marital portion of the W Trust pursuant to section 2519 and the inclusion in H's gross estate of his retained life estate in the H Trust pursuant to section 2036. These arguments appear to be the strongest arguments for the Service.

The Service may have a viable position under section 2511 regarding the imposition of gift tax on the exchange between H and S and H's relinquishment of the qualified income interest in the marital portion of the W Trust in Year 4. We can argue that the transaction was a testamentary transfer between family members lacking the indicia of an arm's length transaction. [redacted]

[redacted]. Petitioner may argue that the settlement was a bona fide sale for adequate and full consideration in money's worth, and therefore, the retained interest would not be subject to section 2036. Petitioner would have to demonstrate that H received consideration equal to for the entire value of the trust corpus. See Estate of Magnin v. Commissioner, T.C. Memo 1996-25 (1996); Gradow v. U.S., 897 F.2d 516 (D.C. Cir. 1990). But See Estate of D'Ambrosio v. Commissioner, 101 F.3d 309 (3rd Cir. 1997); Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997). The facts provided support our position that H did not receive adequate and full consideration for the transfer. [redacted]

[redacted]

[redacted]

Further factual development is necessary to determine if [redacted]. Section 6902; Tax Court Rule 142.

By: ______________________
MELISSA LIQUERMAN
Senior Technician Reviewer,
Passthroughs & Special Industries
Branch
Field Service Division