Throwing the Tax Court Under the Bus Again: Part Two of the Analysis of the Fifth Circuit's Opinion in *McCord*[1]

Last month, this column examined the *McCord's* analysis on the definitional gift issue, in which the 5th Circuit reversed the Tax Court and upheld the validity of a definitional gift for gift tax purposes.[2] This month the column examines the discussion in the 5th Circuit's opinion of the unusual net gift concept.

Specifically, the donees of the gift in the *McCord* case assumed the obligation to pay:

> "[T]he actuarially determined present value of the non-exempt donees' contractually assumed liability for the additional estate taxes that would be incurred pursuant to the current version of section 2035 and the date-of-gift estate tax rates, should the triggering condition subsequent of the subject Tax Code provision occur, i.e., should either or both of the Taxpayers fail to survive for three years after January 12, 1996," [insert page in appellate court decision].

Translated into English, this debt contingency referred to the inclusion in the donor's gross estate of the gift taxes paid on the transaction, pursuant to section 2035 (c) of the Code, if the donor died within three years of making the gift. And the net value of the gift, therefore, was argued to be reduced by the donees' obligation to pay this liability. Essentially, the donees were argued to have received less value because of this debt overhang. What is most interesting about the overhang is that, if the contingency did not occur, it would not have reduced the value that the donees received.

For example, if the donees received $X, and the gift tax payment that would have been included in the donor's gross estate (and resulting estate taxes paid as a result), were 10 % of $X, then the donees would argue that they received $.90 of $X.[3] The decrease in the value of the gift, illustrated at 10 % in the above example,[4] is value that passes to the donees if the contingency does not occur (i.e., if there is no death within three years). This could, then, be value that passes to the donees without any gift tax concerns.

The Tax Court was suspicious of this reduction, and disallowed it. Interestingly, this part of the Tax Court opinion was the most detailed and lengthy of all the holdings of the Court in the case. The Tax Court had multiple theories for disallowing the gift, and its strongest was the following:

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[1] [insert cite of appellate court decision]
[2] insert cite of last month's column].
[3] Note that this would result in an interrelated computation because at .9 of $X, the gift tax payment would not have been 10 % of $X, but something less. This type of computation requires setting of two formulas, with two unknown variables, to determine the exact amount of the reduction.
[4] As noted by fn. 1, the actual reduction would have been less than 10 %, when the interrelated computations are solved.

> "However, the dollar amount of a potential liability to pay the 2035 tax is by no means fixed; rather, such amount depends on factors that are subject to change, including estate tax rates and exemption amounts (not to mention the continued existence of the estate tax itself," (Tax Court opinion on page 71 of the opinion).

The Fifth Circuit disagreed:

> There is nothing speculative about the date-of-gift fact that if either or both Taxpayers were to die within three years following the gift (as did Mr. McCord), the non-exempt donees would have been (and, coincidently, were) legally bound to pay the additional estate tax that could result from the provisions of section 2035," (at page 32 of 5^{th} circuit decision).

The Fifth Circuit concluded that the liability was not too speculative, and could be calculated pursuant to actuarial principles, using current tax laws, tax rates, 7520 rates, and actuarial tables. Importantly, the Court could not have been stronger in its conclusion that this contingent liability could be taken into account to reduce the value of the gift for gift tax purposes.

As a result, the holding currently adds a definite consideration in all taxable gifts planning, to shift the estate tax liability associated with inclusion of the gift tax payment in the gross estate, to the donees, thereby reducing the value of the gift. But query whether the concept can be extended in creative ways.

In the QPRT planning concept, the retention of a reversion by the grantor if death occurs within a period of time lowers the remainder value of the gift without any decrease in the efficacy of the gift.[5]

Can the same be done for a non-zeroed out GRAT in a surviving spouse situation? For example, if the conclusion is that death within the retained terms requires the entire GRAT to be included in the gross estate under 2036,[6] consider the effect of a provision that requires the remainder beneficiaries to pay all estate taxes, on the value of the gift.[7] Using the reasoning of the Fifth Circuit in *McCord*, the result would be to substantially decrease the value of the remainder gift in the GRAT. At the cost of only a contingent liability that does not reduce the value of the gift if the grantor survives the term, the value of the gift of the remainder would then be lowered. This concept will likely be considered by planners in the future, but there are concerns. First, it cannot be done with a zeroed out GRAT, and zeroed out GRATs are preferred these days by clients and

[5] This result follows because if death occurs during the retained term, the property is already includable in the grantor's gross estate. Accordingly, having a reversion to the actual property cannot result in "greater" inclusion. But adding the reversion does decrease the taxable gift.
[6] This conclusion, which may not be entirely correct, is for discussion in another column in the future.
[7] Note that this should not be done in a surviving spouse setting. In that instance, if the grantor dies before the expiration of the retained interest in the GRAT, the GRAT should pass (normally) in such a way as to qualify for the marital deduction.

planners. Second, this is merely the Fifth Circuit's opinion on this issue, and is contrary to the Tax Court. Taxpayers outside of the Fifth Circuit may not have the same level of comfort that their Circuit will follow the Fifth's reasoning. Third, the requirements for and definition of qualified payments in 2702 must be carefully considered to make sure this obligation by the remainder beneficiaries does not run afoul of those rules (and disqualify the entire GRAT, a very bad result).

Analogously, the gift of life insurance to an insurance trust, which carries with it the three year rule under sections 2035 and 2042, should also be a candidate for this *McCord* liability shifting. In this instance, the irrevocable insurance trust would agree to pick up the estate tax liability should the grantor die within three years of the transfer, and this would be argued to reduce the gift tax value (the interpolated terminal reserve value/replacement policy value) of the transferred insurance. Again, like all attempted extensions of planning strategies, the unanticipated negative consequences must be carefully considered. In the insurance context, does the shifting of liability as proposed create "transfer for value" issues which could cause the insurance to become subject to income tax?

In conclusion, the Fifth Circuit's decisions in *McCord*, both the defined value holdings and the reduction in gift value for assumed tax liabilities, provide planners with much to think about in planning. If nothing else, the decision shifts the negative momentum that has been coming out of the Tax Court recently, and provides a pro taxpayer holding for a sophisticated planning strategy. It is a refreshing and welcomed taxpayer victory.