DEALING WITH UNIQUE ASSETS - MINERAL INTERESTS

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I. TYPES OF MINERAL ECONOMIC INTERESTS AND THEIR INCOME TAX TREATMENT

A. Introduction

The federal tax rules for energy resources are based on the concept of an "economic interest." Interestingly, the term "economic interest" is not a clearly defined term. It is used more than seventy times in the Internal Revenue Code and the Treasury Regulations, but neither the courts nor the IRS has provided a specific definition. In practical terms, an economic interest can be thought of as a clear and direct interest in a mineral property and the income from its production, which has enough substance to be treated as an ownership interest for income tax purposes (i.e., the awarding of taxable income and related deductions). The regulations simply provide that:

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . .and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . , to which he must look for a return of his capital. Treasury Regulation Section 1.611-1(b).

This definition is derived almost word for word from the Supreme Court's decision in *Palmer v. Bender*, 287 US 551 (1933), which established the "economic interest" concept as a key element in natural resources taxation.

It is important to understand what constitutes an economic interest in order to understand what types of tax consequences a landowner-client may have with respect to the property owned by them. Having an economic interest is a prerequisite to obtaining a depletion deduction. To this end, some of the more common types of economic interests (e.g., lease bonus royalty interests, overriding royalty interests, working interests, carried interests, production payments, and net profit arrangements) are discussed in more detail below. Most commonly, landowners seeking counsel regarding estate planning will have leased their mineral property and retained a royalty interest. However, there are occasions when an ambitious or sophisticated landowner will seek to either develop the mineral interest themselves or will cut a deal to be paid for the exploitation of their mineral property in a form other than a royalty interest. For these reasons, a short discussion of overriding royalty interests, working interests, carried interest arrangements, production payments, and net profit arrangements are included in this outline.

B. Lease Bonus

1. Definition of a Lease Bonus

The term "bonus" is the term applied to the consideration received by the landowner (i.e. lessor) upon execution of an oil and gas lease. Lease bonuses are often thought of as being a sum of money paid by a lessee in order to induce the lessor to execute the lease. As a practical matter, insofar as the lessee is concerned, the bonus pays for the right to enter upon the leased premises and explore for oil and gas, commonly for a period of time (typically between one and five years) from the date of the lease. The aforementioned time period is frequently referred to as the "primary term" of the lease.

C. Royalty Interest

1. Definition of a Royalty Interest

A "royalty interest" generally consists of an interest in the underlying oil and gas reserves which is retained when the owner of land (i.e. lessor) grants to another (e.g., by lease) the right to ascertain whether a commercial quantity of oil and gas exists and, if so, to develop the property and produce this mineral. U.S. v. 525 Company, 342 F2d 759. Stated another way, a royalty is a share of production, or the value or proceeds of production, free of the costs of production, if production occurs. A royalty is usually expressed as a fraction (e.g., a 1/5th). A royalty interest typically bears no portion of the costs of exploration, development and production. Accordingly, it is referred to as a non-operating mineral interest. IRC Section 614(e)(2). In return for assuming the risks involved in exploring and developing the property, the lessee is granted the right to a fixed portion of the production, and a defined fraction of the production is set aside for the retained royalty interest of the original owner (or sold for his account).

D. Working Interest

1. Definition of a Working Interest

The development of oil and gas properties usually begins with a leasing arrangement in which the landowner assigns an interest to an oil and gas operator. The property interest acquired by the operator is known as the operating mineral interest in tax parlance or, in the jargon of the trade, as the working interest or leasehold interest. The working interest is so-called because the working interest owner has the right to work on the leased premises to search, develop and produce oil and gas. The owner of the working interest bears all costs in connection with finding the oil or gas, as well as those attributable to lifting the oil or gas from the reservoir. The working interest expires upon termination of the lease. Most leases provide for a primary term, usually for a fixed number of years, during which the lessee has the right to search, develop, and produce from the leased premises. Some leases also provide for the payment of periodic delay rentals by a lessee. A delay rental is simply a payment from a lessee to a lessor to maintain an oil and gas lease during the primary term without drilling on the leased premises. It should be noted that many modern leases are "paid-up" leases, meaning that such lease does not contain a provision for the payment of delay rentals; instead, the lease will be effective for the entirety of the primary term without the requirement of the payment of delay rentals by the lessee. If a lease contains a delay rental provision, then, if production is not obtained, the lease will continue upon the payment of the delay rental so as to extend the end of the primary term. Likewise, if production is secured during the primary term, the lease will remain in force for so long as oil and gas is produced. Additionally, many oil and gas leases will provide for the payment of a shut-in royalty by a lessee to a lessor in order to maintain an oil and gas lease during a period of time wherein there is no production because a well, though capable of production, is shut-in.

2. Nomenclature

A working interest is sometimes referred to as an "operating interest" or "leasehold interest" but such terms convey the same meaning since the interest involved is burdened with all operating costs. Confusion occasionally results in use of the term "operator." In one sense, all of the co-owners of the working interest are operators because they collectively own the operating (working) interest. Generally, however, the task of physically conducting day-to-day operations is assigned only to one of the co-owners or to an outside party. The entity which carries on the physical operations is also referred to as the "operator," but here the term has a different connotation and is analogous, for example, to the situation where an individual is hired to operate a ranch.

E. Overriding Royalty Interest

A landowner's royalty interest (as described above) is an interest of the type reserved by the lessor in a leasing transaction. An "overriding royalty" is a royalty that is carved out of the lessee's interest in an oil and gas lease. An overriding royalty will terminate whenever the underlying oil and gas lease terminates. Unlike a royalty interest, which is connected to the ownership of the minerals in the ground, an overriding royalty interest stems from the ownership of a portion of the revenues generated as a result of the production of oil and gas. Overriding royalties are frequently used to compensate parties that have assisted in the creating or structuring of a drilling venture and/or parties that provided services to the lessee (e.g., landmen, geologists, etc.). Overriding royalties may also be reserved upon an assignment of the lease by a lessee. For instance, assume that an individual has a working interest in oil and gas on a tract of land, such working interest having been secured from the landowner who retained a one-eighth royalty. The working interest represents seven-eighths of the oil and gas in place. The lessee assigns the lease to a third party and retains one-eighth of all the oil and gas in place. The third party is now possessed of the working interest, which represents six-eighths of the oil and gas in place, and the landowner and the assignor each are possessed of one-eighth of the oil and gas in place. However, the one-eighth royalty possessed by the assignor of the lease is referred to as an overriding royalty and exists only so long as the working interest upon which it is a burden exists. GCM 22730. As a practical matter, you rarely come across a landowner who has retained an overriding royalty interest.

F. Carried Interest Arrangements

A carried interest arrangement typically occurs when a party has a fractional interest (the "carried party"), usually in an oil and gas lease, wherein some or all of the costs associated with such oil and gas lease are paid by the remaining working interest owners (the "carrying party") for a period of time (e.g., to casing point). Sometimes, but not always, the carried party's rights are subject to the rights of the carrying party to be reimbursed for the costs (or some multiple of the costs) expended by the carrying party. Under such arrangement, the carried party agrees that he, she, or it will not be entitled to any proceeds from oil and gas production until the carrying party is reimbursed, from production, for the expenditures (or a multiple of the expenditures) made on the carried party's behalf.

G. Production Payments

A production payment, sometimes called an "oil payment," is the right to a share of production from property, or the proceeds therefrom, free of the costs of production that terminates after a specific volume of production has been paid to, or an agreed upon sum from the sale of such production has been realized by, the production payment owner. Production payments may be created by an oil and gas lease (perhaps as an additional benefit to the lessor) or, more commonly, by an oil and gas lessee by a grant or reservation. The key distinction of a production payment is that it is limited in duration. Treasury Regulation 1.636-3 defines a production payment as containing the following elements:

1. A right to a specified share of production or the proceeds from such production;
2. It must be an economic interest (i.e., a clear and direct interest in a mineral property and the income from its production);
3. The property upon which it is a burden need not be an operating mineral interest;
4. If it can be satisfied by other than production, it is not an economic interest;
5. It can be measured by dollars, volume of mineral production, or time; and
6. It must have an expected economic life (at the time of its creation) of shorter duration than the economic life of the mineral property upon which it is a burden.

H. Net Profit Arrangements

A net profits interest is a non-operating interest that is usually created when the owner of property grants an oil and gas lease to another party and provides for a royalty to be paid in the form of a percentage of net profits derived from production. A net profits interest, similar to a royalty interest, is expressed as a percentage of production and is free of the costs of production. However, a net profits interest is different from a royalty interest in that it is payable only if there is a net profit, while a royalty interest is payable even if a net profit is not achieved.

I. Summary of Payments Under a Gas Lease- Federal Tax Consequences

The following table summarizes payments at acquisition, from production and for damages under a gas lease:

1. Tax Treatment to the Landowner and the Lessee-Bonus

Bonuses are regarded as advance royalties and, as such, are treated as ordinary income to the landowner recipient. Treasury Regulations state that a bonus paid by a lessee represents a lease cost, deductible by the lessee. Specifically, Treasury Regulation Section 1.612-3(a)(3) states "[i]n the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit . . . recoverable through the depletion allowance." It may be argued that if the lessee, upon payment of a bonus, is required to capitalize it as lease cost, why, as to the lessor, should not the same bonus be viewed as consideration received upon the sale of an asset? GCM 22730 offers the following explanation:

A lease merely divides the oil and gas in place between the lessor and the lessee, and the retained royalty, "freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens," and thus the lessor is not regarded as having disposed of a capital asset.

GCM 22730 goes on to state that:

> [T]he view that a lessor . . . parts with no capital interest, though the lessee, . . . acquires a capital interest upon the execution . . . of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery.

A cash method taxpayer must include items of gross income in the year in which they are constructively received. Rev. Rul. 68-606, 1968-2 C.B. 42, provides that cash method taxpayers who receive an installment bonus contract must include its fair market value in gross income in the year in which the lease is executed only if the obligation is transferable and readily saleable. If the contract is not transferable, a cash method taxpayer realizes income only in the year that an installment payment is received

2. Tax Treatment of Royalty Interest to the Landowner

A landowner retaining a royalty interest reports royalties received as ordinary income. *See* GCM 22730. Since the royalty owner holds an economic interest in the property, he is also entitled to a corresponding depletion deduction. IRC Section 613A(a) generally restricts owners of interests in oil and gas properties to the use of cost depletion. However, a number of exceptions are provided, with the most notable being a limited exemption for independent producers and royalty owners. IRC Section 613A(c). Most individuals receiving royalties will qualify as independent producers and royalty owners, and will therefore be entitled to deduct the greater of cost or percentage depletion.

3. Tax Treatment of Royalty Interest to the Lessee

Royalties paid by the owner of the operating interest (generally the lessee) are excluded from the taxpayers' income, both for income tax purposes and in computing the amount of gross income eligible for percentage depletion.

Tax Treatment of Payments under a Oil & Gas Lease
(Based on similar table in Baer, 605-2nd T.M., Oil and Gas Transactions)

Payment Name*	Payor or Lessee	Payee or Lessor
BONUS-- Payment for executing lease.	Capitalize Treas. Reg. section 1.612-3(a)(3)	Ordinary Income Percentage depletion allowed to August 17, 1986. Only cost depletion after August 17, 1986. Treas. Reg. 1.612-3(a)(1)
INSTALLMENT BONUS Also consideration for granting a lease, advance payment for oil & gas; each installment is usually larger than normal delay rental.	Capitalize	Ordinary Income Rev. Rul. 68-606, total amount includible at time of signing lease if right to income is transferable. Generally, this treatment is the same as for lease bonus.
DELAY RENTAL Rent; a payment to defer development rather than a payment for oil & gas.	Capitalize (per IRS position under section 263A)	Ordinary Income No depletion. Treas. Reg. section 1.612-3(C)(2)
SHUT-IN ROYALTY Royalty payment made during the period a producing well is shut-in (temporarily closed or never connected) for some reason.	Deductible if treated as a royalty to Lessor. Capitalize if treated as a delay rental to Lessor	Ordinary Income Treated same as royalty if lease will not terminate for non-payment. Treated as delay rental if lease will terminate for non-payment.
ROYALTY Payment for oil or gas.	Deducible Under Rev. Rul. 72-165, when ad valorem taxes are paid by lessee to the extent paid from production income.	Ordinary Income Subject to depletion (percentage or cost); percentage depletion is allowed if payee qualifies under IRC section 613A.
ADVANCE ROYALTY Royalty payment made before production.	Deducible Under Rev. Rul. 72-165, when ad valorem taxes are paid by lessee to the extent paid from production income.	Ordinary Income Subject to cost depletion in year payments are made. Percentage depletion allowed until August 17, 1986.
ADVANCE MINIMUM ROYALTY Minimum royalty required by oil & gas lease.	Deductible At option of payor: (1) In year paid or accrued or (2) When oil or gas is sold or recovered. Treas. Reg. section 1.612-3(b)(3)	Ordinary Income Subject to cost depletion in year payments are made. Percentage depletion allowed until August 17, 1986.

*(Caution: The name given to a payment is not determinative of its tax treatment.)

Production Payments

Payment Name*	Payor or Lessee	Payee or Lessor
RETAINED (SALES TRANSACTION) Not an economic interest. Is treated as a mortgage.	Repayment of principal and interest expense.	Repayment of principal and interest expense.
RETAINED (LEASING TRANSACTION) Treated as an economic interest.	Capitalize, bonus paid in installment. Treas. Reg. section 1.636-2(a).	Ordinary Income Subject to depletion (percentage or cost). Treas. Reg. section 1.636-2(b).
CARVED OUT AND SOLD: NOT AN ECONOMIC INTEREST A loan.	Repayment of principal and interest expense.	Repayment of principal and interest expense.
CARVED OUT AND SOLD: AN ECONOMIC INTEREST Applies to carved-out production payments advanced for the exploration or development of the property.	Deducible Capitalize as installment lease bonus.	Ordinary Income Subject to depletion (percentage or cost); percentage depletion is allowed if payee qualifies under IRC section 613A.

Damages

Payment Name*	Payor or Lessee	Payee or Lessor
BUSINESS AND GOODWILL (LAND) Payments made to the landowner by the oil or gas operator for damages to the surface, to growing crops, to streams, or other assets of the landowner.	If acquired or leased, capitalize as geological and geophysical (G & G) costs. If not acquired or leased, expense.	Return of capital to the extent of basis of the property. Amounts in excess of basis are IRC section 1231 gain.
LOSS OF PROFIT Crop damage.	If acquired or leased, capitalize as G & G costs. If not acquired or leased, expense.	Ordinary Income
ANTICIPATED DAMAGES BUT NONE WAS DONE Damages based on the anticipation that damages would be done	If acquired or leased, capitalize as G & G costs. If not acquired or leased, expense.	Ordinary Income

II. MANAGEMENT/MAINTENANCE OF THE MINERAL INTERESTS AND THE USE OF TAX PARTNERSHIPS

A. Purposes Behind the Use of Tax Partnerships by Mineral Owners

Tax partnerships (usually in the form of state law limited partnerships or limited liability companies) have long been used as the instrument to house mineral interests held by landowners for a variety of reasons. Below are some of the more common reasons for using tax partnerships as the ownership vehicle for mineral interests:

1. Maintenance of the Property

Forming a partnership and funding it with mineral interests allows the transferor to establish a framework for managing and maintaining the mineral interest during and after the transferor's lifetime. The ability to manage and maintain mineral interests is generally vested in the manager (if the vehicle selected is a state law limited liability company) or the general partner (if the vehicle selected is a state law limited partnership). The operating agreement or limited partnership agreement, as applicable, of the selected ownership vehicle would contain management and succession provisions providing for what types of decisions the manager or general partner, as the case may be, is eligible to make (generally the manager or general partner, as the case may be, makes all of the day-to-day operational decisions), and would provide a succession plan so that certain designated persons would be appointed to serve in this decision-making capacity after the original transferor is no longer involved with the partnership (e.g., due to death, disability, or resignation).

2. Maintaining the Ownership of the Property

Where mineral interests are placed in a tax partnership, the transferors can retain the ability to transfer indirect ownership interests in oil and gas investments to family members without fractionalizing the ownership of these assets or affecting the continuity of the family's oil and gas investment strategies.

3. Ability to Restrict Transfers

The terms of the partnership agreement (i.e., the limited partnership agreement or limited liability company agreement, as the case may be) can be tailored to limit who can receive an interest in the partnership and, indirectly, an interest in the underlying minerals. Specifically, including the appropriate buy-sell terms in the operating agreement can enable the original transferor of the mineral interests to continue the ownership of the oil and gas investments within the transferor's family lines and to restrict the right of non-family persons to acquire interests in the same.

4. Liability Protection

Mineral interest owners generally have minimal liability exposure in connection with the production of oil or gas on the properties in which they have retained a royalty interest. However, in some cases, landowners choose to take part in the development of the mineral property through a working interest or some other form of economic interest, and, therefore, holding the mineral interest in a limited liability entity is prudent. Additionally, placing the mineral interests in a tax partnership (that is a limited liability entity) can also protect the mineral interests from liabilities arising out of the transferor's individual circumstances.

B. Key Provisions in the Partnership Agreement

1. Additional Capital Contributions

Generally the property held inside the partnership will be subject to some form of ad valorem taxes, and/or other operating expenses, as such, it may be necessary to include a provision in the provisions of the operating agreement dealing with capital contributions requiring the members/partners to contribute additional capital to the partnership as need to fund these expenses. Note that the need for additional funding is likely only necessary in the early years of the partnership where the property is being developed as there may not be enough income generated by the production activities to cover these expenses. However, as the minerals begin being produced (or in the case where producing minerals are used to fund the partnership initially), this becomes less of an issue.

2. Tax Distributions

In the event the manager/general partner of the partnership does not intend to distribute all of the cash generated by the mineral interests in the partnership to the partners/members, there is often a provision in the operating agreement or partnership agreement providing for distributions of cash to the partners/members to subsidize the tax burden borne by each partner/member as a result of their ownership interest in the partnership. The need for such a provision is most important where the intent of the partnership is to reinvest the proceeds from the production of the mineral interest in other investments.

3. Management Succession

Including a management succession provision in the operating agreement of the limited liability company operating agreement or limited partnership agreement for the entity housing mineral interests gives the original transferor(s) the ability to determine at the outset the governance of the mineral interests. Generally where the mineral interests are placed in a partnership and are intended to benefit the transferor's family and future generations, the management succession provisions specify succession of the decision-making authority to be vested in the family lines of the transferor and his or her lineal descendants.

4. Buy-Sell Restrictions

Buy-sell restrictions permit the original transferor(s) of the mineral interests to the partnership to limit the ownership of the partnership to certain permitted transferees in order to further the estate planning goals of the transferor(s). Some of the more common types of buy-sell provisions are those dealing with the ability to transfer interests in the partnership to individuals of the original transferor's family, to marital trusts and other types of trusts, to the estate of an owner of a partnership interests, and to charitable organizations. Additionally, often included as buy-sell provisions in the relevant operating agreement are those provision dealing with the divorce of a partner/member (that is an individual) and the death of the spouse of a partner/member (that is an individual).

5. Assignee vs. Substituted Member/Partner

The estate planning goals of owners of the partnership need to be carefully considered when determining whether a transferee of a partnership interest/membership interest is to be an assignee (i.e., a partner/member with economic rights, but no voting rights) or a substituted member/partner (i.e., a partner/member with economic rights and voting rights). If a transfer to a trust is anticipated, whether a transferee is considered an assignee or a substituted member/partner will affect the value placed on the assets transferred. That is, an assignee interest would likely be valued significantly lower than an interest received by a transferee in which the transferee is considered to be a substituted member/partner.

III. INCOME TAXATION OF OIL AND GAS PARTNERSHIPS

Oil and gas tax partnerships are an animal completely unlike any other, and they hold oil and gas property in a unique manner for tax purposes. To this end, having an advisor that is comfortable with the taxation of oil and gas partnerships will be important in assisting your clients with their planning needs as these complexities exist even in the simplest of estate plans (where a tax partnership is utilized). The purpose of this outline is to merely point out the major issues to consider when an oil and gas partnership is used in connection with an overall estate plan so that the advised estate planner can make sure to avoid any missteps associated with the application of Subchapter K of the Internal Revenue Code to his or her client's oil and gas family partnership.

A. Intangible Drilling Costs and Development Costs

In connection with the drilling of oil and gas wells, taxpayers that have a working or operating interest have the option to either expense or to capitalize intangible drilling and development costs ("IDC"). IRC § 263(c). Taxpayers who elect to have an immediate write-off in the year such IDC was incurred must make a binding one-time election with the IRS. The option to expense IDC applies to all amounts paid by an operator "for wages, fuel, repairs, hauling, supplies, etc. incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas." Treas. Reg. § 1.612-4(a). The election to immediately write-off IDC apply to those costs incurred to: (i) drill, shoot or clean a well; (ii) clear the land and prepare the pad site for the drilling of wells (i.e., ground clearing, surveying, road making, drainage, and geological works); and (iii) construct derricks, tanks, pipelines and other physical structures necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Any costs expended on equipment that is normally considered to have a salvage value and is depreciable property is not allowed to be immediately deducted through the IDC election. The costs incurred by the taxpayer for this type of property may only be recovered through the depreciation allowance. Expenses that relate to the installation of production and treatment facilities are not considered to be an IDC. The expenses for operating wells or other facilities for the production of oil and gas are deductible as ordinary and necessary business expenses. The election to expense IDC is made by the partnership and not the individual partners.

The election to expense IDC is available only to the owner of a working or operating interest. Rev. Rul. 75-304. As such, the owner of only a royalty interest will not be eligible to deduct expenses associated with the drilling of wells for the production of oil and gas since a royalty interest owner does not bear the costs of production and therefore will never benefit from the IDC. The issue that arises to the working interest owner who holds its working interest in a partnership form is whether the passive activity loss rules of IRC § 469 apply to limit the ability of the working interest owner to deduct IDC. IRC § 469 applies to limit the ability of a taxpayer to deduct losses from passive activities. A passive activity is any activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate. Contained within the language of IRC § 469 is the working interest exception which holds that "the term "passive activity" will not include any working interest in any oil and gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest." IRC § 469(c)(3).

Due to the potential liability exposure associated with a working interest, most working interest owners hold their working interest indirectly through a limited liability entity (most notably the limited partnership or the limited liability company). The obvious rub for a working interest owner is weighing the benefits and burdens of the immediate IDC deductions versus the increased liability exposure to the working interest owner by holding the working interest directly or in an entity that does not limit liability (i.e., the general partnership) in order to avoid the passive activity loss rules of IRC § 469. Careful attention should be used by the practitioner to properly discuss with his or her client who holds working interests the potential benefits and burden of the IDC deduction and whether or not holding the working interest in a limited liability vehicle is the best option. The practitioner might find that holding the working interest outside of a limited liability vehicle coupled with the purchase of liability insurance (or liability insurance held by the operator in a joint venture) might best suit his or her client's needs.

B. Basis of Oil and Gas Properties held by Partnership

On the exchange of property held by a partner to a partnership in exchange for an interest in the partnership, the tax consequences resulting from such exchange are governed by Subchapter K of the IRC. Specifically, IRC § 721 states the general rule that no gain or loss is recognized to a partner on the contribution by such partner of property to the partnership in exchange for an interest in the partnership. The basis held by the partner in his or her partnership interest is equal to the adjusted basis of the property contributed to the partnership plus any gain recognized by the partner on the contribution. IRC § 722. Likewise, the basis of the property contributed by the partner to the partnership shall be equal to the adjusted basis of the property at the time of contribution plus any gain recognized by the contributing partner on the contribution. IRC § 723. In tax jargon, the basis determined pursuant to IRC § 722 is often referred to as the "outside basis" and the basis determined under IRC § 723 is often referred to as the "inside basis." The determination of basis is critical in partnership tax to properly account for the operations of the partnership and to ensure that the flow through income tax regime is maintained. In the normal case of depreciable property, the partnership computes the depreciation allowance applicable to the subject property and this amount flows through to the partners (based on the partners' allocation scheme) to be applied on their individual tax returns and then this amount will adjust the partners' outside basis in the property.

When oil and gas property is held by a tax partnership, the inside basis of the property is held by the individuals partners and not the partnership so that each partner determines its depletion allowance. IRC § 613A(c)(7)(D). In determining each partner's allocable share of basis in the oil and gas property held by the partnership, the partnership shall allocate to each partner his proportionate share of the adjusted basis of each oil and gas property. Each partner shall separately keep records of his share of the adjusted basis in each oil and gas property of the partnership, adjust such share of the adjusted basis for any depletion taken on the property (regardless of whether the partner takes cost depletion or percentage depletion), and use such adjusted basis each year in computing his cost depletion for that year or his gain or loss on the disposition of such property by the partnership. In essence, a partner in an oil and gas partnership holds both the inside basis of the oil and gas property and the outside basis of the partnership interest. For partnerships that satisfy the substantial economic effect test of the regulations under IRC § 704(b), then the initial allocations of basis of the oil and gas property will be made in accordance with such allocation scheme. If the allocations do not have substantial economic effect, the allocations of the basis of the oil and gas property among partners will be governed exclusively by IRC § 613A(c)(7)(D) and the regulations thereunder. The regulations under IRC § 613A(c)(7)(D) provide that basis in an oil and gas property must be allocated in accordance with the partners' interest in "capital" unless the partnership agreement provides that the allocation is made in accordance with the partners' shares of "income", and when the allocation is made each partner's share of income is "reasonably expected to be substantially unchanged throughout the life of the partnership". The default rule under IRC § 613A is that basis is allocated in accordance with each partner's share of capital. If the partnership agreement provides for a special allocation of income, then it appears that the § 613A regulations will cause the partnership to allocate depletable basis in accordance with capital instead of income. As a result, the allocation of basis based on capital instead of income can have the result of the economic agreement among the partners having little correlation to the allocation of basis. If the partners are concerned about the application of § 613A to the allocation of basis, then the partners need to follow the rules of § 704(b) since the regulations state that § 704(b) controls over § 613A.

The regulations under § 613A require reallocation of the basis of depletable property on an increase or decrease in a partner's interest in the partnership. Reallocation is required on the admission of a new partner, withdrawal of a partner, or an increase or decrease in a partner's interest in the partnership. The reallocation of basis among the partners makes logical sense but the implementation of this requirement is complicated due to the basis of the properties being held outside of the partnership. The regulations provide that the partnership may use either written data provided by the partners to the partnership as to the amount of depletable basis or use assumptions to estimate the total basis remaining among the partners in order to reallocate the basis among the partners.

The allocation of inside basis under the scheme set forth in § 613A or § 704(b), as applicable, has no effect on a partner's outside basis. A partner's outside basis in an oil and gas partnership is determined in the same manner as any other partnership governed by Subchapter K of the Code. Since the basis of oil and gas properties is held outside of the partnership, special basis rules are included in IRC § 705 to make sure that a partner's outside basis is properly adjusted to account for depletion taken by the partner pursuant to IRC § 611. It is important to note that IRC § 705 provides rules for dealing with depletion at the partnership level where the property is not oil and gas property. A practitioner will not want to confuse this with the treatment of depletion for oil and gas property. Except for oil and gas property, the partnership itself holds the basis of the mineral property and the calculations of depletion at the partnership level are included in a partner's distributive share (either in the calculation of gain or loss for the year) and the partner's outside basis is increased or decreased accordingly. IRC § 705(a)(1)(C) provides that the excess depletion deductions taken by the partnership over the adjusted basis of the property shall increase the partner's outside basis. This is necessary to ensure that the depletion deductions are not lost on the partner because if there was not a corresponding outside basis increase to the partner then on a sale by the partner of his or her partnership interest gain would be recognized to the extent of the depletion deduction.

The aforementioned rule is not applicable to oil and gas partnerships since the basis of the property is held outside of the partnership and the calculation of depletion is computed outside of the partnership context. As such, a special basis rule is included for oil and gas partnerships in § 705(a)(3) that provides that a partner's outside basis is to be decreased (not below zero) for depletion taken by the partner to the extent of basis in the oil and gas property. The result of this rule for oil and gas partnerships is to put the partners of an oil and gas partnership in the same tax position as other similarly situated partners in other mineral partnerships. This special basis rule is necessary due to the unique nature of oil and gas partnerships which require basis of the property to be held by the individual partners as opposed to the partnership.

C. Depletion of Oil and Gas Property: Cost vs. Percentage

The hybrid rules discussed in part (B) above concerning inside and outside basis for oil and gas properties was enacted as part of the historic revision of oil and gas depletion rules that occurred in 1975. Up until this time, any producer of oil and gas could claim a percentage depletion deduction which is measured by the fixed percentage of the gross income from the property. During the early 1970s when oil prices skyrocketed, many of the major integrated oil and gas companies were highlighted by the press as price gougers at the expense of the American public. The percentage depletion allowance was seen as an unnecessary governmental subsidy to this booming market segment. In response to public pressure, Congress was ready to move on new legislation that would have had the effect of denying percentage depletion to any oil and gas producer and instead require such producer to use the less favored cost depletion. Cost depletion is computed generally in the following manner: cost of the mineral interest divided by the estimated recoverable reserves (which represents cost per unit) multiplied by the number of units sold during the tax year. However, late in the legislative process, a compromise was struck that allowed certain producers the ability to use percentage depletion while others must use the less favorable cost depletion.

IRC § 611 and the regulations thereto provide that there be allowed as a deduction in computing taxable income in the case of oil and gas properties a reasonable allowance for depletion which shall be computed on either the adjusted depletion basis of the property (i.e., cost depletion as determined under IRC § 612) or upon a percentage of gross income from the property (i.e., percentage depletion as determined under IRC § 613A), whichever results in the greater allowance for depletion for any taxable year. As such, eligible taxpayers that can qualify for either method will annually determine which method provides him or her the greatest depletion allowance and use that method for the given tax year. Generally, the percentage depletion allowance is preferred by taxpayers since it is not limited to the taxpayer's adjusted basis in the property and often yields the greater deduction amount. In practice, a taxpayer using the cost depletion method can only take depletion adjustments for so long as that taxpayer has a positive basis in the property whereas a taxpayer can utilize the percentage depletion allowance even if the adjusted basis of the property has been reduced to zero. Normally IRC § 704(d) limits the ability of the taxpayer from claiming partnership deductions in excess of its basis in the partnership. However, since depletion is claimed outside of the partnership, then IRC § 704(d) is not applicable to the taxpayer. As such, the taxpayer may take depletion deductions in excess of the basis such taxpayer has in his or her partnership interest.

The compromise met by Congress in 1975 was to deny percentage depletion for integrated producers while allowing independent producers to continue to claim percentage depletion on a limited amount of annual domestic production. Percentage depletion is completely denied for any foreign oil and gas production. Under IRC § 613A(d), integrated producers are those producers who are engaged in refining oil and gas properties or engaged in the retailing of such products, subject to certain exceptions, as well as any company related to another company that is engaged in such operations. By inference, if a producer does not fit the definition for an integrated producer, then such producer would qualify as an independent producer. As a result of Congress's legislative action in 1975, integrated oil and gas companies have been limited to cost depletion.

As a result of this new legislation, the hybrid partnership rules discussed above were adopted to ensure that integrated producers could not circumvent the direct application of IRC § 613A by instead holding the oil and gas property subject to depletion through a partnership as opposed to direct ownership. Congress recognized that in many cases oil and gas partnerships were important to the development of mineral properties and as such limiting integrated producers from becoming partners with independent producers in oil and gas partnerships would be detrimental to the development of mineral properties. In order to balance the need to have integrated producers and independent producers as partners in a partnership and to restrict the ability of integrated producers to claim percentage depletion, Congress enacted IRC § 613A(c)(7)(D) discussed above so that the depletion allowances are computed outside of the partnership. In a partnership between an integrated producer and an independent producer, the integrated producer would compute depletion on the cost method and the independent producer would compute on the greater of the cost method or percentage method.

D. Capital Account Maintenance: Depletion

The capital accounts of the partners which have been credited with the value of oil and gas property should be adjusted to reflect the wasting of the property through depletion allowances. The § 704(b) regulations contain specific rules applicable to oil and gas properties to account for depletion. A partnership is normally able to directly control the adjustment of partner's capital accounts through the allocation of income and deductions in non-oil and gas partnerships. In an oil and gas partnership with the basis of oil and gas properties held outside of the partnership pursuant to Section 613A, the partnership does not compute depletion for oil and gas properties since depletion is taken outside of the partnership structure by the individual partners. To maintain capital accounts pursuant to § 704(b), the regulations permit the partnership to adopt one of the following methods: (i) simulated cost depletion; (ii) simulated percentage depletion; or (iii) actual depletion. The election is made on a property by property basis in the first year in which depletion is claimed and is binding for each year thereafter.

Under either simulated method, the partnership will compute the aggregate depletion for an oil and gas property and then reduce the capital accounts of the partners in the same proportion as the basis in such property was allocated among the partners. The amount of depletion computed under either simulated model will be based on the general principal used to compute cost depletion or percentage depletion, as applicable. The regulations assume that with simulated percentage depletion that all partners are eligible for percentage depletion. The third approach is the actual depletion method which requires the capital account of a partner to be adjusted by the actual amount of depletion allowance taken with respect to each oil and gas property. This latter approach requires annual information exchanges between the partnership and the individual partners.

E. Disposition of Partnership Oil or Gas Property

Upon the disposition of partnership oil and gas property, gain or loss is measured to a partner by the difference between that partner's basis in the sold property and the portion of amount realized by the partnership allocated to such partner on the disposition. Each partner computes gain or loss independently of other partners on the sale of oil and gas property. The partner's allocable portion of amount realized is determined in accordance with § 704(b) and generally matches proportionately the allocation of basis of such disposed property to the partners.

In the typical situation of a disposition of property by a non-oil and gas partnership, the gain or loss is determined inside the partnership and is measured as the difference between the amount realized by the partnership and the basis of the property held by the partnership. This relatively simple concept is subject to abuse by tax planners in oil and gas partnerships since the basis of the property is held outside of the partnership so that the opportunity existed for gamesmanship by taxpayers to allocate the amount realized among the partners to create taxable gain or loss to the individual partners as they determined. To prevent this abuse, the first rule of § 704(b) in allocating the amount realized from the sale of an oil and gas property is to allocate the amount realized first to offset any basis held by any partners in such disposed property. This rule is referred to as the "no loss" rule as it prevents the ability of the partnership to create tax losses for certain partners based on the allocation of the sale prices. The remaining proceeds, if any, will be allocated among the partners as the partners decide provided the allocation satisfies the substantial economic effect rules of § 704(b).

The tax effect of the regulatory scheme under § 704(b) to the allocation of the amount realized from the disposition of oil and gas property is (i) any loss realized by the partnership must be recognized proportionately by all partners in accordance with their basis in the disposed property; (ii) no loss may be recognized by one or more partners while other partners break- even or recognize a gain; and (iii) any taxable gain on the disposition may be allocated among the partners as the partners decide so long as such allocation complies with the normal rules under § 704(b).

F. Recapture of Intangible Drilling Costs and Depletion (IRC § 1254)

Certain costs associated with oil and gas properties placed in service after 1986 are subject to recapture under IRC § 1254 upon disposition. IDC and development costs are subject to recapture to the extent such costs would have been included in the adjusted basis of the property if they would have been capitalized instead of being immediately deducted by the taxpayer in the year the cost was incurred. IDC recapture under IRC § 1254(b) is to be determined under rules similar to the determination of depreciation recapture under IRC § 1245. Depletion is also subject to recapture under IRC § 1254. The amount of depletion recapture will be limited to the lesser of the: (i) the amount of depletion deductions taken by the taxpayer on the property that actually reduced the adjusted basis of the property or (ii) the taxable gain on disposition. The result of the recapture provisions is to convert capital gain into ordinary income by accounting for the deductions taken by the taxpayer against previous ordinary income. As shown in the statutory language of IRC § 1254, percentage depletion is of much greater benefit to the taxpayer than cost depletion because while both depletion methods reduce adjusted basis to zero, with percentage depletion any depletion deductions in excess of basis will not be subject to the recapture provisions of IRC § 1254.

For property place into service before 1987, the amount recaptured is the lower of (1) the amounts deducted for IDC that exceed the amounts that would have been allowed had the IDC been capitalized, or (2) the excess of gain realized from a sale or exchange over the adjusted basis of the property.

G. Application of IRC § 704(c) to Oil and Gas Partnerships

IRC § 704(c)(1)(A) provides that income, gain, loss and deduction with respect to property contributed by a partner to the partnership will be shared among the partners so as to take into account the difference between the property's adjusted basis and its fair market value at the time of contribution. The purpose of this rule is to prevent the shifting of precontribution gains or losses among the partners. Reg. § 1.704-3(a)(1). IRC § 704 primarily applies to sales by a partnership of contributed property and depreciation and depletion with respect to contributed property.

In making IRC § 704(c) allocations to resolve issues reflected in book/tax disparity, the regulations allow the partnership to use any reasonable method that is consistent with the purpose of IRC § 704(c). The regulations specifically authorize three methods: (i) traditional method; (ii) traditional method with curative allocations; and (iii) remedial method. A partnership may use different allocation methods with respect to different properties, but the method used for a specific property must be consistently used year to year. When the traditional method is applied, issues often arise as a result of the "ceiling rule." The "ceiling rule" states that the total income, gain, loss or deduction allocated to a partner for a taxable year with respect to any IRC § 704(c) property may not exceed the total partnership income, gain, loss or deduction with respect to that property for the taxable year. The ceiling rule can have the effect of temporarily shifting precontribution gains among partners or limiting tax depreciation allocated to noncontributing partners. The traditional method with curative allocations and the remedial method aim to remedy the distortions caused by the application of the ceiling rule.

In the context of an oil and gas partnership, the application of IRC § 704(c) is more complicated since the basis of the oil and gas property is held outside of the partnership by the partners. In general, the rules of IRC § 704(c) apply in the same general manner as any other mineral partnership, but there are increased complexities and little statutory, regulatory, and administrative guidance due to the unique nature of oil and gas partnerships. Generally speaking when dealing with depreciation allowances, IRC § 704(c) seeks to remedy any precontribution gains of depreciable property by allocating more of the tax depreciation to the noncontributing partners so that the contributing partner over the remaining depreciable life of the property recognizes the precontribution gain in the form of additional taxable income each year since the contributing partner did not have the benefit of the larger depreciation deductions. The theory behind this shifting of the depreciation allowance to the noncontributing partners is that the property at the end of its depreciable life will be worthless so that the partnership will not be able to sell the property and recognize the built-in gain at that time. As such, the contributing partner would not have to recognize his or her precontribution gain.

In the context of the application of IRC § 704(c) to oil and gas partnerships, the partners will be primarily concerned with the allocation of basis to the partners and the calculation of the depletion deductions, as allocations to cure book/tax disparity are determined based on how the partners determine to allocate basis upon the contribution of the IRC § 704(c) oil and gas property to the partnership. This concept is especially important in an oil and gas partnership where one partner contributed the oil and gas property that is subject to § 704(c) gain and the other partners are equity/cash partners. The equity/cash partners will want to structure the partnership so that they receive their proportionate share of the book depreciation on the oil and gas property. However, since the property has a book-tax disparity on contribution, the depletion allowances will be affected by IRC § 704(c). Based on the allocation method chosen, the annual tax impact to each partner could vary greatly based on the shifting of the depletion allowances. As a result of this shifting, the partner who contributed the § 704(c) property could be required to recognize more taxable income in a given tax year since that partner would be allocated a smaller depletion allowance. The mechanics of the allocations methods are outside the scope of this outline and could be the subject of a lengthy outline all by themselves but in general, the partner who contributed the § 704(c) property will prefer to choose the traditional method and the equity/cash partners will prefer to choose the traditional method with curative allocations or the remedial method. The traditional method is more favorable to the partner who contributed § 704(c) property because of the application of the "ceiling rule" which could limit the amount of tax depletion being shifted away from the partner who contributed the § 704(c) property to the other partners. The other methods aim to cure the problems caused by the "ceiling rule" and generally result in the equity/cash partners being able to receive their full pro rata share of tax depletion on the property without distortion caused by the application of the "ceiling rule." The authors recommend that the parties seek competent oil and gas tax professionals to advise on the transaction structure when dealing with the situation of a partner that is contributing IRC § 704(c) property to a partnership and the other partners are contributing non-IRC § 704(c) property. The choice of allocation method will be a key negotiating term that will need to be agreed to by the partners prior to entering into a partnership arrangement.

H. Miscellaneous Issues

Since the partners of an oil and gas partnership hold the basis of the property outside of the partnership, the partners themselves will separately calculate the depletion and gain or loss for the partnership property. Additionally, when an oil and partnership disposes of the property, each partner is then required to compute the gain or loss on the property separately. These wrinkles require the partnership to communicate closely with the partners so that the partners can adequately determine the tax consequences arising from the ownership of the partnership interest. Specifically, the partnership will need to adequately communicate the gross income from the operations of the property so that each partner can determine the amount of depletion to take against their share of the property's basis (note that gross income is necessary to compute percentage depletion, which is the depletion calculation method normally utilized by most taxpayers that are the subject of this outline; however, in the event the taxpayer is forced to use cost depletion, the partnership will need to communicate information related to the amount of oil or gas produced and the amount of estimate reserves in order for the taxpayer to appropriately calculate their depletion deduction).

IV. ESTATE PLANNING STRATEGIES

A. Types of Trusts

1. Revocable Trusts and Testamentary Planning

Many times a revocable trust is used in a testamentary estate planning capacity. These trusts provide many benefits, some of which are listed herein, but are revocable and can be changed at anytime by the Settlor. There are many purposes for the use of a revocable trust, including, but not limited to, (a) providing privacy for the disposition of the testator's estate assets during probate proceedings, (b) provide estate tax planning through the creation of multiple trusts, (c) providing a management plan during a period of incapacity of a testator, (d) avoiding probate in states where the probate procedures are complicated or (e) avoiding probate for property owned in states other than the state of domicile of the testator. A revocable trust is a useful tool in many situations and should never be overlooked as a foundational estate planning tool.

2. Irrevocable Asset Trust

A commonly used estate planning strategy is the use of irrevocable trusts. An irrevocable trust created by a grantor can be used to transfer assets to individuals, usually of a lower generation than the taxpayer, while providing the benefits of the following:

a. <u>Continued</u> direct or indirect control of the assets under the Trustee structure of the Trust;

b. <u>Creditor</u> protection for the beneficiaries (i.e. the assets of the trust are not subject to debts of the beneficiaries);

c. <u>Protection</u> from marital discord (i.e. the assets are not part of the marital estate and are therefore not subject to division on divorce);

d. <u>Estate exclusion</u> – the assets in the irrevocable asset trust are not included in the donor's estate and are also not included in the beneficiaries' estates in most cases.

A properly structured and drafted irrevocable trust can provide benefits for multiple generations while allowing the taxpayer to develop and implement control structures to control the wealth to achieve the benefits and objectives desired by the taxpayer. An irrevocable asset trust can be used by a taxpayer for many purposes and to satisfy many objectives such as:

a. <u>Receipt</u> of annual exclusion gifts;

b. <u>Ownership</u> of life insurance policies on the life of the taxpayer;

c. <u>Ownership</u> of other assets expected to appreciate in value; and

d. <u>Involvement</u> in more sophisticated estate planning strategies.

These are just a few of the more common uses of an irrevocable asset trust.

3. Annual Demand Trust or "Crummey" Trust

a. <u>An Annual Demand Trust or "Crummey" Trust</u> is an irrevocable asset trust that is designed to receive gifts that are excluded from gift tax under IRC Section 2503(b). If the terms of the trust are drafted correctly, and the gift to the trust is properly documented, the gift to the trust will not be a taxable gift. In order to qualify as an annual exclusion gift under Section 2503(b) the beneficiary must have a right to withdraw the gift made to a trust for a certain time period. If the gift is not withdrawn, the right lapses as to the gift and the gift becomes part of the trust corpus

b. Advantages:

(1)The gift removes asset appreciation (and asset if annual exclusion gift) from the donor or taxpayer's estate. Additionally, the gift, if it is an annual exclusion gift, will not reduce the taxpayer's Unified Credit Against Gift Tax (discussed below) for gifts. The involvement by taxpayers in an annual giving program can provide significant wealth transfer benefits over a taxpayer lifetime, and the more descendants a taxpayer has, the more effective the giving can be.

(2)The Annual Demand Trust provides all of the benefits and protections of an irrevocable asset trust as described above.

c. Disadvantages:

(1)Trust is irrevocable (by the donor).

(2)The Donor or Taxpayer does not receive any benefit from the appreciation or income of the assets in the Trust.

(3)Beneficiary may withdraw gifts to trust as they are made, if donor wants gifts to qualify for annual exclusion.

(4) Beneficiary notice requirements upon each gift to trust and trust tax returns may be required.

(5)Complex rules as to beneficiary regarding lapse of withdrawal rights in excess of $5,000 per year.

(6)Legal, accounting and time expense in establishing and maintaining trust and in following proper funding procedures.

(7)Parents can be Trustees of trusts for the benefit of their children for distribution purposes without the risk of inclusion so long as the distributions are based on an ascertainable standard under IRC § 2041 and the distribution is not to satisfy a support obligation of the parent under state law.

4. The Irrevocable Life Insurance Trust

a. An Irrevocable Life Insurance Trust is an irrevocable asset trust that is designed to own and be a beneficiary of life insurance policies on the life of, in most cases, the donor or grantor of the trust. The beneficiaries of the trust are usually the spouse or descendants of the donor. This trust, in many cases, is also designed as an Annual Demand Trust so that annual exclusion gifts can be used to fund the life insurance premiums on the policy owned by the trust.

b. Advantages

(1) Removes life insurance proceeds from Grantor's estate (if Grantor is not insured or, if insured, is not Trustee over the life insurance policy);

(2) Proceeds available but not required to provide liquidity to Grantor's estate (by loan or purchase) to pay estate taxes or purchase assets Grantor would rather have out of estate (i.e., family business).

(3) Distribution of trust property can be coordinated with Grantor's overall estate plan.

(4) Cash value and proceeds removed from liability for Grantor's debts if:

(a) Grantor is not insolvent immediately after gifts to trust; or

(b) Gifts to trust are not made with intent to defraud Grantor's creditors (present or future).

(5) Fund obligations of Grantor remaining at death (such as alimony or child support or other continuing obligations of the Grantor's estate).

(6) Provide for advance distribution to beneficiaries when surviving spouse of Grantor is close in age to other beneficiaries (second marriage situation).

(7) Benefits and protections provided by irrevocable asset trust as listed above.

c. Disadvantages

(1) Trust is irrevocable and Grantor must part with complete control of life insurance policy owned by the trust.

(2) Grantor cannot be Trustee over the life insurance policy without inclusion in Grantor's estate.

(3) Beneficiary (or managing conservator parent in divorce situation) may withdraw gifts to trust as they are made, if Grantor wants gifts to qualify for annual exclusion.

(4) Beneficiary notices are required upon each gift to trust.

(5) Complex rules as to beneficiary regarding lapse of withdrawal rights in excess of $5,000 per year.

(6) Legal, accounting and time expense in establishing and maintaining trust and in following proper funding procedures.

(7) Potential adverse tax consequences to Grantor and beneficiaries.

(a) Life insurance proceeds may be included in Grantor's estate if Grantor dies within three years of the trust's receipt of the life insurance policy.

(b) Grantor must use some of his or her unified credit if:

i. A gift to the trust exceeds the annual exclusion amounts available to the Grantor for gifts to the Crummey beneficiaries of the trust;

ii. If the Crummey beneficiaries are not the ultimate beneficiaries of the irrevocable trust or if the gifts made to the trust are not subject to Crummey Withdrawal Power. If the total amount of such gifts exceeds the unified credit, gift taxation will occur.

(c) Trusts will be subject to generation-skipping transfer tax to the extent that proceeds from the trust pass to the grandchildren or later descendants of the Grantor and either:

i. The trust has more than one beneficiary or, if the trust has only a single beneficiary, but the trust assets are not includable in the single beneficiary's estate upon death; or

ii. The Grantor has not applied a portion of his Generation-Skipping Transfer Tax exemption to the gifts made to the trust.

5. Intentionally Defective Grantor Trust

a. What is an Intentionally Defective Grantor Trust ("IDGT")

The intentionally defective grantor trust ("IDGT") is an irrevocable asset trust under which the settlor or creator (or in some instances the beneficiary) is treated as the owner of the trust for income tax purposes by intentionally subjecting itself to provisions under the grantor trust rules of IRC. §§ 671-679, but the grantor is not treated as the owner for estate, gift or generation-skipping transfer tax purposes. An IDGT has all of the same benefits and protections as an irrevocable asset trust as discussed above, but an additional benefit of creating the IDGT under which the grantor must include in taxable income items of income, deductions and credits of the trust and pay tax on such amount, is that the amount of the tax paid is the equivalent of a tax free gift to the extent such amount is not reimbursed. Further, the tax treatment of the IDGT allows for sales between the grantor and the trust which do not cause income taxation upon the transfer allowing the grantor to shift future appreciation (over the repayment costs) to the trust and its beneficiaries. For purposes of this presentation, a Settlor IDGT refers to an IDGT that treats the creator or Settlor as the grantor for income tax purposes. A Beneficiary IDGT is an IDGT that treats the beneficiary as the grantor for income tax purposes.

b. Creating the Settlor IDGT

There are numerous provisions and circumstances in the Internal Revenue Code which create a grantor trust. The IDGT utilizes those provisions which cause the grantor to be treated as owner for income tax purposes but not estate tax purposes. Further, it is important to select grantor trust powers which can be released by the powerholder (without gift taxation to grantor) so the trust is no longer taxed to the grantor. Below are commonly used grantor trust rules for purposes of creating the IDGT:

(1) Nonadverse Trustee Power to Add Beneficiaries-A grantor is treated as owner of the entire trust if a nonadverse trustee has the power, without the approval or consent of an adverse party, to add persons, including charity, other than after-born or after-adopted children to the class of beneficiaries. § 674(a). The grantor may be more comfortable with this power if the powerholder and trustee are two different individuals.

(2) Power of Appointment-A grantor is treated as owner of the entire trust if a nonadverse party has the power, without the approval or consent of an adverse party, to appoint trust income and principal, exercisable during grantor's lifetime. § 674(a).

(3) Power to Pay Life Insurance Premiums-A grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be applied to the payment of premiums of insurance on the life of the grantor or the grantor's spouse. § 677(a)(3). This power alone may be inadequate for

wealth migration purposes and utilizing the IDGT. Cases decided under the predecessor to IRC 677(a)(3) held that the grantor is taxable only on trust income actually used to pay premiums.

(4) Right to Substitute Assets-A grantor is treated as the owner of any portion of the trust over which the grantor or any person has the right exercisable in a nonfiduciary capacity, to acquire trust assets by substituting assets of equivalent value. § 675(4). There is a concern that this power creates a risk of estate inclusion; however, the Service has ruled that no such inclusion will occur merely because of the retention of a right to substitute assets, based on the Tax Court's holding in Jordahl Estate v. Commissioner. 65 T.C. 92 (1975, acq., 1977-1 C.B.1. To avoid this risk, one may grant the right to a party other than the grantor. Section 675(4)(C) taxes the grantor if the power to substitute assets is held "by any person."

(5) Power to Borrow-The power of a grantor or a nonadverse party or both that enables the grantor to borrow from the trust without adequate interest or adequate security will cause the portion of the trust subject to such power to be treated as owned by the grantor, except where a trustee is otherwise given the right to make the loans under a general lending power. § 675(2). As long as the power extends to the entire trust, the donor should be treated as the owner of the entire trust.

c. Creating the Beneficiary IDGT

A B-IDGT is created using § 678 of the Code. The most common way to create a B-IDGT is to create a trust and give a beneficiary a withdrawal right of a portion of the corpus (i.e. a Mallinckrodt power). This is considered a power over corpus and therefore satisfies § 678(b). Under § 678(a)(2), when the withdrawal right is "partially released or otherwise modified," grantor trust status continues as to the beneficiary, so long as the beneficiary holds a power under §§ 671-677 that, if held by the creator or settlor of the trust, would create a grantor trust as to the creator or settlor. Application of § 678(a)(2) necessarily requires that §§ 671-677 be read in the context of § 678, meaning that as long as no one other than the beneficiary otherwise possesses a power under §§ 671-677, the beneficiary will be treated as the grantor of the trust for income tax purposes. See PLR 9311021.

(1)Power to Substitute Assets under § 675(4)(C)-If a creator retains a right to substitute assets of equivalent value as described in § 675(4)(C), then the trust is treated as a grantor trust to the creator. If a beneficiary has the withdrawal right as discussed above, and that right is partially released or otherwise modified, and the beneficiary has the right to substitute assets of equivalent value as described in § 675(4)(C), the beneficiary will be treated as the grantor of the trust, as long as the creator is not otherwise treated as the grantor. PLR 9311021. The language in § 678(a)(2) leads the reader to believe that the same person whose withdrawal right lapses should be the person who holds the power under § 671-677. Therefore, a B-IDGT in this situation is different than a Settlor IDGT, because in that case, any person can have the power to substitute under § 675(4)(C).

(2)Power Over Income under § 677-If a beneficiary has a right to distribute income to himself or others without the approval or consent of any adverse party, he would be considered the owner of that portion of the trust over which he has a power to distribute income. § 677. As a beneficiary of a trust, the beneficiary presumably has a right to the income. If the beneficiary is the Trustee then the right to income will fall under § 677. With the right to income and the lapse of the power to vest corpus, the trust would be a grantor trust as to the beneficiary, as long as the creator was not otherwise treated as the grantor under §§ 671-677. PLR 9450014.

d. Comparing the Settlor-IDGT to Beneficiary-IDGT

The difference between the two IDGTs is obvious. The Settlor IDGT provides flexibility to allow taxpayers to transfer assets out of their estate, thereby removing the underlying asset and the asset's future appreciation from the taxpayer's estate, while utilizing a portion of the taxpayer's remaining lifetime gift exemption. The taxpayer may also transfer assets out of their estate for sufficient consideration and remove the future appreciation of the assets from the taxpayer's estate. The client can maintain control of the asset by serving as Trustee, but cannot benefit from the trust. However, many clients are interested in estate planning and reducing estate taxes, but do not want to give up the benefits of the assets and any future appreciation therefrom. The Beneficiary IDGT provides the flexibility to allow taxpayers to transfer the assets out of their estate for sufficient consideration, limit the appreciation that is in the taxpayer's estate, and still benefit from any future appreciation that is captured inside the Beneficiary IDGT as a beneficiary.

e. IDGT Taxation

As stated above, a properly drafted intentionally defective grantor trust will make the grantor liable for the income tax generated from the income of the trust. The tax liability belongs to the grantor, not the trust. However, it is possible to give the trustee of the intentionally defective trust, so long as such trustee is not related or subordinate to the grantor as defined in § 672, the sole and absolute discretion to make distributions to the Internal Revenue Service (or similar state agency) in order to satisfy any federal or state income tax liability incurred by the grantor which is attributable to income of the intentionally defective grantor trust. Revenue Ruling 2004-64; PLR 200120021.

6. Charitable Giving Issues.

a. Valuation of Charitable Gifts

Oil and gas interests are not the ideal assets to donate to charities. One reason for this is the need for proper valuations of the interests being donated. In order to receive an income tax charitable deduction for a gift of an oil or gas interest, donors must comply with certain appraisal requirements. The fair market value of the mineral interest on the date of the gift, as to which a deduction of more than $5,000 is claimed, must be determined by a "qualified appraisal" that follows all the rules set by the IRS. See Treas. Reg. § 1.170A-13(c).

The qualified appraisal allows donors to obtain the desired income tax charitable deduction. It is important to keep in mind that the IRS will not permit a charitable deduction without the appraisal. In order to be a "qualified appraisal," the appraisal must be made not earlier than sixty days prior to the date of the contribution of the appraised property, be prepared, signed, and dated by a qualified appraiser, include certain required information regarding the appraised property, and not involve a prohibited appraisal fee. These requirements are set forth in Reg. §§ 1.170A-13(c)(3)(A)–1.170A-13(c)(3)(D).

When claiming the deduction for a contribution of a mineral interest, donors must attach an appraisal summary (IRS Form 8283) to the income tax return on which they first claim the deduction. The appraisal summary must be signed and dated by the donee charity, be signed and dated by the qualified appraiser, and state the appraised fair market value of the property on the date of contribution. Subsequently, should the charity sell, exchange, or otherwise dispose of any property for which the charity signed an appraisal summary within three years of the date of gift, the charity must then file an information return (IRS Form 8282) to report the amount received on the disposition. Should the amount claimed by the donor as a deduction (based upon the value reported on Form 8283) significantly exceed the amount received by the charity to dispose of the property (as reported on Form 8282), the IRS could have grounds to question the validity of the donor's claimed deduction.

b. Partial Interest Rule

Another drawback of making charitable gifts of oil and gas interests is the application of the partial interest rule. Under the partial interest rule, a charitable deduction usually is not allowed if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a non-charity for less than full and adequate consideration. For example, where a donor owns a fee simple mineral interest, the contribution of the property to charity where the donor retains a life estate or the remainder interest in the property is not deductible under the partial interest rule. See Reg. § 1.170A-7(a)(2). Notwithstanding this general rule, certain exceptions to the "partial interest rule" do exist, including the deductible contribution of an undivided portion of a taxpayer's entire interest in property. In general, donors of mineral interests must either contribute their entire interest or an undivided fraction or percentage of their entire interest in order to claim a deduction for their gift. Donors often mistakenly believe that they can retain the mineral rights while gifting the surface. Unfortunately, the retention of the mineral interests in the gifted property will cause the gift to be one of a partial interest for which the donor will not be allowed a deduction.

c. Unrelated Business Income Tax

Because royalties are considered passive income, the income is generally not subject to unrelated business income tax (UBIT). Sec. 512(b)(2). In a series of rulings, the IRS has held that the royalty income is not subject to UBIT as long as the "royalty interest" is not really a "working interest" controlled by the charity (i.e. the charity is liable for operational expenses associated with developing the minerals). Rev. Rul. 69-179; PLR 7741004. The IRS has also said that it will not permit charities to characterize income from a working interest as a royalty to avoid UBIT. Rev. Rul. 69-192.

B. Types of Transfers

1. Gift

a. Annual Exclusion Gifts

(1)An Annual Exclusion Gift is defined in IRC § 2503(b), and allows a donor to make a gift each year to individuals that, if not over a certain amount, will not be a taxable gift. This gift can be given each year. During 2020, the amount is $15,000 per beneficiary.

(2)Sometimes trusts are funded with annual exclusion gifts (i.e., $15,000 {as increased for inflation} per donee per year or $30,000 {as increased for inflation} per donee per year if two Grantors) from Grantor. These gifts often are made to Irrevocable Life Insurance trusts to pay life insurance premiums or to irrevocable asset trusts for grandchildren for education.

(3)Qualification as present interest gift-Transfer to trust qualifies as a present interest gift subject to annual exclusion if:

(a) A beneficiary ("Crummey Beneficiary") may withdraw property given to trust for a period of time following a gift ("Crummey Withdrawal Power");

(b) <u>Crummey Beneficiary</u> does not exercise withdrawal power and allows power to lapse.

(c) Amounts over $5,000 or 5% of the trust corpus given to the trust must be subject to a continuing power of appointment in favor of the beneficiary to avoid a gift as a result of the beneficiary's failure to withdraw.

(1)Annual Exclusion Gifts of Limited Partnership Interests-a scheme that many practitioners use or have used in the past is to obtain an appraisal of limited partnership interests (discussed below) and give limited partnership interests to a trust equal to the value of the annual exclusion amount ($15,000 per beneficiary in 2020) and reporting the gift as an annual exclusion gift. There are recent cases ruling that limited partnership interests may not qualify for annual exclusion gifts, so be cautious in using this strategy. See Price v. Commissioner, T.C. Memo 2010-2. To ensure that the limited partnership has value to the transferee, consider providing a right of first refusal in the partnership or the other limited partners that can be exercised at fair market value of the partnership interest.

b. Taxable Gifts

(1)A taxpayer may decide to make a "taxable gift" to a trust, which would be considered a gift in excess of the annual exclusion amount.

(a) The federal gift tax is a tax on the privilege of transferring property during life.

(b) The tax is assessed based upon the value at the date of the gift of the property given.

(c) The federal gift tax is generally payable on April 15 of the year following the year of the gift.

(2)Just because a gift is in excess of the annual exclusion amount, and is considered a "taxable gift," does not mean that a gift tax will be due. A Unified Credit Against Gift Tax is provided for in IRC § 2505 and reduces the gift tax due by the amount of tax calculated under § 2502(a)(2) for a $5,000,000 gift. In laymen's terms, this means that over a taxpayer's lifetime, as of 2020, a taxpayer can give gifts over the annual exclusion amount equal to $11,580,000 (indexed), cumulative, without paying a gift tax.

(3)In 2020, the gift tax rate is the highest income tax rate, which is currently 40%. Many practitioners are discussing with clients the possibility of making large gifts and paying a gift tax as opposed to waiting until new legislation is passed which will raise the gift tax rate or create a new estate tax rate, both of which could be higher than 40%. Economically it is an option that should be explored with clients.

c. Generation-Skipping Transfer Tax

The Generation-Skipping Transfer Tax - a flat tax is imposed upon transfers to person two generations or more below the donor ("skip persons") which is in addition to the gift or estate tax**.** The tax was repealed in 2010 under the 2001 Act, but was reinstated in 2010, for years 2011-2012 and then made "permanent" in 2012. Under the 2017 Act, if gifts are made to a trust in which skip persons are potential or actual beneficiaries, an exemption is allowed up to a certain amount ($10,000,000; indexed – 2020: 11,490,000) against the generation-skipping transfer tax. This exemption would be deemed allocated on the gift tax return when gifts were made and could be used during life or upon death. Although an annual exclusion gift may not use a portion of the unified credit, as explained above, generation-skipping transfer tax exemption would need to be applied to the gift, depending on the type of trust the gift was made too.

d. Defined Value Gifts

Another type of gift that may be used, which would likely be in the form of a "taxable gift," is a gift using a "defined value clause" to an irrevocable trust. In this strategy, the taxpayer determines how much gift tax the taxpayer wants to pay or how much unified credit the taxpayer wants to use and makes a "defined value" gift of property in the amount of $X to the irrevocable trust, with the remainder of the property going to another place. To decrease the gift tax exposure, the remainder can go to charity, or may go to a grantor retained annuity trust (not discussed in this outline). These types of gifts have been "blessed" by the courts (at least when charity receives the remainder) and are used primarily with difficult to value assets such as limited partnership interests and limited liability company interests. Upon audit, if the value of the property is considered to be higher than reported on the gift tax return, the irrevocable trust does not receive anymore assets, but the amount of the gift "deemed" to be made to the charity or grantor retained annuity trust is increased, resulting in the gift tax not being increased. The key to this strategy is that the GRAT (or charity) must have an independent third party (not related or subordinate under Section 672) that is appointed as the Valuation Trustee to ensure that the value of the assets transferred to the GRAT (or charity) are valued at fair market value. See McCord v. Comm'r, 461 F.3d 614, (5th Cir. 2006) and Petter v. Commissioner, TC. Memo. 2009-280. Based on these types of gifts, the assets "actually received" by each donee is determined by an independent agreement between each donee (i.e. the irrevocable trust and the charity or grantor retained annuity trust). The donees agree on the value of the assets and the assets are allocated accordingly.

However, practitioners would be wise to carefully draft defined value causes so as to prevent an argument that the provision was a "savings clause"–adjustment clauses requiring that any gift subject to Gift Tax revert back to the donor. See C.I.R v. Procter, 142 F.2d 824 (4th Cir. 1944); McCord v. Commissioner, 120 T.C. 358 (2003), rev'd sub nom. Succession of McCord v. C.I.R., 461 F.3d 614 (5th Cir. 2006); Petter v. C.I.R., 98 T.C.M. (CCH) 534 (T.C. 2009) aff'd sub nom. Estate of Petter v. C.I.R., 653 F.3d 1012 (9th Cir. 2011); Wandry v. C.I.R., 103 T.C.M. (CCH) 1472 (T.C. 2012); King v. United States, 545 F.2d 700 (10th Cir. 1976). The transfer in Procter is illustrative of the savings clause dilemma. In Procter, the transfer clause stated that to the extent the value of the transfer was later held to be more than what was intended, the excess property was deemed not to be included in the conveyance. The Fourth Circuit held that the clause operated to reverse a completed transfer, and therefore was contrary to public policy because: (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment. Procter at 827. In the March 2012 Tax Court Memorandum, Wandry v. Commissioner, T.C. Memo 2012-88, the United States Tax Court blessed the use of defined value clauses, holding that "[a] savings clause is void because it creates a donor that tries 'to take property back.' On the other hand, a formula clause is valid because it merely transfers a 'fixed set of rights with uncertain value.' The difference depends on an understanding of what the donor is trying to give away." While the distinction is subtle, practitioners must know the distinction in order to prevent drafting a clause that will later be held invalid. The significance of Wandry is not only a blessing by the Tax Court regarding formula clauses; it is the first case where the clause at issue does not involve charities, third parties or other entities as beneficiaries of the amount over the defined value. This being said, Wandry was a Memorandum Opinion, not binding on courts or other parties to similar disputes. In October 2012, the IRS voluntarily dismissed its appeal of Wandry, thereby putting the validity of formula clauses still at issue. However, in November 2012, the IRS issued Action on Decision 2012-004, 2012-46 IRB, 11/13/2012, in which the IRS stated a Nonacquiescence in the Wandry decision. In the June 2020 Tax Court Memorandum, Nelson v. Commissioner, T.C. Memo 2020-81, the Tax Court rejected taxpayer arguments for treating a transfer as defined value gift where the transfer documents failed to describe the gift in terms of the "value as finally determined for Federal gift tax purposes," but instead defined the gift as a value determined by an appraisal to be obtained within a specified period of time. Like Wandry, Nelson was a Memorandum Opinion, not binding on courts or other parties to similar disputes. In King v. United States, the taxpayer used a clause similar to that in Procter. The clause in King provided that if the IRS ever determined that the fair market value of certain stock, which was sold by the taxpayer to trusts created for the taxpayer's children, was different from the sale price then the price would be adjusted to match the IRS's valuation. The Tenth Circuit, holding for the taxpayer, agreed with the district court that "there was an intention to cause the trusts to pay full and fair consideration for the stock and to make an actual adjustment of the price paid upon the determination by the IRS." Therefore, there was no completed gift by the taxpayer and no Gift Tax due by the taxpayer. It is worth noting that the court in Wandry, which was also decided in the Tenth Circuit, did not find King to be controlling because the clause in Wandry, a "defined value clause," differed to greatly from the clause in King, a "price adjustment clause."

2. Sales

a. As opposed to a gift, a grantor may want to sell the desired asset to an IDGT (one containing one or more of the grantor trust powers listed above) in a sale transaction in exchange for an installment note, self-canceling installment note or private annuity. In this manner, the grantor is able to transfer the future appreciation of the asset without income or gift tax consequences. The reason this is an attractive option as opposed to a gift is 1) the grantor does not have to use as much of the gift tax unified credit or pay as much gift tax, and 2) the taxpayer receives consideration for the transfer.

b. Installment Sale Requirements

(1) If the IDGT promissory note sale technique is to be effective and not treated as a transfer with a retained life estate causing estate inclusion under IRC § 2036(a)(1) or a transfer with a retained interest under § 2702, the transaction must be structured as a bona fide sale for full and adequate consideration. The sales transaction should satisfy the following:

(a) The rate of interest under the promissory note should not be based upon the income generated by the asset sold.

(b) The obligation under the promissory note should not be charged to the transferred property.

(c) The promissory note should be a personal obligation of the purchaser.

(2) The first test is satisfied from the use of the AFR. Further, the Tax Court has held that if a note that is given in exchange for property carries an interest rate equal to the AFR and is equal in value to the amount of the property sold, then the note is equivalent to the property. Frazee v. Commissioner, 98 T.C. 554 (1992).

(3) Coverage - In order for the installment sale to be respected as a bona fide sale, the IDGT must have "independent 'economic' significance." That is, for the trust to be respected, the trust must have sufficient assets such that an independent third party would transact with the trust. The greater the value of assets within the IDGT, the better. There is no bright-line test as to how much coverage is sufficient. However, the Service has indicated informally that other assets equal in value or exceeding ten percent (10%) of the purchase price should be sufficient coverage for "independent 'economic' significance." Coverage or "independent significance" is created by either a taxable gift by the grantor bank letter of credit or personal guarantee by the trust beneficiaries or a third party. The Service has indicated that a personal guarantee by the beneficiaries is effective to avoid application of § 2036(a)(1) to the seller, so long as the guarantors have sufficient assets to support the guarantee. PLR 9515039.

c. When to Consider the IDGT Sale Transaction

(1) In most wealth migration transfers the goal is to reduce or freeze the value of the grantor's estate and shift future income and growth out of the estate. With this goal in mind, the IDGT sale transaction should be considered when the grantor owns an appreciating asset. In addition to the appreciating asset, the discounted asset (limited partnership interests, non-voting membership interests, minority stock, non-voting stock and undivided interests) are key assets to transfer. When identifying the asset to be transferred, it is necessary for the asset to produce cash flow, the IDGT to have existing cash flow or other assets be available for distribution in kind so that payments can be made by the trust on the promissory note, SCIN or private annuity.

(2) Consideration - The asset to be sold to the IDGT can be sold in exchange for a promissory note, self-canceling installment note, or private annuity.

(a) Promissory Note - If a standard promissory note is used, the asset is sold to the IDGT in exchange for the promissory note secured by the IDGT assets. The note would provide for periodic (at least annual) payments. Income generated by the asset sold or other IDGT assets would be utilized to make the note payments.

(b) Self-Canceling Installment Note - An additional payment mechanism for use with an IDGT sale is the self-canceling installment note or "SCIN." The SCIN is an installment note that contains a provision under which the buyer's obligation to pay automatically ceases in the event a specified person, called the measuring or reference life, dies before the end of the term of the note. Income generated by the asset sold or other IDGT assets would be utilized to make the SCIN payments. The SCIN can be an effective means of transferring property to family members without estate or gift tax consequences in the event of the death of the seller-transferor before the last payment has been made under the terms of the installment note.

(c) Private Annuity - Under a private annuity an agreement is executed between the transferor/annuitant and the transferee/buyer (the IDGT). The agreement requires the transferee/buyer, in exchange for the transfer, to make periodic payments to the transferor/annuitant for the lifetime of an individual (usually the lifetime of the transferor or the transferor and transferor's spouse). The private annuity is a useful federal estate tax savings tool because payments end when the transferor dies and the entire value of the asset sold is immediately removed from the transferor's gross estate. Income generated by the asset sold or other IDGT assets would be utilized to make the annuity payments.

d. Tax Consequences of IDGT/Sale Transaction

(1) Federal Income Tax- When a grantor enters into a transaction with a trust under which he or she is deemed the owner for income tax purposes, and therefore all items of income and deduction related to the transaction are attributed to the grantor, the result is a none taxable event. Rev. Rule 85-13; Rothstein, supra. Specifically, the sale of stock by a grantor to a grantor trust for a note will not give rise to taxable income. PLR 9535026. Note also that neither the sale of property by one spouse to the other's spouse's grantor trust, nor the sale of property by one spouse's grantor trust to the other spouse's grantor trust, would be taxable as a sale for income tax purposes. PLR 201927003. Further, the sale of assets by one trust deemed owned by a beneficiary under Code Sec. 678 of the grantor trust rules, to another trust deemed owned by that same beneficiary under Code Sec. 671 of the grantor trust rules, was not a taxable event for income tax purposes. PLR 202022002. Remember, however, that the grantor is taxed on all income earned by the assets of the trust.

(2) Federal Gift Tax-Except for the initial coverage gift, there are no gift tax consequences to the grantor under the IDGT sale transaction. However, the grantor trust rules require that the income tax generated by the trust assets be payable by the grantor. Because the income will not be actually distributed to the grantor to pay the taxes, the grantor's estate is reduced by the amount of the tax while the trust is enhanced by such amount. This result does not sit well with the Service. In the GRAT context in PLR 9444033 the Service implied that the grantor's payment of the income taxes could represent a gift to the remaindermen and a constructive addition to the trust for generation-skipping transfer tax purposes. Later, in PLR 9543049, the Service withdrew the implication without comment. It is clear from the language of § 671 that the grantor has the legal obligation for the payment of the tax. The Service's position has neither statutory nor regulatory authority.

(3) Federal Estate Tax-The primary goal of the transaction is to shift future appreciation from the estate (estate freeze)

(a) Promissory Note – If the grantor dies while the promissory note remains outstanding, the value of the balance of the note will be includable in the grantor's gross estate. The taxation that occurs when the grantor dies and still holds an unpaid promissory note can be summed up in four words: avoid it if possible! If possible, it is wise for the IDGT to pay off any promissory note owed to the grantor prior to death. This, of course, cannot always be accomplished. The Internal Revenue Code ("IRC") does not does not provide clear guidance on the issue; thus, there are several theories regarding the income tax results at the death of the grantor if the promissory note has not been paid. The issue to be determined is when, for income tax purposes, did the transfer of the assets received for the promissory note from the grantor to the grantor's estate occur.

i. If the transfer is deemed to have occurred immediately prior to death, the assets deemed transferred to the trust should not receive a basis step-up under § 1014(a) because they were not owned by the grantor at his death. Therefore, gain is reported on the decedent's final income tax return to the extent the value of the note exceeds the decedent's basis in the property sold to the IDGT as income in respect of a decedent, unless (ii) immediately following applies.

ii. If the transfer is deemed to have occurred immediately prior to death, as in (i) immediately above, and the sale would qualify for installment treatment under IRC § 453, gain or loss is reported on the decedent's final income tax return and the decedent's estate's annual income tax return as payments of the note are received. In this instance, gain would be deemed income in respect of a decedent and no basis adjustment would occur.

iii. Perhaps the most aggressive theory argued by some commentators is that the transfer occurs contemporaneously with death, and results in both the trust assets and the note receiving a step-up in basis to fair market value, resulting in no gain or loss either on subsequent note payments to the estate or subsequent disposition by the trust of the trust assets. Pursuant to the rationale in *United States v. Land*, 303 F.2d 170 (5th Cir. 1962), one must look at the instant of death as the triggering event. This leads to the conclusion that a transfer could not have occurred immediately prior to death, but "by reason of death." Therefore, since the seller of the property is not the decedent but his or her estate, the provisions of IRC § 1014(a) would apply to revalue the basis of the asset, and presumably the note, and no gain or loss would apply. Section 1014 of the IRC, however, suggests that the trust assets would not receive a basis adjustment in this situation. Section 1014(a) provides a step-up in basis to one "acquiring the property from a decedent or to whom the property passed from a decedent." Section 1014(b) delineates the circumstances in which property has been acquired from or passed from a decedent, one of which includes acquisition by "bequest, devise, or inheritance," suggesting that the asset must pass under the decedent's will or under intestacy, which does not occur. In addition, such a disposition would require the grantor to have sufficient rights over the trust property to cause it to be included in his or her gross estate, which would defeat the purposes of transferring assets to the trust.

iv. Finally, there is the theory that the transfer occurred when the assets were transferred to the trust. Therefore, at the decedent's death, the estate only owns a promissory note, which receives a step-up in basis, and the trust assets are owned by the trust at the decedent's death, resulting in no step-up in basis treatment. This is a logical position a practitioner could take because it acknowledges the transaction as a completed transfer for transfer tax purposes by the grantor. Rev. Rule 85-13 holds that the grantor is treated as the owner of the grantor trust, and therefore, transactions between the two should be disregarded for all income-tax purposes. Pursuant to the Rev. Rule 85-13 reasoning, this theory surmises that although the transfer is disregarded for income tax purposes (i.e. the trust assets take on the grantor's basis when transferred), the trust assets are considered to be owned by the trust for transfer tax purposes at the outset of the transfer, which occurs during the grantor's life. As a result, because the trust assets are owned by the trust for transfer tax purposes, the trust assets do not qualify for § 1014 step-up basis treatment at the grantor's death. However, because the note is owned by the decedent at death for transfer tax (i.e. estate tax) purposes, the note receives a § 1014 basis adjustment to fair market value at decedent's death. See Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. Tax'n 149 (2002); Deborah V. Dunn and David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J. Tax'n 49 (2001); Sederhaun and Hunder, *Reversal of Fortune: The Use of Grantor Trust in Estate Planning*, The Chase Journal, VII, issue 4 1998.

(b) SCIN - The value of the self-canceling installment note is zero in the grantor's gross estate if he or she dies during its term; however, the grantor must realize unrealized gain on his or her first estate income tax return as a cancellation of an installment obligation.

(c) Private Annuity - The value of the private annuity is zero in the grantor's estate upon his or her death (and no income tax.) Remember, the private annuity has no term other than the life of an individual(s) so if the grantor lives longer than his or her actuarial life there is more value in the grantor's estate than under the promissory note or SCIN.

e. Special Considerations for Settlor or Beneficiary IDGT Sale

The audit risk in a sale to a Settlor IDGT by the grantor is that the value of the assets sold will be increased upon audit by the IRS and the consideration given will not have been adequate. In this case, a gift will be considered made to the IDGT in the amount of the difference between the new valuation and the consideration paid. The gift tax consequences are potentially less troublesome in a situation where a B-IDGT is used and the value is questioned and challenged upon IRS audit, but the estate tax issues are more troublesome. If a sale is made by the tax-grantor/primary beneficiary to a B-IDGT, and the value of the asset is challenged and the IRS is successful, the gratuitous transfer deemed made by the tax-grantor/primary beneficiary will typically be considered to be an incomplete gift to the B-IDGT if the tax grantor/primary beneficiary possesses authority to distribute or appoint trust property to himself and others (if to others resulting in incremental gift by tax grantor/primary beneficiary). In this situation, you would be confronted with having a portion of the B-IDGT assets subject to inclusion in estate of the tax grantor/primary beneficiary therefore creating an estate tax issue that would not be present with the use of a Settlor IDGT. As discussed earlier, unlike the GRAT or GRUT the IDGT sale is not specifically authorized under the code. Rather, the transaction theory is established utilizing the grantor trust rules under §§ 671 – 678 and the excludability of transfers for full and adequate consideration for gift and estate tax purposes. Additionally, there is very little case law guidance on the IDGT sale.

f. Defined Value Clause

A grantor may use a defined value clause to sell a "defined value" in the amount of $X worth of assets to the S-IDGT or B-IDGT and gift the remainder to a zeroed-out GRAT (not discussed in this outline) or charity. If the

GRAT is used, it pays an annuity to the grantor for X number of years and at the end of the term, the GRAT distributes any assets to the remainder beneficiaries. If a charity is used, there is no gift tax on the gift of the remainder. If the GRAT is used, because the GRAT is a zeroed-out GRAT, the gift tax consequences are nominal. Upon audit by the IRS, if the value of the transferred asset is challenged and subsequently increased, the same dollar amount of the asset is sold to the S-IDGT or B-IDGT (i.e. the "defined value") and the remainder gift to the GRAT or charity is "deemed" increased. Because of the nature of the GRAT, the annuity amount increases and the gift amount subject to gift tax remains approximately the same. The key to this strategy is that the GRAT (or charity) must have an independent third party (not related or subordinate under § 672) that is appointed as the Valuation Trustee to ensure that the value of the assets transferred to the GRAT (or charity) are valued at fair market value. The Valuation Trustee must be an individual or entity with sufficient knowledge to form an educated opinion as to the valuation methods employed by the independent appraiser. Keep in mind, the same concerns regarding defined value clauses and savings clauses apply in the sale context. Therefore, practitioners need to be mindful of how the clause is drafted in order to prevent the clause later being held invalid.

3. Limited Partnership or Limited Liability Company

a. Profits Interest

A strategy that has been used in the past to transfer wealth to lower generation is creating a limited partnership and granting a profits interest (as opposed to a capital interest) to a lower generation. A profits interest is a partnership interest that provides the owner the benefit of the partnership's future earnings and appreciation, but the profits interest holder does not have a capital interest on the date the profits interest is granted. This strategy will work for an unrelated employee of the partnership, but may have gift tax consequences under IRC Section 2701 if granted to a person who is related to the grantor of the profits interest.

b. Section 2701

Section 2701 applies anytime a family member transfers an interest in a corporation or a partnership to a member of the transferor's family, but retains an applicable retained interest. An applicable retained interest is defined as an interest in an entity with a distribution right or a liquidation, put, call or conversion right. IRC 2701(b)(1). In this context, Section 2701 would apply if a profits interest was granted but the family member grantor retained a distribution or liquidation right to receive priority upon liquidation for the grantor's capital account. If the grantor retains an applicable retained interest, the profits interest is treated as a gift. The value of the gift is determined using the subtraction method with the applicable retained interest being valued at zero. Section 2701(a)(3). Essentially, a gift is reported of the entire value of the limited partnership assets.

There are exceptions to the result of Section 2701 (which means no gift tax).

(a) If the retained interest is of the same class as the transferred interest, Section 2701 shall not apply. IRC Section 2701(a)(2)(B);

i. A interest is of the same class if the rights are identical to the rights of the transferred interest, except for non-lapsing differences in voting rights. Treas. Reg. Section 25.2701-1(c)(3).

(b) Section 2701 does not apply to the issuance of a profits interest to the extent it results in a proportionate reduction of each class of equity interest held by the transferor and all applicable family members. Treas. Reg. Section 25.2701-1(c)(4).

c. Proposed Terms of Limited Partnership

(1) A method that could be used to hedge against the effects of Section 2701 related to profits interests and family members is to consider using a limited partnership where some partners contribute capital and others do not, but all partnership interests have the same rights (even though the opening capital account balances differ). The terms of the partnership agreement would provide that all limited partnership interests have the same rights and liquidate based on positive capital account balances. It may be necessary to require the non-capital contributing partner to be a partner for a set time period, one to two years, before the interest would vest. In this manner, all partners have the same rights and interests upon the creation of the partnership, or if a new partner is admitted without any capital contribution, upon the admittance of the new partner.

(2) Example-Taxpayer owns non-producing mineral interests valued by a qualified appraiser at $2,000,000. In Year 1, Taxpayer creates a tax partnership with his two sons. Taxpayer contributes the non-producing mineral interests to the partnership and takes back a 20% partnership interests. Each of Taxpayer's sons takes a 40% partnership interest. The partnership interests owned by all partners have the same voting rights, share proportionally in profits and losses and liquidations are based upon positive capital accounts. On the date of creation, Taxpayer's capital account is $2,000,000 and each of his son's capital accounts is $0. Sons are

responsible for leasing the minerals. In Year 2, the partnership signs a mineral lease, receives a $250,000 lease bonus, and retains a royalty interest. In Year 3, the minerals begin to produce and the royalty income for Year 3 is $750,000. Year 4, Year 5, Year 6 and Year 7 have royalty income of $700,000, $700,000, $675,000 and $650,000, respectively. At the end of Year 7, the capital accounts of the limited partners are as follows:

	Taxpayer CA	Son #1 CA	Son #2 CA	Capital Additions
	20%	40%	40%	
Year 1	$ 2,000,000	$ -	$ -	$2,000,000
Year 2	$ 2,050,000	$ 100,000	$ 100,000	$ 250,000
Year 3	$ 2,200,000	$ 400,000	$ 400,000	$ 750,000
Year 4	$ 2,340,000	$ 680,000	$ 680,000	$ 700,000
Year 5	$ 2,480,000	$ 960,000	$ 960,000	$ 700,000
Year 6	$ 2,615,000	$ 1,230,000	$ 1,230,000	$ 675,000
Year 7	$ 2,745,000	$ 1,490,000	$ 1,490,000	$ 650,000

At the end of Year 7, the capital accounts are $2,745,000, $1,490,000 and $1,490,000 for the Taxpayer, Son #1 and Son #2, respectively. This is assuming no distributions were made during that time period. Under this scenario, Taxpayer has shifted $2,980,000 from his estate without any gift, estate or income taxes, and Sons have earned value through their interests and efforts toward leasing the minerals on behalf of the partnership.

(3) Caveat-In regards to mineral interests, if successful, this strategy will only be successful with non-producing minerals. It is clear that this type of partnership cannot be created with minerals that are already producing. Rev. Proc. 93-27 states that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership" Further, "this revenue procedure does not apply if the profits interest relates to a <u>substantially certain</u> and <u>predictable stream of income</u> from partnership assets, such as income from high-quality debt securities or a high-quality net lease…" Based on this Rev. Proc., the benefits of this type of partnership would not be available for producing minerals because there would exist a taxable event upon the grant of such an interest. If the minerals are non-producing, and a lease is not in place, then it is more likely that this type of limited partnership would work, especially if the owner of the "profits interest" was responsible for finding and securing a mineral lease for production.

C. Valuation Issues

1. Introduction

When a transfer of an asset is made, whether by gift or sale, an appraisal or valuation has to be performed on the asset to determine the value of the asset being transferred, either for reporting on a gift tax return or for determining that the asset was sold for Fair Market Value. Fair Market Value is defined as the "price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open market and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."[1]

[1] American Society of Appraisers, Business Valuation Standards, Glossary

2. Mineral Interests

Mineral Interests must be appraised by an appraiser who is qualified to value mineral interests. The person is usually a petroleum engineer and has methods of placing a value on producing and non-producing minerals.

3. Limited Partnership Interests and Limited Liability Company Membership Interests

Before an interest in a limited partnership or limited liability company can be appraised, the assets owned by the limited partnership or LLC must be appraised. If the assets are publicly traded securities or cash, there is no issue with the value. But if the assets are mineral interests or real estate, these assets must be appraised as discussed above. Once the underlying assets have been appraised, the limited partnership interests are appraised by a Qualified Appraiser, usually someone different than the individual who appraised the mineral interests. The Qualified Appraisal will consider certain factors when valuing the interests:

a. Control

In general, limited partners have restricted, if any, control over the business and operations of the partnership. The General Partner is the person or persons who have the ability to control the operations and the limited partner is generally in an investment position. There are certain decisions that a limited partner may be involved with, but these decisions are limited, and based upon the terms of the limited partnership agreement, which will determine how much or how little control a limited partner has. Because of this lack of control over the operations of a limited partnership, limited partnership interests are usually discounted by certain rates due to the lack of control that is inherent in the limited partnership. Certain provisions, as discussed above will affect this lack of control discount. Also, the percentage of the interest being transferred will determine if there is a discount and if so, how much. For limited liability company membership interests, many companies issue voting and non-voting interests. Non-voting interests have no voting rights, but only get to share in the economic benefits of the company. They have no control over the operations and therefore have less value than voting interests.

b. Marketability

Transfers of limited partnership interests are usually restricted by the limited partnership agreement. Additionally, there is a very limited and specialized market, if any, for limited partnership interests. Moreover, private, non-registered limited partnership interests do not trade on recognized exchanges. Due to this lack of transferability and a market, limited partnership interests generally receive a discount for lack of marketability. Factors that affect this discount, besides for the lack of an open market, are provisions in the partnership agreement providing restrictions on transferability, the ability to withdraw capital or withdraw from the limited partnership, and values of the partnership interests that may be predetermined in the partnership agreement. These same type of factors affect the value as membership interests.

IRC Section 2704

The Treasury Department has issued proposed regulations that would amend IRC § 2704 to reduce or eliminate discounts for lack of control and lack of marketability if the discounts were applied to obtain the value of an interest transferred to a member of the transferor's family. However, the Treasury Department has selected this proposed regulation as one of eight regulations that must either be streamlined or fully repealed based on President Trump's Executive Order 13789 which was intended to eliminate regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the Internal Revenue Service (IRS). Notice 2017-38, 2017-30 IRB. Ultimately, the proposed regulations were withdrawn as of October 20, 2017.