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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

JUDITH BADGLEY,
Plaintiff,
v.
UNITED STATES OF AMERICA,
Defendant.

Case No. 17-cv-00877-HSG

**ORDER GRANTING DEFENDANT'S
MOTION FOR SUMMARY JUDGMENT
AND DENYING PLAINTIFF'S MOTION
FOR SUMMARY JUDGMENT**

Re: Dkt. Nos. 44, 46

United States District Court
Northern District of California

On January 23, 2017, Plaintiff Judith Badgley, as Executor of the Estate of Patricia Yoder (“the Estate”),¹ filed this action against Defendant United States of America, seeking a refund for an alleged overpayment of \$3,810,004 in estate taxes under 26 U.S.C. § 7422. *See* Dkt. No. 8 (“FAC”) ¶¶ 4, 13. Currently pending before the Court are Plaintiff and Defendant’s cross motions for summary judgment. *See* Dkt. Nos. 44 (“Pl. Mot.”), 47 (“Def. Opp.”), 48 (“Pl. Reply”), 46 (“Def. Mot.”), 49 (“Pl. Opp.”), 51 (“Def. Reply”).² On January 4, 2018, the Court heard argument on the motions. After carefully considering the parties’ arguments, the Court **GRANTS** Defendant’s motion, and **DENIES** Plaintiff’s motion.

I. BACKGROUND

Unless otherwise noted, the facts set forth in this section are not disputed. As necessary, the Court discusses further factual details in the course of its analysis.

¹ Because several individuals involved in this action share the surname “Yoder,” this Order refers to members of the Yoder family by their first names.
² Plaintiff requests that the Court take judicial notice of several other filings in this case. *See* Dkt. Nos. 45, 50. The Court **GRANTS** Plaintiff’s requests for judicial notice to the extent that the Court recognizes the existence of these publicly available documents.

1 **A. Factual Background**

2 In 1976, brothers Donald Yoder and H. Frank Yoder III created a partnership called Y&Y
3 Company (“Y&Y Co.”) to manage several parcels of California real estate. Dkt. No. 46-3
4 (“Badgley Dep.”), 17:4-12; Dkt. No. 46-6 (“Frank Yoder Dep.”), 9:8-17; *see also* Dkt. No. 44-2
5 (“Pl. Ex. A”). Donald was also a half partner in Yoder and Yoder, which he co-owned with his
6 father. Frank Yoder Dep., 18:2-7. Patricia Yoder was married to Donald. Dkt. No. 44-4 (“Pl. Ex.
7 C”) at 32. In 1982, Patricia and Donald created the D&P Yoder Revocable Trust, which held
8 Donald’s interest in both partnerships. Pl. Ex. C at 70; *see also* Dkt. No. 44-3 (“Pl. Ex. B”) at 25.
9 Donald died in 1990. Dkt. No. 46-4 (“Pamela Yoder Dep.”), 7:12-20; *see also* Pl. Ex. B at 25.
10 Patricia then became a one-half partner in both Y&Y Co. and Yoder and Yoder. Frank Yoder
11 Dep., 16:12-17. Y&Y Co. partnership documents dating to 1997 reflect this transfer of the
12 partnership interest from Donald to Patricia. *See* Pl. Ex. B; Frank Yoder Dep., 31:1-8.

13 By the 1990s, Y&Y Co. owned three multi-tenant parcels of real estate in Southern
14 California. Badgley Dep., 16:1-9; Pamela Yoder Dep., 27:12-19, 71:15-22. Y&Y Co. did not
15 acquire or sell any properties between 1998 and 2012. Badgley Dep., 30:23-31:3; Pamela Yoder
16 Dep., 32:21-24. Patricia became involved in Y&Y Co.’s affairs after Donald passed away in
17 1990. Badgley Dep., 60:2-19, 126:25-128:12. Yoder Development (now owned by Donald and
18 Patricia’s daughter, Pamela Yoder) managed the properties of Y&Y Co. from the 1980s onward.
19 Badgley Dep., 16:12-19, 18:9-15, 27:13-24; Pamela Yoder Dep., 16:2-17:15, 25:19-23; Dkt. No.
20 46-7 (“RFA”), RFA #2.

21 On February 1, 1998, Patricia created the Patricia Yoder Grantor-Retained Annuity Trust,
22 which she funded with her one-half partnership interest in Y&Y Co. Badgley Dep. 56:14-25; *see*
23 Dkt. No. 44-7 (“GRAT”), Schedule A (“Property Transferred and Delivered to the Trustee[,] 50%
24 partnership interest in Y&Y Company, a California general partnership[.]”). Patricia placed into
25 the GRAT the three properties that were owned by Y&Y Co. Badgley Dep., 56:20-25. The
26 transfer was not a bona fide sale, and no consideration was given in exchange for the transfer.
27 RFA #49. The GRAT states that Patricia Yoder was to receive annual annuity payments for the
28 lesser of fifteen years or her prior death (paid quarterly) equal to 12.5% of the date-of-gift value of

1 the property transferred to the GRAT. GRAT at 1-3. In 1998, the GRAT paid Patricia an annuity
2 in the amount of \$302,259 per year in quarterly payments, which represented 12.5% of the date-
3 of-gift value of the one-half Y&Y Co. partnership interest. GRAT at 2; RFA ##30-31.

4 Under the GRAT, the Y&Y partnership interest was to pass to Patricia's two living
5 daughters, Plaintiff and Pamela Yoder, on the completion of Patricia's annuity payments. Badgley
6 Dep., 59:7-60:1; *see* GRAT at 3; Def. Mot. at 5. The GRAT also states: "If the Trustor fails to
7 survive the Trust Term, the Trustee shall pay all remaining amounts due under the obligation to
8 pay the annuity as set forth herein together with the portion of the Trust Estate includible in the
9 Trustor's gross estate to the Trustee of the Survivor's Trust created under the D & P Yoder
10 Revocable Trust dated July 26, 1990."³ GRAT at 3. Plaintiff explains that "[t]he reason for the
11 GRAT was to enable Patricia to make a gift to her daughters Pamela and Judith of the GRAT
12 corpus remaining after paying Patricia a fixed annuity for a term of 15 years." Pl. Mot. at 11; *see*
13 Dkt. No. 44-25 ("Badgley Dep. 2"), 59:7-16. The GRAT provides that "[i]f at any time the
14 Trustor becomes unable or unwilling to act as Trustee, the persons listed below shall serve as
15 successor Trustees in the order named. First: Pamela A. Yoder[.] Second: Judith M. Badgley."
16 GRAT at 4; *see* Pl. Mot. at 11. Patricia signed the GRAT as Trustor and Trustee, and Judith and
17 Pamela signed as Special Trustees. Def. Mot at 5; *see* GRAT at 5-6.

18 At least as early as 2002, the income generated by the Y&Y Co. partnership was sufficient
19 to fund Patricia's quarterly annual annuity payments. *See* Dkt. No. 46-9 ("Def. Ex. 7"); Def. Mot.
20 at 6; Def. Reply at 3.⁴ Between 2002 and 2012, Y&Y Co. reported income of \$999,192 (2002),
21 \$1,119,383 (2003), \$1,120,283 (2004), \$1,197,510 (2005), \$1,319,704 (2006), \$1,306,287 (2007),
22

23 ³ Along with this fact, Defendant presents a graphic image that Defendant represents as showing
24 the relationship between the GRAT, the revocable trust, and the Yoders. *See* Def. Mot. at 4.
25 Plaintiff disputes Defendant's "graphic depiction of 'Y&Y Ownership 1998-D.O.D. (4:11-25)' to
26 the extent that it incorrectly shows Patricia Yoder as the trustee of the GRAT at the date of her
27 death." Pl. Opp. at 3-4. In this Order, the Court does not rely on Defendant's graphic depiction or
28 Patricia's status as trustee. Thus, these facts are not material even if they are disputed.

⁴ While Plaintiff disputes Defendant's characterization of income as "steady," Plaintiff does not
dispute the facts as stated by Defendant. *See* Pl. Opp. at 5. Plaintiff argues only that Y&Y Co.'s
income was unpredictable and did not match the annuity; Plaintiff does not disagree that this
income was always greater than the annuity payment during the operative time period. *See id.*;
Def. Reply at 3.

1 \$1,325,478 (2008), \$1,125,718 (2009), \$994,642 (2010), \$1,179,989 (2011) and \$1,219,227
 2 (2012); on the Forms K1 it issued to its partners, it allocated half of its income to the GRAT. *See*
 3 *id.*; Dkt. Nos. 46-10 (“Def. Ex. 8”), 46-11 (“Def. Ex. 9”), 46-12 (“Def. Ex. 10”), 46-13 (“Def. Ex.
 4 11”), 46-14 (“Def. Ex. 12”), 44-16 (“Pl. Ex. M”), 44-17 (“Pl. Ex. N”), 44-18 (“Pl. Ex. O”), 44-19
 5 (“Pl. Ex. P”), 44-20 (“Pl. Ex. Q”); *see also* Badgley Dep., 82:10-83:24;. Y&Y Co. also made cash
 6 distributions to the GRAT during this time that ranged from \$435,400 to \$730,000. *Id.* Patricia
 7 reported that the GRAT’s share of Y&Y Co. income was larger than her annual annuity of
 8 \$302,259. Def. Mot. at 7; *see* Dkt. Nos. 44-21 (“Pl. Ex. R”), 44-22 (“Pl. Ex. S”), 44-23 (“Pl. Ex.
 9 T”).⁵

10 Y&Y Co. distributions were paid to a bank account in the name of the GRAT. Badgley
 11 Dep., 82:10-83:24, 129:3-8. Patricia controlled that account. *Id.* Patricia used the account to
 12 make quarterly annuity payments to her personal accounts. Dkt. No. 46-8 (“Def. Ex. 6”) at 6-8, 11
 13 (Plaintiff’s Interrogatory Responses ## 3, 4, 6, 15). Patricia managed and invested the excess
 14 Y&Y Co. distributions after making GRAT annuity payments by transferring excess funds to
 15 other investment accounts. Badgley Dep., 96:16-24, 129:3-18. Patricia’s involvement with Y&Y
 16 Co.’s affairs stayed the same after she transferred her one-half interest in the GRAT.⁶ Pamela
 17 Yoder Dep. 73:13-25, 100:12-16; Badgley Dep., 127:15-23. For instance, Patricia assisted in
 18 hiring new office staff, and was authorized to make payments on behalf of Y&Y Co. Badgley
 19 Dep. 60:14-18, 126:25-128:23; Pamela Yoder Dep. 62:17-63:16, 67:23-69:20. In addition,
 20 Patricia had the authority to replace Pamela as property manager for Yoder Development. *See*
 21 Badgley Dep. at 128:13-129:2; Pamela Yoder Dep., 85:21-86:9. Patricia, at least in 2008,

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 24 ⁵ Plaintiff disputes this fact to the extent that Defendant suggests “that Patricia treated the income
 25 of Y&Y company as her money.” Pl. Opp. at 6. Defendant offers these facts to show only that
 26 Patricia received some personal benefit from Y&Y Co.’s income, even if the income is not
 27 technically “hers.” *See* Def. Reply at 3. Thus, to the extent that a dispute of fact exists, that
 28 dispute is not “genuine.”

⁶ Plaintiff presents an “important point of clarification” regarding Patricia’s involvement with
 Y&Y Co. after she transferred her interest to the GRAT. Pl. Opp. at 5. Plaintiff clarifies that from
 that point forward, Patricia acted “not in her individual capacity,” but rather in a fiduciary capacity
 as trustee. *Id.* This is not a dispute of material fact: Plaintiff’s distinction is not relevant to
 whether Patricia did *in fact* take these actions. Plaintiff similarly does not even characterize her
 own point as a “dispute.”

1 approved an increase in management fees paid to Yoder Development by Y&Y Co. Pamela
2 Yoder Dep., 51:2-52:7, 21:9-22:17.

3 Patricia died on November 2, 2012. Badgley Dep., 12:16-23. Patricia received her last
4 annuity payment from the GRAT on September 30, 2012, in the amount of \$75,564.75. Def. Ex. 6
5 at 11 (“Plaintiff’s Interrogatory Responses #15”). Patricia was hospitalized approximately two
6 weeks before her death. Badgley Dep., 67:15-17. The day before Patricia’s death, Judith and
7 Pamela obtained a letter from Dr. John Storch, MD, stating that Patricia could not manage her
8 financial affairs. Dkt. No. 44-14 (“Pl. Ex. L”); Badgley Dep., 68:12-69:23. No quarterly
9 payments were due, and no payments were made, between the date of Patricia’s hospitalization
10 and her death. Badgley Dep., 81:18-24; RFA #45. Patricia died before the expiration of her
11 GRAT term. Pl. Mot. at 14.

12 **B. Procedural History**

13 On January 29, 2014, Pamela signed a tax return on behalf of the Estate of Patricia Yoder.
14 See Dkt. No. 44-9 (“Pl. Ex. H”). The return reported a total gross estate of \$36,829,057, including
15 the value of the assets held in the GRAT. *See id.*; Dkt. No. 46-5 (“Hipshman Dep.”), 17:6-25;
16 RFA # 8. The Estate paid the reported taxes of \$11,187,475. *Id.* On May 16, 2016, Plaintiff filed
17 a Claim for Refund and Request for Abatement, seeking a refund from the Internal Revenue
18 Service (“IRS”) of \$3,810,004 in estate tax alleged to have been overpaid by the Estate as a result
19 of the inclusion of the full value of the GRAT. Badgley Dep. 116:10-25; Dkt No. 44-12. (“Pl. Ex.
20 K”). The IRS did not advise on the allowance or disallowance of the refund claim within six
21 months of its filing. Pl. Mot. at 15. Plaintiff, as the taxpayer’s representative, subsequently filed
22 this action in the Central District of California. *Id.* at 15-16; *see* Dkt. No. 1. On January 30, 2017,
23 Plaintiff filed the FAC, and on February 23, 2017, the case was transferred to this district based on
24 the parties’ stipulation. *See* Dkt. Nos. 10-11.

25 **II. LEGAL STANDARD**

26 Summary judgment is proper when a “movant shows that there is no genuine dispute as to
27 any material fact and the movant is entitled to judgment as a matter of law.” Fed. R. Civ. P. 56(a).
28 A fact is “material” if it “might affect the outcome of the suit under the governing law.” *Anderson*

1 *v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). A dispute is “genuine” if there is evidence in the
2 record sufficient for a reasonable trier of fact to decide in favor of the nonmoving party. *Id.* The
3 Court views the inferences reasonably drawn from the materials in the record in the light most
4 favorable to the nonmoving party, *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S.
5 574, 587-88 (1986), and “may not weigh the evidence or make credibility determinations,”
6 *Freeman v. Arpaio*, 125 F.3d 732, 735 (9th Cir. 1997), *overruled on other grounds by Shakur v.*
7 *Schriro*, 514 F.3d 878, 884-85 (9th Cir. 2008).

8 The moving party bears both the ultimate burden of persuasion and the initial burden of
9 producing those portions of the pleadings, discovery, and affidavits that show the absence of a
10 genuine issue of material fact. *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986). Where the
11 moving party will not bear the burden of proof on an issue at trial, it “must either produce
12 evidence negating an essential element of the nonmoving party’s claim or defense or show that the
13 nonmoving party does not have enough evidence of an essential element to carry its ultimate
14 burden of persuasion at trial.” *Nissan Fire & Marine Ins. Co. v. Fritz Cos.*, 210 F.3d 1099, 1102
15 (9th Cir. 2000). Where the moving party will bear the burden of proof on an issue at trial, it must
16 also show that no reasonable trier of fact could not find in its favor. *Celotex Corp.*, 477 U.S. at
17 325. In either case, the movant “may not require the nonmoving party to produce evidence
18 supporting its claim or defense simply by saying that the nonmoving party has no such evidence.”
19 *Nissan Fire & Marine Ins. Co.*, 210 F.3d at 1105. “If a moving party fails to carry its initial
20 burden of production, the nonmoving party has no obligation to produce anything, even if the
21 nonmoving party would have the ultimate burden of persuasion at trial.” *Id.* at 1102-03.

22 “If, however, a moving party carries its burden of production, the nonmoving party must
23 produce evidence to support its claim or defense.” *Id.* at 1103. In doing so, the nonmoving party
24 “must do more than simply show that there is some metaphysical doubt as to the material facts.”
25 *Matsushita Elec. Indus. Co.*, 475 U.S. at 586. A nonmoving party must also “identify with
26 reasonable particularity the evidence that precludes summary judgment.” *Keenan v. Allan*, 91
27 F.3d 1275, 1279 (9th Cir. 1996). If a nonmoving party fails to produce evidence that supports its
28 claim or defense, courts enter summary judgment in favor of the movant. *Celotex Corp.*, 477 U.S.

1 at 323.

2 **III. DISCUSSION**

3 Plaintiff moves for summary judgment on two principal bases, asserting that: (1) Internal
4 Revenue Code (“IRC”) § 2036(a)(1) does not apply to Patricia’s GRAT; and (2) Treasury
5 Regulation 20.2036-1(c)(2)(i) (“the Regulation”) is overly broad and invalid to the extent that it
6 applies to the GRAT. On this basis, Plaintiff asserts that Defendant improperly included the
7 GRAT in calculating Patricia’s gross estate, and Plaintiff is entitled to a tax refund. Defendant
8 moves for summary judgment on the opposite grounds, arguing that section 2036 applies to
9 Patricia’s GRAT and that the Regulation is valid.

10 **A. Section 2036 Applies to Patricia’s GRAT and the GRAT Property Was Properly**
11 **Included in Patricia’s Gross Estate**

12 The parties agree that IRC section 2036 controls. That section states:

13 *(a) The value of the gross estate shall include the value of all*
14 *property to the extent of any interest therein of which the decedent*
15 *has at any time made a transfer (except in case of a bona fide sale*
16 *for an adequate and full consideration in money or money’s worth),*
by trust or otherwise, under which he has retained for his life or for
any period not ascertainable without reference to his death or for any
period which does not in fact end before his death-

17 *(1) the possession or enjoyment of, or the right to the*
18 *income from, the property, or*

19 *(2) the right, either alone or in conjunction with any person, to*
20 *designate the persons who shall possess or enjoy the property or the*
21 *income therefrom.*

22 (emphasis added). Defendant contends that section 2036(a)’s “possession or enjoyment of” or
23 “right to income” language applies to Patricia’s GRAT for two alternative reasons: first, because
24 Patricia reserved a right to annual annuity payments from the GRAT, which she created with her
25 one-half share in Y&Y Co.; and second, because Patricia possessed and enjoyed the property
26 because she retained “other interests and powers” in Y&Y Co., including her control over and
27 personal benefit from Y&Y Co. activities. *See* Def. Mot. at 12.

28 In arguing that Patricia’s fixed annuity qualifies as some possession, enjoyment, or right to
income within the meaning of section 2036(a)(1), Defendant relies primarily on three cases that it
characterizes as reflecting the Supreme Court’s broad understanding of the operative language.

1 Def. Mot. at 11-13; *see C.I.R. v. Church's Estate*, 335 U.S. 632 (1949); *Spiegel's Estate v.*
2 *Comm'r*, 335 U.S. 701 (1949). Both *Church's* and *Spiegel's* interpret IRC section 811(c), section
3 2036(a)'s predecessor, and build on the Supreme Court's prior decision in *Helvering v. Hallock*,
4 309 U.S. 106 (1940). *Hallock*, in turn, interprets section 302(c), the predecessor to section 811(c).
5 Defendant argues that the statutory language has remained substantively the same despite these
6 changes, and Plaintiff does not dispute that proposition. *See* Def. Mot. at 12.

7 Rather, Plaintiff highlights the absence of statutory or judicial authority expressly equating
8 a fixed-term annuity with some possession, enjoyment or right to income. *See* Pl. Opp. at 8.
9 Plaintiff stresses that section 2036 could state that a right to income includes an "annuity" had
10 Congress so desired. *Id.* At the core of Plaintiff's position is a distinction between "a fixed
11 annuity payment payable out of transferred property" on the one hand, and "the retention of a
12 'right to income'" on the other. *Id.* Contending that section 2036 applies only to the latter,
13 Plaintiff argues that (1) income and a fixed annuity payment are distinct because the former
14 fluctuates while the latter does not; (2) a right to income connotes an "ascertainable and legally
15 enforceable power" to receive income, which Patricia lacked; and (3) Patricia's annuity could have
16 been satisfied with "income and principal, or principal only." Pl. Opp. at 8-9.

17 The Court finds that section 2036 applies to Patricia's GRAT. At oral argument, both
18 parties acknowledged the lack of binding authority squarely addressing the issue presented here.
19 Plaintiff is accordingly correct that Defendant's authorities do not expressly equate a fixed-term
20 "annuity" with a right to income or some other possession or enjoyment. Nonetheless, the U.S.
21 Supreme Court has adopted a substance-over-form approach that favors a finding that Patricia's
22 annuity comprises some possession, enjoyment, or right to income from the transferred property.

23 The Court first articulated its pragmatic approach to the IRC's possession, enjoyment, or
24 right to income language in *Hallock*. *See* 309 U.S. at 109. Specifically, the *Hallock* Court
25 considered whether the IRS Commissioner correctly calculated the gross estate tax of several
26 decedents to include trust properties transferred inter vivos. *See id.* Though each conveyance was
27 unique, all of the "dispositions of property by way of trust" included a settlement "provid[ing] for
28 return or reversion of the corpus to the donor upon a contingency terminable at his death." *Id.* at

1 110.

2 The Court in *Hallock* concluded that the Commissioner had properly calculated the
 3 decedent's gross estate taxes to include the trust properties. In so holding, the Court stated that the
 4 grantor's reservation of any interest, however remote, was sufficient to bring the conveyance
 5 within the code's "possession or enjoyment" language. *See id.* at 111-12 (finding non-dispositive
 6 the "technical forms in which interests contingent upon death are cast" (citing *Klein v. United*
 7 *States*, 283 U.S. 231 (1931)). The Court expressed concerns with importing "distinctions and
 8 controversies from the law of property into the administration of the estate tax" that would
 9 "preclude[] a fair and workable tax system." *Id.* at 118. The Court emphasized a "harmonizing
 10 principle" from its earlier decision in *Klein*:

11 [T]he statute taxes not merely those interests which are deemed to
 12 pass at death according to refined technicalities of the law of
 13 property. It also taxes inter vivos transfers that are too much akin to
 14 testamentary dispositions not to be subjected to the same excise. By
 15 bringing into the gross estate at his death that which the settlor gave
 16 contingently upon it, this Court fastened on the vital factor. It
 17 refused to subordinate the plain purposes of a modern fiscal measure
 18 to the wholly unrelated origins of the recondite learning of ancient
 19 property law.

20 *Id.* at 112, 118. The Court found that this principle reduced the prospect that a "change merely in
 21 the phrasing of a grant" could create a "judicially cognizable difference" in the application of the
 22 tax code. *Id.* at 112.

23 Building on this substantive approach, the Court in *Church's* read *Hallock* as extending
 24 section 811(c)'s possession or enjoyment "string" to apply to "*any trust transfer except by a bona*
 25 *fide transfer* in which the settlor, absolutely, unequivocally, irrevocably, and without possible
 26 reservations, parts with all of his title and all of his possession and all of his enjoyment of the
 27 transferred property." 335 U.S. at 645 (emphasis added). The Court continued:

28 After such a transfer has been made, the settlor must be left with no
 present legal title in the property, no possible reversionary interest in
 that title, and no right to possess or to enjoy the property then or
 thereafter. In other words such a transfer must be immediate and out
 and out, and must be unaffected by whether the grantor lives or dies.

Id. at 645-46. The Court again prioritized pragmatic considerations, noting that "[t]estamentary
 dispositions of an inter vivos nature cannot escape the force of this section by hiding behind legal

1 niceties contained in devices and forms created by conveyancers.” *Id.* at 646 (quoting *Goldstone*
 2 *v. United States*, 325 U.S. 687, 690 (1946)). The Court found that the Commissioner had properly
 3 calculated the decedent’s gross estate tax by including the trust corpus. *Id.* at 323-24. The Court
 4 reasoned that the decedent, who retained both the possibility of reverter and required the “trustees
 5 to pay him income for life,” continued to possess and enjoy the property (there, stocks) that he had
 6 previously owned and then transferred to the trust. *Id.* at 634, 644. The Court found that “passage
 7 of the mere technical legal title to a trustee is not necessarily crucial in determining whether and
 8 when a gift becomes ‘complete’ for estate tax purposes.” *Id.* at 644-45. Looking to “substance
 9 and not merely form,” the Court concluded that the decedent “retained for himself until death a
 10 most valuable property right in these stocks—the right to get and to spend their income.” *Id.*

11 In *Spiegel’s*, the Court reaffirmed that section 811(c)’s applicability hinges primarily “on
 12 the nature and operative effect of the trust transfer.” 335 U.S. at 705. Notably, the view of the
 13 *Spiegel’s* Court supports Defendant’s broad reading of *Church’s* and of section 2036. *See* 335
 14 U.S. at 705 (quoting 335 U.S. 632). The Court in *Spiegel’s*, moreover, arguably extended
 15 *Church’s* further by emphasizing that the settlor’s intent to retain a reversionary interest does not
 16 bear on the “possession or enjoyment” inquiry. *Id.* Instead, the grantor’s retention of any
 17 “absolute or contingent” “present or future interest” vitiates the “‘complete’ kind of transfer”
 18 required to show that the grantor “has certainly and irrevocably parted with his ‘possession or
 19 enjoyment.’” *Id.* The Court emphasized that “[a]ny requirement less than that. . . such as a post-
 20 death attempt to probe the settlor’s thoughts in regard to the transfer,” would facilitate
 21 circumvention of the section, and thus frustrate Congress’s legislative intent. *Id.* at 706 (emphasis
 22 added).

23 Based on the Supreme Court’s pragmatic approach to section 2036’s operative language,
 24 Patricia’s right to a fixed-annuity payment from the GRAT brought her transferred property within
 25 the meaning of that section. The undisputed facts show that: (1) Patricia funded the GRAT with
 26 her one-half interest in Y&Y Co.; (2) the three Y&Y Co. properties were placed into the GRAT;
 27 (3) Patricia’s transfer of her one-half interest was not a bona fide sale, and no consideration was
 28 given; (4) the income generated by the GRAT each year was greater than Patricia’s annual

1 annuity; and (5) Patricia died before the GRAT's expiration. *See* Badgley Dep., 16:1-9, 30:23-
 2 31:3, 56:14-25; Pamela Yoder Dep., 27:12-19, 32:21-24, 71:15-22; RFA #49; Def. Exs. 8-12; Pl.
 3 Exs. M-Q, R-T; Def. Mot. at 7; Pl. Mot. at 14. Plaintiff does not dispute, and there is no evidence
 4 to show, that any of the three properties constituting the original trust corpus were ever sold to
 5 fund Patricia's annuity. *See* Def. Opp. at 7.⁷ As a result, Patricia's annuity necessarily drew either
 6 from the GRAT's accumulated income (i.e. the principal) *or* the current income that flowed into
 7 the GRAT each year from the rents received through Y&Y Co. Def. Mot. at 13; Def. Reply at 5.
 8 Plaintiff sets forth no legal basis for distinguishing these two funding sources within the meaning
 9 of section 2036 or its predecessors. *See* Pl. Opp. at 8-9.

10 The Third Circuit's decision in *McNichol's Estate v. C.I.R.*, 265 F.2d 667, 673 (3d Cir.
 11 1959) is persuasive, and supports a finding that Patricia's annuity provided her with some
 12 possession, enjoyment, or right to income within the meaning of section 2036. *See* Def. Mot. at 7.
 13 In *McNichol's*, the Third Circuit considered whether several income-producing real estate
 14 properties were properly included in a decedent's gross estate. *See* 265 F.2d at 668. The decedent
 15 had orally transferred the properties to his children, and his children "orally understood" that "the
 16 decedent should retain for his lifetime the income from the real estate." *Id.* Despite that the
 17 decedent had not expressly reserved an "enforceable claim to the income" in the trust document,
 18 the Third Circuit held that section 811(c)(1)(B) applied. *Id.* at 670-73. So holding, the Third
 19 Circuit found that section 811(c) applied even where a reserved "life interest" was "retained in
 20 connection with or as an *incident* to the transfer." *Id.* at 670 (emphasis added). The court also
 21 concluded from 811(c)'s legislative history that Congress added the "right to income" language to
 22 extend the statute's application to "cases where a decedent was entitled to income even though he
 23 did not actually receive it." *Id.* at 671. "Hence," the Court continued, "the 'right to income'

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 26 ⁷ Even if Patricia *had* sold one of these properties to fund the annuity, that would likely also
 27 constitute some "use and enjoyment" of the property sufficient for section 2036. *See* Def. Reply at
 28 8 n.5. Plaintiff does not expressly respond to that argument. Rather, Plaintiff states that "as a
 matter of policy. . . section 2036(a)(1) should not depend on the exercise of the trustee's discretion
 whether or not to sell the transferred property." *See* Pl. Opp. at 11-12. Plaintiff cites no authority
 for that proposition. Plaintiff's argument also contravenes the above discussed concern of the U.S.
 Supreme Court regarding the use of testamentary instruments to shield property from taxation.

1 clause, instead of circumscribing the ‘possession or enjoyment’ clause in its application to retained
2 income, broadened its sweep.” *Id.*

3 Pursuant to that understanding of Congress’s purpose, the *McNichol’s* court held that the
4 decedent’s receipt of rents from the properties in the trust constituted enjoyment of the transferred
5 properties. *Id.* at 671. The court also found that “[e]njoyment” was “synonymous with substantial
6 present economic benefit.” *Id.* (citing *Commissioner v. Estate of Holmes*, 326 U.S. 480 (1945)).
7 *McNichol’s* then reconciled this pragmatic view of “enjoyment” with *Church’s* repeated reference
8 to a “property right” in “income.” *Id.* at 673. *McNichol’s* opined that *Church’s* somewhat narrow
9 emphasis on a “right” was “patterned to fit” the factual situation confronting that Court (i.e. “a
10 transfer of property under a formal trust agreement in which the trustor retained an enforceable
11 right to the income”). But:

12 [A]s we read the decision its bite goes deeper; and the opinion
13 constitutes a sweeping and forthright declaration that technical
14 concepts pertaining to the law of conveyancing cannot be used as a
15 shield against the impact of death taxes when in fact possession or
16 enjoyment of the property by the transferor—and more particularly
17 his enjoyment of the income from the property—ceases only with
18 his death.

19 *Id.* This reading of *Church’s* aligns with Defendant’s argument here.

20 In line with these pragmatic concerns, the Court agrees with Defendant that differentiating
21 between annuities based on their funding source would facilitate circumvention of the tax code.
22 For instance, an individual could substitute the word “income” for annuity in a trust document,
23 give property to the trust, and structure the trust so that the annuity payment is less than the
24 amount of income generated. *See* Def. Reply at 5. Consequently, the property in the trust (that is,
25 the original corpus) would never need to be sold, and could pass to eventual beneficiaries free of
26 taxation. In addition, an individual could “select[] an investment such as a mutual fund from
27 which annuity payments could be made from capital distributions, as opposed to current income,”
28 and call the payout an annuity. Def. Mot. at 16. Plaintiff does not respond to either circumstance
beyond asserting that policy decisions should be left to Congress. *See* Pl. Opp. at 20-21. But
these examples of circumvention illustrate the types of circumstances that have motivated the
Supreme Court’s pragmatic substance-over-form approach.

1 Plaintiff contends that Patricia could have no “right to income” because she did not have
 2 an “ascertainable and legally enforceable power” to receive income from the transferred property.
 3 Pl. Opp. at 9. For support, Plaintiff highlights that Y&Y Co.’s income fluctuated while Patricia’s
 4 annuity remained constant. *See id.* at 8-9. This argument fails. As a threshold, it assumes that
 5 income and annuity are distinct for the purpose of section 2036, but as explained above the Court
 6 disagrees with that conclusion. In addition, Plaintiff relies for her interpretation of “right” on
 7 *United States v. Byrum*, 408 U.S. 125, 136-37 (1972). But the *Byrum* Court construed the “right”
 8 language in section 2036(a)(2)—not section 2036(a)(1).⁸ The Supreme Court has not expressly
 9 extended its interpretation of that subsection to section 2036(a)(1). Finally, Plaintiff admits that
 10 an “implied right to income” can exist when “annuity payments are no more than disguised
 11 payments of income.” Pl. Mot. at 17 n.8. That implied right exists here because: (1) Patricia
 12 created the original trust corpus with her one-half share in Y&Y Co. including the three Southern
 13 California properties; (2) there is no evidence that any of those properties were ever sold off; and
 14 (3) Y&Y Co.’s income was always greater than Patricia’s annuity payment. *See* Badgley Dep.,
 15 16:1-9, 30:23-31:3, 56:14-25; Pamela Yoder Dep., 27:12-19, 32:21-24, 71:15-22; RFA #49; Def.
 16 Exs. 8-12; Pl. Exs. M-Q, R-T; Def. Mot. at 7; Pl. Mot. at 14. The income from Y&Y Co., whether
 17 accumulated or current, thus always funded Patricia’s annuity. And Patricia expressly reserved
 18 that annuity right in the GRAT. *See* GRAT 1-3.

19 Apart from whether Patricia enjoyed a “right to income” from the GRAT, Plaintiff
 20 contends that Patricia’s fixed-annuity could not constitute some other “possession or enjoyment.”
 21 Specifically, Plaintiff asserts that enjoyment is equivalent to “right to income,” which Patricia
 22 lacked, and that “possession” applies only where the property owner continues to possess or use
 23 the property for the remainder of her life. Pl. Mot. at 20-21. As discussed, Patricia did enjoy a
 24 “right to income” within the meaning of section 2036(a)(1). And even if Patricia lacked a right to
 25 income, she still enjoyed the property given her access to current and/or accumulated income
 26

27 ⁸ Section 2036(a)(2) extends to an individual with “the right, either alone or in conjunction with
 28 any person, to designate the persons who shall possess or enjoy the property or the income
 therefrom.”

1 from her interest in Y&Y Co. That is sufficient to bring the GRAT within the meaning of section
2 2036.⁹

3 **B. The Regulation is a Reasonable Interpretation of Section 2036**

4 Treasury Regulation 20.2036-1(c)(2)(i) requires that transferred GRAT property be
5 included in a decedent's gross estate under section 2036 where the decedent retains an annuity
6 interest and dies before the expiration of the GRAT term:

7 This paragraph (c)(2) applies to a grantor's retained use of an asset
8 held in trust or a retained annuity. . . including without limitation . . .
9 a grantor retained annuity trust (GRAT) paying out a qualified
10 annuity interest within the meaning of §25.2702-3(b) of this chapter.
11 . . .

12 If a decedent transferred property into such a trust and retained or
13 reserved the right to use such property, or the right to an annuity,
14 unitrust, or other interest in such trust with respect to the property
15 decedent so transferred for decedent's life, any period not
16 ascertainable without reference to the decedent's death, or for a
17 period that does not in fact end before the decedent's death, then the
18 decedent's right to use the property or the retained annuity, unitrust,
19 or other interest (whether payable from income and/or principal)
20 constitutes the retention of the possession or enjoyment of, or the
21 right to the income from, the property for purposes of section
22 2036.¹⁰

23 Plaintiff contends that the Court should disregard the Regulation as an unreasonable
24 interpretation of section 2036 as applied to Patricia's GRAT. *See* Pl. Mot. at 24 (citing *Prof'l*
25 *Equities v. Commissioner*, 89 T.C. 165 (1987)). Defendant argues that the Regulation is a
26 reasonable interpretation of section 2036 and valid under *Chevron, U.S.A., Inc. v. Natural Res.*
27 *Def. Council, Inc.*, 467 U.S. 837 (1984). Plaintiff does not expressly dispute that *Chevron* applies;
28 instead, Plaintiff claims that the Regulation is interpretive and thus given less deference as
compared to a legislative rule. *See* Pl. Opp. at 19.

The Court applies *Chevron's* two-step framework. *See Mayo Found. for Med. Educ. &*
Research v. United States, 562 U.S. 44, 52 (2011). At *Chevron* step one, the Court asks "whether

⁹ Because the Court finds this basis sufficient to justify including Patricia's GRAT within the gross estate, the Court does not decide whether Patricia retained some "other interests and powers" in Y&Y Co. that are sufficient to show possession or enjoyment of the property. *See* Def. Mot. at 12.

¹⁰ There is no dispute that Patricia's annuity was a "qualified annuity interest." *See* Def. Mot. at 10-11, 13.

1 Congress has directly addressed the precise question at issue.” *Id.* (quotation omitted). The
2 parties agree that section 2036 does not expressly address whether annuity payments constitute
3 some possession, enjoyment, or right to income from the transferred property. Def. Mot. at 14; Pl.
4 Mot. at 19. So the Court proceeds to step two. At that step, the Court “may not disturb an agency
5 rule unless it is arbitrary or capricious in substance, or manifestly contrary to the statute.” *Mayo*
6 *Found. for Med. Educ.*, 562 U.S.at 53 (quotation omitted).

7 The Court concludes that the Regulation is reasonable, and valid under *Chevron*. In
8 drafting the Regulation, the IRS and Treasury Department relied principally on the above
9 discussed binding authorities, including *Church’s*, *Hallock*, and *Spiegel’s*. See Grantor Retained
10 Interest Trusts—Application of Sections 2036 and 2039, T.D. 9414, 73 Fed. Reg. 40173-01 (July
11 14, 2008) at 40174. Those cases support Defendant’s view of section 2036, which parallels the
12 Regulation’s interpretation of that section. The IRS and Treasury Department also drew on
13 section 2036’s legislative history to devise the Regulation, observing that Congress amended
14 section 811(c) to include interests retained for a term of years. *Id.* (citing H.R. Rep. no. 81-1412 at
15 9 (1949)). Though Plaintiff cites legislative history for the opposite conclusion, Plaintiff does not
16 explain why that history supports the Regulation. See Pl. Opp. at 20.

17 In addition, Defendant persuasively sets forth several of the Regulation’s administrative
18 benefits. Those benefits include, for instance, consistency with trust accounting regulations under
19 section 662. 73 Fed. Reg. 40173-01 at 40174. In explaining this benefit, the implementing
20 agencies declined to adopt the distinction that Plaintiff draws here between annuities funded from
21 current income and those funded from accumulated income. See *id.* at 40175. In doing so, these
22 agencies observed that Plaintiff’s interpretation “would condition the estate tax treatment on the
23 nature and performance of the investments selected by the trustee.” *Id.* The agencies reasonably
24 concluded that section 2036’s application should not hinge on discretionary investment decisions
25 or investment performance.

26 Plaintiff argues that the Regulation is invalid because Section 2036 does not equate
27 “income” with a fixed-term annuity in section 2036. Pl. Opp. at 19-20. That silence does not
28 mean that the agencies’ interpretation of the section is arbitrary or capricious. For the reasons

1 stated, the Court concludes that the Regulation is a permissible interpretation of Section 2036.
 2 Plaintiff also contends that the regulation is arbitrary because it: (1) would result in inclusion of all
 3 private annuities in a decedent's gross estate, thereby contradicting cases standing for the opposite
 4 proposition; and (2) is overly broad to the extent that the Regulation subsequently includes
 5 GRATs like Patricia's that "have no ordering rule, do not provide for income payments disguised
 6 as annuity payments, and at the time of the grantor's death can satisfy the annuity payments
 7 entirely out of principal." *See* Pl. Mot. at 23-25. Plaintiff's second argument fails once the Court
 8 rejects her annuity/income distinction.

9 Plaintiff's first argument is similarly unavailing. For that argument, Plaintiff relies on
 10 *Lafargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982). But Plaintiff's claim ignores the long-
 11 recognized difference between property transferred through a bona fide sale in exchange for an
 12 annuity, and property transferred through a trust in the absence of a bona fide sale:

13 In the bona fide sale, there is a negotiation and agreement between
 14 two parties, each of whom is the owner of a property interest before
 15 the sale; each uses his or her own property to provide consideration
 16 to the other in exchange for the property interest to be received from
 17 the other in the sale. When the transferor retains an annuity . . .
 18 interest in the transferred property (as in the case of a GRAT or
 19 GRUT), the transferor is not selling the transferred property to a
 20 third party in exchange for an annuity because there is no other
 21 owner of property negotiating or engaging in a sale transaction with
 22 the transferor. The transferor, instead, is transferring the property
 23 subject to a retained possession and enjoyment of, or right to, the
 24 income from the property.

25 73 Fed. Reg. 40173-01 at 47015. And it was the finding of a bona fide sale upon which the Ninth
 26 Circuit relied in *LaFargue*. *See* 689 F.2d at 846-47 ("Under these circumstances, absent some
 27 indication that the annuity payment agreed upon is a mere disguise for transferring the income of
 28 the trust to the grantor, rather than a payment for the property transferred, we cannot justify
 disregarding the formal structure of the transaction as a sale in exchange for an annuity."").
 Plaintiff does not explain how the Regulation would otherwise collapse the section's "bona fide
 sale" exception.

Finally, Plaintiff claims that the Regulation is invalid because the formula it uses to
 determine the includable value of the GRAT corpus assumes that annuity is paid solely from

1 income. *See* Pl. Opp. at 20. Plaintiff points out that an annuity can, in fact, be paid either from
 2 principal or from income. *See id.* Plaintiff asserts that the agencies' formula thus yields a
 3 capriciously large amount includable for taxation. *See id.*


4 In response, Defendant explains that the agencies' formula reasonably "looks to the
 5 amount of property needed, given the interest rate at the time of death, to fund the annuity." Def.
 6 Reply at 12. In doing so, the formula focuses on two factors: first, the value of property, in order
 7 to address Congress's principal concern that donors might use trusts to hide properties from the
 8 estate tax; and second, interest, which "valuing an annuity necessarily requires." *Id.* Defendant
 9 explains that, because the interest rate was low at the time of Patricia's death, "the amount of
 10 property needed to generate the total annuity payment" was much greater than the amount actually
 11 included in the GRAT. *Id.* In other words, the high taxation rate in the instant case is partly a
 12 result of interest rate fluctuation. The Court concludes that this explanation of the IRS's formula
 13 is persuasive and well-reasoned. Accordingly, the Court concludes that the Regulation is
 14 reasonable, and Patricia's GRAT was properly included in calculating Patricia Yoder's gross
 15 estate.

16 **IV. CONCLUSION**

17 For these reasons, the Court **GRANTS** Defendant's motion for summary judgment, and
 18 **DENIES** Plaintiff's motion for summary judgment. The clerk is directed to enter judgment in
 19 accordance with this order in favor of Defendant and to close the case.

20 **IT IS SO ORDERED.**

21 Dated: 5/17/2018

22 
 23 HAYWOOD S. GILLIAM, JR.
 24 United States District Judge