Case No. 18-16053

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JUDITH BADGLEY,

Plaintiff and Appellant,

vs.

UNITED STATES OF AMERICA,

Defendant and Appellee.

APPELLANT JUDITH BADGLEY'S OPENING BRIEF

Appeal from the United States District Court, Northern District of California

Case No. 17-cv-00877-HSG

Honorable Haywood S. Gilliam, Jr., United States District Judge

---

PAUL FREDERIC MARX (SBN 27551)
Rutan & Tucker, LLP
611 Anton Boulevard, Suite 1400
Costa Mesa, California 92626-1931
Telephone: (714) 641-5100
Facsimile: (714) 546-9035
pmarx@rutan.com

Attorneys for Plaintiff and Appellant
JUDITH BADGLEY

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page

FEDERAL CASES

Page

FEDERAL CASES (CONT.)

TAX COURT CASES

Page

STATE CASES

FEDERAL STATUTES

STATE STATUTES

RULES

REGULATIONS

Page

REGULATIONS (CONT.)

PERIODICALS

NON-PERIODICAL PUBLICATIONS

OTHER AUTHORITIES

I. STATEMENT OF JURISDICTION

This is an appeal from an action brought by plaintiff and appellant Judith Badgley ("Badgley"), as a co-Executor of the Estate of Patricia Yoder, for the refund of the overpayment of $3,810,004 in estate tax paid in January 2014 for the Estate of Patricia Yoder, pursuant to the Internal Revenue Code of 1986, as amended.

This Court has jurisdiction over this Appeal pursuant to 28 U.S.C. section 1291 because the granting of a motion for summary judgment is appealable as of right; moreover, when a district court disposes of an action on cross-motions for summary judgment, the orders granting and denying the respective motions are appealable. *Jones-Hamilton Co. v. Beazer Materials & Services, Inc.*, 973 F.2d 688, 694-695 (9th Cir. 1992).

Here, the district court erred in entering an Order denying Badgley's Motion for Summary Judgment and granting defendant and appellee United States of America's ("Appellee") cross-Motion for Summary Judgment. (Excerpts of Record ["ER"] 0002-0018.) The Judgment was entered on May 17, 2018. (ER 0018.) Badgley timely filed a notice of appeal on June 7, 2018. Fed. R. App. P. 3(a), 4(a)(1)(A). (ER 0019-0045.)

II. STATEMENT OF ISSUES PRESENTED FOR REVIEW

In 1998, Patricia Yoder ("Decedent") created an irrevocable trust to which she transferred her 50% interest in a partnership named Y&Y Company. In exchange for the transfer of that partnership interest, Decedent received the right to a series of fixed annual payments (i.e., an annuity) paid quarterly for 15 years or until her earlier death. At the expiration of the 15-year term or upon Decedent's earlier death, all remaining amounts due to her would be paid to her or to her estate, as the case might be, and the remaining balance of the trust's corpus (if any) would be distributed to her adult daughters, Badgley and Pamela Yoder ("Pamela"). The Trust was structured in such a way that the annuity interest Decedent received on creating the trust was a qualified interest under section 2702(b)(1) of the Internal Revenue Code and Regulation section 25.2702-2(a)(7).[1] This type of trust is commonly known as a Grantor Retained Annuity Trust ("GRAT").

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and all references to "Regulation" are to regulations issued by the Treasury Department under Title 26 of the Code of Federal Regulations on income and estate tax.

Decedent died in November 2012, less than 90 days before the end of the GRAT's 15-year term. At Decedent's death (and for many years prior thereto) the principal of the GRAT was sufficient to fully satisfy the annuity payments without need to utilize any income of the GRAT for that purpose.

The ultimate issue in this case is what amount attributable to Decedent's retained annuity interest was includable in Decedent's gross estate for estate tax purposes. The resolution of that issue turns on the interpretation of section 2036(a)(1), and validity of Regulation section 20.2036-1[2] as applied to Decedent's retained annuity interest.

Badgley's position is that only the net present value of the remaining unpaid annuity amounts at Decedent's death ($101,903.86) was includable in Decedent's gross estate. (ER 0503-04, 0522, 0529 [Badgley decl., ¶ 14], 0689-0712 [Ex. H].) The district court, on the other hand, held that under section 2036(a)(1) as interpreted by the Regulation, the entire date-of-death value of the corpus of the GRAT

---

[2] All references to "the Regulation" are to section 20.2036-1 of the Treasury Regulations on Estate Tax. The provisions of section 2036(a)(1) and the Regulation pertinent to this case are set forth in the Appendix to this brief.

($10,987,029) was includable. (ER 0002-18, 0199, 0522, 0615-0688 [Ex. G], 0529 [Badgley decl. ¶ 14], 0790 [Hipshman decl. ¶ 5].) The difference in includable amounts translates into $3,810,004 of estate tax which the estate paid and for which Badgley, as statutory executor, is seeking a refund.

Section 2036(a)(1) is referred to as a "string" section because it posits three metaphorical strings attached to transferred property which, if retained by the transferor for one of three statutory periods linked to the transferor's death, pulls the property back into his or her gross estate for federal estate tax purposes at full date-of-death value. The three metaphorical strings are *possession* of the transferred property, *enjoyment* of the transferred property, and *the right to the income from* the transferred property.

Badgley's position is that Decedent did not retain possession or enjoyment of the transferred property nor a right to the income therefrom, and to the extent the Regulation provides otherwise it is an unreasonable interpretation and invalid extension of section 2036(a)(1).

Badgley appeals the district court's Order denying her Motion for Summary Judgment and granting Appellee's cross-Motion for Summary Judgment, and judgment entered thereon, raising the

following issues:

1. Whether a right to receive an annuity from a GRAT provides the grantor with the possession or enjoyment of, or a right to the income from, the property of the GRAT within the meaning of section 2036(a)(1) where (a) the GRAT is irrevocable, (b) neither possession nor enjoyment of, nor the income from, the property is expressly reserved to the grantor, (c) there is no requirement that GRAT income be used to pay the annuity, (d) the amount of the annuity bears no relationship to the income of the GRAT, and (e) the principle of the GRAT is sufficient alone to fully satisfy the annuity payment. (Badgley asserts a right to an annuity from a GRAT, under the above facts, does not provide the grantor with the possession or enjoyment of, or a right to the income from, the property of the GRAT within the meaning of section 2036(a)(1).)

2. Whether the Regulation, insofar as it purports to extend the coverage of section 2036(a)(1) to annuity interests such as that retained by Decedent, is unauthorized and invalid and, therefore, not entitled to judicial deference. (Badgley asserts the Regulation is not entitled to judicial deference, and is invalid as applied to GRATs like Decedent's GRAT.)

III. STATEMENT OF THE CASE

In June 2016, Badgley, in her capacity as a statutory executor of Decedent's estate, filed a claim for refund of an overpayment of Decedent's estate tax in the amount of $3,810,004. (ER 1373.) Where the IRS does not allow or disallow a refund claim within six months after it has been filed, the taxpayer may file a refund action in the United States District Court. Section 6532(a)(1); Regulation section 301.6532-1(a). The IRS did not allow or disallow Badgley's refund claim within such six-month period, and she filed her Complaint in January 2017 seeking a refund of the overpayment. (ER 1380.) Badgley filed a First Amended Complaint shortly thereafter, which Appellee answered. (ER 1367 and 1380.)

Badgley filed her Motion for Summary Judgment on November 20, 2017 (ER 0497-01360 [dkt. nos. 44 through 44-26]). Appellee filed its cross-Motion for Summary Judgement on November 30, 2017 (ER 0193-0496 [dkt nos. 46 through 46-1]). Both parties filed Oppositions (ER 0141-0192 [dkt. no. 47] and ER 0067-0092 [dkt. no. 49]) and Replies (ER 0096-0140 [dkt. no. 48] and ER 0046-0066 [dkt. no. 51]). The district court heard oral argument in early January 2018, at the conclusion of which it took the Motions under submission.

On May 17, 2018, the District Court entered its Order denying Badgley's Motion and granting Appellee's cross-Motion, and entered Judgment for Appellee. (ER 0001.) The district court held that Decedent's retained annuity interest was a retained right to income within the meaning of section 2036(a)(1), with the result that the entire date-of-death value of the corpus of Decedent's GRAT was includable in Decedent's estate for estate tax purposes. (ER 0014 [Order, 13:1-24]).

The district court also held, in the alternative, that Decedent's retained annuity interest provided her with some possession and enjoyment of the transferred partnership interest within the meaning of section 2036(a)(1), and for that reason as well, the entire date-of-death value of the corpus of Decedent's GRAT was includable in Decedent's estate for estate tax purposes. (ER 0009 and 0014 [Order, 8:21-22, 13:25]). As set forth in this Brief, both holdings are in error.

IV. STATEMENT OF FACTS

The parties respective Motions set forth the material facts. (ER 0200-0206, 0506-0512). An abbreviated statement of facts is set forth here, as not all of the facts in the cross-Motions are germane to this Appeal.

Decedent's husband Donald Yoder ("Donald") and his brother H. Frank Yoder, III ("Frank") were 50% partners in a Y&Y Company, a general partnership and property development company which Donald and Frank formed in the 1970's. (ER 0506, 0527 [Badgley decl. ¶¶ 3-4], 0531-0550 [Ex. A].) After Donald's death in 1990, Decedent succeed to Donald's 50% partnership interest in Y&Y Company, which at the time owed several commercial properties that Y&Y Company had developed. (ER 0507, 0527 [Badgley decl. ¶ 4], 0551-0557 [Ex. B].)

Decedent created the GRAT in February 1998, irrevocably transferring to it her 50% partnership interest in Y&Y Company, which 50% partnership interest was then valued at $2,418,075. (ER 0507, 0528 [Badgley decl. ¶¶ 8-9], 0607-0614 [Ex. F], 0615-0688 [Ex. G].)

Decedent's purpose for creating the GRAT was to make a gift to her daughters (Badgley and Pamela) of the GRAT corpus remaining after paying Decedent an annuity of $302,259 per year for a term of 15 years or until her earlier death. (ER 0507-0508, 0528 [Badgley decl. ¶ 8], 0607-0614 [Ex. F].) At the expiration of the 15-year term (January 31, 2013) or upon Decedent's earlier death, the

corpus of the GRAT, less all remaining amounts due under the annuity obligation, was to be (and was) distributed to Badgley and Pamela. (ER 0508.) After creating and funding the GRAT, Decedent filed a 1998 Gift Tax Return reporting the gift of the remainder interest to her daughters, and paid gift tax of $180,606. (ER 0507, 0528 [Badgley decl. ¶ 9], 0615-0688 [Ex. G].)

Years after creating the GRAT, Decedent contracted a respiratory disease that made her susceptible to respiratory infections. In late October 2012, Decedent was hospitalized with an acute infection. (ER 0508, 0785 [Yoder decl. ¶ 7].) Decedent's condition was incurable, and she died in her home on November 2, 2012, 89 days before the end of the GRAT's 15-year term. (ER 0510, 1364 [dkt. no 27, ¶ 6].) Only the annuity amount for the last quarter of 2012 and the prorated annuity amount for January, 2013 remained unpaid at Decedent's death. (ER 0510.)

Decedent held title to all of her other property in a revocable trust created under the D. and P. Yoder Revocable Trust dated June 15, 1982, as amended, (the "Survivor's Trust"). (ER 0510, 0528 [Badgley decl. ¶ 5], 0558-0596 [Ex. C].) Pursuant to the terms of the Survivor's Trust, Badgley and Pamela together succeeded Decedent

as trustee when Decedent became unable to continue to act as trustee herself (because of her failing physical and mental health) shortly before her death. (ER 0510, 0528-0529 [Badgley decl. ¶¶ 6-14], 0597-0599 [Ex. D], 0689-0712 [Ex. H].)

As previously stated, Badgley and Pamela believed that only the net present value of the remaining unpaid annuity amounts at Decedent's death was includable in Decedent's gross estate. Nevertheless, after discussing the matter with their tax advisors, Badgley and Pamela decided that to avoid an underpayment penalty assessment should their position not prevail, they would include the entire date-of-death value of the corpus of the GRAT in the Decedent's estate tax return and pay the tax computed thereon, and thereafter seek a refund of the amount of tax attributable to the excess of the date-of-death value of the GRAT corpus over the net present value of the remaining unpaid annuity amounts at Decedent's death. (ER 0511, 0529 [Badgley decl. ¶ 13], 0787 [Yoder decl. ¶ 15].) Accordingly, in January 2014, Badgley and Pamela, in their capacities as statutory executors of Decedent's estate, timely filed an estate tax return for the estate and paid estate tax in the amount of $11,206,694. (ER 0511, 1364 [Dkt. no. 27, ¶ 9], 0529-0530 [Badgley decl. ¶¶ 14-

15], 0689-0712 [Ex. H], 0713-0758 [Ex. I], 0787 [Yoder decl. ¶ 16].)

In June 2016, Badgley timely filed a claim for refund of $3,810,004 in estate tax, plus interest. (ER 0511, 1364-1365 [Dkt. no. 27, ¶ 10], 0530 [Badgley decl. ¶ 17], 0768-0782 [Ex. K].) The IRS did not thereafter take action to allow or disallow the refund claim within the six month period after it was filed. (ER 0511, 1369 [Dkt. no. 8, ¶ 11], 1365 [Dkt. 27 ¶ 11].) Accordingly, Badgley filed the Complaint in the district court seeking the refund of estate tax as stated in the refund claim. (ER 0512, 1380.)

The facts set forth in the Order denying Badgley's Motion for Summary Judgment and Granting Appellee's cross-Motion for Summary Judgment are accurate with two exceptions and one point of clarification:

1. Decedent did not place into the GRAT the three properties that were owned by Y&Y Company, as the Order states several times. (ER 0003, 0011, 0012 [Order, 2:24-25, 10:26, 11:3-4]). As the Order correctly states elsewhere, Decedent funded the GRAT with her 50% partnership interest in Y&Y Company. (ER 0003, 0005, 0014 [Order 2:22, 4:15-16, 13:11-13]).

2. It is not correct that no consideration was given to Decedent in exchange for her Y&Y Company partnership interest. (ER 0003 [Order, 2:25-26]). The transfer was a gift in part only. The annuity constituted some consideration for such partnership interest, although not adequate and full consideration.

3. Decedent's involvement with Y&Y Company's affairs after she transferred her partnership interest to the GRAT was as a fiduciary in her capacity as trustee of the GRAT, not in her individual capacity. (ER 0005, 0006 [Order, 4:15-21, fn.6; 5:1-2]).

The following facts are particularly noteworthy:

1. The only right Decedent expressly reserved in the GRAT instrument was the right to receive the annuity for 15 years or until her earlier death. (ER 0607 – 0614, 0608.)

2. The GRAT instrument did not contain a provision that the annuity payments must first be satisfied from income, with principal applied only to the extent income was insufficient (commonly referred to as an "ordering rule").[3] (ER 0607 – 0614.)

3. The GRAT instrument did not provide for the

[3] An example of a statutory ordering rule in the context of annuity payments can be found in section 664(b).

distribution of income to Decedent, nor did the term "accumulated income" appear anywhere in the GRAT instrument. (ER 0607 – 0614.)

4. Y&Y Company's income was unpredictable and did not match the annuity amount in any year. (ER 0004, 0005 [Order, 3:18-21, fn.4; 4:1-2]).

5. For many years prior to Decedent's death the principal of the GRAT was sufficient to fully satisfy the annuity payments without utilizing any income generated by the GRAT's assets. (ER 0529 [Badgley decl., ¶ 14], ER 0689-0712 [Ex. H], ER 0530 [¶ 15], ER 0713-0758 [Ex. I]).

6. At Decedent's death the assets of the GRAT consisted of the Y&Y Company partnership interest valued at $6,409,000, an investment account at Union Bank valued at $3,193,471, and a money market account at U.S. Bank valued at $1,384,558. (ER 0526-0530 [Badgley decl.], ER 0698-0699 [Ex. H, item 11, pp. 10-11]).

7. Prior to her death, Decedent became unable to continue to act as trustee of the GRAT because of her failing physical and mental health. (ER 0785 [Yoder decl., ¶¶ 7, 9], ER 0788 Ex. L [Memo of Dr. John Storch]; ER 0528-0529 [Badgley decl., ¶ 11]).

V. SUMMARY OF THE ARGUMENT

The question presented in this case is whether, at the time of Decedent's death,[4] she had the "possession or enjoyment of," or a "right to the income from," the transferred property within the meaning of section 2036(a)(1). The answer is that she did not.

This case turns on the interpretation of section 2036(a)(1) and the proper role of the court in that interpretive process.

It is beyond dispute that under a strict constructionist interpretation of, or literalist approach to, section 2036(a)(1) Badgley must prevail because Decedent did not expressly retain the possession or use of the Y&Y Company partnership interest,[5] because section 2036(a)(1) does not expressly include the retention of an annuity as a "string" triggering estate inclusion, and because the words "annuity" and "income" are not synonymous.

---

[4] The presence or absence of a retained section 2036(a)(1) string must be tested at the time of a decedent's death because the statute requires that the retained string be held throughout any of three statutory periods, the relevant one in this case being a "period which does not in fact end before [the decedent's] death."

[5] Decedent's possession, management and control of the partnership interest *in her capacity as the Trustee* of the GRAT is irrelevant. *United States v. Byrum*, 408 U.S. 125, 132-134 (1972); *Trombetta v. Commissioner*, 106 T.C.M. (CCH) 416, 424 (2013).

The district court, however, did not agree that income and annuity are distinct for the purposes of section 2036(a)(1) (ER 0014 [Order, 13:5-6]). The district court ruled that Decedent retained some possession or enjoyment, and right to income, within the meaning of section 2036(a)(1) based on what it labeled a "pragmatic substance-over-form approach," as articulated in dicta by the Supreme Court in *Commissioner v. Estate of Church*, 335 U.S. 632 (1949), *Estate of Spiegel v. Commissioner*, 335 U.S. 701 (1949), and *Helvering v. Hallock*, 309 U.S. 106 (1940).

However, the "pragmatic substance-over-form approach" based upon Supreme Court dicta has been replaced by the "ordinary common meaning at the time Congress enacted the statute approach." *Wisconsin Central Ltd v. United States*, No. 17-350 ____ U.S. ____ (June 21, 2018); *see also United States v. Byrum*, 408 U.S. 125, 136-37, 145-47 (1972). In other words, Badgley's case rests on what the statute *does* say, whereas the district court ruled on the basis of what it and the Treasury Department ("Treasury") believe the statute *should* say. Even were the belief of the district court and Treasury correct, it is for Congress, not Treasury nor the judiciary, to make it so.

Case law supports the proposition that an annuity interest does

not provide the grantor with possession or enjoyment of GRAT property. But the most compelling confirmation of this is in the Preamble to the Regulation, Treasury Decision 9414, 73 FR 40173-40179, July 14, 2008 (the "Preamble") and in the Regulation itself – the Preamble because of its singular focus on the right to income string and implicit negation of the possession and enjoyment strings, and the Regulation itself because of its precise wording.

The Preamble discloses that a commentator recommended that an annuity interest like that reserved by Decedent, where trust principal alone was sufficient to fully satisfy the annuity payment, should not be treated as a retained right to income within the meaning of section 2036(a)(1). Treasury rejected this recommendation as bad policy because it would condition estate tax treatment on the nature and performance of the investments the trustee selected. Treasury believed that the application of section 2036 should not be dependent on either the trustee's exercise of his or her discretion to invest in income or non-income producing assets, or the actual performance of the trust assets.

If Treasury believed that an annuity interest like that of Decedent provided her with possession or enjoyment, it would not

have been necessary for the Preamble to have discussed the policy concern because neither possession nor enjoyment would be affected by the value or performance of the trust assets. Therefore, because it should not be presumed that the Preamble unnecessarily addressed the policy concern, the Preamble must be interpreted as implicitly ruling out possession and enjoyment as requiring estate inclusion of such a retained annuity interest.

Regarding the right to income, even under a substance-over-form approach there should be estate inclusion *only* if, at the time of the grantor's death,[6] the GRAT's income *must* be used to pay the annuity. Therefore, Decedent's annuity interest was not in substance the same as an income right because at Decedent's death (and for

---

[6] A retained string may no longer be present at the time of a decedent's death due to events occurring after the transfer. For example, if a decedent transferred property subject to a retained life estate but later (more than three years before death) relinquished the life estate, section 2036(a)(1) would not apply even though the decedent "retained" the right to the income "for life." H.R. No. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 (Part 2) CB 457, 490-91, at 490. See *Estate of Ware v. Commissioner*, 480 F2d 444 (7th Cir. 1973) (decedent-grantor was trustee with power to accumulate or distribute trust income, but resigned as trustee many years before dying; no inclusion under § 2036). In this case, Appellee must agree that had Decedent lived another 91 days or more, what Appellee claims to be her retained right to income would have lapsed and there would be no inclusion under section 2036(a)(1).

many years prior thereto) it was not necessary to use any income to pay the annuity.[7] The annuity could have been paid out of principal consisting of assets other than the Y&Y Company partnership interest, out of principal consisting of proceeds from the sale of the Y&Y Company partnership interest, or by distributions of the Y&Y Company partnership interest in kind, whichever the Trustee might choose.

The Regulation was issued in 2008 (ten years after Decedent created her GRAT) as a so-called "legislative regulation" which purported to extend the coverage of section 2036(a)(1) by giving novel meaning to the wording of the statute and, further, by failing to except from such coverage annuity interests such as that retained by Decedent, based on what Treasury believed was good tax policy.

Legislative regulations are regulations issued by an agency that administers a statute that is found to be ambiguous. Generally, a court will find a statute ambiguous only when (1) Congress overtly left the statute ambiguous by telling the agency to write the rule, or

---

[7] The district court sought to avoid this point by postulating that GRAT principal was nothing other than "accumulated income." (ER 0012, 0014 [Order, 11:5-7, 13:16-17, 13:25]). This is erroneous. The GRAT had no "accumulated income."

(2) Congress left a gap in the statute and thus implied that the agency should write the rule. Such regulations are entitled to what is referred to as "*Chevron*[8] deference."

Treasury implicitly took the stance Congress left a gap in section 2036(a)(1) when Congress failed to expressly say the retention of an annuity is a string requiring estate inclusion, and Treasury issued the Regulation to fill that perceived gap. There is no such gap. Therefore, the Regulation does not qualify as a legislative regulation and is not entitled to *Chevron* deference.

Moreover, because the Regulation does not except annuity interests like that retained by Decedent from section 2036(a)(1) coverage, it constitutes an unreasonable interpretation and invalid extension of the statute and, therefore, is not even entitled to a lesser degree of deference known as "*Skidmore*[9] deference."

In short, Congress did not say a retained annuity interest is a string under section 2036(a)(1). Treasury has attempted to create such a string by regulatory sleight of hand. Congress alone has the "institutional competence" and "constitutional authority" to revise

---

[8] *Chevron USA Inc. v. National Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[9] *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

statutes in light of new developments. *See Wisconsin Central Ltd. v. United States, supra*. Congress may someday be persuaded by the policy concern underlying the Regulation to apply section 2036(a)(1) to retained annuity interests like Decedent's, but in the meantime Congress has not chosen to do so.

Badgley requests that this Court reverse the Judgment, and order the district court to enter a new judgment granting Badgley's Motion for Summary Judgment and denying Appellee's Motion for Summary Judgment, for the reasons stated in this Brief.

VI. ARGUMENT

A. Standard of Review.

This Court reviews a district court's order granting or denying summary judgment *de novo*. *McDonald v. Sun Oil Co.*, 548 F.3d 774, 778 (9th Cir. 2008) (addressing order granting summary judgment); *Jones-Hamilton Co.*, 973 F.2d at 691-692 (same); *E. & J. Gallo Winery v. EnCana Corp.*, 503 F.3d 1027, 1033 (9th Cir. 2007) (addressing order denying summary judgment). This Court examines all evidence in the light most favorable to the non-moving party (*McDonald*, 548 F.3d at 778), and "does not weigh the evidence or determine the truth of the matter, but only determines whether there is a genuine issue for trial," (*Balint v. Carson City*, 180 F.3d 1047, 1054 (9th Cir. 1999) (*en banc*)), and whether the district court "applied the relevant substantive law" (*Tzung v. State Farm Fire & Casualty Co.*, 873 F.2d 1338, 1339-1340 (9th Cir. 1989)).

B. The District Court Erred In Denying Badgley's Motion For Summary Judgement And Granting Appellee's Cross-Motion For Summary Judgment.

1. The District Court's Holding That Decedent Retained Some Possession Or Enjoyment Of The Transferred Property Is Erroneous.

The reference in section 2036(a)(1) to the "possession or enjoyment" of the transferred property was designed to ensure that the

section reached assets that do not generate income (e.g., vacation homes, works of art) if the decedent retained the right to occupy or otherwise use the property. See 5 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, par. 126.6.2 (2d Ed).

The terms "enjoy" and "enjoyment" are not terms of art, but connote substantial present economic benefit. *United States v. Byrum, supra*, at 145. In *Byrum* the decedent transferred closely-held stock to an irrevocable trust and retained, for a period which did not end before his death, a right to vote the stock and to veto the sale of the stock by the trustee. Following the decedent's death the Internal Revenue Service claimed that the corpus of the trust was includable in his estate under section 2036(a)(1) because the rights he retained were tantamount to retaining the enjoyment of the stock which he had transferred to the trust. *Id.* at 130. The Supreme Court rejected this argument holding that section 2036(a)(1) must be construed according to its plain language. *Id.* at 145-47, *see also, Estate of Maxwell v. Commissioner*, 3 F.3d 591, 593 (2d Cir. 1993) ["'possession' and 'enjoyment' have been interpreted to mean 'the lifetime use of the property'"].

"Enjoyment" of the transferred property also means entitlement to the rents and profits (i.e. income) derived therefrom. The decision in *Commissioner v. Estate of Church, supra,* makes clear that the "right to income" and "enjoyment" can be two sides of the same coin. Justice Black stated "enjoyment" means, inter alia, the right to income. *Commissioner v. Estate of Church,* at 637 ["One certainly cannot be considered, as in the actual enjoyment of an estate, who has no right to the profits or income arising or accruing therefrom."].

The district court's reliance on *Estate of McNichol v. Commissioner*, 265 F.2d 667 (3d Cir. 1959) is misplaced. *Estate of McNichol* concerned an agreement between the decedent and his children that he would continue to receive the income from the transferred property until his death. *Id.* at 668-669. The issue was whether section 2036(a)(1) required the right to income to be legally binding, and the Court held that it did not. *Estate* of *McNichol* is relevant here because it observes that *there can be no enjoyment of property without either possession or income* (in *Estate of McNichol*, it was income). "He who receives the rent in fact enjoys the property." *Id.* at 671.

Thus, case law makes clear that Decedent cannot be held to have retained the enjoyment of the partnership interest unless she retained a right to the income from it. As explained in the following portions of this Brief, she did not retain such right.

The Preamble and the Regulation itself make clear that the retention of an annuity interest does not constitute the retention of possession or enjoyment[10] of GRAT property.

In the Preamble there is discussion of a commentator's recommendation that section 2036(a)(1) should not apply to an annuity right where trust principal alone is sufficient to fully satisfy the annuity payment. Treasury rejected the commentator's recommendation because of a policy concern having to do with the income or non-income producing nature of the GRAT investments. By *not* rejecting the recommendation on the grounds relied upon by the district court (i.e., that a retained annuity comprises some possession or enjoyment of the transferred property, that the principal of the GRAT was nothing other than "accumulated income," or that

[10] The Regulation substitutes the word "use" for the word "enjoyment." The word "use" means the employment, occupation, exercise, or practice of property. Webster's New International Dictionary, Third Edition.

receiving the partnership interest in kind or the proceeds from its sale would be tantamount to having the possession and enjoyment of the property), and because possession and use cannot be affected by the trustee's investment strategy or the performance of trust assets, the Preamble implicitly confirms the reservation of an annuity does not provide the grantor with the possession or use of the GRAT property.

The Regulation itself, moreover, does not treat a retained annuity as retained possession or use/enjoyment of the transferred property. The Regulation establishes two separate word-groups: "retained use of an asset held in trust," and "retained annuity, unitrust, or other interest in any trust." Each word-group is paired with a specific section 2036(a)(1) string and repeatedly referred to disjunctively, differentiated from the other word-group by the word "or". The word-group "retained use of an asset held in trust" is paired with the possession or enjoyment string, never with the right to income string; and the word-group "retained annuity, unitrust, or other interest in any trust," is paired with the right to income string, never with the possession or enjoyment string. The Regulation thus does not associate a "retained annuity" with "possession or enjoyment."

Thus, the district court's holding that Decedent's retained annuity provided her with some possession or enjoyment of the transferred property within the meaning of section 2036 (ER 0009 and 0012 [Order, 8:21-22, 11:11-12]) is contrary to case law, the Preamble, and the wording of the Regulation itself.

2. Decedent's Annuity Right Was Not An Income Right In Disguise.

Prior to 2008 neither the Internal Revenue Code nor any regulation addressed how section 2036(a)(1) should apply to a retained annuity interest. The Supreme Court, however, provided some guidance on this issue in *Fidelity-Philadelphia Trust Co.* v. *Smith*, 356 U.S. 274 (1958), indicating that section 2036(a)(1) would not apply to a retained right to an annuity if three conditions were satisfied:

1. The obligation to make payments to the decedent was not chargeable to the transferred property,

2. The obligation was the transferee's personal obligation, and

3. The amount of the payments to be made to the decedent was not dependent on the actual amount of income generated by the

transferred property. *Fidelity-Philadelphia Trust Co.*, *supra*, 356 U.S. at 280 (fn. 8).

The *Fidelity-Philadelphia Trust Co.* principle was followed in *Estate of Becklenberg v. Commissioner* where the court stated:

> We agree that decedent retained a right to receive $10,000 annually, by way of annuity or by distribution from the Trust. Although this sum was, in fact, paid to decedent out of the income of the Trust for most years, it does not appear that the payments were restricted to income. . . . Under the 1938 Trust, payments might be made from principal. Under the construction of the Superior Court, decedent would have had to be paid $10,000 annually, even though the Trust produced an income of less than $10,000, and it had been necessary to invade corpus. Unlike the Tax Court, we believe that the Trust had an obligation to pay decedent $10,000 annually, and that her right to receive it was not limited to the property transferred by her or the income therefrom.
>
> The Tax Court has computed the amount of the Trust assets to be includible in decedent's gross estate as though the Trust here required decedent to be paid $10,000 out of taxable income, whereas decedent could have been paid out of principal. She retained the right to receive $10,000 annually for life; she did receive $10,000 annually for life. Thus at her death, there was nothing left to be included in her gross estate.

Estate of Becklenberg v. Commissioner, 273 F.2d 297, 301 (7th Cir. 1959).

Hence, pursuant to the *Fidelity-Philadelphia Trust Co.* principle, if at the time of the grantor's death a GRAT has sufficient

property other than the transferred property with which to pay the annuity, no estate tax inclusion should occur on account of the retained annuity.[11]

In this case, even if it were held that under the *Fidelity-Philadelphia Trust Co.* principle Decedent's retained right to an annuity *initially* constituted, in substance, a right to income due to the absence of adequate additional property with which to pay the annuity, by the time of Decedent's death there was more than adequate additional property so that her annuity interest would no longer be a right to income in disguise. (ER 0529 [Badgley decl., ¶ 14, ER 0689-0712 [Ex. H], ER 0530 [¶ 15], (ER 0713-0758 [Ex. I]). In other words, the period during which the annuity payments would be directly linked to the Y&Y Company partnership interest due to the lack of additional assets in the GRAT would have expired well prior to Decedent's death because of the GRAT's acquisition of additional assets.

Not every retained annuity interest is in substance the same as a

---

[11] The applicability of the *Fidelity-Philadelphia Trust Co.* principle in the context of a transfer to a trust has not been questioned. *See Estate of Becklenberg*, *supra*. The court in *Trombetta v. Commissioner*, 106 T.C.M. (CCH) 416 (2013) unhesitatingly assumed its pertinence.

right to income. Some are, but not all. Logic tells us that an annuity right can be treated as in substance tantamount to a right to income only where: (a) the trust instrument requires the distribution of income to satisfy the annuity payment in whole or in part; or (b) it is necessary to use income to satisfy the annuity payment, at least in part; or (c) there is a mathematical relationship between the anticipated income from the transferred property and the amount of the annuity. In this case the GRAT did not require the distribution of income, at Decedent's death (and for many years prior to her death) the annuity payment did not need to include any income, and there was no mathematical relationship between the anticipated income from the Y&Y Company partnership interest and the amount of the annuity. Therefore, Decedent's retained annuity interest was not in substance the same as an income interest.

The district court held that at the time of Decedent's death the "annuity necessarily drew either from the GRAT's accumulated income (i.e., the principal) *or* the current income that flowed into the GRAT . . .." (ER 0012 [Order, 11:5-7]).

This holding is contrary to law and incorrect. The GRAT had no "accumulated income," and there was no requirement that the

annuity be paid from current income. There was no "accumulated income" because under the California version of the Uniform Principal and Income Act, unless the trust instrument specifically provides for an accumulated income account, there is no such category of income, there is only current income and principal:

> The statute refers to the *income* of a trust; it imposes upon the beneficiary the tax liability which attaches to 'such income.' The Legislature manifestly relied upon the traditional concept of 'income' in selecting this word. Webster's New International Dictionary, 2d edition, defines income as 'That gain or recurrent benefit . . . which proceeds from labor, business or property. . . .'; the definition obviously expresses the common understanding of the word's meaning. 'Principal' constitutes the capital sum or corpus. Under standard principles of trust accounting, and, indeed, pursuant to the specific directions of the instant trust instrument, income accumulations were added to principal. Once the income has been entombed as principal within the trust, we cannot later resurrect it as income.

McCulloch v. Franchise Tax Board, 61 Cal.2d 186, 192 (1964). Decedent's GRAT did not provide for an accumulated income account, so all undistributed income automatically became principal as of the end of each calendar year.

The district court's postulate that the principal of the GRAT was "accumulated income" appears to be an attempt to negate the existence of principal from which the annuity payments could be

satisfied without recourse to income; however, the court's postulate is wrong under California law.

Moreover, the annuity could have been paid entirely out of proceeds from the sale of the Y&Y Company partnership interest. Such proceeds would constitute "pure" principal (meaning principal not traceable to undistributed income) even under the district court's erroneous postulate. The district court dismissed this point by noting that no such sale took place. (ER 0012 [Order, 11:3-5]). Badgley observed that if, as Treasury stated in the Preamble, it would be poor policy to condition estate tax treatment on the nature and performance of the investments selected by the trustee, it would, by the same token, be poor policy to condition the application of section 2036(a)(1) on whether or not the trustee sold the transferred property. Apparently seeing some merit in Badgley's observation, the district court noted that if one of the three properties constituting the original trust corpus (evidencing the court's confusion as to what constituted the original trust corpus) had been sold to fund the annuity "that would likely also constitute some 'use and enjoyment' of the property sufficient for section 2036." (ER 0012 [Order, 11:25-28, fn. 7]). Even if the court's surmise that the use of sale proceeds to pay the annuity would

likely constitute some use and enjoyment of the property were correct (which it is not, see pp. 20 et seq. *supra*), such possible future use and enjoyment would not be "sufficient for section 2036" because the enjoyment specified in section 2036(a)(1) means *present* enjoyment. *Byrum*, *supra*, at 145.

The district court's holding that Decedent had an implied right to income is also incorrect. The Court mistakenly deemed Badgley's acknowledgement that it is possible for there to be an implied right to income where the annuity payments mirror the income of the GRAT, i.e., where the GRAT is in substance a disguised GRIT (as in *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985)) to be an admission that Decedent had an implied right to income. (ER 0014 [Order 13:9-11].) An implied right to income, i.e., an annuity right which is in substance an income right, exists (a) where there is such a disguised GRIT, (b) where the trust instrument requires that income be distributed to satisfy the annuity payment in whole or in part, or (c) where income must be used to satisfy the annuity payment at least in part. None of those circumstances were present in this case; Decedent had no implied right to income.

Finally, by *not* stating that even an annuity interest where

payment can be fully satisfied out of principal is in substance a right to income and *not* rejecting the commentator's recommendation on that ground, the Preamble implicitly acknowledges that such an annuity interest is in substance what it is in form: a true annuity and not a disguised right to the income from the transferred property.

3. Regulation Section 20.2036-1 Is Invalid As Applied To Decedent's Annuity Interest.

a. The Regulation Is Not Entitled To Judicial Deference.

In an apparent attempt to achieve certainty and avoid potential inconsistencies in the application of the guidance provided by *Fidelity-Philadelphia Trust Co.*, *supra*, Treasury in 2008 issued the Regulation as a purported legislative regulation to resolve what it perceived to be an ambiguity in section 2036(a)(1). There is no ambiguity. Treasury overstepped its bounds. It had no the authority to issue a legislative regulation.

Nevertheless, the district court gave the Regulation *Chevron* deference. This was error, and evidenced a misunderstanding of the *Chevron* two-part test for judicial review.

Congress shows its intention for the agency to write a legislative regulation by specific delegation of authority in the statute

(for example, section 664(a)). Congress may also signal its intention for the agency to promulgate a legislative regulation by deliberately leaving a gap in the statute for the agency to fill. *See, e.g., Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44 (2011); *see also*, *Altera Corp. v. Commissioner*, Case: 16-70496 (9th Cir. 7/24/2018), opinion withdrawn 8/7/2018.

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.
>
> *Chevron USA Inc., supra* at 843-844.

Thus, legislative regulations receive *Chevron* deference. Regulations other than legislative regulations are interpretive regulations, which interpret and thereby merely state the agency's view on the meaning of the statute. They are entitled to some, but lesser, deference, called *Skidmore* deference, so long as the interpretation is reasonable. See Joseph L. Cummings, Jr. The

Supreme Court's Deference to Tax Administrative Interpretation, Tax Lawyer, Vol. 69, No. 2, 419, at pp. 422, 433.

Neither section 2036 nor its predecessor contains a specific delegation of authority to promulgate a legislative regulation. Treasury apparently decided, however, that by failing to expressly include a retained annuity as a string under section 2036(a)(1) in 1926 when Congress enacted the predecessor of section 2036(a)(1), Congress explicitly left a gap for Treasury to fill in 2008. This is nonsensical.

It appears that Treasury was motivated by a policy concern to treat all annuity interests as rights to income even where the annuity could be entirely satisfied out of principal; but Treasury had no authority to promulgate a regulation to that effect.

When dealing with an agency regulation, the Supreme Court, in *Chevron USA Inc., supra*, established a two-part test for judicial review. The Supreme Court's basic statement was as follows:

> If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress . . . . [However,] if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Chevron USA Inc., supra at 842-43.

Accordingly, under *Chevron* step one, the inquiry is whether the intent of Congress is unambiguously expressed in the statute. To determine this, the job of the court "is to interpret words consistent with their ordinary meaning at the time Congress enacted the statute." *Wisconsin Central Ltd. supra*, No. 17-350 ____ U.S. ____ at ___. [12] If the meaning of the statute is clear, then the administrative interpretation cannot vary from it. Federal courts can interpret federal statutes as competently as federal agencies for the purpose of determining their *unambiguous meaning*, using traditional tools such as text, precedent, and legislative history, and the courts have no reason to cede that power to agencies. *See, e.g., Freeman v. Quicken Loans, Inc.*, 566 U.S. 624 (2012) (Justice Scalia said there was no reason to address *Chevron* when he could see that the statute could not support the agency interpretation.)

[12] The district court misunderstood the nature of the step-one inquiry, believing that the fact that whether an annuity interest in a GRAT constituted a section 2036(a)(1) string requiring estate inclusion and the validity of the Regulation were both questions of first impression meant that step-one was satisfied. (ER 0015, 0016 [Order, 14:24, 15:1]).

The meaning of section 2036(a)(1) is clear. There is no uncertainty as to the meaning of the word "income," as used in the statute. Regulation section 1.643(b)-1 defines "income," when not preceded by certain adjectives not here relevant and when not determined under the terms of the trust instrument, to mean the amount of income of a trust as determined under local law.[13] Section 16324 of the California Uniform Principal and Income Act defines "income" as "money or property that a fiduciary receives as *current* return from a principal asset." Cal. Probate Code § 16324, emphasis added.

Moreover, Congress knows the difference between an annuity and income. For example, it enacted section 2702 to address the problems and disputes arising from the valuation of the grantor's retained interests in, among other things, grantor retained income trusts, i.e., a trust where the grantor has retained the right to the

---

[13] Section 1.643(b)-1 of the Income Tax Regulations provides in pertinent part as follows:

> "**Definition of income**. *** income, when not preceded by the words 'taxable,' 'distributable net,' 'undistributed net,' or 'gross,' means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law."

income of the trust for a term of years (a "GRIT"), by defining as "qualified interests" certain interests that are more easily valued according to actuarial principles, such as fixed-term annuities. The legislative history of section 2702 makes it clear that Congress distinguished between a right to income and a right to an annuity:

> Thus, a person who makes a completed transfer of ... property in trust and retains ...the right to the income of the trust for a term of years...is treated as making a transfer equal to the value of the whole property.***In contrast, the creation of a trust the only interest[s] in which [is] an annuity for a term of years...is valued under present law.

136 Cong. Rec. 30538-30539 (1990) at 30540; *see also Walton v. Commissioner*, 115 T.C. 589, 599 (2000) (Acq.).

Appellee has conceded that an annuity is distinct from income (Appellee's Memorandum in support of its Motion (dkt. nos. 46-1 and 51) ER 0205 [7:3-6] and ER 0055 [6:10-11]), but submits that this is true only in cases falling outside the purview of section 2036(a)(1), *e.g.*, for purposes of section 2702. Appellee can cite no authority that Congress meant to invoke this idiosyncratic definition of "income" in section 2036(a)(1).

The meanings of the words "possession" and "enjoyment" in section 2036(a)(1) are also clear. *See United States v. Byrum, supra,* and *Estate of Maxwell v. Commissioner, supra*.

Although Treasury may believe that the use of GRATs must be curtailed because they are tax avoidance devices, that does not justify an interpretation of section 2036(a)(1) to require including the entire date-of-death value of the corpus of a trust in a decedent's gross estate where the statute does not expressly so provide. Moreover, it is a court's job only to apply, not revise or update, the terms of statutes. *See Wisconsin Central Ltd., supra,* No. 17-350 ____ U.S. ____.

As the Preamble discloses, the Regulation is premised on dicta in *Commissioner v. Estate of Church, supra, Estate of Spiegel v. Commissioner, supra* and *Helvering v. Hallock, supra,* having to do with the legislative history of section 2036(a)(1) and, based on such dicta, treats *all* retained annuity interests, without exception, as retained income rights. This interpretation of section 2036(a)(1) is overly broad and must be limited by application of the ordinary meaning principle of statutory interpretation set forth in *Byrum, supra,* and most recently reaffirmed in *Wisconsin Central Ltd., supra*. The

word "income" must not be infused with a novel meaning under the banner of substance-over-form.

Wisconsin Central Ltd., supra, is the most recent Supreme Court case involving statutory interpretation and consideration of *Chevron* deference. In that case the issue was the meaning of the term "money remuneration." Justice Gorsuch, delivering the opinion of the Court, held that the word "money" unambiguously excludes "stock"; and in so doing rejected the government's policy argument, stating that "it is not [the Court's] function 'to rewrite a constitutionally valid statutory text under the banner of speculation about what Congress might have' intended," further stating:

> The majority [of the Court of Appeals] all but admitted that stock isn't money, but suggested it would make "good practical sense" for our statute to cover stock as well as money. Meanwhile, Judge Manion dissented, countering that it's a judge's job only to apply, not revise or update, the terms of statutes. The Eighth Circuit made much the same point when it addressed the question. Judge Manion and the Eighth Circuit were right. Written laws are meant to be understood and lived by. If a fog of uncertainty surrounded them, if their meaning could shift with the latest judicial whim, the point of reducing them to writing would be lost. That is why it's a "fundamental canon of statutory construction that words generally should be interpreted as taking their ordinary, contemporary, common meaning . . . at the time Congress enacted the statute." Congress alone has the institutional competence, democratic legitimacy, and (most importantly) constitutional authority to revise

> statutes in light of new social problems and preferences. Until it exercises that power, the people may rely on the original meaning of the written law.

Id. at ____ (internal citations omitted). Finding no ambiguity in the statute, Justice Gorsuch gave no *Chevron* deference to the agency regulations. *Id*. at ____.

The district court in this case did not have the benefit of Justice Gorsuch's opinion to point out that what the district court labeled the Supreme Court's "pragmatic substance-over-form approach" has been replaced by the Supreme Court's "ordinary meaning at the time Congress enacted the statute" approach. And the district court paid little heed to *Byrum* on the erroneous ground that *Byrum* was concerned only with the interpretation of section 2036(a)(2). Although *Byrum* was concerned with the meaning of the word "right" as used in section 2036(a)(2), it was also concerned with the meaning of the word "enjoyment" as used in section 2036(a)(1), holding that the rights retained by Mr. Byrum did not amount to "enjoyment" of the transferred stock. Regardless of the specific Code section under consideration, *Byrum* held that a term when used in a tax statute "must be given its normal and customary meaning" (*Byrum*, 408 U.S. at 136), and ruled against the Government on the ground that the

interpretation of the statute which it was urging departed from the plain meaning of the statutory language.[14]

In *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), a more recent Supreme Court case involving the interpretation of a section of the Internal Revenue Code, the Court, adhering to the ordinary meaning principle, rejected the Government's policy argument, stating:

> Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern.

Gitlitz, supra, 531 U.S. at 220.[15]

The effect of the Regulation is not to elucidate section 2036(a)(1), but to revise it by adding the retention of any annuity interest as an additional string under section 2036(a)(1) in order to close what Treasury perceived to be a loophole. Treasury sought to accomplish by executive action what could only be accomplished by legislation. If Treasury thinks that as a matter of tax policy every right to an annuity should be treated as a right to income, its recourse is to lobby Congress to amend the statute.

---

[14] The Government believed the holding in *Byrum* created a loophole in section 2036 and, as a result, went to Congress which, in response, enacted section 2036(b). Tax Reform Act of 1976, Pub.L.No. 94-455.

[15] The holding in *Gitlitz* was reversed by Congress in the Job Creation and Worker Assistance Act of 2002.

By refusing to except from the coverage of section 2036(a)(1) an annuity interest such as that retained by Decedent, where there is no ordering rule and where the annuity can be fully satisfied out of principal, the Regulation unreasonably and invalidly purports to extend the reach of section 2036(a)(1), and is therefore not even entitled to *Skidmore* deference.

b. The Regulation Prescribes A Flawed Formula For An Annuity With A Fixed Term.

The formula which the Regulation prescribes for an annuity with a fixed term is flawed in that it assumes that the annuity payment will be composed entirely of income despite the fact that, by its nature, an annuity with a fixed term contemplates the amortization of principal over the fixed term and does not place a priority on distributions from income.[16] If principal were amortized, interest rate changes would not cause the formula to produce such extreme fluctuation in the amount includable in a decedent's estate.[17]

---

[16] Most short term GRATS, particularly those designed to produce a negligible remainder value gift, contemplate the amortization of principal as the primary source for the annuity payment and do not expect to satisfy the annuity payments solely, or even mostly, out of income. For example, consider a two year GRAT funded with Berkshire Hathaway Inc. stock, which has never paid a dividend.

[17] In this case, because of historically low interest rates at the time of

VII. CONCLUSION

Even though section 2036(a)(1) refers to "income" and does not mention "annuity," and "income" and "annuity" have distinct meanings, and even though case law, the Preamble and the Regulation establish that retention of an annuity interest like Decedent's is not "possession or enjoyment" within the meaning of section 2036(a)(1). Appellee argued, and the district court agreed, that section 2036(a)(1) must be interpreted to apply to all retained annuity interests in substance because otherwise taxpayers who set up GRATs will be able to avoid estate tax, i.e., there will be a tax loophole.

Such policy concerns, valid or not, are irrelevant in this case. In *Byrum* and *Gitlitz* the Supreme Court ignored policy and interpreted the text of the Internal Revenue Code sections before the Court consistent with the normal, customary, and ordinary meaning of

---

Decedent's death, the formula produced an includable amount of $28,375,622.94 when the date-of-death value of the GRAT corpus was only $10,987.029. To counter the fact that in periods of extremely low interest rates the failure to amortize principal will cause the formula to produce an unrealistically high includable amount, the Regulation contains a ceiling limitation providing that the includable amount cannot exceed the date-of-death value of the GRAT corpus. There is no comparable downside limitation, so that for a decedent who died in 1982, when short term rates were 15%, the formula would have produced an absurdly low includable amount.

the words, leaving it to Congress to close the perceived loopholes based on public policy. A perceived loophole does not give Treasury license to usurp the role of Congress by the issuance of a regulation. If Treasury believes that tax policy dictates that every retained annuity, without exception, should be covered by section 2036(a)(1), its recourse is to lobby Congress to amend the statute to so provide.

The district court's interpretation of section 2036(a)(1) as applied to Decedent's GRAT was in error and must be reversed. Under the construction approach exemplified in *Wisconsin Central Ltd.*, no retained annuity, other than one where the annuity amount was designed to mirror the anticipated income from the GRAT property (cf. *Ray*), would be treated as a right to income. Under a more liberal interpretive approach based upon the dicta from *Church*, *Spiegel*, and *Hallock*, all retained annuities where income must be utilized in whole or in part to satisfy the payment, and those designed to mirror GRAT income, would be treated as retained rights to income. Under *neither* approach, however, would Decedent's retained annuity be treated as a right to income.

The district court also erred in giving deference to the Regulation's "interpretation" of section 2036(a)(1) and in finding it to

be a valid interpretation as to Decedent's GRAT. The Supreme Court's current approach to statutory interpretation and deference to agency regulations is clearly set forth in *Wisconsin Central Ltd.*, *supra*: unless the statute is ambiguous, as indicated by Congress overtly telling the agency to write the rule or deliberately leaving a gap in the statute for the agency to fill, the court's role is limited to interpreting the language of the statute in accordance with the ordinary meaning of its text as intended by Congress when it enacted the statute.

Once it is understood that the Regulation is not a legislative regulation and therefore cannot take policy into consideration, the Preamble confirms by negative inference that, absent the policy concern, section 2036(a)(1) would not apply to Decedent's retained annuity because it could be satisfied entirely from principal. Because The Regulation does not except annuity interests like that retained by Decedent, it is an unreasonable interpretation and invalid extension of section 2036(a)(1).

For the reasons stated in this brief, Badgley requests that this Court reverse the Judgment, and order the district court to enter a new

judgment granting Badgley's Motion for Summary Judgment and denying Appellee's cross-Motion for Summary Judgment.

Dated: September 7, 2018

Respectfully submitted,

/s/ PAUL FREDERIC MARX
PAUL FREDERIC MARX
Rutan & Tucker, LLP
Attorneys for Plaintiff and
Appellant JUDITH BADGLEY

APPENDIX

Internal Revenue Code (26 U.S.C.) section 2036(a)(1) provides in pertinent part as follows:

(a) **General rule**

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

(1) the possession or enjoyment of, or the right to the income from, the property, ...

Treasury Regulations on Estate Tax (26 C.F.R.) section 20.2036-1 provides in pertinent part as follows:

(2) *Retained annuity, unitrust, and other income interests in trusts*.-(i) *In general*.-This paragraph (c)(2) applies to a grantor's retained use of an asset held in trust or a retained annuity, unitrust, or other interest in any trust . . . including without limitation the following (collectively referred to in this paragraph (c)(2) as "trusts"): . . . trusts established by a grantor . . . such as a grantor retained annuity trust (GRAT) paying out a qualified annuity interest within the meaning of § 25.2702-3(b) of this chapter, . . . If a decedent transferred property into such a trust and retained or reserved the right to use such property or the right to an annuity, unitrust, or other interest in such trust with respect to the property decedent so transferred for decedent's life, any period not ascertainable without reference to the decedent's death, or for a period that does not in fact end before the decedent's death, then the decedent's right to use the property or the retained annuity, unitrust, or other interest (whether payable from income and /or principal) constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036. . . . In the case of a retained annuity or unitrust, the portion of the trust's corpus includible in the

decedent's gross estate is that portion of the trust corpus necessary to generate sufficient income to satisfy the retained annuity or unitrust (without reducing or invading principal), using the interest rates provided in section 7520 and the adjustment factors prescribed in §20.2031-7 (or §20.2031-7A), if applicable.

Statement of Related Cases

Pursuant to 9th Circuit Rule 28-2.6

Case Number 18-16053

Appellant does not know of any related case pending in this Court, as defined by Ninth Circuit Rule 28-2.6.

Dated: September 7, 2018

Respectfully submitted,

/s/ PAUL FREDERIC MARX
PAUL FREDERIC MARX
Rutan & Tucker, LLP
Attorneys for Plaintiff and Appellant JUDITH BADGLEY

Certificate of Compliance

Pursuant to 9th Circuit Rule 32-1(e)

Case Number 18-16053

I certify that this brief complies with the length limits permitted by Ninth Circuit Rule 32-1. The brief is 9,498 words, excluding portions exempted by Fed. R. App. P. 32(f), if applicable. The brief's type size and type face comply with Fed. R. App. P. 32(a)(5) and (6).

Signature of Attorney: /s/ PAUL FREDERIC MARX

Date: September 7, 2018

Certificate of Service

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on September 6, 2018.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

Signature: /s/ PAUL FREDERIC MARX